Australian Office of Financial Management

Annual Report 2007-08

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Australian Government

Australian Office of Financial Management

7 October 2008

The Hon Wayne Swan MP
Treasurer
Parliament House
CANBERRA ACT 2600

Dear Treasurer

I have pleasure in presenting the Annual Report of the Australian Office of Financial Management for the year ending 30 June 2008 for presentation to the Parliament.

The Report has been prepared in accordance with guidelines approved on behalf of the Parliament by the Joint Committee of Public Accounts and Audit.

Yours sincerely

Neil Hyden
Chief Executive Officer

Treasury Building Langton Crescent CANBERRA ACT 2600 • Telephone: (61-2) 6263 1111 • Facsimile: (61-2) 6263 1222

AOFM

ITS ROLE

The AOFM's role is to support the efficient operation of Australia's financial system by sustaining the market for Australian Government debt and to advance the Government's net worth through the management of debt, financial investments and cash balances.

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Review by the Chief Executive Officer

Treasury Bond market

Five years ago, in the 2003-04 Budget, the Government announced that it would continue to issue Treasury Bonds in order to maintain the Treasury Bond market. Budget surpluses and the proceeds from asset sales had removed the need to borrow for budget funding, so the decision to continue issuance was based entirely on the benefits that the economy derives from having an active and efficient Treasury Bond market, together with the market in Treasury Bond futures contracts. These markets help financial institutions manage their interest rate risk and thereby contribute to a lower cost of capital in Australia. They also strengthen the financial system against the potential impact of financial shocks.

Over the subsequent five years, the volume of Treasury Bonds on issue remained around $50 billion, while other financial markets, and the economy, grew substantially. Thus the relative size of the Treasury Bond market gradually declined. For much of this period, the financial system adjusted without apparent difficulty to this relative contraction. Adjustments occurred in various ways. Some domestic investors reduced their holdings of Treasury Bonds by switching to other assets. Market traders made greater use of derivatives (including Treasury Bond futures contracts) in place of Treasury Bonds in adjusting their trading positions and managing interest rate risk. The Reserve Bank of Australia widened the range of securities it would accept in its open market operations, increasing the relative attractiveness of other securities and reducing the dependence on Treasury Bonds. Demand for Treasury Bonds from overseas investors increased strongly, but this increase was initially able to be accommodated through reductions in holdings by domestic investors. However, there was a limit on how far these trends could continue.

During 2007-08 the demand from overseas investors for Treasury Bonds intensified, underpinned by the strength of the Australian economy and exchange rate, and boosted by the turbulence in global financial markets triggered by the sub-prime housing crisis in the United States of America. As a result of this increased demand, some Treasury Bond lines became difficult to source, bid-ask spreads widened, liquidity deteriorated and market makers were not always able to provide two-way prices. However, overall, the Treasury Bond and Treasury Bond futures markets continued to operate reasonably effectively and were less affected by the turmoil than many other financial sectors. They continued to provide an efficient central reference point for the pricing of financial assets and the management of interest rate risk. As a result they provided important anchors for Australia's financial system as it responded to the impact of global credit and liquidity concerns.

Nevertheless it became apparent that some increase in the volume of bonds on issue was desirable to ensure that Treasury Bonds continue to play their role in the effective operation of Australia's financial markets. Following consultations by AOFM with market participants, the Treasurer announced on 20 May 2008 that the Government would increase issuance by $5 billion in 2008-09, with scope for further increases in subsequent years.

The Treasurer also announced two other measures to enhance market efficiency. First, the AOFM's securities lending facility would accept a wider range of securities as collateral. This facility allows bond market intermediaries to borrow Treasury Bonds for short periods, improving their capacity to make two-way prices. In a tight market, its operation had become constrained by a requirement that other Commonwealth Government Securities be provided as collateral. Relaxing this requirement will improve its effectiveness in supporting the smooth operation of the market.

Second, bonds issued by State and Territory governments will be exempted from interest withholding tax. This should increase the attractiveness of these bonds as a low-risk alternative to Treasury Bonds and allow them to make a greater contribution to financial market stability.

Treasury Bond market conditions improved in the latter part of the financial year following the announcement that issuance would be increased, supported by a general improvement in financial market sentiment.

Legislation to provide for the increase in bond issuance and securities lending received Royal Assent in July 2008. Additional issuance commenced later in the month.

This report includes an article which reviews the role of the Commonwealth Government Securities market in the light of developments since the 2003 review, including the experience in 2007-08.

Management of the portfolio

Since its establishment in 1999, the AOFM has sought to manage its debt portfolio to reduce debt servicing costs over the medium term at acceptable risk. It has used interest rate swaps to achieve this aim. By swapping from longer to shorter-term debt, debt servicing costs can normally be reduced. However over recent years market yield curves have flattened and, at times, become inverted, reducing the savings potentially available through the use of swaps. A major part of this shift appears to have been due to structural changes in global and domestic financial markets that have reduced the term premium for holding longer-term debt. Transient factors, such as changes in expectations about future movements in short-term interest rates, shifts in monetary policy and the impact of credit concerns on credit spreads, have also played a role.

In its 2007 review of the portfolio management strategy, the AOFM decided to continue the interest rate swap program but adjusted its benchmark portfolio to move it closer to the structure that would result from debt issuance without swaps. This followed a similar adjustment in 2005. Consequently, the volume of swaps required to manage the portfolio to the benchmark was reduced, as were the expected savings in debt service costs.

Movements in market interest rates over the course of 2007-08 made it generally unattractive for the Commonwealth to undertake swaps to receive fixed rates, and only a small volume of swaps ($300 million) was executed.

The analysis undertaken for the 2008 review indicated that the evidence for a positive term premium had weakened further. It concluded that, while the portfolio management strategy based on a positive term premium had produced substantial savings over an extended period, it no longer provided a firm basis for achieving future savings in debt servicing costs. It was therefore decided to change the strategy and the existing interest rate risk management framework was terminated from the end of 2007-08.

Under the new approach to be followed in 2008-09, the maturity structure of the portfolio will follow from the outcomes of debt issuance. Consequently, no new interest rate swaps are planned for 2008-09. Existing swaps will be managed in the light of market conditions and run off gradually over time.

In his announcement of increased Treasury Bond issuance, the Treasurer also announced that the AOFM would manage the investment of the proceeds of the additional issuance and that the Government would widen its investment powers to allow it to invest in a broader range of assets. As a result, the increase in issuance was not expected to involve any net cost to the Government. Since July 2008 the AOFM has invested the proceeds of additional issuance in a range of low risk securities, including bonds issued by State governments and Kangaroo bonds issued by supranational organisations. It is managing these assets together with the liabilities to which they relate, separately from other assets and liabilities in its portfolio.

Portfolio outcomes

The debt servicing cost of the debt and swaps in the portfolio increased to 6.55 per cent in 2007-08, compared with 6.42 per cent the previous year. The yield on physical debt fell as relatively expensive debt issued in the 1990s matured and was replaced by new debt issued at lower interest rates. However, high short-term interest rates increased the cost of swaps, which added to the overall cost of the debt portfolio.

Higher short-term rates also had a positive impact on the return obtained from term deposits, which yielded an average of 6.89 per cent during the year.

The net cost of funds on the combined portfolio of debt and assets in 2007-08 was 6.40 per cent, compared with 6.56 per cent the previous year.

Movements in market interest rates had an unfavourable impact on the market value of the portfolio in 2008-09. Unrealised losses from re-measurements amounted to $118 million. This was largely driven by the widening in credit spreads in the swap curve, as swap rates rose significantly more than the yields on Treasury Bonds.

Communications Fund

The AOFM manages the investments of the Communications Fund on behalf of the Department of Broadband, Communications and the Digital Economy. Investments are made in high quality money market instruments including bank accepted bills and negotiable certificates of deposit. The return obtained by the Fund in 2007-08 was 7.36 per cent, which was four basis points above the return for the UBS Australian Bank Bill Index. This Index is the performance benchmark for the Fund before fees.

In the 2008-09 Budget the Government announced that the Communications Fund will be closed and its assets transferred to a new fund, the Building Australia Fund, which will be managed by the Future Fund Board of Guardians. The transfer of assets from the Communications Fund to the Building Australia Fund is expected to occur in 2008-09.

Operational risk

The AOFM has continued its efforts to strengthen its management of operational risk. Activities undertaken during the year included an enterprise risk assessment to re-evaluate the operational and financial risks affecting the Agency and the controls in place to mitigate them, a review of the Fraud Control Plan and completion of an Anti-Money Laundering and Counter-Terrorism Financing Program.

Cooperation with other debt managers

The AOFM actively supports sovereign debt management in other countries. It has seconded one staff member to assist in capacity development in debt management in Papua New Guinea under the Strongim Gavman program and one in the Solomon Islands as part of the Regional Assistance Mission Solomon Islands. These deployments aim to develop cash and debt management capabilities through training and mentoring, as well as the development of systems and procedures. Another AOFM staff member was seconded to the Papua New Guinea Department of Treasury for a period of three weeks to help develop its debt reporting and recording capacity. This year a forum was conducted by the AOFM in Brisbane attended by

officials responsible for sovereign debt management of the two countries, together with seconded AOFM staff, to improve the assistance provided.

The AOFM hosted visits from debt management officials from Indonesia and Thailand, and made presentations on debt management to Chinese and Indonesian public sector officials attending a residential study course on fiscal management at the Australian National University.

AOFM officers participated as speakers in the Organisation for Economic Cooperation and Development's Working Party on Public Debt Management, in a forum on Public Debt Management and Government Securities Markets conducted in Beijing by the OECD and the Chinese Government, and in the OECD's Global Forum on Public Debt Management in Amsterdam.

Staff

Since its establishment in 1999, all AOFM staff have been engaged under Australian Workplace Agreements. With the change in government policy on 13 February 2008, the AOFM is working towards the establishment of a collective agreement. Since that date, no new Australian Workplace Agreements have been made. As an interim arrangement, new recruits are engaged under common law contracts.

There were no changes in the senior staff of the Agency during 2007-08.

2007-08 was an eventful year, with turbulent financial markets, sharp movements in interest rates and spreads, together with a change of Government. At the end of the year, it appeared that volatility in global financial markets could continue for some time. On the other hand, decisions by the incoming Government, confirming the commitment to sustain the Treasury Bond market, increasing Treasury Bond issuance in 2008-09 and expanding the Agency's investment mandate, have provided clear strategic directions for the future.

The AOFM faced considerable challenges in 2007-08 in managing its portfolio and implementing policy initiatives. Staff rose to meet these challenges with skill and determination. I thank them all for the contributions they have made during the year.

Neil Hyden
Chief Executive Officer

AOFM

PART 1

AOFM OVERVIEW

AOFM OVERVIEW

Role, function, outcome and output structure

The Australian Office of Financial Management (AOFM) is a specialised agency responsible for the management of Australian Government debt. Its activities include the issue of Treasury Bonds, management of the Government's cash balances, and management of a portfolio of Government debt and short-term investments. It also manages the investment of monies for the Communications Fund on behalf of the Department of Broadband, Communications and the Digital Economy.

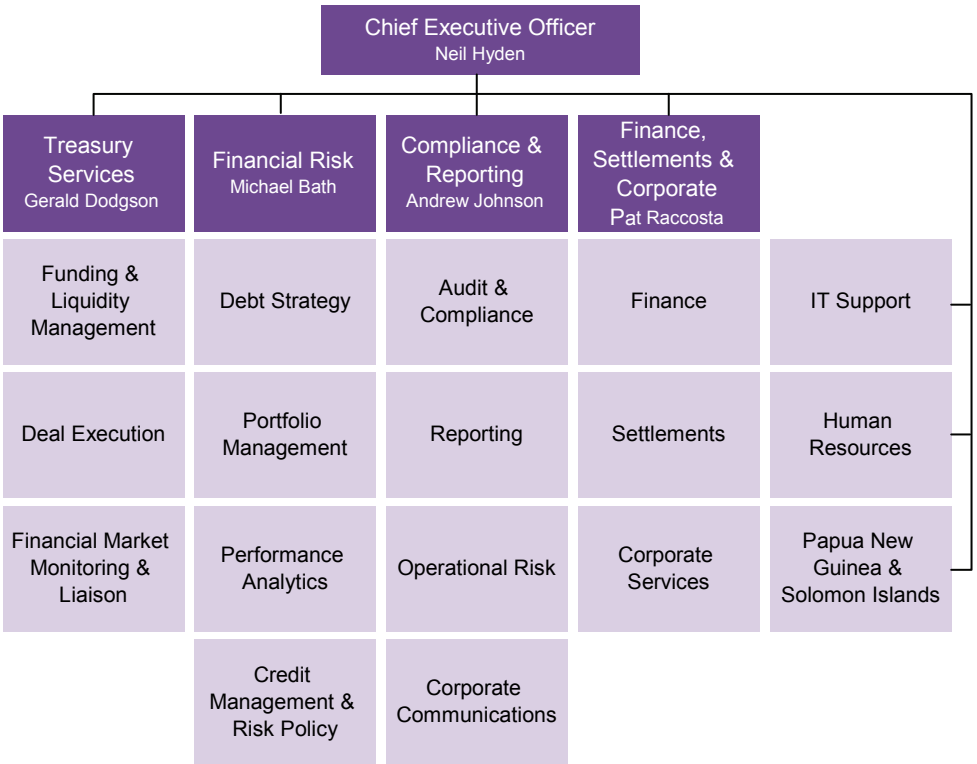
The AOFM forms part of the Treasury portfolio. It is accountable to the Secretary to the Treasury and to the Treasurer, and through the Treasurer to the Parliament and the public. However, its finances are separate from those of the Treasury as it is a prescribed agency under the *Financial Management and Accountability Act 1997* and maintains its own accounts. Its staff are employed under the *Public Service Act 1999*.

For budgetary purposes, the AOFM's activities comprise a single output — debt management — directed to one outcome. This is to enhance the Australian Government's capacity to manage its net debt portfolio, offering the prospect of savings in debt servicing costs and an improvement in the net worth of the Australian Government over time. Accordingly the AOFM aims to manage Australian Government net debt at least cost, subject to an acceptable level of risk, and to contribute to supporting financial market efficiency.

Organisational structure

During 2007-08, the AOFM was organised as set out in Figure 1. It is structured in four groups that undertake treasury operations, financial risk management, compliance and reporting, and finance, settlement and corporate functions. There is also an information technology support unit and a human resources unit, while two staff members are seconded to the Papua New Guinea and Solomon Islands governments to support their debt management activities. Roles and responsibilities within the office are structured to ensure an appropriate segregation of duties and reporting lines.

Figure 1: AOFM organisational structure



AOFM

PART 2

OPERATIONS AND PERFORMANCE

OPERATIONS AND PERFORMANCE

Introduction

The principal functions of the AOFM are:

- issuing Treasury Bonds to support the Treasury Bond and Treasury Bond futures markets;
- managing the Australian Government's daily cash balances through short-term borrowings and investments; and
- managing its portfolio of debt and financial assets to minimise their net cost, subject to acceptable risk.

This section outlines the activities undertaken in 2007-08 and reports on their performance.

Treasury Bond issuance

Objective

For some 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. These markets are supported because they allow financial market participants to better manage their interest rate risk; they thereby contribute to a lower cost of capital in Australia. The existence of active and efficient Treasury Bond and Treasury Bond futures markets alongside the banking system also strengthens the robustness of Australia's financial system and reduces its vulnerability to shocks.

On 20 May 2008, following consultations with market participants about the adequacy of the supply of Commonwealth Government Securities, the Treasurer announced that the Government would increase its issuance of Treasury Bonds. He observed that, due to budget surpluses, the Government did not need to issue securities to finance spending, but pointed out that Treasury Bonds play a special role by providing the lowest-risk, highest quality instrument in financial markets. Because they are risk-free, these bonds are the benchmark used by market participants to set interest rates beyond the short end of the yield curve, including in the bond futures market. The Treasurer said that the Government is committed to ensuring that its bonds can play this role efficiently.

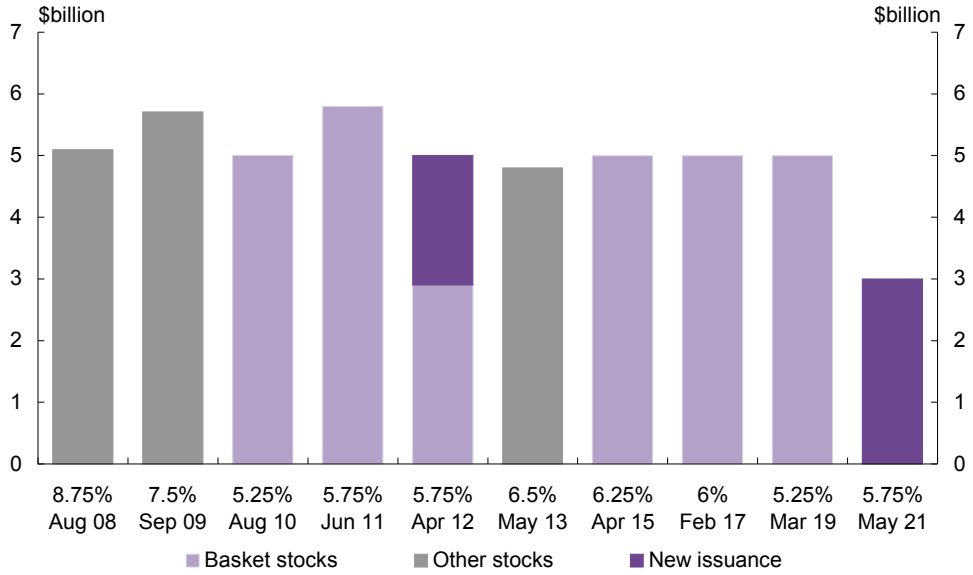
The Treasurer announced that the Government would legislate to allow an increase in Treasury Bonds on issue of up to $25 billion, with an increase of $5 billion in 2008-09. Legislation providing for this received Royal Assent in July 2008.

Achieving the objective

In 2007-08, the AOFM issued $5.1 billion of Treasury Bonds. This comprised further issuance of $2.1 billion of April 2012 Treasury Bonds, together with issuance of $3.0 billion of a new May 2021 Treasury Bond line.

Chart 1 shows Treasury Bond issuance over the year, as well as levels of Treasury Bonds outstanding as at 30 June 2008.

Chart 1: Treasury Bond issuance for 2007-08 and Treasury Bonds outstanding as at 30 June 2008



The level of Treasury Bonds outstanding (net of Australian Government holdings) increased by around $2.2 billion during the year, to $49.4 billion, since bond issuance ($5.1 billion) exceeded maturities ($2.9 billion).

Consultation with financial markets

The AOFM increased its monitoring of market conditions following the emergence of the global financial market turbulence that began in mid-2007 by maintaining an active dialogue with market participants, the Reserve Bank of Australia (RBA) and the Australian Securities Exchange (ASX). It participated as an observer in meetings of the Debt Securities Committee and Repo

Committee of the Australian Financial Markets Association (AFMA). Its consultations with market participants were particularly valuable in the lead up to the Government's decision to increase the volume of Treasury Bond issuance.

Performance

Market efficiency

Global financial market turbulence combined with strong demand for Treasury Bonds from overseas investors led to some stress in the Treasury Bond market in 2007-08. Despite this the Treasury Bond and Treasury Bond futures markets continued to operate reasonably effectively. As a result they provided important anchors for Australia's financial system as it responded to the impact of the credit and liquidity concerns triggered by the sub-prime housing crisis in the United States of America.

The turbulence in financial markets was marked by an increased investor aversion to risk, a significant repricing of credit risk in both global and domestic financial markets and an increased demand for risk-free assets such as Treasury Bonds. Weakness in the United States dollar and favourable interest rate differentials also contributed to increased overseas investor demand for Australian Treasury Bonds. Non-resident holdings of the bonds reached record levels and at the end of the financial year exceeded 60 per cent of the bonds on issue.

With the increased demand, some Treasury Bond lines became difficult to source at times. As a result, bid-ask spreads widened, liquidity deteriorated and market makers were not always able to provide two-way prices. Bond market conditions improved in the latter part of the financial year following a general improvement in financial market sentiment and the announcement that Treasury Bond issuance would be increased.

The financial market turbulence impacted on turnover in the Treasury Bond and Treasury Bond futures markets.

- The turnover of Treasury Bonds decreased by around 7 per cent in 2007-08 compared to 2006-07.

- The turnover of 3-year Treasury Bond futures contracts increased by around 2 per cent in 2007-08 compared to 2006-07, and turnover of the 10-year contracts increased by around 17 per cent. In 2006-07, the corresponding growth rates had been 12 per cent and 34 per cent.

All Treasury Bond futures contract close-outs in 2007-08 occurred smoothly.

The impact of financial turbulence on the repurchase (repo) market in Treasury Bonds was less marked. According to market contacts the AOFM securities lending facility greatly assisted in minimising pressures in this regard. The facility allows bond market participants to borrow

Treasury Bonds for short periods, which enhances the efficiency of the market by improving the capacity of intermediaries to make two-way prices. Reflecting the strong demand for Treasury Bonds there was a substantial increase in use of the AOFM securities lending facility in 2007-08.

- The facility was used 88 times in 2007-08 compared with 38 times in 2006-07. The face value lent was around $2,515 million, an increase of around 96 per cent over 2006-07.
- The majority of transactions continued to be for one day only, although there were 19 instances where bonds were lent for two days or more (compared to eight occasions in 2006-07). One loan extended to seven days.
- The largest amount lent on a single day was $269.2 million.

Efficiency of issuance

Treasury Bonds are issued by competitive tender using an electronic tender system. In 2007-08, the turnaround time for the release of tender results was further reduced. Tender results are now available to bidders less than one minute after the close of bidding. Prior to implementation of the present electronic tender system in 2006-07 the turnaround time for the release of tender results was six to eight minutes.

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

Table 1: Treasury Bond tender results — 2007-08

Tender date	Coupon and maturity	Face value amount allocated ($m)	Weighted average issue yield (%)	Spread to secondary market yield (basis points)	Range of bids accepted (basis points)	Times covered
14-Aug-07	5.25% 15-Apr-2012	400	6.2588	-0.32	1.00	2.56
28-Aug-07	5.25% 15-Apr-2012	401	6.1579	0.29	0.50	3.59
11-Sep-07	5.25% 15-May-2021	800	5.8540	na	2.50	2.34
25-Sep-07	5.25% 15-May-2021	600	6.1866	0.66	1.00	2.69
16-Oct-07	5.25% 15-May-2021	401	6.3031	-0.19	0.50	4.18
30-Oct-07	5.25% 15-Apr-2012	400	6.5050	-2.00	0.00	3.25
13-Nov-07	5.25% 15-Apr-2012	300	6.4322	0.22	1.50	4.07
11-Dec-07	5.25% 15-May-2021	400	6.2059	0.59	1.00	2.29
22-Jan-08	5.25% 15-Apr-2012	300	6.2652	0.65	1.50	2.29
12-Feb-08	5.25% 15-May-2021	399	6.1802	-0.78	1.50	2.78
22-Apr-08	5.75% 15-Apr-2012	300	6.3900	-1.25	0.00	4.88
17-Jun-08	5.25% 15-May-2021	401	6.7438	1.38	2.00	2.45
Average over year to June 2008				-0.07	1.08	3.17
Average over 3 years to June 2008				0.07	0.76	3.72
Average over 10 years to June 2008				0.37	1.13	3.73

The average weighted issue yield was just under the secondary market mid-rate yield. For five tenders, the weighted average issue yield was below the secondary market mid-rate yield.

Cash management

Objective

The AOFM manages the daily cash balances of the Australian Government in the Official Public Account (OPA).[1] 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 Reserve Bank of Australia.[2]

Achieving the objective

In 2007-08, term deposits with the RBA were the only instrument used to manage the cash balances. Cash balances not required immediately are invested outside the OPA with the RBA for nominated periods of time, with the maturity dates set primarily to finance large future outlays. The magnitudes and tenor of the term deposits are determined by the AOFM. Interest rates for term deposits are based on Overnight Indexed Swap rates.

The daily movement in the Australian Government's financial asset position at the RBA (OPA cash balance plus term deposits) during 2007-08 is shown in Chart 2.

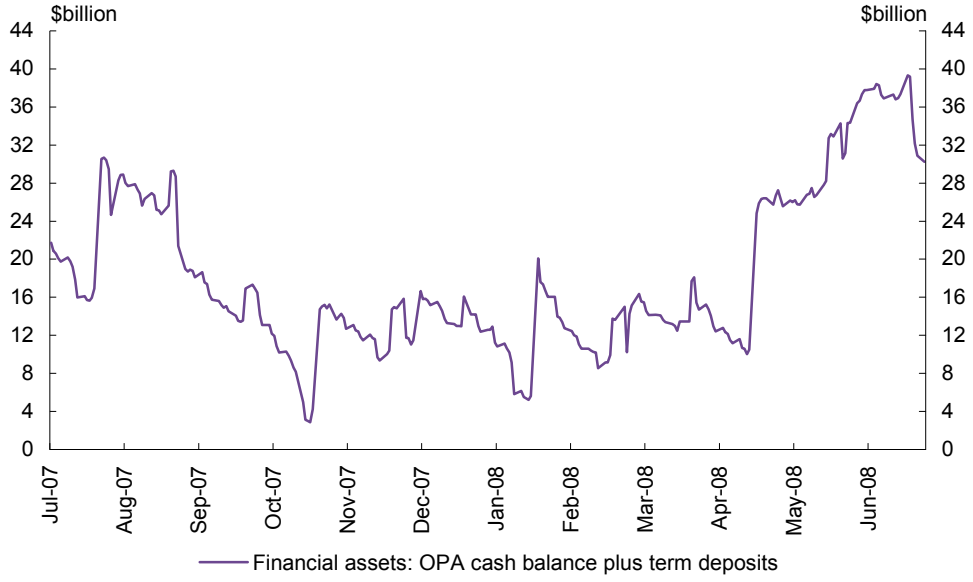
The 'peak-to-trough' swing for financial asset holdings was around $36 billion in 2007-08, compared to $27 billion in 2006-07 and $28 billion in 2005-06. Daily net cash flows exceeded $10 billion on all four of the quarterly tax collection days.

In August 2008, the AOFM commenced investing cash balances in a broader range of low credit risk short-term investment assets, namely highly-rated bank accepted bills, certificates of deposit issued by Authorised Deposit-taking Institutions. The broader range of short-term investment options is expected to enhance investment returns on surplus cash balances.

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

2 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 2007-08



Performance

During 2007-08 the AOFM placed 376 term deposits with the RBA. The stock of term deposits fluctuated from a minimum of $2.2 billion in October 2007 to a maximum of $38.8 billion in June 2008. It was not necessary to issue Treasury Notes to help meet the within-year funding requirement. Treasury Notes were last issued in 2003.

The objective of meeting the Government's financial obligations when they fall due was met, with the overdraft facility provided by the RBA accessed only once for one day.

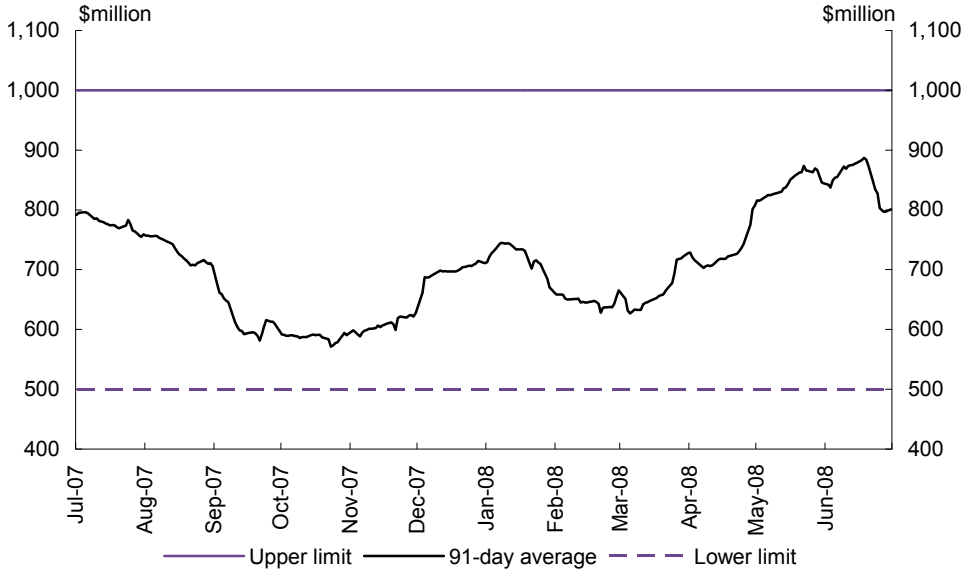
The yield obtained on term deposits during 2007-08 was 6.89 per cent, compared with 6.15 per cent in 2006-07.

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 2007-08 these limits were the same as applied in 2006-07, 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.

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.

Chart 3: 91-day moving average cash balance



Minimising debt servicing costs subject to acceptable risk

Objective

In managing its debt portfolio, the AOFM has sought 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.

In this context, the measure of cost used is historic accrual 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. However, it does not include unrealised market value gains and losses. 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 unrealised 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. However 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 composition of the physical debt in the AOFM's portfolio provides little opportunity for reducing debt servicing costs, because the volume and nature of the debt is determined by the policy of issuing to support the Treasury Bond and Treasury Bond futures markets. Furthermore, the volume and tenor of assets held as term deposits are largely determined by cash management requirements.

However, for many years the AOFM has been able to reduce debt servicing costs by using derivative instruments to adjust the portfolio's cost and risk characteristics, such as modified duration and short-dated exposure. It has used interest rate swaps[3] to achieve this objective by shifting the characteristics of the portfolio from those of the physical debt towards those of a target or 'benchmark' portfolio.

Historically, debt issued for long periods at fixed rates of interest has typically commanded a higher interest rate than shorter-term debt, because lenders 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, as interest rate movements are able to flow through to the overall cost of funds more quickly.

Over recent years market yield curves have flattened and, at times, become inverted. Part of this shift may have reflected changes in expectations about future movements in short-term interest rates, but part also appears to have been due to structural changes in global and domestic financial markets that have affected the term premium for holding longer-term debt. This has reduced the potential savings available from adjusting the portfolio's cost and risk characteristics through interest rate swaps.

In seeking to reduce debt servicing costs, the AOFM has used 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 is reviewed annually. In 2005 and 2007, the annual reviews concluded that the savings expected to be generated from targeting a modified duration significantly below that of the physical debt portfolio had reduced. There had also been some reduction in the expected variability in debt servicing costs, but smaller in magnitude than the reduction in expected savings. Accordingly, the modified duration of the benchmark portfolio was increased in these reviews from 2.0 to 2.5 years and again from 2.5 years to 3.0 years. (By comparison, the modified duration of the nominal physical debt (before swaps) has generally been a little above 4.0 years.) The short-dated exposure of the benchmark portfolio was also reduced from 35 per cent to 25 per cent.

3 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.

Higher duration targets for the benchmark, that are closer to those of the unswapped portfolio, entail smaller swap programs to keep the actual portfolio in line with the benchmark but they also offer less scope for savings in debt service costs over the medium-term.

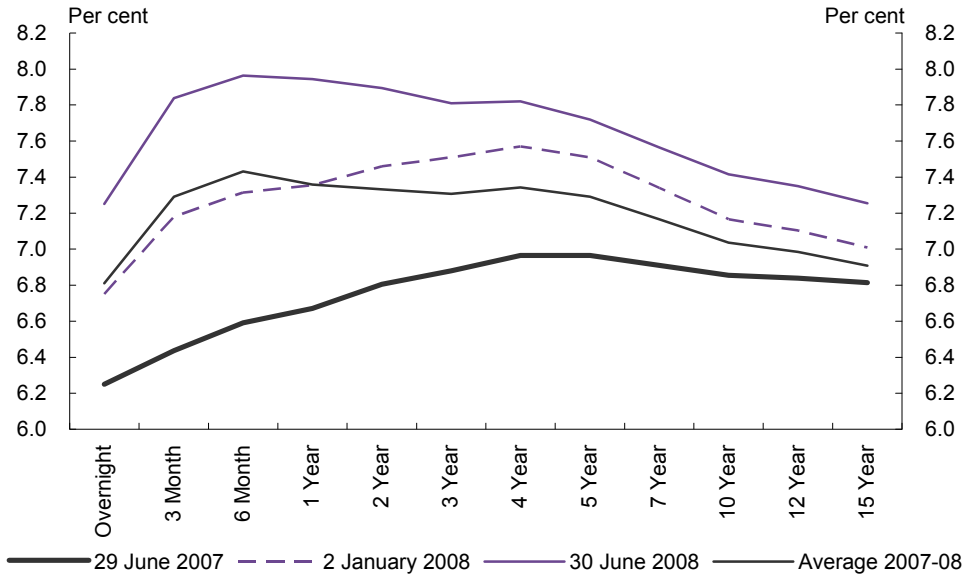
Management of the portfolio during 2007-08

The benchmark parameters for 2007-08 were set at a modified duration of 3.0 years and a short-dated exposure of 25 per cent. Guided by the new benchmark, it was planned that the average term to maturity of the actual debt portfolio would increase gradually, and its short-dated exposure would fall, as debt was rolled over and existing interest rate swaps matured. Provision was made for a small program of new swaps to provide flexibility to respond to changing market conditions, but swaps would be executed only if they were expected to provide savings to the Commonwealth over the medium-term, or a reduction in risk.

Undertaking swaps to pay fixed rates would have accelerated the transition of the portfolio towards the benchmark, but was unattractive because it required commitments to pay fixed rates that were high relative to the levels that had applied in previous years.

On the other hand, the attractiveness of undertaking swaps to receive fixed rates changed over the course of the year with changes in the shape of the swap yield curve. Movements in swap yields and the shape of swap yield curves during the year are illustrated in Chart 4.

Chart 4: Australian swap yield curves 2007-08

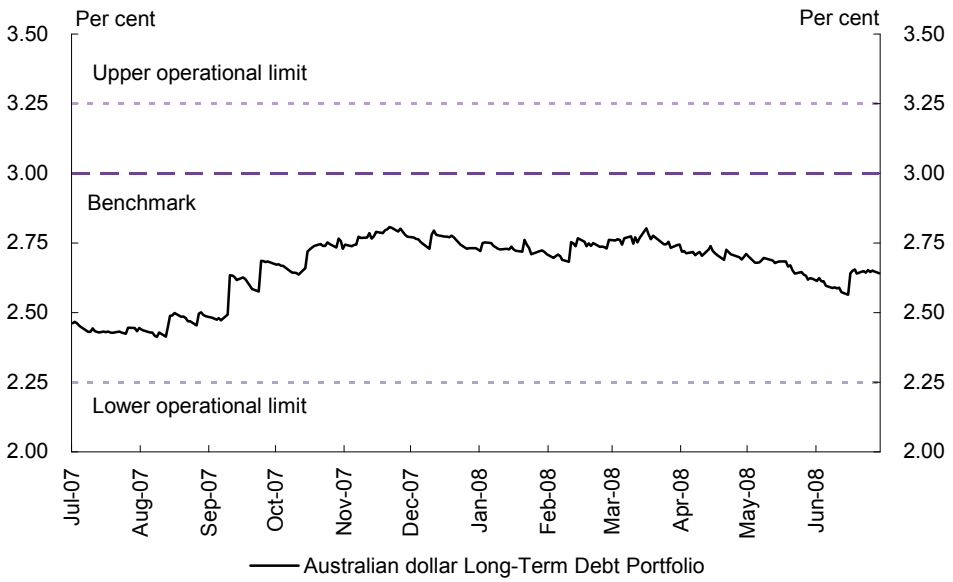


Source: Australian Financial Markets Association, Reuters.

At the start of the year the curve was 'humped', with an upward slope to the mid-part of the curve. A small volume of swaps to receive fixed rates was undertaken to offset the medium-term cost impact of issuing mid-curve Treasury Bonds (specifically into the April 2012 line) at historically high yields in October and November 2007.[4] However, only $300 million in swaps were executed to this end. After this time, significant increases in short-term bank bill rates (the floating rate reference point for interest rate swaps) resulted in an inverted curve beyond six months. This reduced the likelihood that any additional swaps would actually reduce the cost of mid-curve issuance. Consequently, no further swaps were executed from mid-November 2007.

The resultant path of modified duration for the nominal component of the Long-Term Debt Portfolio over the year is shown in Chart 5.

Chart 5: Modified duration — nominal component of Australian dollar Long-Term Debt Portfolio 2007-08

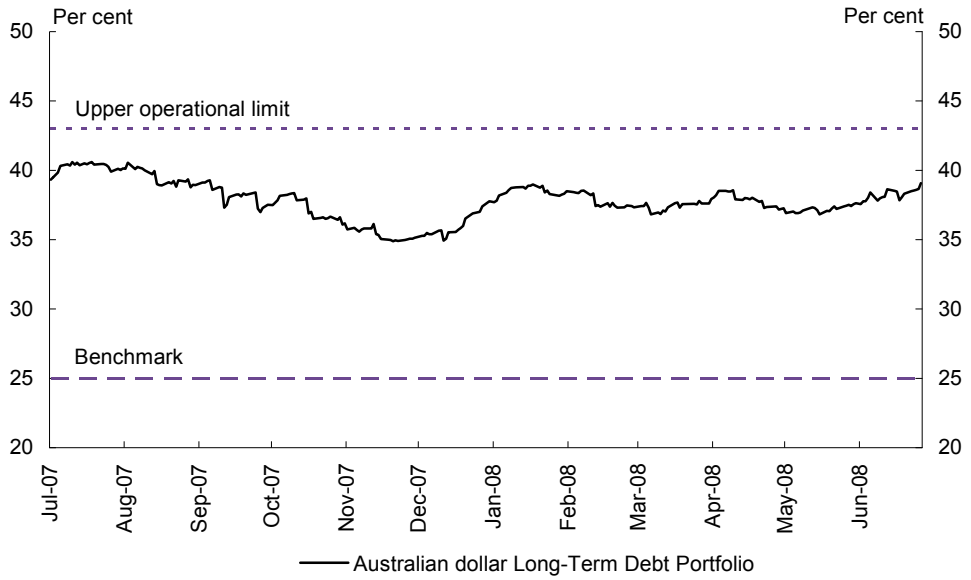


The downward drift through the last quarter of 2007-08 was a consequence of the relatively low volume of Treasury Bond issuance during this period. At the end of the financial year, the modified duration of the portfolio stood at 2.64 years.

Short-dated exposure remained above the benchmark target throughout 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 course of short-dated exposure of the portfolio during 2007-08.

4 Refer to Table 1.

Chart 6: Short-dated exposure — nominal component of Australian dollar Long-Term Debt Portfolio 2007-08



Swap execution in 2007-08

The $300 million of interest rate swaps undertaken in 2007-08 were executed with maturities of four years. The average spread from mid-market was 0.67 of a basis point.

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

	2006-07			2007-08		
	Amount ($m)	Average bp	Range bp	Amount ($m)	Average bp	Range bp
Mid-dated swaps (receive)	1,500	-0.25	-0.9 to 0.3	300	-0.67	-1.2 to -0.3
Long-dated swaps (receive)	1,000	-0.16	-0.7 to 0.3	0		

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

Performance

Reducing debt servicing cost

The debt servicing cost[5] of the gross debt managed by the AOFM in 2007-08 was $3.7 billion (after swaps), on an average book value of $56.8 billion. This represented a cost of funds of 6.55 per cent. Term deposits held with the RBA generated interest revenue of $1.2 billion on an average book value of $17.4 billion, giving a yield of 6.89 per cent.

Taken together, the combined portfolio of debt and assets managed by the AOFM[6] had a net interest expense (before re-measurements) of $2.5 billion, at an effective yield of 6.40 per cent. The corresponding figure for 2006-07 was 6.56 per cent.

Table 3 provides further details of the cost outcomes for the combined portfolio by instrument and portfolio for 2006-07 and 2007-08.

5 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.

6 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.

Table 3: Australian Government debt portfolio cost of funds analysis

	Interest expense		Book volume		Effective yield	
	2006-07	2007-08	2006-07	2007-08	2006-07	2007-08
	$ million		$ million		per cent per annum	
Contribution by instrument						
Treasury fixed coupon bonds	(2,988)	(2,947)	(47,641)	(48,476)	6.27	6.08
Treasury Inflation Indexed Bonds	(601)	(593)	(8,108)	(8,317)	7.42	7.13
Treasury notes	-	-	-	-		
Other miscellaneous domestic debt	(2)	(0)	(20)	(4)	9.81	8.22
Foreign loans (a)	0	(1)	(7)	(6)	-4.88	16.82
Gross physical CGS debt	(3,591)	(3,541)	(55,775)	(56,804)	6.44	6.23
Interest rate swaps	9	(180)	-	-		
Gross CGS debt (after swaps)	(3,581)	(3,722)	(55,775)	(56,804)	6.42	6.55
				-		
Term deposits with the RBA	1,147	1,197	18,645	17,378	6.15	6.89
Net CGS debt	**(2,435)**	**(2,524)**	**(37,130)**	**(39,426)**	**6.56**	**6.40**
Contribution by portfolio						
Long Term Debt Portfolio	(3,613)	(3,727)	(56,267)	(56,892)	6.42	6.55
Cash Management Portfolio	1,178	1,204	19,137	17,466	6.16	6.89
Net CGS debt	**(2,435)**	**(2,524)**	**(37,130)**	**(39,426)**	**6.56**	**6.40**
Remeasurements (b)	1,015	(118)				
Net CGS debt (after re-measurements)	**(1,420)**	**(2,642)**	**(37,130)**	**(39,426)**		

(a) Interest expense and effective yield on foreign loans incorporates foreign exchange revaluation effects.
(b) Re-measurements refers to unrealised changes in the market valuation of financial assets and liabilities.

The debt servicing cost of physical debt fell by $50 million compared to 2006-07, 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 a higher volume of nominal debt and the impact of higher interest rates.

Returns on interest rate swaps fell by $190 million compared to 2006-07. This was due almost entirely to higher short-term market interest rates from monetary tightening and higher margins for credit. These higher short-term rates increased the cost of the floating legs of swaps. Overall, swaps added to the interest costs of the portfolio (before re-measurements) by $180 million during the year.

However, the higher short-term interest rates had a positive impact on the return obtained on term deposits. The interest revenue on term deposits in 2007-08 was $1.2 billion, on an average book volume of $17.4 billion. This represented a return on funds of 6.89 per cent, compared with 6.15 per cent in 2006-07. The average volume of term deposits was slightly lower, offsetting the absolute amount of interest received. Nevertheless, term deposits contributed an extra $50 million in interest in 2007-08 compared to 2006-07. They also had a favourable effect on the

net cost of funds in percentage terms on the combined portfolio of debt and assets, as the yield on term deposits was higher than the cost of servicing gross debt.

Movements in market interest rates had an unfavourable impact on the market value of the portfolio in 2007-08. Unrealised losses from re-measurements amounted to $118 million. They comprised a gain of $390 million on nominal debt offset by losses of $114 million on indexed debt and $394 million on interest rate swaps.

The sensitivity of the market value of the nominal CGS debt in the AOFM's portfolio to changes in market interest rates is over three times the sensitivity of the market value of the interest rate swaps where the changes in interest rates are uniform across the yield curve. The effects are in opposite directions, so the impact of a uniform shift in interest rates on nominal CGS debt will more than offset the impact on swaps. The net loss in the portfolio from re-measurements in 2007-08 was largely driven by the widening in credit spreads, specifically in the swap curve. That is, swap rates rose significantly more than did CGS yields.

Lower real yields on indexed debt, due to increased demand for this debt arising from market concerns about inflation, also contributed to the adverse revaluation effects.

Comparisons with alternative portfolios

The cost outcomes for the actual portfolio can be compared with the outcomes that might have been obtained with other possible portfolios. One such alternative portfolio is the physical debt in the portfolio without swaps. Another is the benchmark portfolio. Simulated outcomes for these portfolios are compared with the outcome for the actual portfolio in Table 4. The comparisons are based on the Long-Term Debt Portfolio, which is the part of the AOFM's total portfolio that is actively managed using interest rate swaps.

Table 4: Relative performance analysis: Long-Term Debt Portfolio (LTDP), benchmark and unswapped portfolios in 2007-08

	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	2.66	-3,728	6.55	-3,846
Benchmark	2.87	-3,713	6.53	-3,711
Unswapped	4.03	-3,548	6.24	-3,272

As interest rates (in particular, bank bill and swap rates) trended higher throughout the financial year, portfolios with higher duration and/or lower exposure to short-term interest rates demonstrated better performance, both inclusive and exclusive of revaluation effects.

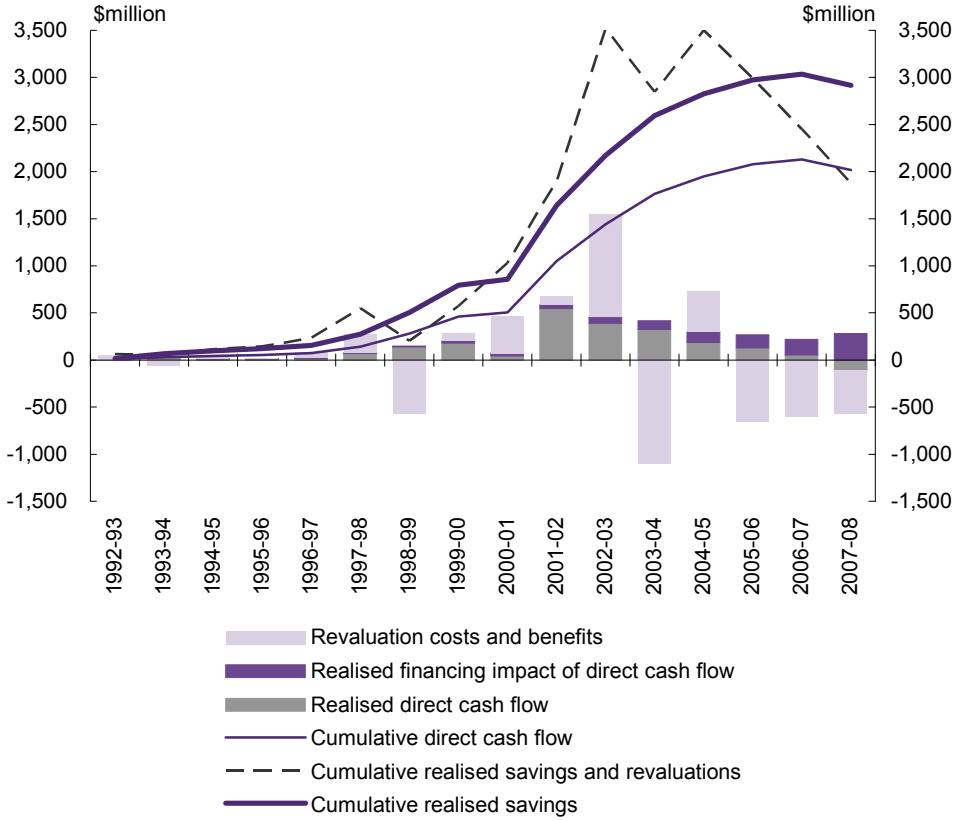
The model used to simulate the benchmark portfolio transitioned to the new benchmark targets in the first six months of the financial year. It was therefore less exposed than the actual portfolio

to the spikes in rates that occurred in the first quarter of the 2008 calendar year. Consequently, the Long-Term Debt Portfolio underperformed the model benchmark by $15 million in accrual terms and by $135 million in mark-to market terms.

Table 4 does not include performance data on either of the two previous benchmark portfolios (modified duration of 2.0 and 2.5 years). However it is clear that these previous benchmarks would have performed worse than the actual portfolio, given its higher modified duration averaging 2.66 years through the year. If the benchmark portfolio had not been changed at the start of the financial year, and additional swaps had been executed to hold the actual portfolio close to the unchanged benchmark, the performance of the actual portfolio during the year would have been worse than it was. The performance of the portfolio in 2007-08 thus benefited from the decision to change the benchmark.

As indicated in Table 4, the unswapped portfolio performed better in 2007-08, both before and after re-measurements, than both the actual portfolio and the benchmark portfolio. Swaps are undertaken as part of a medium-term strategy whose performance should primarily be judged over a period of years. 2007-08 was the first year that domestic interest rate swaps did not provide savings in the debt servicing costs of the portfolio (excluding revaluation effects). Chart 7 illustrates the whole of life performance of the domestic interest rate swaps since the first such swap was executed in 1992.

Chart 7: Savings arising from domestic interest rate swaps



As at 30 June 2008, interest rate swaps had generated total direct savings of just over $2 billion. Including second round, or financing, benefits, the total savings were $2.9 billion. However, the unrealised market value of the swap portfolio stood at negative $1.04 billion. The total cumulative economic benefit from interest rate swaps including unrealised revaluations was thus approximately $1.9 billion.

2008 review of the portfolio management strategy

In its annual reviews of the benchmark and the portfolio management strategy over recent years, the AOFM has considered the continued appropriateness of the strategy in the light of developments in market conditions, including changes in its assessment of the term premiums that underlie the shape of the yield curves and the margins between long and short-term market rates. The 2007 review concluded that, while structural factors appeared to have progressively lowered term premiums, a positive premium remained and was likely to provide a basis for continuing savings in debt servicing costs through interest rate swaps.

The analysis undertaken for the 2008 review indicated that the evidence for a positive term premium had weakened further and no longer provided a firm basis for achieving future savings in debt servicing costs. While the portfolio management strategy based on a positive term premium had produced substantial savings over an extended period, in current circumstances it would be better to accept the maturity structure of the debt portfolio as it exists and develops from the AOFM's issuance activities. The AOFM and the Advisory Board therefore decided to change the strategy and terminate the existing interest rate risk management framework from the end of 2007-08.

Under the new approach to be followed in 2008-09, the structure of the portfolio will follow from the outcomes of debt issuance to support the Treasury Bond and Treasury Bond futures markets, together with the management of assets resulting from the proceeds of issuance and the management of the Government's daily cash balances. Existing interest rate swap contracts will be managed in the light of market conditions and run off gradually over time. With the benchmark framework discontinued, the AOFM will no longer be reporting relative performance, however the cost outcome of the portfolio will continue to be monitored and reported.

Credit management

The use of interest rate swaps brings an exposure to counterparty credit risk. Collateral agreements, which require counterparties to post collateral when the AOFM's credit exposure rises above a predefined threshold, remained the main tool for credit risk management in 2007-08. The AOFM has Credit Support Annexes with 19 of its counterparties. On 30 June 2008, 91.8 per cent of the total nominal face value of the interest rate swap portfolio was covered by collateral agreements.

Table 5: Derivative counterparties by credit rating as at 30 June 2007 and 30 June 2008

Credit rating: Moody's/ Standard & Poors (a)	Number of AOFM counterparties by credit rating as at 30 June 2007	Number of AOFM counterparties by credit rating as at 30 June 2008
Aaa/AAA	1	0
Aa1/AA+	2	1
Aa2/AA	12	10
Aa3/AA-	6	5
A1/A+	3	2
A2/A	0	3
Total number of counterparties	24	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.

The AOFM's exposure to counterparty credit risk on swaps was zero at 30 June 2008.

Communications Fund

The AOFM manages the investments of the Communications Fund on behalf of the Department of Broadband, Communications and the Digital Economy.[7]

When the Fund was established, investments were limited to term deposits with the Reserve Bank of Australia until longer-term investment arrangements were decided. Revised investment guidelines were finalised in June 2007 and the AOFM completed the transition of the portfolio to the longer-term investment strategy in August 2007. Under this strategy, investments are held in a portfolio of short-term Australian denominated dollar money market instruments and deposits, including bank accepted bills, negotiable certificates of deposit and commercial paper. At end-June 2008 the value of the Fund's investments totalled approximately $2.4 billion.

Following the transition to the longer-term investment strategy, the before-fees investment portfolio performance benchmark for the Fund is the UBS Australian Bank Bill Index. The after-fees performance benchmark is the UBS Australian Bank Bill Index less 2 to 3 basis points. Both performance benchmarks were exceeded in 2007-08.

- The before-fees return of the Communications Fund exceeded the benchmark by 4 basis points.
- The after-fees return of the Communications Fund exceeded the benchmark by 5-6 basis points.

Financial information concerning the operation of the Communications Fund is reported in the financial statements of the Department of Broadband, Communications and the Digital Economy.

In the 2008-09 Budget the Government announced that the Communications Fund will be closed and its assets transferred to a new fund, the Building Australia Fund, which will be managed by the Future Fund Board of Guardians. The new fund will finance critical economic infrastructure in transport and communications such as road, rail, ports and broadband. The transfer of assets from the Communications Fund to the Building Australia Fund is expected to occur in 2008-09.

7 The Communications Fund was established in September 2005 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.

Operational risk

Objective

Operational risk is the risk of loss due to operational failures resulting from internal processes, people, or systems, or from external events. It encompasses risks such as fraud risk, settlement risk, accounting risk, personnel risk and reputation risk. The AOFM aims to manage its exposure to operational risk to acceptable levels.

Achieving the objective

The AOFM maintains a culture of prudence and high ethical standards, which are reinforced by adherence to the Australian Public Service Code of Conduct and the AFMA Code of Conduct. This foundation is accompanied by detailed controls and procedures overseen by the Operational Risk Committee and the Audit Committee. The Compliance Unit also monitors compliance with financial risk management policies and procedures on a daily basis.

In 2007-08, the AOFM undertook a number of activities to enhance the operational risk framework including:

- a review, at a high level, of operational and financial risks affecting the Agency and the controls in place to mitigate these risks. The review identified AOFM activities with inherent higher operational and financial risks and found that the controls in place were effective in managing these risks. No significant operational risk failures occurred in 2007-08;

- an update of the AOFM's Fraud Control Plan (FCP), including a re-assessment of the risks of fraud from within the Agency and externally. A new FCP was developed by the Compliance Unit and approved by the AOFM Audit Committee. The review considered potential fraud risks and found that the Agency's controls were appropriate for preventing and detecting fraud. No instances of fraud were detected in the Agency in 2007-08;

- completion of the Certificate of Compliance, an annual requirement for Chief Executives of agencies governed by the *Financial Management and Accountability Act 1997* (FMA Act), to report on compliance with the financial management framework. As a part of this process the Agency reviewed the requirements of the FMA Act, FMA Regulations, FMA Orders and FMA Finance Minister Delegations and associated government financial policies. It identified 260 requirements applicable to the Agency. A risk assessment of the Agency's compliance with these requirements found that the Agency's controls and processes provide reasonable confidence of compliance. Further testing of the higher risk areas detected two minor instances of non-compliance with FMA regulation 10;

- a comprehensive review of the AOFM's Chief Executive Instructions (CEIs) and internal financial delegations issued under the *Financial Management and Accountability Act 1997*. The CEIs provide a detailed framework of financial and management controls and delegations which limit discretion, approval and spending of public monies to minor amounts or alternatively require senior executive approval;

- completion of an Anti-Money Laundering and Counter-Terrorism Financing Program to ensure the AOFM's compliance with legislation that places obligations on prescribed reporting entities in relation to, among other things, customer identification, transaction reporting and record-keeping; and

- internal audits covering activities such as general controls, IT general controls, compliance, Communications Fund investments and GST and FBT administration.

Settlement operations

The AOFM settles high value payments on its administered portfolio of debt and assets. In 2007-08, the AOFM settled around $6.4 billion of payments of CGS interest and principal payments, $1.8 billion of swap payments and $318.8 billion in purchases of term deposits with the Reserve Bank of Australia. The AOFM also ensures that administered receipts are settled promptly and correctly by transaction counterparties. Settlements risk is a key risk managed by the AOFM. In 2007-08, the AOFM was late in settling one payment obligation. No compensation was sought by the counterparty. During the year all AOFM counterparties settled all payment obligations in line with their contractual obligations.

Information Technology operations

The AOFM has an established technology platform that includes integrated services for the delivery of treasury management and market data. The services provided by AvantGard Quantum, Bloomberg and Reuters continue to meet the requirements of the AOFM by providing a reliable environment that supports the Agency's debt management activities.

Cooperation with other debt managers

Over the 2007-08 financial year, the AOFM continued to provide support for debt management activities in Papua New Guinea and the Solomon Islands. One position was staffed in the Solomon Islands and one staff member seconded to Papua New Guinea under the auspices of the Regional Assistance Mission Solomon Islands and the Strongim Gavman program (previously named Enhanced Cooperation Program) 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 forum was conducted by the AOFM in Brisbane attended by officials responsible for sovereign debt management of the two countries,

together with seconded AOFM staff, to improve the assistance provided. Another AOFM staff member was seconded to the Papua New Guinea Department of Treasury for a period of three weeks to help develop its debt reporting and recording capacity.

The AOFM hosted visits from debt management officials from Indonesia and Thailand, and made presentations on debt management to Chinese and Indonesian public sector officials attending a residential study course on fiscal management at the Australian National University.

AOFM officers participated as speakers in the Organisation for Economic Cooperation and Development's Working Party on Public Debt Management, in a forum on Public Debt Management and Government Securities Markets conducted in Beijing by the OECD and the Chinese Government, and in the OECD's Global Forum on Public Debt Management in Amsterdam.

Agency financial performance

Agency activities recorded an operating surplus of $2.71 million for 2007-08 financial year, comprising total revenue of $10.22 million and expenses of $7.51 million. As at 30 June 2008, the AOFM was in a sound net worth and liquidity position, reporting net assets of $14.40 million, represented by assets of $15.69 million (including current assets of $0.61 million) and liabilities of $1.29 million.

As at 30 June 2008, the AOFM maintained cash and unspent appropriations totalling $14.20 million. These funds are held to settle liabilities as and when they fall due and for future asset replacements and improvements.

During 2007-08, the AOFM did not return or establish a provision for return, by the way of dividend, of unspent appropriation monies to Government.

AOFM

ROLE OF THE COMMONWEALTH GOVERNMENT SECURITIES MARKET

ROLE OF THE COMMONWEALTH GOVERNMENT SECURITIES MARKET

Introduction

Over the past decade fiscal surpluses and proceeds from asset sales have eliminated the need for the Commonwealth to issue debt for budget financing purposes. As a result the volume of Commonwealth Government Securities (CGS) on issue began to fall as bond lines matured and repurchases were made of other stocks. Before long, it appeared that ongoing reductions in the volume of debt on issue could threaten the continued viability of the CGS market. In 2002-03 the Government undertook a review of whether it was desirable to continue to reduce the level of outstanding CGS debt.

After extensive consultations with interested stakeholders, the Review concluded that an efficient Treasury Bond market should be maintained. It considered that, given the state of development of Australia's financial markets and the lack of effective alternatives to CGS, the higher costs associated with managing interest rate risk without a Treasury Bond futures market would add slightly to interest rates in Australia. Further, the Australian financial system might become less diversified and more vulnerable to shocks during periods of instability. The Government announced in the 2003-04 Budget that it would maintain sufficient Treasury Bonds on issue to support the Treasury Bond futures market. The Review did not see a need, in the absence of a funding requirement, for maintaining markets for other Australian Government debt and the issuance of Treasury Indexed Bonds was halted.

Since then the issuance of Treasury Bonds has continued at a steady rate of around $5 billion each year. In May 2008 the Government announced that it would increase issuance to $10.3 billion in 2008-09 to support the effective operation of the market.

There have been significant changes in the Australian financial markets over the last five years. This article reviews the role of the Treasury Bond market in light of experience and developments over this period.

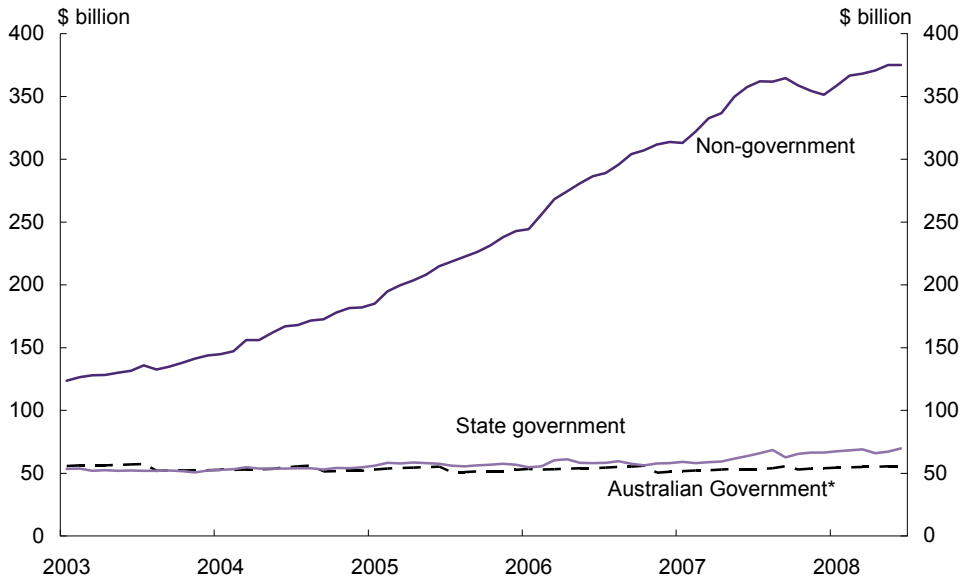
Changes in bond market structure and turnover

Since 2003, the volume of fixed coupon Treasury Bonds on issue has remained relatively steady at around $50 billion,[1] with the selection of bond lines and the timing of issuance targeted to support the Treasury Bond futures market. However other financial markets, and the Australian economy, grew rapidly. Over the five years to end-June 2008, turnover in Australian financial markets more than doubled, while nominal GDP increased by over a third.

Over the five years to end-June 2008, the total volume of bonds on issue in Australia more than doubled. Most of the increase was in non-government bonds (see Chart 1).

- Treasury Bonds declined as a percentage of all bonds on issue in Australia from around 24 per cent at end-June 2003 to approximately 11 per cent at end-June 2008.
- Nevertheless the Australian Government remains the largest single bond issuer in Australia.

Chart 1: Bonds on issue in Australia



* Includes fixed coupon Treasury Bonds and Treasury Indexed Bonds (excludes Commonwealth holdings).
Source: Reserve Bank of Australia

The volume of semi-government bonds on issue in Australia has been broadly similar to that of Australian Government bonds over recent years. Some State governments have diversified their

1 Following the decision in May 2008 to increase issuance of Treasury Bonds, the volume of fixed coupon Treasury Bonds on issue is expected to total approximately $55 billion at end-June 2009.

funding sources by issuing securities denominated in Australian dollars in overseas markets. The liquidity of the domestic issuance by these States was lower than if all their issuance had occurred in Australia. Over the next few years the volume of semi-government bonds on issue is projected to increase substantially due to increased funding needs of State and Territory governments. This will enhance liquidity. In addition, these governments are likely to undertake a larger proportion of their bond issuance onshore following the Australian Government's decision to exempt domestically issued semi-government bonds from interest withholding tax.[2]

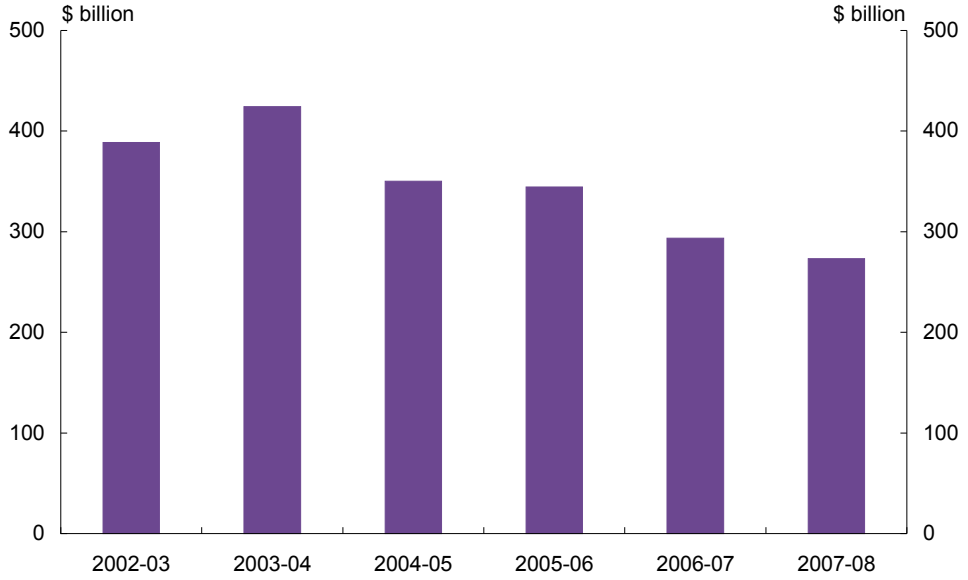
Over the five years to end-June 2008, the volume of non-government bonds on issue in Australia increased by 186 per cent. Within this total, bonds issued by banks and other financial corporations increased by 253 per cent and bonds issued by non-residents increased by 456 per cent. This growth in issuance has been supported by sustained strong growth in funds under management, particularly superannuation funds.

New issuance of bonds in Australia by non-financial corporations largely came to a stop in 2007-08 when the market was disrupted by credit concerns, and the volume of bonds on issue fell over the course of the year. Corporations turned to banks for a larger share of their financing and, to meet these and other funding needs, banks increased their domestic issuance of bonds during the year. The banks also undertook extensive issuance overseas in foreign currencies.

The contraction in the size of the Treasury Bond market relative to total bonds on issue in Australia has been accompanied by a downward trend in turnover. Secondary market turnover of Treasury Bonds is estimated to have fallen from $389 billion in 2002-03 to $273 billion in 2007-08, a decline of around 30 per cent (see Chart 2). Over the same period, turnover in semi-government bonds rose by 22 per cent and turnover in bank and corporate fixed debt securities increased by more than 150 per cent.

2 Previously the securities issued overseas benefited from exemption from interest withholding tax, but those issued in Australia did not.

Chart 2: Annual turnover of fixed coupon Treasury Bonds

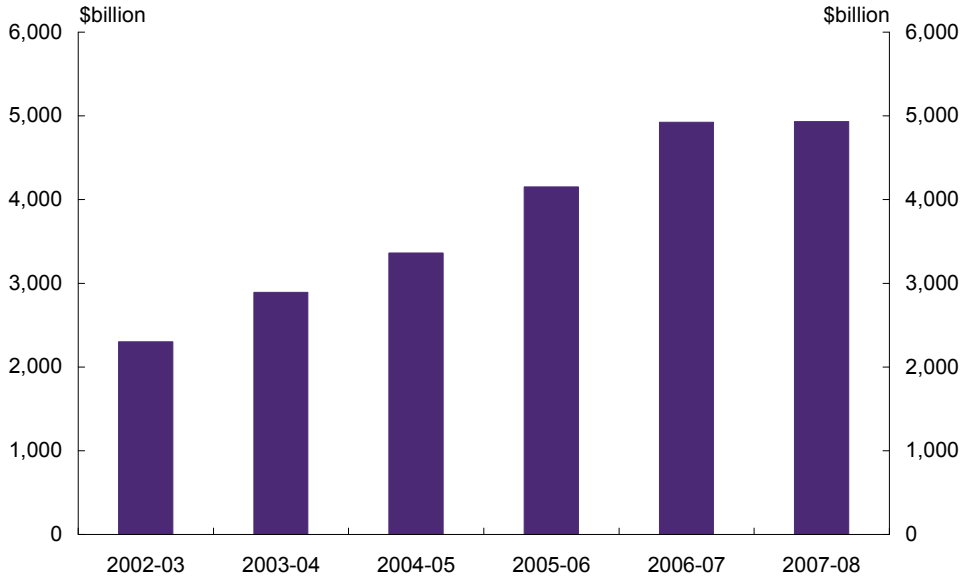


Source: Australian Financial Markets Association

An important factor in the reduced turnover of Treasury Bonds has been an increased preference by investors and bond traders to use derivatives (such as futures and swaps) to adjust their portfolio and trading positions rather than trades involving physical securities. This reflects the relative ease of using derivatives and their low cost in terms of capital use.

On the other hand, the annual turnover of Treasury Bond futures contracts more than doubled between 2002-03 and 2006-07. As a result, the annual value of Treasury Bond futures turnover is now in excess of 100 times the value of Treasury Bonds on issue. In contrast the annual secondary market turnover of Treasury Bonds is now less than 6 times the value of the bonds on issue.

Chart 3: Annual value of Treasury Bond futures turnover



Source: Australian Securities Exhange

An increase in the proportion of Treasury Bonds held by passive investors (who are more inclined to 'buy and hold' bonds rather than actively trade them) may also have contributed to the decline in their secondary market turnover. In particular, the proportion of Treasury Bonds held overseas has increased, including by central banks and institutional investors. However, many of these holders are prepared to use their bonds in repurchase (repo) transactions. CGS repo turnover increased slightly over the five years to 2007-08.

Overall, it appears that financial market participants adjusted without undue difficulty to the decline in the relative size of the Treasury Bond market for much of this period. Adjustments occurred in various ways. Some domestic investors reduced their holdings of Treasury Bonds by switching to other assets. Traders made greater use of derivatives (including Treasury Bond futures contracts) in adjusting their positions and managing interest rate risk. The market generally became more efficient in its use of the available stock of bonds.

Policy actions also helped. The Reserve Bank of Australia (RBA) widened the range of securities that it would accept in its open market operations; this increased the relative attractiveness of other securities and reduced dependence on Treasury Bonds. The Sydney Futures Exchange introduced limits on net open interest positions around the close-out of the Treasury Bond futures contracts; this reduced the risks of problems arising in close-outs. The AOFM established its securities lending facility to lend Treasury Bonds that were in temporary short supply; this increased the confidence of market makers in dealing in the bonds.

In 2006-07 and 2007-08, the demand for the bonds from overseas investors increased strongly, underpinned by the strength of the Australian economy and the exchange rate. Initially the

increase was able to be accommodated through reductions in holdings by domestic investors. However there was a limit on how far this could go. Strains appeared during 2007-08 when demand for the bonds soared as turbulence in global financial markets, triggered by the sub-prime housing crisis in the United States, encouraged a flight to quality. Some bond lines became difficult to source, bid-ask spreads widened, liquidity deteriorated and market makers were not always able to provide two-way prices.

The Government's decision to increase issuance in 2008-09 will help ease these pressures. In addition, increased issuance of semi-government bonds by State and Territory governments, and the consolidation of some semi-government markets following the extension of interest withholding tax exemptions, should help make semi-government bonds relatively more attractive as close alternatives to CGS.

Pricing and referencing other financial products

For many years Treasury Bonds and Treasury Bond futures have provided the principal benchmarks for pricing other fixed-rate debt securities and served as standard reference points when comparing rates between other financial products. This reflects the unambiguous risk-free status of the bonds. Efficient pricing of debt securities is important not just for the functioning of financial markets, but also for the real economy and the efficient allocation of capital between sectors and alternative uses.

Other financial instruments can also act as pricing and reference points. Domestic interest rate swaps are used as a reference point for pricing some corporate securities and Kangaroo bonds. Semi-government bonds potentially provide another reference point, but so far have not developed this role, perhaps because their market is segmented and they are not regarded as sovereign risk-free assets, particularly by overseas investors.

The Treasury Bond spot and futures markets and the domestic interest rate swaps market have continued to provide important pricing and reference points for debt markets over the last five years. However the turbulence in financial markets in 2007-08 affected them differently. Trading in Treasury Bonds was constrained by a heightened demand for the bonds in the face of a fixed supply, but the market continued to operate satisfactorily. The Treasury Bond futures market appeared to be little affected by market turbulence, although turnover eased along with activity in financial markets generally. Interest rate swaps were affected by the pressures on the banking system and the revaluation of credit. Bond-swap spreads widened and, along with other credit spreads, exhibited considerable volatility.

The availability of prices for Treasury Bonds and Treasury Bond futures during this period provided pricing information that gave market participants a fuller picture of market pressures and developments than they otherwise would have had. Without information from these two sources, the pricing of other securities would have been more difficult.

Managing interest rate risk

As noted above, the 2002-03 Review attached considerable importance to the role of the Treasury Bond futures market in managing interest rate risk (that is, the risks associated with adverse movements in interest rates). It observed that the capacity to manage interest rate risk contributes to a lower cost of capital in Australia, as investors may accept a lower yield on a corporate bond if they can hedge its interest rate risk, while the ability of financial institutions to manage interest rate risks associated with their balance sheets may contribute to lower costs for consumers on a range of products including retail loans.

Financial market participants in Australia use two main markets to manage their interest rate risk, the Treasury Bond futures market and the interest rate swap market. At the time of the Review, the Treasury Bond futures market was the primary vehicle for managing outright interest rate risk, providing standardised, exchange-traded products with high liquidity, low transaction costs and accessibility for a wide range of participants. Interest rate swaps are over-the-counter bilateral agreements tailored to meet the needs of counterparties. They are generally more expensive hedging instruments than Treasury Bond futures due to their lower liquidity, less transparent pricing and the concentrated nature of the swap market.

The Review considered that without a Treasury Bond futures market, interest rate swaps would likely become the main interest rate risk management tool. It also considered that the costs associated with interest rate swaps could increase if the Treasury Bond market were to close, as participants in the swap market use Treasury Bond futures extensively to hedge interest rate exposures associated with providing swaps. Without Treasury Bond futures, swap market participants would likely require higher premiums as compensation for taking significant additional risk on their balance sheets.

Both the Treasury Bond futures market and the interest rate swaps market have grown substantially over the past five years and each is playing an effective role in the management of interest rate risks. However, for the most part the points made by the Review continue to apply.

Events over the last year have highlighted the value of having a liquid risk-free asset as the base for the risk transfer mechanism. Other interest rate instruments, such as interest rate swaps and semi-government bonds, were more adversely affected by the recent financial turmoil as uncertainties developed and credit spreads widened. It is likely that it would have been more difficult and costly for financial market participants to have responded to market turbulence in managing their interest rate risks if the Treasury Bond and Treasury Bond futures markets had not been available.

On the other hand, the efficient functioning of the Treasury Bond futures market depends on the continued health of the underlying physical market. A sustained loss of liquidity of the Treasury Bond market could potentially impact on the ability of the futures market to source its

settlement prices. This did not occur in 2007-08, when all close-outs were completed smoothly, but warrants continued vigilance.

Vulnerability of the financial system

The 2002-03 Review considered that, without a Treasury Bond futures market, Australian financial markets may become less diversified and more vulnerable to shocks during periods of instability. It observed that, in the absence of Treasury Bonds, the interest rate swap market would likely substitute for them in a number of ways. However, this may increase the concentration of financial market activity in the banking sector, as banks play a significant role in the swap market. In times of major economic and financial instability, this could add to the risk in the financial system. Although major shocks are rare, their consequences can be more severe in less diversified systems.

In 2007-08 the Australian financial system was significantly impacted by turbulence in global credit markets. This was sparked by problems in sub-prime lending for housing in the United States, which brought a greatly increased caution about credit exposures and a general upward repricing of risk. There was mounting uncertainty about risks involved in structured investment instruments such as asset-backed securities and the extent to which counterparties may have had direct or indirect exposures to losses on such instruments.

The Australian financial system appears to have been relatively free of the unsound lending and incautious investment practices. The domestic loan portfolios of the banks were of high quality, with a ratio of non-performing assets that was low by both international and historical standards. The banks had only limited direct exposure to the sub-prime problems in the United States, primarily through small holdings of financial instruments backed by sub-prime debt. Some had indirect exposures through their links to institutions and businesses that were directly affected by the tightening in credit conditions.

Australian banks continued to tap both the domestic and international markets, but their funding costs increased substantially, particularly for term funding. The spread between the yield on domestic three-month bank bills and the overnight indexed swap rate rose to over 70 basis points, compared to an average spread of around 10 basis points over previous years. Some banks issued five-year domestic bonds at spreads of 100 or more basis points above the (increased) bank bill rate, compared to less than 20 basis points in 2006-07.

Australian non-financial corporations also faced increased difficulty in borrowing, both domestically and overseas. Domestic bond issuance by these corporations slowed sharply and the volume of bonds on issue fell over the course of 2007-08. The corporations increasingly turned to the banking sector to meet their financing needs, which it was able to provide, but with a significant increase in cost.

The offshore market for asset-backed commercial paper was particularly affected by the turmoil and largely closed to new issues by Australian entities. The domestic market remained open and onshore issuance increased, covering some of the shortfall, but at significantly higher spreads than in the past. Some of the funding vehicles that relied on asset-backed paper were able to draw on liquidity facilities provided by the banks or alternatively sold their paper to the banks that sponsored them.

The market for residential mortgage-backed securities (RMBS) experienced even greater difficulties as the sources of funding for these securities were reduced. While the credit quality of Australian RMBS remained high, these securities were adversely affected by the general repricing of risk originating from overseas markets and reduced demand as investors, particularly from overseas, consolidated their investment activities. In the first half of 2007 domestic RMBS of the highest credit quality were trading at spreads of less than 20 basis points above the bank bill swap rate, but these spreads rose as high as 150 basis points in 2007-08. It became unprofitable for housing lenders to issue RMBS at such spreads, even with some increases in mortgage interest rates, and the stock of RMBS on issue fell by over 18 per cent in the year.

One outcome of these various pressures was substantial re-intermediation in the financial system as banks were forced to provide a larger share of the financing for the corporate sector. The banks were able to meet this need as their balance sheets were strong and they were able to increase their borrowings domestically and abroad, albeit at substantially increased cost. In particular, bonds issued by Australian banks increased by almost 20 per cent in 2007-08. The liquidity of the financial system was also supported by actions of the RBA, which widened the range of acceptable securities in its open market operations.

The interest rate swap market continued to operate, but was adversely affected by the pressures on the banking system and credit market turmoil. Its liquidity was reduced, with bid-ask spreads widening and considerable volatility in bond-swap spreads.

If there had been no Treasury Bond futures market, the demands placed on the swap market for the hedging and management of interest rate risk would have been greater. Given the general soundness of the Australian banking system, it may well have been able to carry the additional burden without difficulty. Nevertheless, this experience highlights the advantages of maintaining diversity in the structure of the financial system, so that the impact of major financial shocks, when they arise from time to time — as they inevitably must — can be better absorbed and distributed.

The shocks flowing from the recent global credit crisis have been severe, even extreme, in historical experience. Australia has been fortunate that they came at a time when its economy was prosperous, buttressed by the long-term growth of the Chinese economy, high commodity prices, and a strong exchange rate. Despite this, the impact was deep and extensive. Maintaining the strength of the financial system can help reduce its vulnerability in the future.

Some other arguments advanced for continued issuance

The 2002-03 Review also considered, but did not accept, some other arguments for continuing to issue Treasury Bonds in the absence of fiscal deficits. Subsequent experience appears generally to have supported its conclusions in this regard.

Providing instruments for investment

Many investors view Treasury Bonds as attractive long-term investments because of their low credit risk. In announcing its decision in 2003 to maintain the Treasury Bond market, the Government noted that this would maintain the ability of such investors, including superannuation funds, to hold Commonwealth Government bonds, but emphasised that its decision was not specifically targeted at meeting investor demand for risk-free assets. Various alternative low risk investment options were also available, including State government debt and debt issued by highly rated supranational institutions.

Since then, the supply of Treasury Bonds on issue has remained fixed while the volume of funds under management in Australia has grown dramatically. Investors appear to have adjusted readily to this shift in relativities. In part, this may have been because, an increased range and volume of other low risk long-term assets became available.

- State and Territory governments maintained their issuance of long-dated bonds and some have issued bonds with longer maturities than the Commonwealth. The volume of semi-government issuance is likely to increase in the future.

- Kangaroo bond issuance has grown rapidly.[3] The volume of Kangaroo bonds on issue increased from around $20 billion in 2003 to more than $100 billion in 2007-08. Around 50 per cent of these bonds are AAA-rated. While the bulk of Kangaroo bond issuance has been for medium-term maturities some issuance has been long-term.

- Some very long-dated domestic infrastructure bonds have also been issued.

Another factor that may have facilitated the adjustment to a smaller relative supply of Treasury Bonds was a shift in investor preferences away from lower risk investments in order to achieve higher returns. However, this trend was reversed in 2007-08 when developments in global financial markets brought a greater aversion to risk and a flight to higher credit quality. Part of this increased aversion to risk may prove temporary, but to the extent that it persists it could bring an on-going increase in the demand for low risk securities in the future.

3 Kangaroo bonds are Australian dollar denominated bonds issued by non-residents.

Nevertheless, with the increased availability of alternative low risk investment instruments, there does not appear to be a strong public policy case in Australia for issuing Treasury Bonds to meet demands for them by particular categories of investors.

Implementing monetary policy

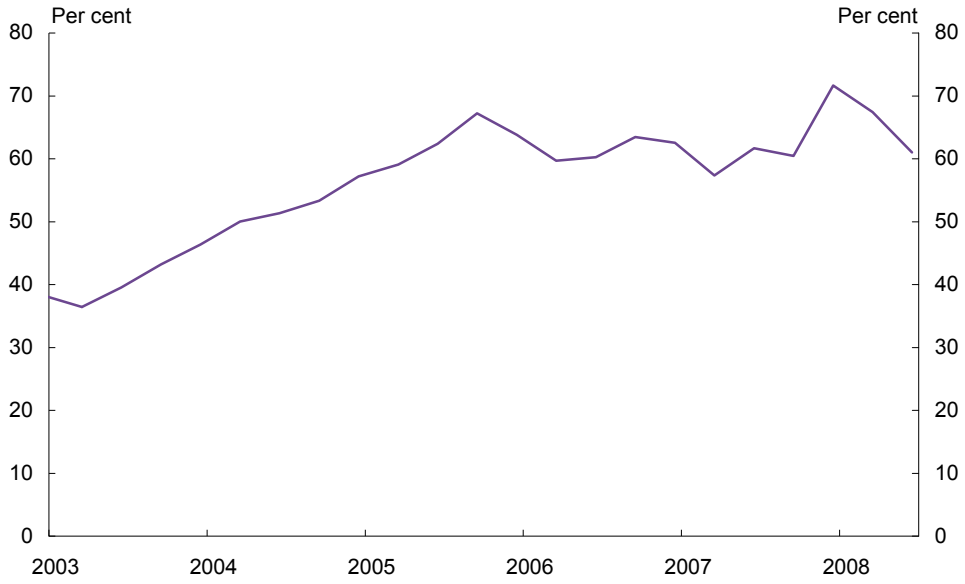
Prior to 1997 the RBA conducted its domestic market operations using only CGS. Since then, in response to the declining supply of CGS, it has progressively widened the range of acceptable collateral it uses in its domestic open market operations. At times in recent years it has also used foreign exchange swaps in its conduct of monetary policy.

The bulk of the RBA's domestic open market operations are now conducted by way of repurchase agreements involving bank bills, bank certificates of deposit and semi-government securities. Transactions involving CGS are now only a small proportion of its activities. This has not noticeably constrained the operation of monetary policy.

Attracting foreign capital inflow

The share of Treasury Bonds on issue held by non-resident investors has increased over recent years and at end-June 2008 was more than 60 per cent. This increase has been supported by interest rate differentials and a strong Australian dollar, but may also have been affected by overseas investors diversifying their foreign currency exposures.

Chart 4: Non-resident holdings of Treasury Bonds



The benefits of foreign capital inflows depend on the use to which the inflows are put. In the absence of a borrowing need, there is no strong case for issuing government debt to attract such inflows. With a strong economy and a floating exchange rate, attracting capital inflows does not provide additional grounds for issuing Treasury Bonds.

Promoting Australia as a global financial centre

Australia's financial markets and associated market infrastructure are sophisticated and well regulated giving them a leading position in the Asia-Pacific region. In particular, Australia is a regional leader in the issuance of international and domestic securities and has more international debt securities outstanding than any other Asia-Pacific nation. An efficient Treasury Bond market is a core element in the operation of the Australian financial system. However the 2002-03 Review did not nominate the promotion of Australia as a global financial centre as grounds for maintaining the Treasury Bond market.

Australia's financial markets and the financial services sector have grown vigorously over recent years and maintained Australia's position as a global financial centre. It is likely that liquid Treasury Bond and futures markets have played some part in this growth, particularly given the active offshore participation in those markets. Even if this role does not in itself justify retention of the Treasury Bond market, it is an added benefit of doing so.

The cost of Treasury Bond issuance

The benefits of maintaining the Treasury Bond market must be weighed against the debt servicing costs of the bonds issued, less the returns obtained from the use of the proceeds.

Since 2003 the proceeds of bond issuance not required for the redemption of maturing debt have been placed in term deposits with the RBA. The weighted average yield obtained on these deposits over the five years to end-June 2008 was 5.88 per cent, while the weighted average yield on Treasury Bonds issued over this period was 5.61 per cent. By this test, the additional issuance to maintain the Treasury Bond market did not impose a net cost on the Commonwealth.[4]

In his announcement of increased Treasury Bond issuance on 20 May 2008, the Treasurer indicated that the AOFM would manage the investment of the proceeds of the additional issuance using a wider range of investment instruments. Since July 2008 the AOFM has invested these proceeds in a range of low risk securities, including bonds issued by State governments and Kangaroo bonds issued by supranational organisations. These assets yield a positive spread

4 Some funds were transferred to the Future Fund and the Higher Education Endowment Fund where they were expected to obtain a higher yield for the Commonwealth. For example, the Future Fund has a long-term target return of 4.5 to 5.5 per cent real. However the net benefits or costs obtained from these transfers should be counted separately from those of the decision to maintain the Treasury Bond market.

over Treasury Bonds. As a result, the increase in issuance is likely not to involve any net cost to the Government.

Conclusion

There have been significant changes in Australian debt markets over recent years, but the Treasury Bond and Treasury Bond futures markets remain important to the Australian economy for the roles they play in the management of interest rate risks and in strengthening the resilience of the financial system to major shocks. In particular, the recent financial market turbulence has highlighted the roles of the Treasury Bond and Treasury Bond futures markets as anchors for the financial system.

In order to maintain liquid and viable Treasury Bond and Treasury Bond futures markets the volume of Treasury Bonds on issue will need to be adjusted from time to time to allow for growth in demand as a result of growth in financial market activity. The Government's decision to provide legislative authority for future increases in issuance provides an appropriate framework for such adjustments. The AOFM will continue to monitor developments in the market and advise on appropriate policy responses.

AOFM

PART 3

MANAGEMENT AND ACCOUNTABILITY

MANAGEMENT AND ACCOUNTABILITY

Corporate governance

The Secretary to the Treasury exercises general oversight of the AOFM's activities and is responsible for advising the Treasurer on government policy relating to debt management and investment. The Secretary approves detailed debt management and investment policies, sets operational limits and addresses any breaches of limits. In discharging his responsibilities, the Secretary is advised by the AOFM Advisory Board.

The Chief Executive Officer (CEO) of the AOFM is responsible for the day to day management and direction of the AOFM. The CEO exercises powers delegated by the Treasurer and the Secretary for debt issuance, investment, portfolio management and management of the AOFM's staff. The CEO has final responsibility for all aspects of the financial management of the Agency (which is separate from that of the Treasury as the AOFM is a prescribed agency under the *Financial Management and Accountability Act 1997*). The AOFM reports regularly to the Treasurer on its portfolio, prepares an annual report for presentation to Parliament and releases information about its activities on its website.

AOFM Advisory Board

The AOFM Advisory Board provides advice to the Secretary on debt management policy and the operational strategy and performance of the AOFM. The Board does not possess executive powers or decision making authority. The Advisory Board members at 30 June 2008 were:

- Dr Ken Henry AC, Secretary to the Treasury (Chair);
- Tony Cole AO, Head of Mercer Investment Consulting — Asia Pacific;
- Dr Paul Grimes, General Manager, Budget Group, Department of Finance and Deregulation;
- Neil Hyden, Chief Executive Officer, AOFM;
- Greg Maughan, consultant;
- Nigel Ray, Executive Director, Fiscal Group, Treasury; and
- Peter Warne, Chairman of Next Financial Limited, Australian Leisure & Entertainment Property Group, Teys Limited and St Andrews Cathedral School Foundation Limited. He is also a Director of ASX Limited and subsidiary companies,

Macquarie Group Limited, WHK Group Ltd, Capital Markets Cooperative Research Centre Limited Ltd and a number of other unlisted companies.

The Advisory Board met on four occasions in 2007-08.

Senior management committees

Several senior management committees operate to assist the CEO in the management of the Agency and to facilitate communication and coordination.

Executive Committee

The Executive Committee coordinates the overall management of the Agency, including consideration of strategic issues, coordination of priorities, financial management, organisational arrangements and resource management. Its membership comprises the CEO, the Head of Compliance and Reporting, the Chief Finance Officer, the Director of Financial Risk and the Head of Treasury Services.

Liability Management Committee

The Liability Management Committee advises the CEO on operational debt policy and financial risk management issues. The committee reviews policy and operational settings, deal execution and market conditions. Its membership comprises the CEO, the Head of Compliance and Reporting, the Director of Financial Risk and the Head of Treasury Services, together with other senior staff with relevant functional responsibilities.

Operational Risk Committee

This committee manages operational risks. It recommends and determines compliance priorities and control procedures and oversees the identification, categorisation and prioritisation of operational risks. Its membership comprises the CEO, the Head of Compliance and Reporting, the Chief Finance Officer, the Director of Financial Risk and the Head of Treasury Services, together with other senior staff with relevant functional responsibilities.

Human Resources Committee

This committee advises on the management of human resources, including employment policies, training and development, recruitment, performance management and remuneration. It consists of members of the Executive Committee and the Human Resource Manager.

Information Technology Steering Committee

This committee oversees current and planned information technology projects and operations. Its membership comprises the CEO (Chair), the Chief Finance Officer and the IT Manager.

Investment Committee

This committee oversees the AOFM's operational management of the Communications Fund and gives advice on eligible investments. Its membership comprises the CEO, the Head of Compliance and Reporting, the Chief Finance Officer, the Director of Financial Risk and the Head of Treasury Services, together with other senior staff with relevant functional responsibilities.

Other elements of the governance framework

Other elements of the AOFM's governance framework include:

- formal delegations and authorisations from the Treasurer of powers under various Acts that provide the legal authority for the AOFM's debt management and investment activities;
- policies, including a Balance Sheet Policy, Credit Policy and Liquidity Policy, and operational limits, that are approved by the Secretary to the Treasury;
- Chief Executive Instructions and internal financial delegations, which establish an administrative framework for the delegation of the Chief Executive's powers under the *Financial Management and Accountability Act 1997*;
- a Contract Management Policy, which establishes guidelines for managing contractual relationships with suppliers of goods and services based on Australian Government legislative requirements and best practice principles;
- a fraud risk assessment and Fraud Control Plan which comply with the Commonwealth Fraud Control Guidelines and include appropriate fraud prevention, detection, investigation and reporting procedures;
- Business Continuity and Pandemic Plans to maintain the Agency's critical activities in the event of a major disruption to the office or influenza pandemic; and
- an Information Technology Disaster Recovery Plan relating to servers, system databases and key software applications which establishes the processes required to restore critical IT-reliant functions in the aftermath of a significant disruption.

Audit

Audit Committee

The AOFM Audit Committee is a forum for review of audit and related issues. It approves the AOFM's internal audit plan, reviews audit reports and advises on action to be taken on matters raised in them, advises on the preparation and review of the AOFM's financial statements, reviews operational risks and oversees development of the Fraud Control Plan.

The Audit Committee membership at 30 June 2008 comprised:

- Peter Warne, independent member of the AOFM Advisory Board (Chair);
- David Lawler, former Group Auditor, Financial Controller of Institutional Banking and Executive General Manager of the Commonwealth Bank of Australia, Audit Committee member of the Defence Materiel Organisation, the Australian Trade Commission, the Australian Agency for International Development, the Australian Sports Anti-Doping Authority and National ICT Australia;
- Neil Richardson, Manager, Asset and Liability Analysis Unit, the Treasury; and
- Andrew Johnson, the Head of Compliance and Reporting, AOFM.

Invited attendees included the Australian National Audit Office (ANAO), the AOFM internal auditor (PricewaterhouseCoopers) and the AOFM Chief Finance Officer. The Committee met on four occasions during 2007-08.

Internal auditor

PricewaterhouseCoopers undertook a substantive program of internal audit activities during 2007-08. In addition to the regular annual audit review of internal operational controls and information technology controls, it completed three major reviews in 2007-08.

- Compliance function review — a review of the AOFM's compliance function The review found evidence of a sound compliance culture and made recommendations for the development of the compliance work program, updating policies and procedures, improved linkages with internal audit and improved staff training.
- Communications Fund review — a review of the framework for the AOFM's management of investments for the Communications Fund, including the legal framework, policies and procedures.
- GST and FBT review — this reviewed the AOFM's compliance with GST and FBT legislation.

Australian National Audit Office reports

The Australian National Audit Office's annual report on *Interim Phase of the Audit of Financial Statements of General Government Sector Entities for the Year Ending 30 June 2008* identified no risk issues in relation to the AOFM and concluded, based on the audit work performed, that internal controls were operating satisfactorily to provide a reasonable assurance that AOFM could produce financial statements free of material misstatement.

During 2007-08, the ANAO did not conduct any other cross-agency audits which involved the AOFM.

Judicial decisions

In 2007-08, no matters relating to the AOFM were the subject of judicial proceedings, tribunal hearings or consideration by the Ombudsman.

Management of human resources

Meeting workforce needs

The AOFM aims to meet its workforce needs primarily through the recruitment of recent graduates and their subsequent development through on the job experience, mentoring, assistance with further academic studies and in-house training. This approach is designed to maintain the core professional strength of the AOFM on a continuing basis. It allows people with strong academic achievements to develop specialised skills and experience related to the AOFM's work requirements, expanding their knowledge of financial markets and debt management, and also of public policy and administration.

The AOFM aims to attract and retain staff by providing challenging and interesting work in a professional work environment with opportunities for learning and career development. A broad-banded classification structure allows staff to advance between work levels within classification grades subject to work availability and performance without formal competitive selection processes. This encourages staff to build their career within the AOFM. Promotions across grades are made via merit selection. This strategy has been successful in attracting and retaining highly qualified professional staff. The annual retention rate has averaged 74 per cent over the seven years since 2001-02. The retention rate for 2007-08 was 82 per cent.

Training and development

The AOFM encourages staff to participate in training and development activities to develop their work skills and enhance their career prospects. While a significant proportion of development occurs through knowledge transfer in on-the-job training, staff also draw on

external courses, conferences, workshops and seminars for development opportunities. During 2007-08 the AOFM offered in-house programs to supplement individual external programs, and conducted an internal seminar series. In addition to all-office briefings, this series included presentations by:

- Australian Transaction Reports and Analysis Centre on Anti-Money Laundering and Counter Terrorism;
- Australian Prudential Regulation Authority on supervisory oversight; and
- Commonwealth Bank of Australia Debt Research Unit on the sub-prime mortgage issue and its impact on banks and financial markets.

AOFM staff are highly qualified with 82 per cent holding degree qualifications (9 per cent have higher degrees and 26 per cent hold double degrees). Twenty-one percent have professional qualifications in their field.

Over the last four financial years, an average of 74.5 percent of AOFM employees have participated in training or development supported by the AOFM. During this period, training averaged 3.5 days per full-time equivalent staff member (FTE) per year and the direct costs of training (paid to external parties) averaged $2,190 per FTE per year. In 2007-08, 81.0 per cent of employees participated in training, 3.9 days per FTE were invested in skill development and $2,713 per FTE was paid to external providers. The AOFM invested 3.6 per cent of direct salary costs in payments for training and development activity over the year.

The AOFM workforce

As at 30 June 2008, the AOFM employed 27.8 full-time equivalent staff under the *Public Service Act 1999*. Table 1 provides a summary of the AOFM workforce by broadband classification.

Table 1: Operative and paid inoperative staff as at 30 June 2007 and 2008

	Ongoing				Non-ongoing				
	Full-time		Part-time		Full-time		Part-time		
Classification	**Male**	**Female**	**Male**	**Female**	**Male**	**Female**	**Male**	**Female**	**Total**
2008									
AOFM1	0	2	0	0	0	0	0	0	**2**
AOFM2	12	7	1	3	1	0	0	0	**24**
AOFM3	4	0	0	0	2	0	0	0	**6**
AOFM4	1	0	0	0	0	0	0	0	**1**
CEO	1	0	0	0	0	0	0	0	**1**
Total	**18**	**9**	**1**	**3**	**3**	**0**	**0**	**0**	**34**
2007									
AOFM1	2	2	0	0	0	0	0	0	**4**
AOFM2	11	8	1	2	0	0	0	0	**22**
AOFM3	5	0	0	0	2	0	0	0	**7**
AOFM4	1	0	0	0	0	0	0	0	**1**
CEO	1	0	0	0	0	0	0	0	**1**
Total	**20**	**10**	**1**	**2**	**2**	**0**	**0**	**0**	**35**

Note: AOFM broadband classifications are nominally linked to Australian Public Service classifications as follows: AOFM1 corresponds to APS1 to APS4, AOFM2 corresponds to APS5 to EL1, AOFM3 corresponds to EL2 and AOFM4 covers higher level EL2.

AOFM staffed two overseas posts during the year to support capacity building in sovereign debt management in Papua New Guinea and the Solomon Islands.

AOFM established a workforce plan during the period and this was promulgated to all staff. The plan has assisted AOFM in retention and recruitment.

Changes to senior management

There were no changes to senior management during the period.

Other staffing changes

Six ongoing employees were recruited during 2007-08 — four to the AOFM2 level and two to the AOFM1 level. They included three graduates who joined in the middle of the financial year. The graduates participated in various training programs relevant to their roles within the public sector. There were a total of six staff exits during the year — all were ongoing employees. For ongoing employees, departures represented 20.5 per cent of average staffing levels in 2007-08 (28.5 per cent in 2006-07).

Industrial Arrangements

Until the change in government policy on 13 February 2008, AOFM employees were employed under Australian Workplace Agreements (AWAs). The AOFM is working towards establishing a collective agreement. As an interim arrangement two new employees were employed during the year under common law contracts. AWAs and contracts specify employment terms and

conditions, with remuneration outcomes based on performance, position and level within the AOFM. They also refer to the Australian Public Service Values in the context of setting out expected performance and behaviour.

The CEO of the AOFM is engaged under an AWA with the Treasury.

Remuneration

Staff remuneration (Table 2) is reviewed annually, with adjustments effective as at 1 July. Under the arrangements in place during 2007-08, salary ranges are set to reflect market rates for conservative financial services organisations, using data provided by the Financial Institutions Remuneration Group. This data covers a wide range of public and private sector financial institutions, including banks, corporate treasuries and State debt management agencies. Mercer Human Resource Consulting provided independent advice in applying the data to the AOFM.

Executive remuneration is reported in Note 12 of Part 4: Financial statements.

Table 2: AOFM salary ranges

	30 June 2008	
	Base Rate	Grade Rate
Classification	$	$
AOFM1	37,082	60,990
AOFM2	57,786	117,522
AOFM3	135,402	169,253
AOFM4	182,112	227,640

To be eligible for a remuneration review, employees must have completed a performance review. Remuneration within the relevant range for the classification depends on the individual performance ratings received. Performance appraisals assess outputs achieved and behaviours exhibited in producing those outputs. There is no performance pay and performance-linked bonuses are not paid.

Non-salary benefits provided to AOFM employees principally comprise superannuation and support for professional development through studies assistance, short courses and payment of job-relevant professional society membership fees. A mobile phone or laptop computer may be provided where there is a business need.

Occupational health and safety

Occupational health and safety services are provided to the AOFM under a Service Level Agreement with the Treasury. The AOFM has one Health and Safety Representative who assists employees in accord with Health and Safety Management Arrangements and the *Occupational Health and Safety Act 1991*.

AOFM staff had access to a number of ongoing health activities in 2007-08, including posture and flexibility, yoga, Tai Chi, Pilates and aerobics classes. Flu vaccinations, health assessments, health information, and dietary assistance were also provided. To prevent injuries in the workplace and to enhance the safety of staff members, workplace assessments were conducted for all new starters. Counselling and other support is available to staff under an Employee Assistance Program provided by Davidson Trahaire.

There were no compensable injury claims in 2007-08. There were no accidents, injuries or dangerous occurrences reported in 2007-08. The AOFM was not the subject of any directions under section 45 of the *Occupational Health and Safety Act 1991*. No notices were given to AOFM under this Act.

Australian Government Disability Strategy

The AOFM follows the Treasury's Workplace Diversity Program and Disability Action Plan in line with the Australian Government Disability Strategy to help eliminate, as far as possible, discrimination on the grounds of disability.

Assets management

The physical assets of the AOFM are managed in accordance with policies and procedures set out in the AOFM's Chief Executive Instructions. The assets are predominantly computers, equipment and leasehold improvements.

Purchasing

The AOFM's policy and procedures on purchasing goods and services are consistent with the requirements of the Commonwealth Procurement Guidelines (January 2005) and are outlined in the Chief Executive Instructions.

ANAO access clauses and exempt contracts

No contract for $100,000 or more was let during the reporting period that did not provide for the Auditor-General to have to access the contractor's premises. No contract in excess of $10,000 (including GST) or standing offer has been exempted from being published in the Purchasing and Disposals Gazette on the basis that it would disclose exempt matters under the *Freedom of Information Act 1982*.

Consultants

The AOFM has policies and procedures to ensure that its procurement activities comply with legislative requirements and government policy, in particular the Commonwealth Procurement Guidelines (2005). The AOFM's Chief Executive Instructions contain additional requirements in relation to the engagement of consultants. These cover the circumstances under which a consultant may be engaged, require that consultancies must be formalised in contracts and provide for appropriate documentation.

During 2007-08, eight new consultancy contracts were entered into involving total actual expenditure of $69,885. In addition, two ongoing consultancy contracts were active during the 2007-08 year, involving total actual expenditure of $130,289.

The numbers for new and ongoing consultancy contracts over the last three years, and expenditure on them, are summarised in Table 3. Details of consultancy contracts of $10,000 or more let during 2007-08 are provided in Table 4.

Table 3: Consultancy contracts

	2005-06	2006-07	2007-08
Number of consultancy contracts			
New Contracts	11	7	8
Ongoing contracts	0	2	2
Expenditure (including GST)			
New Contracts	$251,850	$59,483	$69,885
Ongoing contracts	0	$154,184	$130,289

Table 4: Consultancy contracts of $10,000 or more let during 2007-08

Consultant name	Description	Price	Selection process (a)	Justification (b)
University of Technology Sydney	Research Project	$25,000	Select Tender	C
Finance and Statistical Consultants	Research Project	$25,000	Select Tender	C
Total		**$50,000**		

(a) Select Tender is a procurement process by which the procuring agency selects which potential suppliers are invited to submit tenders under conditions specified in the Commonwealth Procurement Guidelines (January 2005).

(b) Justification for decision to use consultancy:
A — skills currently unavailable within agency
B — need for specialised or professional skills
C — need for independent research or assessment

AOFM

PART 4
FINANCIAL STATEMENTS

INDEPENDENT AUDITOR'S REPORT

To the Treasurer

Scope

I have audited the accompanying financial statements of the Australian Office of Financial Management for the year ended 30 June 2008, which comprise: a statement by the Chief Executive and Chief Financial Officer; income statement; balance sheet; statement of changes in equity; cash flow statement; schedules of commitments and *administered items*; notes to and forming part of the accounts, including a summary of significant accounting policies.

The Responsibility of the Chief Executive for the Financial Statements

The Australian Office of Financial Management's Chief Executive is responsible for the preparation and fair presentation of the financial statements in accordance with the Finance Minister's Orders made under the *Financial Management and Accountability Act 1997* and the Australian Accounting Standards (including the Australian Accounting Interpretations). This responsibility includes establishing and maintaining internal controls relevant to the preparation and fair presentation of the financial statements that are free from material misstatement, whether due to fraud or error; selecting and applying appropriate accounting policies; and making accounting estimates that are reasonable in the circumstances.

Auditor's Responsibility

My responsibility is to express an opinion on the financial statements based on my audit. My audit has been conducted in accordance with the Australian National Audit Office Auditing Standards, which incorporate the Australian Auditing Standards. These Auditing Standards require that I comply with relevant ethical requirements relating to audit engagements and plan and perform the audit to obtain reasonable assurance whether the financial statements are free from material misstatement.

An audit involves performing procedures to obtain audit evidence about the amounts and disclosures in the financial statements. The procedures selected depend on the auditor's judgement, including the assessment of the risks of material misstatement of the financial

GPO Box 707 CANBERRA ACT 2601
19 National Circuit BARTON ACT 2600
Phone (02) 6203 7300 Fax (02) 6203 7777

statements, whether due to fraud or error. In making those risk assessments, the auditor considers internal control relevant to the Australian Office of Financial Management's preparation and fair presentation of the financial statements in order to design audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the Australian Office of Financial Management's internal control. An audit also includes evaluating the appropriateness of accounting policies used and the reasonableness of accounting estimates made by the Australian Office of Financial Management's Chief Executive, as well as evaluating the overall presentation of the financial statements.

I believe that the audit evidence I have obtained is sufficient and appropriate to provide a basis for my audit opinion.

Independence

In conducting the audit, I have followed the independence requirements of the Australian National Audit Office, which incorporate the requirements of the Australian accounting profession.

Auditor's Opinion

In my opinion, the financial statements of the Australian Office of Financial Management:

(a) have been prepared in accordance with the Finance Minister's Orders made under the *Financial Management and Accountability Act 1997,* and the Australian Accounting Standards (including the Australian Accounting Interpretations); and

(b) give a true and fair view of the matters required by the Finance Minister's Orders including the Australian Office of Financial Management's financial position as at 30 June 2008 and its financial performance and its cash flows for the year then ended.

Australian National Audit Office

Warren J. Cochrane
Group Executive Director
Delegate of the Auditor-General

Canberra
15 August 2008

Australian Office of Financial Management

Statement by the Chief Executive Officer and Chief Finance Officer

In our opinion, the attached financial statements for the year ended 30 June 2008 are based on properly maintained records and give a true and fair view of the matters required by the Finance Minister's Orders made under the *Financial Management and Accountability Act 1997,* as amended.

Signed

N Hyden
Chief Executive Officer
15 August 2008

Signed

P Raccosta
Chief Finance Officer
15 August 2008

Income statement

for the year ended 30 June 2008

	Notes	**2008**	2007
		$'000	$'000
REVENUE			
Revenue from government	4A	**8,489**	8,473
Other revenue	4B	**1,464**	1,329
Resources received free of charge		**269**	253
Total revenue		**10,222**	10,055
EXPENSES			
Employee benefits	5A	**4,319**	4,511
Suppliers	5B	**2,786**	3,035
Depreciation and amortisation	5C	**317**	836
Write-down and impairment of assets	5D	**90**	1
Total expenses		**7,512**	8,383
Surplus		**2,710**	1,672

The above statement should be read in conjunction with the accompanying notes.

Balance sheet

as at 30 June 2008

	Notes	**2008**	2007
		$'000	$'000
ASSETS			
Financial assets			
Cash and cash equivalents		**159**	312
Trade and other receivables	6A	**14,454**	11,280
Total financial assets		**14,613**	11,592
Non-financial assets			
Infrastructure, plant and equipment	7A,7C	**620**	859
Intangibles	7B,7C	**418**	525
Other non-financial assets	7D	**40**	71
Total non-financial assets		**1,078**	1,455
Total assets		**15,691**	13,047
LIABILITIES			
Payables			
Supplier	8A	**97**	132
Other payables	8B	**2**	19
Total payables		**99**	151
Provisions			
Employee provisions	9A	**1,071**	1,070
Other provisions	9B	**120**	135
Total provisions		**1,191**	1,205
Total liabilities		**1,290**	1,356
Net assets		**14,401**	11,691
EQUITY(1)			
Contributed equity		**3,423**	3,423
Retained surplus		**10,978**	8,268
Total equity		**14,401**	11,691
Current assets		**609**	583
Non-current assets		**15,082**	12,464
Current liabilities		**971**	1,056
Non-current liabilities		**319**	300

The above statement should be read in conjunction with the accompanying notes.
(1) Refer to the Statement of changes in equity.

Statement of changes in equity

for the year ended 30 June 2008

Item	Retained surplus		Contributed equity		Total equity	
	2008	2007	**2008**	2007	**2008**	2007
	$'000	$'000	**$'000**	$'000	**$'000**	$'000
Opening balance	**8,268**	6,596	**3,423**	3,423	**11,691**	10,019
Surplus for period	**2,710**	1,672	**-**	-	**2,710**	1,672
Closing balance as at 30 June	**10,978**	8,268	**3,423**	3,423	**14,401**	11,691

The above statement should be read in conjunction with the accompanying notes.

Cash flow statement

for the year ended 30 June 2008

	Notes	**2008**	2007
		$'000	$'000
OPERATING ACTIVITIES			
Cash received			
Appropriations		**5,525**	6,126
GST received		**50**	51
Goods and services		**1,254**	1,365
Other cash received		**-**	4
Total cash received		**6,829**	7,546
Cash used			
Employees		**4,326**	4,498
Suppliers		**2,553**	2,811
GST paid		**50**	16
Total cash used		**6,929**	7,325
Net cash from (used by) operating activities	10	**(100)**	221
INVESTING ACTIVITIES			
Cash used			
Purchase of property, plant and equipment		**53**	511
GST paid		**-**	47
Total cash used		**53**	558
Net cash used by investing activities		**(53)**	(558)
FINANCING ACTIVITIES			
Cash received			
Appropriations - contributed equity		**-**	524
Total cash received		**-**	524
Net cash received from financing activities		**-**	524
Net increase (decrease) in cash held		**(153)**	187
Cash at the beginning of the reporting period		**312**	125
Cash at the end of the reporting period		**159**	312

The above statement should be read in conjunction with the accompanying notes.

Schedule of commitments

as at 30 June 2008

	2008 $'000	2007 $'000
BY TYPE		
Other commitments		
Operating leases(a)(b)	**2,424**	3,389
Other commitments(c)	**3,501**	2,452
Total other commitments	**5,925**	5,841
Commitments receivable - GST recoverable on commitments	**85**	55
Net commitments by type	**5,840**	5,786
BY MATURITY		
Operating lease commitments		
One year or less	**323**	411
From one to five years	**1,279**	1,579
Over five years	**822**	1,399
Total operating lease commitments by maturity	**2,424**	3,389
Other commitments		
One year or less	**1,808**	1,477
From one to five years	**1,692**	975
Over five years	**1**	-
Total other commitments by maturity	**3,501**	2,452
Commitments receivable		
One year or less	**41**	42
From one to five years	**44**	13
Total commitments receivable by maturity	**85**	55
Net commitments by maturity	**5,840**	5,786

The above schedule should be read in conjunction with the accompanying notes.

Note: Commitments are GST inclusive and where an input tax credit is available to the AOFM, the recoverable GST is reported in commitments receivable. Commitments were disclosed net of recoverable GST in the 2006-07 financial statements.

(a) Operating leases included are effectively non-cancellable and comprise:

Nature of lease	General description of leasing arrangement
Lease for office accommodation	• The lease term is for 15 years less one day with no option to renew; and • lease payments are subject to review on each second anniversary of the lease commencement date (22 December 2000).
Motor vehicle leases	• The novation of lease rental payments over motor vehicles.

(b) During 2007-08 the AOFM relinquished 176.7 square metres of office accommodation to the Department of the Treasury. The Department of the Treasury has assumed all financial obligations arising from the transfer.

(c) Other commitments relate to contractual obligations for the provision of internal audit services, payroll services, wire services, fiscal agency agreements and service agreements with other parties, including Commonwealth bodies.

Schedule of administered items

	Notes	**2008**	2007
		$'000	$'000
Income and expenses administered on behalf of government			
for the year ended 30 June 2008			
Income before re-measurements			
Non-taxation revenue			
Interest	16A	**2,995,083**	3,133,681
Other revenue	16B	**2,266**	256
Net foreign exchange gains	16C	**754**	902
Total revenue before re-measurements		**2,998,103**	3,134,839
Expenses before re-measurements			
Grants	17A	**30**	31
Interest	17B	**5,350,972**	5,394,975
Total expenses before re-measurements		**5,351,002**	5,395,006
Operating result before re-measurements		**(2,352,899)**	(2,260,167)
Re-measurements			
Net market valuation gains (losses)	18	**(117,648)**	1,014,740
Total re-measurements		**(117,648)**	1,014,740
Net result		**(2,470,547)**	(1,245,427)

The above schedule should be read in conjunction with the accompanying notes.

Schedule of administered items (continued)

	Notes	**2008**	2007
		$'000	$'000
Assets administered on behalf of government *as at 30 June 2008*			
Financial assets			
Cash and cash equivalents	19A	**622**	867
Receivables	19B	**2,836,521**	2,903,786
Investments (under FMA section 39)	19C	**29,098,675**	20,378,564
Accrued revenue	19D	**502**	532
Total assets administered on behalf of government		**31,936,320**	23,283,749
Liabilities administered on behalf of government *as at 30 June 2008*			
Interest bearing liabilities			
Commonwealth Government Securities	20A	**58,399,722**	56,557,075
Total interest bearing liabilities		**58,399,722**	56,557,075
Payables			
Other payables	20B	**1,040,988**	581,194
Total payables		**1,040,988**	581,194
Total liabilities administered on behalf of government		**59,440,710**	57,138,269
Net assets administered on behalf of government	21	**(27,504,390)**	(33,854,520)
Current assets		**29,101,411**	20,380,350
Non-current assets		**2,834,909**	2,903,399
Current liabilities		**5,328,765**	3,021,710
Non-current liabilities		**54,111,945**	54,116,559

The above schedule should be read in conjunction with the accompanying notes.
FMA = *Financial Management and Accountability Act 1997*.

Schedule of administered items (continued)

	2008 $'000	2007 $'000
Administered cash flows		
for the year ended 30 June 2008		
OPERATING ACTIVITIES		
Cash received		
Interest(a)	**1,362,492**	1,370,036
Other	**2,266**	256
Total cash received	**1,364,758**	1,370,292
Cash used		
Interest(a)	**3,589,697**	3,485,713
Total cash used	**3,589,697**	3,485,713
Net cash used by operating activities	**(2,224,939)**	(2,115,421)
INVESTING ACTIVITIES		
Cash received		
Repayments of advances and loans	**88,650**	86,533
Total cash received	**88,650**	86,533
Net cash from investing activities	**88,650**	86,533
FINANCING ACTIVITIES		
Cash received		
Proceeds from borrowings(b)	**4,937,916**	5,157,697
Term deposit maturities	**310,050,000**	253,400,000
Other	**361**	93
Total cash received	**314,988,277**	258,557,790
Cash used		
Repayment of borrowings(c)	**2,922,910**	6,103,749
Term deposit investments	**318,750,000**	255,600,000
Total cash used	**321,672,910**	261,703,749
Net cash used by financing activities	**(6,684,633)**	(3,145,959)
Net decrease in cash held	**(8,820,922)**	(5,174,847)
Cash at the beginning of the reporting period	**867**	1,698
Cash from Official Public Account		
Appropriations	**325,333,975**	265,249,132
Special accounts	**394**	135
	325,334,369	265,249,267
Cash to Official Public Account		
Receipts	**(316,513,331)**	(260,075,158)
Special accounts	**(361)**	(93)
	(316,513,692)	(260,075,251)
Cash at the end of the reporting period	**622**	867

The above schedule should be read in conjunction with the accompanying notes.

(a) Master Agreements between the Australian Government and interest rate swap counterparties provide for transactions to be settled on a net basis. Amounts above are reported on a net basis. Net swap interest receipts for 2007-08 were $36.479 million ($92.355 million for 2006-07), whilst aggregate swap interest receipts for 2007-08 were $1,698.469 million ($1,792.139 million for 2006-07). Net swap interest payments for 2007-08 were $150.478 million ($40.233 million for 2006-07), whilst aggregate swap interest payments for 2007-08 were $1,812.468 million ($1,740.017 million for 2006-07).

(b) Excludes accrued interest received on issuance which is recorded as an offset against interest payments.

(c) Includes redemption of debt issued on behalf of the States.

Notes to and forming part of the financial statements

for the year ended 30 June 2008

Note 1: Summary of significant accounting policies

1.1 Basis of preparation of the financial statements

The Australian Office of Financial Management (AOFM), a 'prescribed agency' under the *Financial Management and Accountability Act 1997* (Commonwealth), is responsible for the Australian Government's debt management activities. The financial statements cover the AOFM as an individual entity and are for the reporting period 1 July 2007 to 30 June 2008. They are required by section 49 of the *Financial Management and Accountability Act 1997*, and are a general purpose financial report prepared on a going concern basis.

The financial statements have been prepared in accordance with:

- Finance Minister's Orders (FMOs) (being the *Financial Management and Accountability Orders* (Financial Statements for reporting periods ending on or after 1 July 2007));
- Australian Accounting Standards, including Interpretations issued by the Australian Accounting Standards Board (AASB) that apply for the reporting period; and
- other authoritative pronouncements of the AASB, which includes the Framework for the Preparation and Presentation of Financial Statements.

The financial statements have been prepared on an accruals basis under the historic cost accounting convention, as modified by the revaluation of certain classes of financial assets and financial liabilities (including derivative financial instruments) at fair value through profit or loss, certain classes of property, plant and equipment and employee entitlements.

The financial statements are presented in Australian dollars and values are rounded to the nearest thousand dollars unless disclosure of the full amount is specifically required by the FMOs.

Liabilities and assets which are unrecognised in the Balance Sheet or Schedules of Assets and Liabilities Administered on Behalf of Government are reported in the Schedule of Contingencies (where applicable) or where remote or unquantifiable, as contingencies reported at Note 11 (departmental) and Note 22 (administered).

The continued existence of the AOFM in its present form, and with its present program, is dependent on government policy and on continuing appropriations by Parliament for the AOFM's administration and program.

Administered revenue, expenses, assets, liabilities and cash flows reported in the Schedule of Administered Items and related Notes are accounted for on the same basis and using the same policies as for departmental items, except where otherwise stated.

1.2 Communications Fund

In 2005-06 the Communications Fund was established under the *Telecommunications (Consumer Protection and Service Standards) Act 1999* to fund improvements in telecommunication services in regional, rural and remote parts of Australia. The AOFM has been authorised by the responsible Ministers (the Minister for Broadband, Communications and the Digital Economy and the Minister for Finance and Deregulation) to make investments on behalf of the Department of Broadband, Communications and the Digital Economy (DBCDE). These investments and their earnings are reported by DBCDE and not the AOFM. See Note 30 for additional information.

1.3 Significant accounting estimates and judgments

No accounting assumptions or estimates have been identified that have a significant risk of causing a material adjustment to carrying amounts of assets and liabilities within the next reporting period.

1.4 Statement of compliance with International Financial Reporting Standards

In some circumstances compliance with Australian Equivalents to International Financial Reporting Standards will not lead to compliance with International Financial Reporting Standards. Paragraph 14 of AASB 101 *Presentation of Financial Statements* requires that where an entity's financial statements comply with International Financial Reporting Standards, then such compliance shall be made in an explicit and unreserved statement in the notes to the financial statements.

These financial statements and associated notes do not fully comply with International Financial Reporting Standards, due to the application of not-for-profit paragraphs contained in AASB 116 *Property, Plant and Equipment*.

(a) New Australian Accounting Standards applicable to the reporting period

AOFM has adopted AASB 7 *Financial Instruments: Disclosures* which became applicable for reporting periods beginning on or after 1 January 2007. AASB 7 requires qualitative and quantitative disclosure of financial risks faced by the AOFM arising from holding financial instruments. The Standard also requires a sensitivity analysis of market risks to which the AOFM is exposed to at the end of the financial year. This information is provided at Note 24.

(b) New Australian Accounting Standards applicable in future reporting periods

The AOFM is not aware of any new Australian Accounting Standard that has been issued but is not yet effective whose application will have an impact on the AOFM's financial results or financial position in future reporting periods.

In accordance with Section 11 of the FMOs, the AOFM is not permitted to adopt a new accounting Standard or AASB Interpretation earlier than its effective date of application without

the approval of the Department of Finance and Deregulation Chief Executive. The AOFM has not early adopted a new Australian Accounting Standard or AASB Interpretation.

1.5 Departmental and administered items

Departmental assets, liabilities, revenue and expenses are those items that are controlled by the AOFM and used or incurred to deliver goods and services to government, including:

- computers, plant and equipment;
- liabilities for employee entitlements;
- revenue from user charging, sale of property assets, etc, where the proceeds are deemed appropriated under the *Financial Management and Accountability Act 1997*; and
- employee expenses and other administrative expenses.

Administered assets, liabilities, revenue and expenses are those items which are controlled by the government and managed or overseen by the AOFM on behalf of the government. These items include the repayment and repurchase of debt, swap transactions, grant payments to other governments and interest payments on debt.

The purpose of the separation of administered and departmental items is to enable assessment of the administrative efficiency of the AOFM in providing goods and services to the government.

Administered items are identified separately in the financial statements by shading.

1.6 Revenue (Departmental)

The revenue described in this Note is revenue relating to the departmental activities of the AOFM.

(a) Revenue from government — output appropriations

The full amount of the appropriation for departmental outputs for the year (less any formal reductions) is recognised as revenue.

Appropriation receivables are recognised (at their nominal amounts) for output appropriations that are undrawn by the AOFM and have not lapsed.

(b) Resources received free of charge

Resources received free of charge are recognised as revenue when, and only when, a fair value can be reliably determined and the services would have been purchased if they had not been donated. Use of those resources is recognised as an expense.

Contributions of assets at no cost of acquisition are recognised as revenue at their fair value when the asset qualifies for recognition.

(c) Other revenue

Revenue from the rendering of a service is recognised by reference to the stage of completion of contracts or other agreements to provide the service.

1.7 Transactions with the government as owner (Departmental)

(a) Equity injections

Appropriations designated as 'equity injections' (less any formal reductions) are recognised directly in Contributed Equity in the Balance Sheet in the financial year that the appropriation takes effect.

Appropriation receivables are recognised (at their nominal amounts) for equity injections that are undrawn by the AOFM and have not lapsed.

The AOFM was not appropriated any equity injections from government for 2007-08 (nil for 2006-07).

(b) Distributions to owners

Distributions to owners are debited to Contributed Equity in the Balance Sheet unless the distributions are in the nature of a dividend. Dividends are debited to Retained Surplus in the Balance Sheet.

The AOFM did not make a distribution to owners during 2007-08 (nil for 2006-07).

1.8 Employee benefits (Departmental)

Liabilities for services rendered by employees are recognised at the end of the financial year to the extent that they have not been settled.

(a) Leave

The liability for employee benefits includes provisions for annual leave and long service leave. No provision has been made for sick leave as all sick leave is non-vesting and the average sick leave taken in future years by employees of the AOFM is estimated to be less than the annual entitlement for sick leave.

The leave liabilities are calculated on the basis of employees' remuneration at the end of the financial year adjusted for expected increases in remuneration effective from 1 July 2008.

Liabilities for short-term employee benefits (such as wages and salaries and annual leave expected to be settled within 12 months from the end of the financial year) are measured at their nominal amounts.

All long service leave employee benefits are measured at the present value of the estimated future cash flows to be made in respect of all employees at the end of the financial year. In determining the present value of the long service leave liability, the AOFM has commissioned an actuarial assessment by the Australian Government Actuary of the anticipated attrition rates and pay increases through promotion and inflation. The Australian Government Actuary has recommended the application of the shorthand method, as prescribed by Section 43.3 of the FMOs, for determining the present value of the long serve leave liability.

(b) Superannuation

Staff of the AOFM contribute to the Commonwealth Superannuation Scheme (Defined Benefit), Public Sector Superannuation Scheme (Defined Benefit), Public Sector Superannuation Scheme (Accumulation Plan) and other employee nominated schemes. Employer contributions (including productivity contributions) of $715,371 have been made to these schemes during the financial year (2006-07: $717,479).

The AOFM makes employer contributions to the Australian Government at rates determined by an actuary to be sufficient to meet the cost to the government of the superannuation entitlements of its employees. The liability for defined superannuation benefits payable to an employee upon termination is recognised in the financial statements of the Department of Finance and Deregulation and is settled by the Australian Government in due course.

An on-cost liability, based on actuarial assessment, has been recognised in the Balance Sheet for employer superannuation contributions payable on accrued annual and long service leave as at the end of the financial year. Employer superannuation contributions are payable on leave benefits that are taken during service, but are not payable on leave benefits paid out on termination.

In addition, a liability has been recognised at the end of the financial year for outstanding superannuation contributions payable in relation to the final fortnight of the financial year.

1.9 Leases (Departmental)

A distinction is made between finance leases and operating leases. Finance leases effectively transfer from the lessor to the lessee substantially all risks and benefits incidental to ownership of leased non-current assets. Under operating leases the lessor effectively retains substantially all such risks and benefits.

The AOFM holds operating leases only. Operating lease payments are charged to the Income Statement on a straight-line basis which is representative of the pattern of benefits derived from the leased assets.

1.10 Cash (Departmental)

Cash means notes and coins held and any deposits held at call with a bank. Deposits held with a bank that are not at call are classified as investments. Cash is recognised at its nominal amount.

1.11 Financial instruments (Departmental)

The AOFM recognises a financial asset or financial liability on its Balance Sheet when and only when, it becomes a party to the contractual provisions of the instrument. A financial asset is de-recognised when the right to receive cash flows from the financial asset has expired and substantially all the risks and rewards of ownership have been transferred to another party. A financial liability is de-recognised when the obligation in the contract is discharged, cancelled or has expired.

The AOFM classifies its financial assets as loans and receivables. Loans and receivables primarily comprise amounts due from other parties for the reimbursement of staff costs associated with staff secondments. Loans and receivables are initially recognised at fair value and are subsequently measured at amortised cost. Amounts due from the Official Public Account (OPA) for undrawn departmental appropriations are not financial instruments as they are not contractually based.

Financial liabilities represent trade creditors and accruals and are recognised at the amounts at which they expect to be settled.

All financial assets and financial liabilities are denominated in Australian dollars, are non-interest bearing and their fair values approximate their carrying values and accordingly the AOFM is not exposed to interest rate risk or exchange rate risk on its departmental financial instruments. The AOFM's maximum exposure to credit risk on departmental financial assets approximates their carrying values. The AOFM's exposure to credit risk on its departmental financial instruments is immaterial.

1.12 Infrastructure, plant and equipment (Departmental)

(a) Asset recognition threshold on acquisition

Purchases of infrastructure, plant and equipment are recognised initially at cost in the Balance Sheet, except for purchases costing less than $500, which are expensed at the time of acquisition. The asset recognition threshold is applied to each functional asset. That is, items or components that form an integral part of an asset are grouped as a single asset.

(b) Revaluations

Basis

Following initial recognition at cost, valuations are conducted with sufficient frequency to ensure that the carrying amounts of assets do not materially differ with the assets' fair values as at the reporting date, in accordance with AASB 116 *Property, Plant and Equipment*.

Fair value has been determined as depreciated replacement cost for leasehold improvements and market selling price in an active market for computers, plant and equipment.

Revaluation adjustments are made on a class basis. Revaluation increments are credited directly to the revaluation reserve in Equity except to the extent that they reverse a previous revaluation decrement of the same asset class. Revaluation decrements for a class of assets are recognised as an expense directly through the Income Statement except to the extent that they reverse a previous revaluation increment for that class. Upon disposal, any revaluation reserve relating to the particular asset being sold is transferred to Retained Surplus.

For all assets, excluding leasehold improvements, any accumulated depreciation as at the revaluation date is eliminated against the gross carrying amount of the asset. For leasehold improvements, accumulated amortisation on revaluation is restated proportionately in accordance with the gross carrying amount of the asset.

Frequency

Infrastructure, plant and equipment is formally revalued every three years. All infrastructure, plant and equipment assets were last revalued as at 1 April 2006.

Assets acquired after the commencement of a revaluation are not captured by the revaluation then in progress.

Conduct

All valuations are conducted by an independent qualified valuer.

(c) Impairment of non-current assets

All assets were assessed for impairment at the end of the financial year. An impairment provision was not required.

(d) Depreciation and amortisation

The depreciable value of infrastructure, plant and equipment assets is written off over the estimated useful lives of the assets to the AOFM using the straight line method of depreciation. Leasehold improvements are amortised on a straight line basis over the lesser of the estimated useful life of the improvements or the unexpired period of the lease.

Depreciation and amortisation rates (useful lives) and methods are reviewed regularly and necessary adjustments are recognised in the current, or current and future reporting periods, as appropriate.

The depreciable value of infrastructure, plant and equipment assets is based on a zero residual value.

Depreciation and amortisation expenses have been determined by applying rates to new depreciable assets based on the following useful lives:

Sub-class of depreciable asset	**2008**	2007
Leasehold improvements	lease term	lease term
Computers	3-5 years	3-5 years
Office equipment	5 years	5 years
Furniture	10 years	10 years

The aggregate amount of depreciation and amortisation allocated for each class of asset during the reporting period is disclosed at Note 5C.

1.13 Computer software (Departmental)

Purchases of computer software are recognised at cost in the Balance Sheet except for purchases costing less than $10,000, which are expensed at the time of acquisition.

An item of software represents:

- a software licence granted for greater than 12 months; or
- a developed software application.

Developed software is recognised by capitalising all directly attributable internal and external costs that enhance the software's functionality and therefore service potential.

Software assets are amortised on a straight line basis over their anticipated useful lives, being three to five years (2006-07: three to five years). Software assets are not subject to revaluation.

An impairment assessment was made as at the end of the financial year and an impairment provision was not required.

1.14 Taxation (Departmental)

The AOFM is exempt from all forms of taxation except for Fringe Benefits Tax (FBT) and the Goods and Services Tax (GST).

Revenue, expenses, assets and liabilities are recognised net of GST, except:

- where the amount of GST incurred is not recoverable from the Australian Taxation Office; and
- for receivables and payables (where GST is applicable).

Receipts and payments in the Cash Flow Statement are recorded in gross terms (that is, at their GST inclusive amounts).

All supplies provided by the AOFM are input taxed under the GST legislation with exception of remuneration benefits provided to staff, services arising from the management of the Communications Fund and staff secondments in Australia. In accordance with applicable GST regulations the AOFM is entitled to a reduced input tax credit (equal to 75 per cent of the GST paid) on some purchases, such as security transaction services, which are applied in making input taxed supplies.

1.15 Reporting of administered activities

Administered revenue, expenses, assets, liabilities and cash flows are presented in the Schedule of Administered Items and related Notes. Except where otherwise stated, administered items are prepared on the same basis of accounting and using the same policies as for departmental items, including the application of Australian Accounting Standards.

(a) Administered cash transfers to and from the Official Public Account

Administered appropriations from the OPA (such as appropriations for the repayment of borrowings) or transfers by the AOFM of administered receipts to the OPA (such as proceeds from the issuance of securities) are not reported in the administered financial statements. This accounting treatment seeks to report the government's transactions with parties outside the General Government Sector and acknowledges that these transactions are internal to the Administered entity. An exception to the above policy relates to the disclosure of administered cash flows, given that cash transferred between the OPA and AOFM's administered bank accounts is necessary for the completeness of the cash flow disclosures.

1.16 Exemption from FMOs

Section 17.5 of the FMOs provides an exemption to the AOFM from presenting the Schedule of Income and Expenses Administered on Behalf of Government, and associated Notes, as set out in the Annexure to the FMOs. Instead the AOFM is required to comply with AASB 101 *Presentation of Financial Statements* for presenting its administered revenue and expenses.

Paragraph 83 of AASB 101 encourages reporting entities to adopt an Income Statement presentation that is most relevant to users in understanding the entity's financial performance.

With the adoption of fair value through profit or loss measurement for certain classes of financial assets and financial liabilities the AOFM has presented its administered revenue and expenses into two categories:

- operating result before re-measurements; and
- re-measurements.

The category 'operating result before re-measurements' records a financial result that is consistent with an accruals (or amortised cost) basis of accounting under the historic cost accounting convention and is most relevant to the AOFM's role in managing its debt portfolio whereby debt and financial instruments are predominately issued and held to maturity (and with portfolio restructuring a rarity).

The category 're-measurements' provides information on the unrealised changes in the market valuation of the portfolio of administered financial assets and financial liabilities during the financial year. This is relevant for assessing changes in financial risk exposures and the value of transactions managed from year to year. In an issue and hold to maturity strategy the revaluation effect will net to zero over the life of a financial instrument.

1.17 Recognition and de-recognition of financial instruments

The AOFM recognises a financial asset or financial liability in its Schedules of Assets and Liabilities Administered on Behalf of Government when and only when it becomes a party to the contractual provisions of the instrument. A financial asset is de-recognised when the right to receive cash flows from the financial asset has expired and substantially all the risks and rewards of ownership have been transferred. A financial liability is de-recognised when the obligation in the contract is discharged, cancelled or has expired.

The AOFM currently accounts for purchases and sales of financial instruments on a trade date basis, i.e. the date on which transactions are entered into. Depending on the transaction type this may be several days prior to settlement.

1.18 Classification and measurement of financial instruments

The AOFM classifies its financial assets in the following categories: financial assets at fair value through profit or loss and loans and receivables. The AOFM classifies its financial liabilities in the following categories: financial liabilities at fair value through profit or loss and other financial liabilities.

The AOFM has determined the classifications on the basis of how it manages and assesses the performance of its financial assets and financial liabilities. Where management monitors cost and risk in mark-to-market terms (and not necessarily only in those terms) in accordance with a documented risk management framework, the AOFM has classified the relevant financial assets and liabilities at fair value through profit or loss.

(a) Non-derivative financial assets at fair value through profit or loss

A non-derivative financial asset is classified at fair value through profit or loss if it is used by the AOFM to manage its short term or long term financing objectives in accordance with a documented risk management framework.

Currently, this category comprises term deposit investments held with the Reserve Bank of Australia (RBA). Under section 39(2) of the *Financial Management and Accountability Act 1997*, the AOFM invests public money in authorised term deposit investments for the purpose of managing the balance of the OPA.

These assets are measured at fair value on initial recognition and at fair value on subsequent measurement. Changes in carrying value are attributed between changes in amortised cost of the asset and other changes. Changes attributable to amortised cost are recognised as Interest Revenue in the Schedule of Income and Expenses Administered on Behalf of Government. Other changes (including changes in valuation due to a change in interest rates) are recognised as Re-measurements in the Schedule of the Income and Expenses Administered on Behalf of Government.

(b) Loans and receivables

Loans and receivables are non-derivative financial assets with fixed or determinable payments that are not quoted in an active market. The AOFM classifies a financial asset as a loan and receivable (as opposed to a financial asset at fair value through profit or loss) in circumstances where the asset is not being managed in mark-to-market terms in accordance with a documented risk management framework.

Currently, this category comprises debt on allocation and advances made to the State and Territory governments.

Until July 1990, the Australian Government borrowed on behalf of the State and Territory governments and allocated a portion of the proceeds of its Treasury Bond raisings to those governments to fund the redemption of previous allocations of raisings. Until 1986, the Australian Government also borrowed on behalf of the State and Territory governments to raise new borrowings. In addition to Treasury Bond allocations, there are outstanding balances on stock issued by the States prior to 1 January 1924 and taken over by the Australian Government in 1927 (under the original *Financial Agreement Act*). The States and Territories are responsible for meeting all obligations as to interest and principal on the debt

on allocation to them in accordance with the provisions of the *Financial Agreement Act 1994* (the current agreement). As at 30 June 2008 approximately $11 million of perpetual debt with no fixed maturity date remained outstanding under the arrangements governed by the *Financial Agreement Act 1994* ($11 million as at 30 June 2007). All other debt has been redeemed. Redemption of the perpetual debt is at the discretion of the relevant State.

In addition to debt governed by the *Financial Agreement Act 1994*, the Australian Government previously made advances to the State and Territory governments under Commonwealth-State financing arrangements, which were not evidenced by the issue of securities (namely, housing advances and specific purpose capital advances). The principal value of these advances outstanding (for which AOFM is responsible for administering) was $3,253 million as at 30 June 2008 ($3,342 million as at 30 June 2007).

Loans and receivables assets are measured at fair value on initial recognition and at amortised cost on subsequent measurement using the effective interest method. Changes in carrying value are recognised as Interest Revenue in the Schedule of Income and Expenses Administered on Behalf of Government.

For financial assets measured at amortised cost, interest revenue earned but not yet received is recognised as Accrued Revenue in the Schedule of Assets Administered on Behalf of Government.

AOFM assesses at each balance date whether there is any evidence of impairment. If there is evidence that an impairment has occurred, the amount of the loss is measured as the difference between the asset's carrying value and the present value of the expected future cash flows, discounted at the financial asset's original effective interest rate.

(c) Non-derivative financial liabilities at fair value through profit or loss

A non-derivative financial liability is classified at fair value through profit or loss if it is used by the AOFM to manage its short term or long term financing objectives in accordance with a documented risk management framework. Currently this category comprises all Commonwealth Government Securities (CGS) debt with exception to debt on allocation to State and Territory governments and overdues.

These liabilities are measured at fair value on initial recognition and at fair value on subsequent measurement. Changes in carrying value are attributed between changes in amortised cost of the liability and other changes. Changes attributable to amortised cost are recognised as Interest Expense in the Schedule of Income and Expenses Administered on Behalf of Government. That is, where a security is issued at a premium or discount to its par value, the premium or discount is recognised at that time and included in the carrying value of the liability. The premium or discount is amortised over the life of the security using the effective interest method. Other changes (including changes in valuation due to a change in interest rates) are recognised as Re-measurements in Schedule of Income and Expenses Administered on Behalf of Government.

For Treasury Capital Indexed Bonds, the principal value appreciates over time with the rate of inflation (in line with a six month lagged consumer price index). As future inflation rates are uncertain, an estimate of the Australian Government's future redemption cost on maturity is not disclosed in the financial statements. Capital accretion is recognised in Interest Expense.

There are no options available to either party to exchange or convert CGS (excluding those held as an investment in the Treasurer's name — see Note 1.20(e)). There are also no options to either party for early settlement.

(d) Other non-derivative financial liabilities

Financial liabilities that are not used by the AOFM to manage its short term or long term financing objectives in accordance with a documented risk management framework are classified as other financial liabilities. This category comprises debt on allocation to State and Territory governments and overdues.

These liabilities are measured at fair value on initial recognition and at amortised cost on subsequent measurement using the effective interest method. Changes in carrying value are recognised as Interest Expense in the Schedule of Income and Expenses Administered on Behalf of Government.

For financial liabilities measured at amortised cost, interest incurred but not yet paid is recognised as Payables in the Schedule of Liabilities Administered on Behalf of Government.

(e) Derivative financial instruments

Derivatives are required by AASB 139 *Financial Instruments: Recognition and Measurement* to be measured at fair value on initial recognition and at fair value on subsequent measurement. The accounting for changes in fair value depends on whether the derivative is designated as a hedging instrument, and on the nature of the hedge.

During the reporting period the AOFM used domestic interest rate swaps to manage the interest rate risk on its net CGS debt portfolio. The AOFM has not designated a hedge relationship between its derivatives and physical CGS debt portfolio. Accordingly, the AOFM's domestic interest rate swaps must be classified at fair value through profit or loss. Refer to Note 2 and Note 3 for details on the AOFM's use of interest rate swaps.

Changes in carrying value are attributed between changes in amortised cost of the swap and other changes. Changes attributable to amortised cost are recognised as Interest Expense (for the pay leg) and as Interest Revenue (for the receive leg) in the Schedule of Income and Expenses Administered on Behalf of Government. Other changes (including changes in valuation due to a change in interest rates) are recognised as Re-measurements in the Schedule of Income and Expenses Administered on Behalf of Government.

No swap debtors have been assessed as being unable to meet contractual obligations due to the Australian Government as at 30 June 2008 (nil for 2006-07). Consequently, the AOFM has not included an allowance for uncollectability for amounts due on interest rate swap contracts.

1.19 Fair value estimation of financial instruments

Where a financial instrument is traded in an active market, fair value is based on quoted market rates, as at the end of the financial year. Where market rates are unavailable because a financial asset or financial liability is not traded in an active market, subjective judgments and valuation techniques may be used, including quotes for similar instruments and discounted cash flow analysis.

(a) Non-derivative financial instruments at fair value

The fair values of domestic CGS and term deposit investments with the RBA are based on discounted cash flows using a zero coupon curve valuation methodology created from observable market rates. The zero coupon curve is based on market yields of the most liquid components of the domestic CGS debt portfolio as at the end of the financial year.

As the secondary market for the Australian Government's foreign currency denominated debt is largely illiquid, the valuation approach for foreign currency denominated debt is based on deposit and swap rates in each relevant foreign currency.

(b) Derivative financial instruments

The net fair value of domestic interest rate swaps is based on discounted cash flows using a zero coupon curve valuation methodology created from observable market swap rates as at the end of the financial year.

1.20 Other significant administered accounting policies

(a) Revenue

All administered revenue is revenue relating to the activities performed by the AOFM on behalf of the Australian Government.

Interest revenue is earned on loans to State and Territory governments, term deposit investments and the receive legs of interest rate swaps. Interest is credited to revenue as it accrues and is calculated on an amortised cost basis using the effective interest method.

Net interest earnings on securities lending are reported as revenue when received.

(b) Grants

Under the *Financial Agreement Act 1994*, the Australian Government assists the State and Territory governments to redeem maturing debt on allocation to them. Payments made to the State and Territory governments under these arrangements are recognised as grants expenses as and when they fall due and payable.

(c) Borrowing costs

In accordance with Section 20.1 of the FMOs borrowing costs are expensed as incurred. Under AASB 123 *Borrowing Costs*, borrowing costs attributable to a qualifying asset may be capitalised. A qualifying asset is an asset that takes a substantial period of time to get ready for its intended use or sale. The AOFM's borrowing program does not specifically raise funds for qualifying assets.

(d) Cash

The AOFM maintains two operational bank accounts with the RBA. Interest is not paid on these accounts.

Deposits are recognised at their nominal amounts.

(e) Administered investments in Commonwealth Government Securities

The face value of Australian Government issued securities held as an investment in the Treasurer's name through the investment power under the *Financial Management and Accountability Act 1997* is deducted from the face value of the administered borrowings liability. Any gain or loss on acquiring investments, calculated on a first-in-first-out basis is reported in the Schedule of Income and Expenses Administered on Behalf of Government and recognised at the time the investment is made.

The net effect of this accounting policy is to report the impact of transactions with external parties only.

Australian Government issued securities held as an investment are available for securities lending (see Note 1.20(f)).

(f) Securities lending facility

The AOFM has a securities lending facility available for Treasury Bonds. The facility is operated by the RBA and is governed by the terms and conditions of an agency agreement between the RBA and the AOFM. The purpose of the facility is to enhance the efficiency of the bond market by allowing bond market participants to borrow Treasury Bonds (generally for a period of no more than several days) when they are not readily available from other sources in the market.

The securities lending facility operates by entering into two simultaneous repurchase agreements with the party wishing to borrow securities — a repurchase agreement (the sale of Treasury Bonds to the party and agreement to buy them back at a future time at an agreed price) and a reverse-repurchase agreement (the purchase of CGS from the party and agreement to sell them back at a future time at an agreed price). The net effect of these two transactions is that the Australian Government holds CGS as security, and not cash.

The exchange is market value matched subject to a two per cent initial margin imposed by the AOFM for credit risk mitigation purposes. There is provision for making margin calls after initial exchange where the CGS pledged as collateral by the other party falls in value relative to the Treasury Bonds loaned under the facility. The repurchase and reverse-repurchase agreements are at-call, that is, they do not have set terms.

Interest is payable under the facility. The interest rate payable by the other party is the target inter-bank lending rate. The interest rate payable by the Australian Government is the target inter-bank lending rate less 300 basis points. Net interest earnings of the Australian Government are reported as revenue when received. The temporary purchase and sale of CGS under the facility is recorded off-balance sheet. See Note 25 for details of transactions undertaken during the financial year under the facility.

(g) Foreign currency

Transactions denominated in a foreign currency are converted at the exchange rate at the date of the transaction. Foreign currency receivables and payables are translated at the exchange rates current as at the end of the financial year. Net foreign exchange gains and losses (both realised and unrealised) arising from foreign currency transactions are reported in the Schedule of Income and Expenses Administered on Behalf of Government.

Note 2: Objectives of the AOFM

The AOFM manages a portfolio of debt and associated financial assets on behalf of the Australian Government. It issues Treasury Bonds to support the Treasury Bond and Treasury Bond futures markets, manages the government's cash, invests in term deposits with the RBA and conducts interest rate swaps to reduce the cost of borrowing, subject to acceptable risk. It undertakes the administration, financial and operational risk management, and financial reporting of its portfolio of CGS debt, term deposits and interest rate swaps.

The AOFM issues Treasury Bonds in accordance with the government's policy of issuing in order to maintain 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. The maturities of the bonds issued are chosen to support the 3-year and 10-year bond futures baskets.

The AOFM manages the cost and risk inherent in the debt on issue by executing domestic interest rate swaps to achieve lower public debt servicing costs, while at the same time keeping the variability of cost to an acceptable level. Three interest rate swaps were executed in 2007-08, the last on 15 November 2007.

The AOFM manages the overall level of cash in the OPA by making short term deposits with the RBA to offset fluctuations in the daily flows in and out of the OPA. It may also make short term borrowings from the public by issuing Treasury Notes, although this has not been necessary in the last five years. The OPA is part of the Balance Sheet of the Department of Finance and Deregulation and not part of the AOFM's Balance Sheet.

On 20 May 2008 the Treasurer announced the government's decision to increase future issuance of Treasury Bonds to ensure that there are sufficient Treasury Bonds on issue to support the Treasury Bond and Treasury Bond futures markets. He also announced that the proceeds of the increased bond issuance would be placed with the AOFM to invest and that the AOFM's investment powers would be enhanced to allow it to invest in a broader range of assets. Legislation to implement these changes was passed by the Parliament in June 2008 and received Royal Assent in July 2008.

The AOFM's borrowing and portfolio management activities comply with applicable accounting standards and legislative requirements. The key legislative mechanisms that governed these activities during the reporting period were as follows:

- the *Loans Redemption and Conversion Act 1921* gives the Treasurer the power to borrow money necessary for the purpose of paying off, repurchasing or redeeming any loan in accordance with the Act;

- the *Commonwealth Inscribed Stock Act 1911* and associated regulations represent the Australian Government's primary vehicle for the creation and issuance of domestic stock prescribed under the Act, including Treasury Bonds and Treasury Notes;

- the *Loans Securities Act 1919* provides the Australian Government with additional borrowing flexibility by allowing overseas borrowings and borrowings in foreign currencies and by providing an explicit authority to enter into swaps and other financial agreements;

- the *Loans (Temporary Revenue Deficits) Act 1953* gives the Treasurer the power to borrow to meet within year deficits of the Consolidated Revenue Fund. All borrowings raised under the authority of this Act must be repaid in the same financial year;

- the *Financial Agreement Act 1994* formalises revised debt consolidation and redemption arrangements applying since 1 July 1990 between the Australian Government and the States and Territories; and

- section 39(2) of the *Financial Management and Accountability Act 1997* gives the Treasurer the power to invest public money in authorised investments.

Note 3: Financial risk management

The AOFM is exposed to risks arising from financial instruments on its administered Balance Sheet comprising interest rate risk, exchange rate risk, liquidity risk and credit risk. These risks are managed within a financial risk management framework that includes policies and limits approved by the Secretary to the Treasury and overseen by the CEO and senior management of the AOFM. The Secretary to the Treasury is advised by the AOFM Advisory Board.

Timing mismatches between the Australian Government's receipts and expenditures cause large fluctuations in the volume of short term assets held by the AOFM, and thus in the overall size of its net portfolio, relative to the gross volume of debt outstanding. To provide stability in the management of the longer term component of its debt, long term financing and short term financing are managed through separate sub-portfolios, the long term debt portfolio and the cash management portfolio.

(a) Interest rate risk management policy

Interest rate risk represents the risk to debt servicing costs and to the value of debt and financial assets caused by changes in interest rates. The AOFM does not conduct trading activities in financial instruments; instead it has a strategy of passively issuing and holding to maturity. Accordingly, the primary measure used to assess cost is the accruals basis of accounting under the historic cost accounting convention. Market value cost measures (which include unrealised changes in the valuation of financial assets and financial liabilities due to changes in interest rates) are considered to be secondary.

The AOFM manages the cost and interest rate risk of its long term debt portfolio by executing domestic interest rate swaps in accordance with its interest rate risk management policy. In this it is guided by reference to a benchmark portfolio that reflects the desired trade-off between expected cost and potential variability around the expected cost. A review of the benchmark portfolio and the assumptions supporting it is undertaken annually. In conjunction with the annual benchmark review, the Secretary to the Treasury sets limits on the volume of domestic interest rate swaps that may be undertaken during the financial year. The CEO of the AOFM determines the swap program within these limits. The 2008 review concluded that the interest rate risk management policy should be changed in 2008-09 and that interest rate swaps will not be undertaken.

The cost and interest rate risk of the long term debt portfolio are regularly measured and reported to senior management, the Secretary to the Treasury and the AOFM Advisory Board. The performance of the portfolio is also assessed relative to the imputed performance of the benchmark portfolio, and stress testing of cost and interest rate risk outcomes is undertaken against alternative interest rate and volume scenarios.

The interest rate risk on the cash management portfolio is managed, subject to liquidity requirements, against limits on the modified duration of the portfolio. Adherence to these limits is monitored by senior management.

(b) Exchange rate risk

Exchange rate risk arises from debt denominated in foreign currency. The Australian Government's policy is to reduce its foreign currency denominated debt to zero. Only a small residual amount of such debt remains in the AOFM's portfolio and the AOFM seeks to repurchase this debt when available on acceptable terms. The volume of foreign currency debt remaining is monitored by senior management. Refer to Note 23A for details of the AOFM's exposure to foreign exchange risk.

(c) Liquidity risk

The liquidity risk of the long term debt portfolio is managed in conjunction with the processes described above for managing the interest rate risk of the portfolio. In particular, the proportion of debt in the portfolio that is subject to immediate repricing is regularly measured and reported to senior management.

The AOFM also manages the government's liquidity risk by managing the overall level of cash in the OPA to ensure that the Australian Government can meet its financial obligations, both planned and unplanned, as and when they fall due. The AOFM maintains the daily volume of cash in the OPA, within limits set by the Treasurer and the Minister for Finance and Deregulation, by monitoring the projected daily transactions of major spending and revenue agencies and by undertaking term deposit investments with the RBA and the issuance of Treasury Notes to the wholesale market. The AOFM also has access to an overdraft facility with the RBA. The overdraft facility is not to be used in normal day-to-day operations but only to cover temporary, unexpected shortfalls of cash and it has a limit of $1 billion. Should circumstances arise for the overdraft to exceed this limit, Ministerial approval is required. The daily balances in the OPA are monitored by senior management.

(d) Credit risk

The AOFM's credit risk exposures arise principally when domestic interest rate swaps that it has executed with counterparties have a positive market value in favour of the AOFM. The AOFM ensures that these counterparty credit risk exposures remain acceptable by containing key measures of credit risk within approved limits. Its credit risk policy establishes credit risk management principles and controls, credit risk mitigation strategies, measures for assessing counterparty credit quality, exposure limits and reporting.

Under the credit risk policy:

- interest rate swaps may only be executed with those counterparties who have a Master Agreement with the AOFM which includes netting arrangements, right-to-break clauses and early termination clauses for credit rating downgrades;
  - the credit risk associated with favourable contractual positions is reduced by netting arrangements to the extent that if a default event occurs, all amounts with the counterparty are terminated and settled on a net basis;
- swap counterparties must have a long term senior credit rating of at least A (by Standard and Poor's) and A2 (by Moody's) where a Collateral Support Annexe is in place, and AA- (by Standard and Poor's) and Aa3 (by Moody's) where a Collateral Support Annexe is not in place;
  - a Collateral Support Annexe requires a counterparty to post collateral in the form of Australian dollars with the AOFM to offset some of the AOFM's credit exposure to it, where the current exposure reaches a specified level;
- credit risk limits apply to the current exposure and potential exposure for each counterparty;
  - current exposure is the current mark-to-market value of all swaps with a counterparty;
  - potential exposure is a conservative estimate of the extent to which the current exposure could vary over time with changes in interest rates; and
- regular reporting is provided to senior management of the current and potential exposures by counterparty, and together with the results of stress testing current exposure for credit downgrades and changes in market interest rates.

The AOFM also has a credit risk exposure on its holdings of term deposits with the RBA and its loans to the State and Northern Territory governments. This risk is regarded as minimal.

Note 4: Revenue

	2008	2007
	$'000	$'000
Note 4A: Revenue from government		
Appropriations:		
Departmental outputs	**8,489**	8,473
Total revenue from government	**8,489**	8,473
Note 4B: Other revenue		
Staff secondments to other agencies	**802**	857
Fees for management of the Communications Fund	**316**	192
Other revenue	**346**	280
Total other revenue	**1,464**	1,329

Note 5: Expenses

	2008 $'000	2007 $'000
Note 5A: Employee benefits		
Wages and salaries	**3,272**	3,393
Superannuation	**693**	725
Leave and other entitlements	**(27)**	38
Other employee expenses	**381**	355
Total employee benefits	**4,319**	4,511
Note 5B: Suppliers		
Provision of goods - external entities	**51**	48
Provision of goods - related entities	**1**	-
Rendering of services - external entities	**1,194**	1,280
Rendering of services - related entities	**1,208**	1,317
Operating lease rentals(a)	**321**	367
Workers compensation premium - related entity(b)	**11**	23
Total suppliers	**2,786**	3,035
Note 5C: Depreciation and amortisation		
Depreciation of infrastructure, plant and equipment	**200**	218
Amortisation of intangibles - computer software	**117**	618
Total depreciation and amortisation	**317**	836
The aggregate amounts of depreciation and amortisation expensed during the reporting period for each class of depreciable asset are as follows:(c)		
Computers, plant and equipment	**142**	146
Leasehold improvements	**58**	72
Intangibles	**117**	618
Total depreciation and amortisation	**317**	836
Note 5D: Write-down and impairment of assets		
Non-financial assets		
Computers, plant and equipment - disposed	**90**	1
Total write-down and impairment of assets	**90**	1
Total expenses	**7,512**	8,383

(a) Amounts relate to minimum lease payments only. Novated lease payments from salary packaging of motor vehicles are disclosed in 'other employee expenses'.
(b) Workers compensation was disclosed as an employee expense in the 2006-07 financial statements.
(c) Depreciation or amortisation was not allocated to the carrying amounts of other assets.

Note 6: Financial assets

	2008 $'000	2007 $'000
Note 6A: Trade and other receivables		
Appropriations receivable - undrawn(a)	**14,044**	11,080
Other	**410**	200
Total receivables	**14,454**	11,280
Gross receivables are represented by:		
Current	**410**	200
Non-current	**14,044**	11,080
Total receivables (gross)	**14,454**	11,280
Gross receivables are aged as follows:		
Not past due	**14,454**	11,280
Total receivables (gross)	**14,454**	11,280

(a) Appropriations receivable-undrawn are appropriations controlled by the AOFM but held in the OPA under the government's 'just-in-time' drawdown arrangements. As at 30 June 2008, the balance comprised undrawn equity injections of $949,070 ($949,070 as at 30 June 2007) and undrawn output appropriations of $13,094,575 ($10,130,575 as at 30 June 2007).

Note 7: Non-financial assets

	2008 $'000	2007 $'000
Note 7A: Infrastructure, plant and equipment		
Computers, plant and equipment - at cost	**94**	51
Accumulated depreciation	**(26)**	(7)
	68	44
Computers, plant and equipment - at 2006 valuation (fair value)	**370**	382
Accumulated depreciation	**(292)**	(178)
	78	204
Leasehold improvements - at 2006 valuation (fair value)	**922**	1,110
Accumulated amortisation	**(448)**	(499)
	474	611
Total infrastructure, plant and equipment (non-current)	**620**	859
Note 7B: Intangibles		
Computer software purchased - at cost	**2,941**	2,931
Accumulated amortisation	**(2,523)**	(2,406)
Total intangibles (non-current)	**418**	525

All revaluations are independent and are conducted in accordance with the revaluation policy stated at Note 1.12. In 2005-06, the revaluations were conducted by an independent valuer, the Australian Valuation Office. As at 1 April 2006, a revaluation decrement was made of $170,252 for leasehold improvements. This comprised a $138,041 offset to the Asset Revaluation Reserve and an expense of $32,211. In addition a revaluation decrement of $36,027 was charged as an expense for computers, plant and equipment as at 1 April 2006.

Note 7: Non-financial assets (continued)

	30 June 2008			
	Leasehold improvements $'000	Computers, plant and equipment $'000	Computer software (purchased) $'000	Total $'000
Note 7C: Reconciliation of the opening and closing balances of property, plant and equipment and intangibles				
As at 1 July 2007				
Gross book value	1,110	433	2,931	4,474
Accumulated depreciation/amortisation	(499)	(185)	(2,406)	(3,090)
Net book value as at 1 July 2007	611	248	525	1,384
Additions:				
Purchases	-	43	10	53
Resources received free of charge	8	-	-	8
Disposals:				
Gross value of disposals	(196)	(12)	-	(208)
Accumulated depreciation/amortisation of disposals	109	9	-	118
Depreciation/amortisation charge for the year	(58)	(142)	(117)	(317)
As at 30 June 2008				
Gross book value	**922**	**464**	**2,941**	**4,327**
Accumulated depreciation/amortisation	**(448)**	**(318)**	**(2,523)**	**(3,289)**
Net book value as at 30 June 2008	**474**	**146**	**418**	**1,038**

	30 June 2007			
	Leasehold improvements $'000	Computers, plant and equipment $'000	Computer software (purchased) $'000	Total $'000
Note 7C: Reconciliation of the opening and closing balances of property, plant and equipment and intangibles (continued)				
As at 1 July 2006				
Gross book value	1,110	406	2,715	4,231
Accumulated depreciation/amortisation	(427)	(45)	(2,096)	(2,568)
Net book value as at 1 July 2006	683	361	619	1,663
Additions:				
Purchases	-	34	524	558
Disposals:				
Gross value of disposals	-	(7)	(308)	(315)
Accumulated depreciation/amortisation of disposals	-	6	308	314
Depreciation/amortisation charge for the year	(72)	(146)	(618)	(836)
As at 30 June 2007				
Gross book value	1,110	433	2,931	4,474
Accumulated depreciation/amortisation	(499)	(185)	(2,406)	(3,090)
Net book value as at 30 June 2007	611	248	525	1,384

Note 7: Non-financial assets (continued)

	2008	2007
	$'000	$'000
Note 7D: Other non-financial assets		
Prepayments	**40**	71
Total other non-financial assets	**40**	71

All prepayments are current assets.

Note 8: Payables

	2008	2007
	$'000	$'000
Note 8A: Supplier payables		
Trade creditors(a)	**97**	132
Total supplier payables	**97**	132
All supplier payables are current liabilities.		
Note 8B: Other payables		
Tax payable	**2**	19
Total other payables	**2**	19
All other payables are current liabilities.		

(a) Settlement is usually made net 30 days.

Note 9: Provisions

	2008	2007
	$'000	$'000
Note 9A: Employee provisions		
Salaries and wages	**35**	25
Annual leave	**316**	325
Long service leave	**578**	596
Superannuation	**142**	124
Total employee entitlement provisions	**1,071**	1,070
Current(a)	**872**	905
Non-current(a)	**199**	165
Note 9B: Other provisions		
Make-good on leasehold premises(b)	**120**	135
Total other provisions	**120**	135
Current	**-**	-
Non-current	**120**	135

Provision for make-good	**2008**	2007
	$'000	$'000
Carrying amount at beginning of period	**135**	125
Additional provision made	**(15)**	10
Amount owing at end of period	**120**	135

(a) Under AASB 101 *Presentation of Financial Statements,* liabilities are to be classified as current where the creditor has a legal right to payment within twelve months, even where payment is not expected. The value of employee entitlement provisions expected to be settled over the next 12 months is $0.312 million ($0.302 million as at 30 June 2007).

(b) In accordance with the terms of its lease agreement for office accommodation, the AOFM is required to restore its leased premises to original condition at the conclusion of the lease. The AOFM has made a provision to recognise this obligation.

Note 10: Cash flow reconciliation

	2008	2007
	$'000	$'000
Reconciliation of cash and cash equivalents as per Balance Sheet to Cash Flow Statement		
Reported cash and cash equivalents as per:		
Cash Flow Statement	**159**	312
Balance Sheet	**159**	312
Reconciliation of surplus to net cash from (used by) operating activities:		
Surplus	**2,710**	1,672
Depreciation and amortisation	**317**	836
Write-down of non-financial assets	**90**	1
Resources received free of charge	**(8)**	-
(Increase) in receivables	**(3,174)**	(2,342)
(Increase) decrease in other assets	**31**	(52)
Increase in employee provisions	**1**	42
Increase (decrease) in other provisions	**(15)**	10
Increase (decrease) in other payables	**(17)**	17
Increase (decrease) in supplier payables	**(35)**	37
Net cash from (used by) operating activities	**(100)**	221

Note 11: Contingent liabilities and assets

Unquantifiable contingencies

The AOFM is not aware of any unquantifiable contingencies as of the signing date that require disclosure in the financial statements.

Remote contingencies

The AOFM has indemnified a number of contractors providing goods and services under contract for losses incurred by the contractor due to, amongst other things, AOFM's failure to observe certain terms of contract, or for wrongful, unlawful or negligent acts committed by the AOFM. The AOFM is not aware of any event that has occurred that may trigger action under the indemnities.

Note 12: Executive remuneration

The number of Senior Executive Service employees who received or were due to receive total remuneration of $130,000 or more:

	2008	2007
$295,000 to $309,999	**-**	1
$310,000 to $324,999	**1**	-
The aggregate amount of total remuneration of executives shown above	**$317,060**	$300,331
The aggregate amount of separation and redundancy payments during the year to executives shown above	**-**	-

Remuneration means any money, consideration or benefit including wages, salaries, performance pay, accrued leave entitlements (excluding superannuation on-costs), superannuation contributions, the cost of motor vehicles, housing, commuting, fringe benefits tax and allowances. Remuneration does not include reimbursement of out-of-pocket expenses incurred for work related purposes. Where the AOFM is not entitled to an input tax credit, remuneration includes the non-recoverable GST amount.

Note 13: Remuneration of auditors

Financial statement audit services are provided free of charge to the AOFM. The fair value of the audit services provided by the Australian National Audit Office was:

	2008	2007
	$	**$**
Remuneration of auditors	**261,000**	253,000

Auditors' remuneration is disclosed inclusive of GST.

No other services were provided by the Auditor-General.

Note 14: Average staffing level

The average staffing level for the AOFM during the year was:

	2008	2007
Average staffing level (ASL)	**29(a)**	33(a)

(a) Paid ASL only.

Note 15: Compensation and debt relief in special circumstances

Departmental
No 'Act of Grace' payments were made during the reporting period (nil for 2006-07).
No waivers of amounts owing to the government were made pursuant to subsection 34(1) of the *Financial Management and Accountability Act 1997* during the reporting period (nil for 2006-07).
No payments were made under the 'Defective Administration Scheme' during the reporting period (nil for 2006-07).
No payments were made under section 73 of the *Public Service Act 1999* during the reporting period (nil for 2006-07).
No payments were made under ex-gratia programs during the reporting period (nil for 2006-07).
Administered
No 'Act of Grace' payments were made during the reporting period (nil for 2006-07).
No waivers of amounts owing to the government were made pursuant to subsection 34(1) of the *Financial Management and Accountability Act 1997* during the reporting period (one waiver for $58 for 2006-07).
No payments were made under the 'Defective Administration Scheme' during the reporting period (nil for 2006-07).
No payments were made under section 73 of the *Public Service Act 1999* during the reporting period (nil for 2006-07).
No payments were made under ex-gratia programs during the reporting period (nil for 2006-07).

Note 16: Revenue before re-measurements administered on behalf of government[(a)]

	2008 $'000	2007 $'000
Note 16A: Interest revenue		
Loans to State and Territory governments:		
State and Territory debt	**325**	335
Housing advances	**170,635**	174,169
Deposits	**1,197,227**	1,146,549
Swaps interest	**1,626,896**	1,812,628
Total interest revenue	**2,995,083**	3,133,681
Note 16B: Other non-taxation revenue		
Securities lending and other revenue	**2,266**	256
Total other non-taxation revenue	**2,266**	256
Note 16C: Net foreign exchange gains		
Foreign currency denominated loans (non-speculative)	**754**	902
Total net foreign exchange gains	**754**	902
Total revenue administered on behalf of government	**2,998,103**	3,134,839

(a) All revenue is recognised using the effective interest method.

Note 17: Expenses before re-measurements administered on behalf of government[(a)]

	2008 $'000	2007 $'000
Note 17A: Grants expenses		
Public Sector:		
State and Territory governments	**30**	31
Total grants expenses	**30**	31
Note 17B: Interest expenses		
Commonwealth Government Securities interest	**3,541,938**	3,591,776
Swaps interest	**1,807,023**	1,803,175
Other costs	**2,011**	24
Total interest expenses	**5,350,972**	5,394,975
Total expenses administered on behalf of government	**5,351,002**	5,395,006

(a) All expenses are recognised using the effective interest method.

Note 18: Administered re-measurements

	2008 $'000	2007 $'000
Net market valuation gains (losses) on financial assets and financial liabilities at fair value through profit or loss(a)		
Commonwealth Government Securities	**276,100**	1,569,477
Investments (deposits)	**(61)**	(22)
Swaps	**(393,687)**	(554,715)
Total administered re-measurements	**(117,648)**	1,014,740

(a) Net market valuation gains (losses) represents the unrealised fair value gains (losses) on the portfolio of administered financial assets and financial liabilities. Changes in the carrying value of financial assets and financial liabilities are attributed between changes in the amortised cost carrying value and other changes in carrying value. Changes attributable to amortised cost are recognised in revenue before re-measurements or expenses before re-measurements. Other changes in carrying value (including due to a change in interest rates) are recognised as re-measurements. In a passive 'issue and hold to maturity' strategy, such as that relating to the AOFM's debt issuance and management activities, the revaluation effect will net to zero over the life of a financial instrument.

Note 19: Assets administered on behalf of government[a]

	2008 $'000	2007 $'000
Note 19A: Cash		
Cash at bank	**622**	867
Total Cash	**622**	867
Note 19B: Receivables		
Loans to State and Territory governments - principal value	**3,263,802**	3,353,019
Less: balance of special account(b)	**(447)**	(422)
	3,263,355	3,352,597
Unamortised net discounts	**(426,834)**	(448,811)
Total loans to State and Territory governments at amortised cost	**2,836,521**	2,903,786
Total receivables	**2,836,521**	2,903,786
Receivables are aged as follows:		
Not past due	**2,836,521**	2,903,786
Maturity profile of receivables		
Receivable:(c)		
Within one year	**1,612**	387
In one to five years	**24,374**	23,321
In more than five years	**2,810,535**	2,880,078
	2,836,521	2,903,786
Note 19C: Investments made under section 39 of the *Financial Management and Accountability Act 1997*		
Deposits at fair value through profit or loss (current)	**29,098,675**	20,378,564
Total investments under FMA section 39	**29,098,675**	20,378,564
Note 19D: Accrued revenue		
Accrued interest on loans to State and Territory governments (current)	**502**	532
Total accrued revenue	**502**	532
Total assets administered on behalf of government	**31,936,320**	23,283,749

(a) Where the AOFM applies fair value accounting to a financial asset, the aggregate value of the financial asset is recorded against a single financial statement class. Where the historic cost accounting convention is applied, the value of a financial asset is disaggregated and recorded against several financial statement classes (for example: the principal value of a financial asset is classified separately to coupons receivable on the asset).
(b) Refer to Note 26F for special account balances.
(c) The maturity profile is based on contractual re-pricing dates.

Note 20: Liabilities administered on behalf of government[a]

	2008 $'000	2007 $'000
Note 20A: Commonwealth Government Securities		
Treasury Bonds at fair value through profit or loss	**48,909,581**	47,419,270
Treasury Capital Indexed Bonds at fair value through profit or loss	**9,461,376**	9,090,858
Other debt securities at fair value through profit or loss	**11,326**	28,683
Other debt securities at amortised cost	**17,439**	18,264
Total Commonwealth Government Securities	**58,399,722**	56,557,075
Maturity profile of Commonwealth Government Securities		
Payable:(b)		
Within one year	**5,280,569**	3,019,905
In one to five years	**28,454,996**	26,961,342
In more than five years	**24,664,157**	26,575,828
	58,399,722	56,557,075
Note 20B: Other payables		
Interest rate swaps at fair value through profit or loss	**1,040,883**	581,069
Interest coupons payable on debt	**105**	125
Total other payables	**1,040,988**	581,194
Maturity profile of payables		
Payable:(b)		
Within one year	**48,196**	1,805
In one to five years	**456,599**	130,474
In more than five years	**536,193**	448,915
	1,040,988	581,194
Total liabilities administered on behalf of government	**59,440,710**	57,138,269

(a) Where the AOFM applies fair value accounting to a financial liability the aggregate value of the financial liability is recorded against a single financial statement class. Where the historic cost accounting convention is applied, the value of a financial liability is disaggregated and recorded against several financial statement classes (for example: the principal value of a financial liability is classified separately to coupons payable on the liability).

(b) The maturity profile is based on contractual re-pricing dates.

Note 21: Administered reconciliation table

	2008 $'000	2007 $'000
Administered reconciliation table		
Opening administered assets less administered liabilities as at 1 July	**(33,854,520)**	(37,782,985)
Plus: Administered revenue (before re-measurements)	**2,998,103**	3,134,839
Less: Administered expenses (before re-measurements)	**(5,351,002)**	(5,395,006)
Administered transfers to / from Australian Government:		
Appropriation transfers from OPA:		
Special appropriations (unlimited)	**325,334,033**	265,249,186
Transfers to OPA	**(316,513,331)**	(260,075,158)
Net market valuation gains (losses)	**(117,648)**	1,014,740
Repayment of overdue debt by NSW	**-**	(124)
Change in special account balance	**(25)**	(12)
Closing administered assets less administered liabilities as at 30 June	**(27,504,390)**	(33,854,520)

Note 22: Administered contingent liabilities and assets

Unquantifiable contingencies

The AOFM is not aware of any unquantifiable contingencies as of the signing date that require disclosure in the financial statements.

Remote contingencies

(i) The government has indemnified agents of foreign currency denominated loans issued by the Australian Government outside Australia against any loss, liability, costs, claims, charges, expenses, actions, or demands due to any misrepresentation by the Australian Government and any breach of warranties. The AOFM is not aware of any event that has occurred that may trigger action under the indemnities.

(ii) In the extremely unlikely event of default by a borrower of Treasury Bonds under the securities lending facility, the AOFM would be in a position to sell the securities pledged by the borrower to offset the increased liability to the government. As at 30 June 2008 there were no open transactions under the AOFM's securities lending facility (nil as at 30 June 2007).

Note 23: Administered financial instruments

Note 23A: Foreign exchange risk

Foreign exchange risk arises from debt the AOFM holds in foreign denominated currencies and represents the risk to debt servicing costs and the value of the net debt portfolio caused by a change in foreign exchange rates. Since 2001 the government has had a policy of zero foreign currency exposure over the long term. Currently the AOFM's foreign exchange risk arises from contractual obligations on foreign currency loans and securities. The AOFM's exposure to foreign exchange risk is not material.

The Australian equivalent principal value of foreign currency loans and securities is disclosed in the following table.

	2008	2007
	AUD $'000	AUD $'000
FOREIGN CURRENCY DENOMINATED LIABILITIES		
Current		
Pounds sterling	**110**	125
Japanese yen	**4**	4
Swiss francs	**52**	49
Deutsche marks	**9**	8
	175	186
Non-current		
United States dollars	**5,528**	6,270
Pounds sterling	**1,040**	1,186
	6,568	7,456
Total foreign currency denominated liabilities	**6,743**	7,642
FOREIGN CURRENCY DENOMINATED ASSETS		
Current		
Pounds sterling	**4**	5
	4	5
Non-current		
Pounds sterling	**1,040**	1,186
	1,040	1,186
Total foreign currency denominated assets	**1,044**	1,191

Note 23: Administered financial instruments (continued)

Note 23B: Interest rate risk

The AOFM's exposure to interest rate risk and corresponding weighted average effective interest rates for each class of financial assets and financial liabilities is set out below. The maturity profile is based on contractual re-pricing dates. Those financial instruments with a fixed interest rate expose the net debt portfolio to changes in fair value with changes in interest rates, whilst those financial instruments at floating interest rates expose the net debt portfolio to changes in debt servicing costs with changes in interest rates. The extent to which the AOFM can match the re-pricing profile of its physical assets with those of its physical liabilities is limited by the differences in the volumes and the need for assets to be available for cash management purposes.

As at 30 June 2008	Floating interest rate	Fixed interest rate maturing in						Non interest bearing	Total	Weighted average interest(b)
		1 year or less	1 to 2 years	2 to 3 years	3 to 4 years	4 to 5 years	> 5 years			
	2008 $'000	2008 $'000	2008 $'000	2008 $'000	2008 $'000	2008 $'000	2008 $'000	2008 $'000	2008 $'000	2008 %
Financial assets										
Cash at bank	-	-	-	-	-	-	-	622	622	-
Interest rate swaps (receive legs)(a)	58,701	187,062	312,331	562,230	335,631	782,472	2,043,075	-	4,281,502	6.33
Loans to State and Territory governments	-	2,110	3,434	5,466	6,654	8,820	2,810,535	4	2,837,023	5.88
Investments	-	29,098,675	-	-	-	-	-	-	29,098,675	7.26
Total financial assets	**58,701**	**29,287,847**	**315,765**	**567,696**	**342,285**	**791,292**	**4,853,610**	**626**	**36,217,822**	
Financial liabilities										
Interest rate swaps (pay legs)(a)	5,280,968	41,417	-	-	-	-	-	-	5,322,385	7.75
Treasury Capital Indexed Bonds	-	-	-	2,232,072	-	-	7,229,304	-	9,461,376	4.22
Treasury Bonds	-	5,269,521	5,872,099	10,612,109	4,912,346	4,826,370	17,417,136	-	48,909,581	6.04
Other Commonwealth Government Securities	-	4,259	-	-	-	-	17,717	6,894	28,870	4.00
Total financial liabilities	**5,280,968**	**5,315,197**	**5,872,099**	**12,844,181**	**4,912,346**	**4,826,370**	**24,664,157**	**6,894**	**63,722,212**	

(a) Amounts are represented on a gross basis. This differs from the presentation in the Schedules of Assets and Liabilities Administered on Behalf of Government, where amounts are on a net basis.

(b) Interest rates are nominal interest rates with exception to Treasury Capital Indexed Bonds (which are real interest rates).

Note 23: Administered financial instruments (continued)

Note 23B: Interest rate risk (continued)

As at 30 June 2007	Floating interest rate	Fixed interest rate maturing in						Non interest bearing	Total	Weighted average interest(b)
		1 year or less	1 to 2 years	2 to 3 years	3 to 4 years	4 to 5 years	> 5 years			
	2007 $'000	2007 $'000	2007 $'000	2007 $'000	2007 $'000	2007 $'000	2007 $'000	2007 $'000	2007 $'000	2007 %
Financial assets										
Cash at bank	-	-	-	-	-	-	-	867	867	-
Interest rate swaps (receive legs)(a)	197,621	183,514	421,042	514,404	777,855	288,684	3,258,441	-	5,641,561	6.26
Loans to State and Territory governments	-	914	3,128	5,009	7,090	8,094	2,880,078	5	2,904,318	5.88
Investments	-	20,378,564	-	-	-	-	-	-	20,378,564	6.27
Total financial assets	**197,621**	**20,562,992**	**424,170**	**519,413**	**784,945**	**296,778**	**6,138,519**	**872**	**28,925,310**	
Financial liabilities										
Interest rate swaps (pay legs)(a)	6,054,727	57,920	109,983	-	-	-	-	-	6,222,630	6.41
Treasury Capital Indexed Bonds	-	-	-	-	2,145,940	-	6,944,918	-	9,090,858	4.22
Treasury Bonds	-	2,995,962	5,389,457	5,954,538	10,608,102	2,859,079	19,612,132	-	47,419,270	6.20
Other Commonwealth Government Securities	-	16,917	4,226	-	-	-	18,778	7,151	- 47,072	6.25
Total financial liabilities	**6,054,727**	**3,070,799**	**5,503,666**	**5,954,538**	**12,754,042**	**2,859,079**	**26,575,828**	**7,151**	**62,779,830**	

(a) Amounts are represented on a gross basis. This differs from the presentation in the Schedules of Assets and Liabilities Administered on Behalf of Government, where amounts are on a net basis.

(b) Interest rates are nominal interest rates with exception to Treasury Capital Indexed Bonds (which are real interest rates).

Note 23: Administered financial instruments (continued)

Note 23C: Derivative contracts

The AOFM recognises the fair value of all of its derivative contracts on its Schedules of Assets and Liabilities Administered on Behalf of Government. For the purposes of managing the cost and interest rate risk associated with the debt portfolio, the AOFM enters into domestic interest rate swap contracts under which it is obliged to receive and pay interest at fixed and/or floating interest rates. These swaps are not held for trading purposes, nor are they designated for hedge accounting.

The notional principal amounts are not exchanged and act as a reference value upon which interest payments can be calculated.

	2008	2007
	$'000	$'000
Interest rate swap contracts — notional principal amounts		
(i) The nature of interest rate swaps as at 30 June is as follows:		
Pay — fixed swaps(a)	1,300,000	**3,300,000**
Receive — fixed swaps(b)	21,850,000	**25,960,000**
	23,150,000	**29,260,000**
(ii) The maturity profile of interest rate swaps as at 30 June is as follows:		
Within one year	5,575,000	**6,410,000**
In one to five years	11,225,000	**13,400,000**
In more than five years	6,350,000	**9,450,000**
	23,150,000	**29,260,000**

(a) Pay-fixed swaps are primarily used to manage the proportion of the debt portfolio subject to immediate re-pricing.
(b) Receive-fixed swaps are primarily used to manage the blend of fixed and variable rate debt in the portfolio.

Note 23D: Credit risk

The AOFM's assets are of strong credit quality. Over the reporting period the AOFM limited its financial investments to term deposits with the RBA and transacted domestic interest rate swaps only with highly rated counterparties with whom it has a Master Agreement. In addition, its loans and receivables comprise loans to the State and Territory governments. The New South Wales Government is the largest debtor with 40% of loans outstanding (by value), followed by the South Australian Government with 20% of loans outstanding (by value).

The AOFM's non-derivative financial assets are highly concentrated in Australia and by individual names. The AOFM has an exposure to financial institutions in relation to its swap contracts. No collateral transactions were undertaken in 2007-08 (nil for 2006-07) with swap counterparties.

The AOFM's exposure to credit risk under the securities lending facility is zero.

Note 23: Administered financial instruments (continued)

Note 23D: Credit risk (continued)

The following tables set out the AOFM's credit risk by asset class and long term credit rating as at 30 June 2007 and 30 June 2008.

	2008				
S&P long-term rating(a)	AAA	AA+	AA	AA-	**Total**
Moody's long-term rating(a)	Aaa	Aa1	Aa2	Aa3	
					$'000
Cash held with the RBA(b)	622	-	-	-	**622**
Loans to State and Territory governments	2,326,621	339,172	-	-	**2,665,793**
Investments with the RBA(b)	29,098,675	-	-	-	**29,098,675**
Interest rate swaps	-	-	-	-	**-**
	31,425,918	339,172	-	-	**31,765,090**

	2007				
S&P long-term rating(a)	AAA	AA+	AA	AA-	**Total**
Moody's long-term rating(a)	Aaa	Aa1	Aa2	Aa3	
					$'000
Cash held with the RBA(b)	867	-	-	-	**867**
Loans to State and Territory governments	2,425,990	199,401	152,197	-	**2,777,588**
Investments with the RBA(b)	20,378,564	-	-	-	**20,378,564**
Interest rate swaps	-	-	1,057	375	**1,432**
	22,805,421	199,401	153,254	375	**23,158,451**

(a) Where a counterparty has a split rating, the AOFM's exposure to the counterparty is allocated to the lower credit rating.

(b) The RBA does not issue debt in the wholesale market and accordingly does not have a credit rating. However, as Australia's central bank it is deemed to have the same rating as the Australian Government.

Note 23: Administered financial instruments (continued)

Note 23D: Credit risk (continued)

The following tables set out the AOFM's credit risk by asset class and geographical location as at 30 June 2007 and 30 June 2008.

	2008			
Geographical Location(a)	Australia	United Kingdom	United States of America	**Total**
				$'000
Cash held with the RBA	622	-	-	**622**
Loans to State and Territory governments	2,665,793	-	-	**2,665,793**
Investments with the RBA	29,098,675	-	-	**29,098,675**
Interest rate swaps	-	-	-	**-**
	31,765,090	-	-	**31,765,090**

	2007			
Geographical Location(a)	Australia	United Kingdom	United States of America	**Total**
				$'000
Cash held with the RBA	867	-	-	**867**
Loans to State & Territory governments	2,777,588	-	-	**2,777,588**
Investments with the RBA	20,378,564	-	-	**20,378,564**
Interest rate swaps	-	1,057	375	**1,432**
	23,157,019	1,057	375	**23,158,451**

(a) Geographical segments are based on the place of incorporation of the legal entity with whom the AOFM has contractual relations.

Note 23: Administered financial instruments (continued)

Note 23E: Net fair values of administered financial assets and liabilities

	Principal value (a) 2008 $'000	**Total carrying amount 2008 $'000**	**Aggregate net fair value 2008 $'000**	Principal value (a) 2007 $'000	Total carrying amount 2007 $'000	Aggregate net fair value 2007 $'000
Administered financial assets (recognised)						
Cash	**622**	**622**	**622**	867	867	867
Loans to State and Territory governments(b)	**3,263,355**	**2,837,023**	**2,665,346**	3,352,597	2,904,318	2,777,166
Investments	**29,050,000**	**29,098,675**	**29,098,675**	20,350,000	20,378,564	20,378,564
Total financial assets (recognised)	**32,313,977**	**31,936,320**	**31,764,643**	23,703,464	23,283,749	23,156,597
Administered financial liabilities (recognised)						
Commonwealth Government Securities	**58,046,372**	**58,399,827**	**58,399,827**	55,567,812	56,557,200	56,557,200
Interest rate swaps	**-**	**1,040,883**	**1,040,883**	-	581,069	581,069
Total financial liabilities (recognised)	**58,046,372**	**59,440,710**	**59,440,710**	55,567,812	57,138,269	57,138,269
Net financial assets (recognised)	**(25,732,395)**	**(27,504,390)**	**(27,676,067)**	(31,864,348)	(33,854,520)	(33,981,672)

(a) Comprises face value of financial instruments, with exception to Treasury Capital Indexed Bonds where the inflation adjusted capital value at the end of the financial year is included in the figures for CGS. An estimate of the redemption value on maturity is not provided for Treasury Capital Indexed Bonds. For all other financial liabilities the principal value represents the amount due on maturity.

(b) Loans to State and Territory governments are recognised at amortised cost in the Schedule of Assets Administered on Behalf of Government. These transactions are not traded and, especially for those with the longest term to maturity, a direct market benchmark to underpin fair value measurement does not exist. In estimating aggregate net fair value, the AOFM based its valuation from data on Treasury Bonds.

Note 23: Administered financial instruments (continued)

Note 23F: Categories of administered financial assets and liabilities

	2008	2007
	$'000	$'000
Administered financial assets		
Cash	**622**	867
Loans and receivables (at amortised cost)		
Loans to State and Territory governments	**2,837,023**	2,904,318
Fair value through profit and loss (designated)		
Investments	**29,098,675**	20,378,564
Carrying amount of financial assets	**31,936,320**	23,283,749
Administered financial liabilities		
Amortised cost		
Debt on allocation to States and Northern Territory and overdues	**17,544**	18,389
Fair value through profit or loss (required by AASB 139)		
Interest rate swaps	**1,040,883**	581,069
Fair value through profit or loss (designated)		
Commonwealth Government Securities, excluding debt on allocation to the States and Northern Territory and overdues	**58,382,283**	56,538,811
Carrying amount of financial liabilities	**59,440,710**	57,138,269

Note 23: Administered financial instruments (continued)

Note 23G: Contractual maturities of financial liabilities

The following table discloses the undiscounted value of the contractual maturities of financial liabilities as at the end of the financial year, including estimated future interest payments.

	2008					2007				
	1 year or less $'000	**1 to 2 years $'000**	**2 to 5 years $'000**	**>5 years $'000**	**Total $'000**	1 year or less $'000	1 to 2 years $'000	2 to 5 years $'000	>5 years $'000	Total $'000
Treasury Bonds	**7,987,582**	**8,165,674**	**25,718,455**	**22,768,407**	**64,640,118**	5,874,692	7,694,217	24,743,659	24,373,765	62,686,333
Treasury Capital Indexed Bonds(a)	**344,971**	**344,971**	**2,979,405**	**7,691,130**	**11,360,477**	332,953	332,953	2,960,123	7,671,601	11,297,630
Other debt securities(b)	**4,628**	**463**	**1,389**	**7,380**	**13,860**	17,671	4,690	1,575	8,895	32,831
Interest rate swaps(c)	**298,564**	**264,264**	**606,104**	**230,486**	**1,399,418**	32,690	34,154	143,147	113,919	323,910
	8,635,745	**8,775,372**	**29,305,353**	**30,697,403**	**77,413,873**	6,258,006	8,066,014	27,848,504	32,168,180	74,340,704

(a) The interest payments and principal value are indexed against the (all groups) Australian Consumer Price Index (CPI). There is a six month lag between the calculation period for the CPI and its impact on the value of interest and principal. Interest payments and principal value on redemption are projected at the CPI for the March quarter and held constant thereafter.

(b) Perpetual debt and overdue debt has been excluded from this analysis.

(c) Interest flows on swaps are disclosed on a net basis and floating interest rates are projected at the relevant reference rate as at the end of the financial year and held constant thereafter.

Note 24: Market risk sensitivity of administered financial instruments

AASB 7 *Financial Instruments: Disclosures* requires each entity with financial instruments to present a market risk sensitivity analysis for each type of market risk exposure arising from financial instruments held. Market risk represents the risk that the fair value or future cash flows of a financial instrument will fluctuate due to changes in market prices.

The main types of market risk the AOFM's net debt portfolio is exposed to are domestic *interest rate risk* and domestic *inflation risk.* Moreover, with a debt management strategy of issuing/buying and holding to maturity (and with portfolio restructuring a rarity), the market risk most relevant to the AOFM is the risk of fluctuations to future principal amounts and future interest cash flows arising from changes in interest rates and inflation. The risk of fluctuations in the fair value of AOFM's net debt portfolio is of a secondary order.

Accordingly, the AOFM has focused its market risk sensitivity analysis on an accruals (or amortised cost) basis of accounting under the historic cost accounting convention, as it provides the best predictive value of future cash flows (and hence costs and returns) arising from the AOFM's net debt portfolio.

(a) Interest rate risk sensitivity analysis

Changes in domestic interest rates will impact on debt servicing costs of AOFM's Treasury Bond portfolio (an Australian dollar fixed interest long term portfolio) when maturing debt is refinanced. When the AOFM borrows to repay maturing debt, there is a risk that debt servicing costs will change due to the interest rate on the new debt being higher or lower than the interest rate on the maturing debt. Changes in interest rates have no impact on future cash flows on principal amounts.

Similarly, the use of Australian dollar interest rate swaps to manage the duration of the portfolio, by receiving a fixed interest rate and paying a floating interest rate (or vice-versa), subjects the portfolio to fluctuations in future net cash flows at the time each floating rate leg is reset against the relevant reference market interest rate. When interest rates rise, net swap return will fall.

As the manager of the government's liquidity, the AOFM holds a fluctuating portfolio of Australian dollar short term deposits. These deposits have fixed interest rates and given their use for cash management purposes they have very short terms to maturity (generally no more than a few months). When these investments mature and are re-invested at the prevailing market interest rate, the return may change due to re-investment at a higher or lower interest rate. Changes in interest rates have no impact on future cash flows on principal amounts.

Note 24: Market risk sensitivity of administered financial instruments (continued)

Under previous Commonwealth-State financing arrangements the Commonwealth made concessional Australian dollar loans to the States and the Northern Territory. These loans are of a fixed interest credit foncier nature. Changes in market interest rates will not cause a fluctuation on future cash flows of interest or principal.

At 1 July 2008, if domestic interest rates had experienced an immediate 100 basis point parallel upward (downward) movement across the yield curve, and if that change were to persist for the 12 months to 30 June 2009, with all other variables held constant, the effect on AOFM's operating result before re-measurements (calculated on an accruals basis) and equity position for the year ended 30 June 2009 would be as follows:

Sensitivity to changes in domestic interest rates (calculated on an accruals basis)

	2008				
Change in interest rates from 1 July 2008		-1%		+1%	
Administered financial assets	**Carrying amount as at 30 June 2008 $'000**	**Impact in 2008-09 on profit $'000**	**Impact in 2008-09 on equity $'000**	**Impact in 2008-09 on profit $'000**	**Impact in 2008-09 on equity $'000**
Cash	622	-	-	-	-
Loans to State and Territory governments	2,837,023	-	-	-	-
Term deposits	29,098,675	(281,562)	(281,562)	281,562	281,562
Administered financial liabilities					
Commonwealth Government Securities					
Treasury Bonds	48,909,581	15,188	15,188	(12,835)	(12,835)
Treasury Capital Indexed Bonds	9,461,376	-	-	-	-
Other Commonwealth Government Securities	28,870	-	-	-	-
Interest rate swaps	1,040,883	146,551	146,551	(146,551)	(146,551)
Total increase (decrease) (before re-measurements)		(119,823)	(119,823)	122,176	122,176

The fair value sensitivity of the portfolio (excluding loans to State and Territory governments, which are measured on an accruals basis) to changes in domestic interest rates as at 30 June 2008 was $19.5 million per basis point. A 1 basis point parallel increase (decrease) in interest rates across the yield curve would result in a favourable (unfavourable) change of $19.5 million in the fair value of the portfolio.

Note 24: Market risk sensitivity of administered financial instruments (continued)

The corresponding figures for the previous 12 months are as follows:

Sensitivity to changes in domestic interest rates (calculated on an accruals basis)

	2007				
Change in interest rates from 1 July 2007		-1%		+1%	
Administered financial assets	**Carrying amount as at 30 June 2007 $'000**	**Impact in 2007-08 on profit $'000**	**Impact in 2007-08 on equity $'000**	**Impact in 2007-08 on profit $'000**	**Impact in 2007-08 on equity $'000**
Cash	867	-	-	-	-
Loans to State and Territory governments	2,904,318	-	-	-	-
Term deposits	20,378,564	(195,691)	(195,691)	195,691	195,691
Administered financial liabilities					
Commonwealth Government Securities					
Treasury Bonds	47,419,270	18,419	18,419	(15,592)	(15,592)
Treasury Capital Indexed Bonds	9,090,858	-	-	-	-
Other Commonwealth Government Securities	47,072	-	-	-	-
Interest rate swaps	581,069	164,349	164,349	(164,349)	(164,349)
Total increase (decrease) (before re-measurements)		(12,923)	(12,923)	15,750	15,750

The fair value sensitivity of the portfolio (excluding loans to State and Territory governments, which are measured on an accruals basis) to changes in domestic interest rates as at 30 June 2007 was $18.5 million per basis point. A 1 basis point parallel increase (decrease) in interest rates across the yield curve would result in a favourable (unfavourable) change of $18.5 million in the fair value of the portfolio.

(b) Inflation risk sensitivity analysis

Whilst their issuance was suspended in 2003-04 and no further issuance is in prospect, the AOFM currently has three lines of Treasury Capital Indexed Bonds on issue. These instruments expose the AOFM to cash flow risk on interest payments and the value of principal payable on maturity arising from indexation against the (all Groups) Australian Consumer Price Index (CPI). There is a six-month lag between the calculation period for the CPI and its impact on the value of interest and principal. When the CPI increases, debt servicing costs and the principal payable on maturity will also rise.

Note 24: Market risk sensitivity of administered financial instruments (continued)

At 1 July 2008, if the CPI were to experience an immediate 1 per cent increase (decrease) and that change were to persist for 12 months to 30 June 2009, with all other variables held constant, the effect on the AOFM's operating result before re-measurements (calculated on an accruals basis) and equity position for the year ended 30 June 2009 would be as follows:

Sensitivity to changes in the consumer price index (calculated on an accruals basis)

	2008				
Change in consumer price index from 1 July 2008		-1%		+1%	
Administered financial assets	**Carrying amount as at 30 June 2008 $'000**	**Impact in 2008-09 on profit $'000**	**Impact in 2008-09 on equity $'000**	**Impact in 2008-09 on profit $'000**	**Impact in 2008-09 on equity $'000**
Cash	622	-	-	-	-
Loans to State and Territory governments	2,837,023	-	-	-	-
Term deposits	29,098,675	-	-	-	-
Administered financial liabilities					
Commonwealth Government Securities					
Treasury Bonds	48,909,581	-	-	-	-
Treasury Capital Indexed Bonds	9,461,376	90,067	90,067	(91,869)	(91,869)
Other Commonwealth Government Securities	28,870	-	-	-	-
Interest rate swaps	1,040,883	-	-	-	-
Total increase (decrease) (before re-measurements)		90,067	90,067	(91,869)	(91,869)

Note 24: Market risk sensitivity of administered financial instruments (continued)

The corresponding figures for the previous 12 months are as follows:

Sensitivity to changes in the consumer price index (calculated on an accruals basis)

	2007				
Change in consumer price index from 1 July 2007		-1%		+1%	
Administered financial assets	**Carrying amount as at 30 June 2007 $'000**	**Impact in 2007-08 on profit $'000**	**Impact in 2007-08 on equity $'000**	**Impact in 2007-08 on profit $'000**	**Impact in 2007-08 on equity $'000**
Cash	867	-	-	-	-
Loans to State and Territory governments	2,904,318	-	-	-	-
Term deposits	20,378,564	-	-	-	-
Administered financial liabilities					
Commonwealth Government Securities					
Treasury Bonds	47,419,270	-	-	-	-
Treasury Capital Indexed Bonds	9,090,858	85,369	85,369	(84,330)	(84,330)
Other Commonwealth Government Securities	47,072	-	-	-	-
Interest rate swaps	581,069	-	-	-	-
Total increase (decrease) (before re-measurements)		85,369	85,369	(84,330)	(84,330)

(c) Assumptions and methods used

Interest rate risk sensitivity has been measured assuming that for the next 12 months domestic interest rates are 100 basis points higher and lower across the entire yield curve than those observed as at year end. The analysis was performed as follows:

- the sensitivity of debt servicing costs for the next 12 months on Treasury Bonds comprised a comparison of:
  - debt servicing costs on the planned issuance program for the next 12 months at the observed market yield for the relevant line of stock as at year end; and
  - debt servicing costs on the planned issuance program for the next 12 months at yields that are 100 basis points higher and lower than the observed market yield for the relevant line of stock as at year end;
- the sensitivity of returns for the next 12 months on interest rate swaps comprised a comparison of:

Note 24: Market risk sensitivity of administered financial instruments (continued)

- the return on each floating rate leg at the relevant reference market interest rate (being either the 3-month or 6-month BBSW rate) as at year end; and

- the return on each floating rate leg at a yield that is 100 basis points higher and lower than the relevant reference market interest rate as at year end. The 100 basis point shift is applied from the date of the first rate re-set for the next financial year for each floating rate leg and is held constant at that level thereafter;

- the sensitivity of returns for the next 12 months on deposits comprised a comparison of:

  - the return on deposits at the relevant reference market interest rate (being the 1-month OIS rate) as at year end; and

  - the return on deposits at a yield that is 100 basis points higher and lower than the relevant reference market interest rate as at year end. The 100 basis point shift is applied from the date of the first re-investment and is held constant at that level thereafter.

Inflation risk sensitivity has been measured assuming that for each quarter in the next financial year the CPI is 1 per cent higher and lower (when compared to the year before) than in the base case. The analysis was performed as follows:

- the sensitivity of debt servicing costs for the next financial year on Treasury Capital Indexed Bonds comprised a comparison of:

  - debt servicing costs for the next financial year on the basis that inflation persists at the average rate experienced in the financial year (base case); and

  - debt servicing costs for the next financial year on the basis that the CPI index is higher and lower by one per cent than the assumed base case level for each quarter.

It has been assumed that the AOFM will issue $5,300 million of Treasury Bonds during the 2008-09 financial year to refinance maturing Treasury Bonds (2007-08: $5,100 million) in accordance with Budget announcements. In addition it is assumed that the volume of investments in RBA term deposits held as at 30 June 2008 of $29,050 million (30 June 2007: $20,350 million) will remain unchanged throughout the course of 2008-09 (2007-08). Interest earned on term deposit investments is assumed to be returned to the OPA when received and not re-invested. It is further assumed that the AOFM will not execute new interest rate swap transactions nor undertake issuance of Treasury Capital Indexed Bonds during 2008-09 (2007-08: nil).

Note 25: Securities lending facility

Details of Treasury Bonds loaned to bond market participants under the securities lending facility are as follows:

	2008		
Bond series	**Number of transactions**	**Face value of Treasury Bonds loaned**	**Net income earned**
		$'000	**$'000**
(i) Open transactions as at the beginning of the financial year			
Nil			
(ii) New transactions completed during the financial year			
August 2008	3	68,200	7
September 2009	20	481,500	48
August 2010	6	75,900	6
June 2011	20	700,072	76
April 2012	3	94,000	8
May 2013	10	382,300	58
April 2015	15	308,700	45
February 2017	9	370,000	32
March 2021	2	34,100	3
	88	**2,514,772**	**283**
(iii) Open transactions as at the end of the financial year			
Nil			

Note 25: Securities lending facility (continued)

	2007		
Bond series	**Number of transactions**	**Face value of Treasury Bonds loaned**	**Net income earned**
		$'000	**$'000**
(i) Open transactions as at the beginning of the financial year			
Nil			
(ii) New transactions completed during the financial year			
October 2007	11	455,500	90
August 2008	3	126,000	10
August 2010	1	5,000	1
June 2011	7	158,200	38
April 2012	1	44,000	4
May 2013	8	361,800	31
April 2015	7	133,500	12
	38	**1,284,000**	**186**
(iii) Open transactions as at the end of the financial year			
Nil			

On 20 May 2008 the Treasurer announced a decision to extend the operation of the securities lending facility, which allows market participants to borrow Treasury Bonds not readily available from other sources in the market, by broadening the range of assets eligible to be placed as collateral.

Note 26: Disclosures of appropriations

Note 26A: Acquittal of authority to draw cash from the Consolidated Revenue Fund (Appropriations) for Ordinary Annual Services Appropriations

Outcome 1 — Enhance the Commonwealth's capacity to manage its net debt portfolio

Particulars	Administered expenses $'000	Departmental outputs $'000	Total $'000
Year ended 30 June 2008 (current period)			
Balance carried from previous year	**10**	**10,447**	**10,457**
Appropriation Act:			
Appropriation Act (No. 1) 2007-2008	**10**	**8,528**	**8,538**
Appropriation Act (No. 3) 2007-2008	**-**	**-**	**-**
	20	**18,975**	**18,995**
Financial Management and Accountability Act :			
Appropriations to take account of recoverable GST (FMA section 30A)	**-**	**47**	**47**
Reductions	**-**	**(39)**	**(39)**
Annotations to 'net appropriations' (FMA section 31)	**-**	**1,254**	**1,254**
Administered appropriations lapsed	**(10)**	**-**	**(10)**
Total appropriations available for payment	**10**	**20,237**	**20,247**
Cash payments made during the year (GST inclusive)	**-**	**(6,982)**	**(6,982)**
Appropriations credited to Special Accounts (excluding GST)	**-**	**-**	**-**
Balance of Authority to draw cash from the Consolidated Revenue Fund for Ordinary Annual Services Appropriations	**10**	**13,255**	**13,265**
Balance carried forward to next year represented by:			
Cash at bank	**-**	**159**	**159**
Departmental appropriation receivable	**-**	**13,095**	**13,095**
Net GST receivable from the ATO	**-**	**1**	**1**
Undrawn, unlapsed administered appropriations (a)	**10**	**-**	**10**
Total	**10**	**13,255**	**13,265**

FMA = *Financial Management and Accountability Act 1997*.

(a) The undrawn, unlapsed administered appropriation is to be formally lapsed by the Minister for Finance and Deregulation in 2008-09.

Note 26: Disclosures of appropriations (continued)

Note 26A: Acquittal of authority to draw cash from the Consolidated Revenue Fund (Appropriations) for Ordinary Annual Services Appropriations (continued)

Outcome 1 — **Enhance the Commonwealth's capacity to manage its net debt portfolio**

Particulars	Administered Expenses $'000	Departmental Outputs $'000	Total $'000
Year ended 30 June 2007 (comparative period)			
Balance carried from previous year	10	7,910	7,920
Appropriation Act:			
Appropriation Act (No. 1) 2006-2007	10	8,373	8,383
Appropriation Act (No. 3) 2006-2007	-	100	100
	20	16,383	16,403
Financial Management and Accountability Act :			
Refunds credited (FMA section 30)	-	4	4
Appropriations to take account of recoverable GST (FMA section 30A)	-	55	55
Annotations to 'net appropriations' (FMA section 31)	-	1,364	1,364
Administered appropriations lapsed	(10)	-	(10)
Total appropriations available for payment	10	17,806	17,816
Cash payments made during the year (GST inclusive)	-	(7,359)	(7,359)
Balance of Authority to draw cash from the Consolidated Revenue Fund for Ordinary Annual Services Appropriations	10	10,447	10,457
Balance carried to next year represented by:			
Cash at bank	-	312	312
Departmental appropriation receivable	-	10,131	10,131
Net GST receivable from the ATO(a)	-	4	4
Undrawn, unlapsed administered appropriations (b)	10	-	10
Total	10	10,447	10,457

FMA = *Financial Management and Accountability Act 1997*.

(a) This amount is offset against GST payable in the AOFM's departmental Balance Sheet.

(b) The undrawn, unlapsed administered appropriation was formally lapsed by the Minister for Finance and Deregulation in 2007-08.

Note 26: Disclosures of appropriations (continued)

Note 26B: Acquittal of authority to draw cash from the Consolidated Revenue Fund (Appropriations) for Other than Ordinary Annual Services Appropriations

Outcome 1 — Enhance the Commonwealth's capacity to manage its net debt portfolio

Particulars	Non-operating Departmental equity injections $'000
Year ended 30 June 2008 (current period)	
Balance carried from previous year	**949**
Sub-total 2007-08 Annual Appropriation	**949**
Appropriations to take account of recoverable GST (FMA section 30A)	**-**
Total appropriations available for payments	**949**
Cash payments made during the year (GST inclusive)	**-**
Balance of Authority to draw cash from the Consolidated Revenue Fund for Other than Ordinary Annual Services	**949**
Balance carried to next year represented by:	
Departmental equity injection appropriation receivable	**949**
Total	**949**
Year ended 30 June 2007 (comparative period)	
Balance carried from previous year	1,473
Total appropriations available for payments	1,473
Cash payments made during the year (GST inclusive)	524
Balance carried to next year	949

FMA = *Financial Management and Accountability Act 1997*.

Note 26: Disclosures of appropriations (continued)

Note 26C: Acquittal of authority to draw cash from the Consolidated Revenue Fund — Administered Special Appropriations (unlimited amount)

Special Appropriation (Act)	**2008**	2007
	$'000	$'000
Airports (Transitional) Act 1996, section 78		
Purpose: payment of principal and interest on former debts of the Federal Airports Corporation		
Cash payments made during year - principal (expenditure)	**-**	-
Cash payments made during year - interest (expenditure)	**-**	-
Appropriations credited to Special Accounts	**-**	-
Refunds credited (net) (FMA section 30)	**-**	-
Total charged to appropriation	**-**	-
Estimated actual - principal (expenditure)	**-**	-
Estimated actual - interest (expenditure)	**-**	-
Australian National Railways Sale Act 1997, section 67AW		
Purpose: payment of principal and interest on former debts of the National Railways Commission		
Cash payments made during year - principal (expenditure)	**-**	-
Cash payments made during year - interest (expenditure)	**-**	-
Appropriations credited to Special Accounts	**-**	-
Refunds credited (net) (FMA section 30)	**-**	-
Total charged to appropriation	**-**	-
Estimated actual - principal (expenditure)	**-**	-
Estimated actual - interest (expenditure)	**-**	-
Commonwealth Inscribed Stock Act 1911, section 6		
Purpose: payment of principal and interest on money raised by Stock issued under the Act		
Cash payments made during year - principal (expenditure)	**2,906,516**	6,103,614
Cash payments made during year - interest (expenditure)	**3,508,605**	3,503,277
Appropriations credited to Special Accounts	**-**	-
Refunds credited (net) (FMA section 30)	**-**	-
Total charged to appropriation	**6,415,121**	9,606,891
Estimated actual - principal (expenditure)	***2,913,978***	*6,111,629*
Estimated actual - interest (expenditure)	***3,507,000***	*3,503,000*

Note 26: Disclosures of appropriations (continued)

Note 26C: Acquittal of authority to draw cash from the Consolidated Revenue Fund — Administered Special Appropriations (unlimited amount) (continued)

Special Appropriation (Act)	**2008**	2007
	$'000	$'000
Financial Agreement Act 1994, section 5		
Purpose: debt redemption assistance and payment of interest to bond holders on behalf of the States and Northern Territory on public debt under the Act		
Cash payments made during year (expenditure)	**350**	352
Appropriations credited to Special Accounts (included in total cash payments above)	**58**	55
Refunds credited (net) (FMA section 30)	**-**	-
Total charged to appropriation	**350**	352
Estimated actual (expenditure)	**-**	-
Financial Management and Accountability Act 1997, section 30A		
Purpose: payments of recoverable GST		
Cash payments made during year (expenditure)	**-**	-
Appropriations credited to Special Accounts	**-**	-
Refunds credited (net) (FMA section 30)	**-**	-
Total charged to appropriation	**-**	-
Estimated actual (expenditure)	**-**	-

Note 26: Disclosures of appropriations (continued)

Note 26C: Acquittal of authority to draw cash from the Consolidated Revenue Fund — Administered Special Appropriations (unlimited amount) (continued)

Special Appropriation (Act)	**2008**	2007
	$'000	$'000
Financial Management and Accountability Act 1997, section 39(9)		
Purpose: to make investments in the name of the Treasurer of the Commonwealth of Australia(i)		
Cash payments made - principal (expenditure)	**318,750,000**	255,600,000
Cash payments made - interest (expenditure)	**-**	-
Appropriations credited to Special Accounts	**-**	-
Refunds credited (net) (FMA section 30)	**-**	-
Total charged to appropriation	**318,750,000**	255,600,000
Estimated actual - principal (expenditure)	***292,166,000***	*232,861,000*
Estimated actual - interest (expenditure)	**-**	-
(i) The AOFM draws appropriations to make term deposit investments with the RBA. These deposits are used to manage the daily variations in the OPA. The cash flows into and out of the OPA are highly variable from day-to-day and so in consequence are the number, size and timing of term deposits.		
Loans Redemption and Conversion Act 1921, section 5		
Purpose: payment of principal, interest and the costs of converting loans made in accordance with the Act		
Cash payments made during year - principal (expenditure)	**-**	-
Cash payments made during year - interest (expenditure)	**-**	-
Appropriations credited to Special Accounts	**-**	-
Refunds credited (net) (FMA section 30)	**-**	-
Total charged to appropriation	**-**	-
Estimated actual - principal (expenditure)	**-**	-
Estimated actual - interest (expenditure)	**-**	-
Loans Securities Act 1919, section 4		
Purpose: payment of principal and interest on money raised by Stock issued under the Act		
Cash payments made during year - principal (expenditure)	**-**	-
Cash payments made during year - interest (expenditure)	**503**	579
Appropriations credited to Special Accounts	**-**	-
Refunds credited (net) (FMA section 30)	**-**	-
Total charged to appropriation	**503**	579
Estimated actual - principal (expenditure)	**-**	-
Estimated actual - interest (expenditure)	***1,000***	*1,000*

Note 26: Disclosures of appropriations (continued)

Note 26C: Acquittal of authority to draw cash from the Consolidated Revenue Fund — Administered Special Appropriations (unlimited amount) (continued)

Special Appropriation (Act)	**2008**	2007
	$'000	$'000
Loans Securities Act 1919, section 5B		
Purpose: payment of money under a swap agreement and any expenditure in connection with the negotiation, management or service of, or a repayment under any such agreement(ii)		
Cash payments made during year - principal (expenditure)	**-**	-
Cash payments made during year - interest (expenditure)	**1,812,468**	1,740,017
Appropriations credited to Special Accounts	**-**	-
Refunds credited (net) (FMA section 30)	**-**	-
Total charged to appropriation	**1,812,468**	1,740,017
Estimated actual - principal (expenditure)	**-**	-
Estimated actual - interest (expenditure)	***1,812,390***	*1,740,014*

(ii) Master Agreements executed between the Commonwealth and swap counterparties provide for settlement of interest rate swaps on a net basis per transaction. All amounts in relation to these transactions are disclosed in this note on an aggregate basis.

Moomba - Sydney Pipeline System Sale Act 1994, section 19		
Purpose: payment of principal and interest on former debts of the Pipeline Authority		
Cash payments made during year - principal (expenditure)	**-**	-
Cash payments made during year - interest (expenditure)	**-**	-
Appropriations credited to Special Accounts	**-**	-
Refunds credited (net) (FMA section 30)	**-**	-
Total charged to appropriation	**-**	-
Estimated actual - principal (expenditure)	**-**	*5*
Estimated actual - interest (expenditure)	**-**	-

Note 26: Disclosures of appropriations (continued)

Note 26C: Acquittal of authority to draw cash from the Consolidated Revenue Fund — Administered Special Appropriations (unlimited amount) (continued)

Special Appropriation (Act)	**2008**	2007
	$'000	$'000
Qantas Sale Act 1992, section 18		
Purpose: payment of principal and interest on former debts of Qantas		
Cash payments made during year - principal (expenditure)	**-**	-
Cash payments made during year - interest (expenditure)	**-**	-
Appropriations credited to Special Accounts	**-**	-
Refunds credited (net) (FMA section 30)	**-**	-
Total charged to appropriation	**-**	-
Estimated actual - principal (expenditure)	**-**	-
Estimated actual - interest (expenditure)	**-**	-
Snowy Hydro Corporatisation Act 1997, section 22		
Purpose: payment of principal and interest on former debts of the Snowy Mountains Hydro Electricity Authority		
Cash payments made during year - principal (expenditure)	**16,000**	-
Cash payments made during year - interest (expenditure)	**1,146**	1,962
Appropriations credited to Special Accounts	**-**	-
Refunds credited (net) (FMA section 30)	**-**	-
Total charged to appropriation	**17,146**	1,962
Estimated actual - principal (expenditure)	***16,000***	-
Estimated actual - interest (expenditure)	***1,146***	*2,000*

Note 26: Disclosures of appropriations (continued)

Note 26C: Acquittal of authority to draw cash from the Consolidated Revenue Fund — Administered Special Appropriations (unlimited amount) (continued)

Special Appropriation (Act)	**2008**	2007
	$'000	$'000
Treasury Bills Act 1914, section 6		
Purpose: payment of principal and interest on money raised by issuance of Treasury Bills		
Cash payments made during year - principal (expenditure)	-	-
Cash payments made during year - interest (expenditure)	-	-
Appropriations credited to Special Accounts	-	-
Refunds credited (net) (FMA section 30)	-	-
Total charged to appropriation	-	-
Estimated actual - principal (expenditure)	-	-
Estimated actual - interest (expenditure)	-	-
Total budget estimate (expenditure)	***300,417,514***	*244,218,648*
Total payments made (expenditure)	***326,995,588***	*266,949,801*
Appropriations credited to Special Accounts (included in total payments made above)	***58***	*55*
Refunds credited (section 30)	-	-

Note 26: Disclosures of appropriations (continued)

Note 26D: Acquittal of authority to draw cash from the Consolidated Revenue Fund — Special Appropriations (Refund Provisions)

In 2007-08 the AOFM drew down $50,000 under section 28 of the *Financial Management and Accountability Act 1997* to repay monies received from a counterparty in error. For 2006-07 the AOFM did not use section 28 of the *Financial Management and Accountability Act 1997* or any other legislative provision allowing refunds to be paid where it would otherwise have no appropriation available for making repayments.

Note 26E: Acquittal of authority to draw cash from the Consolidated Revenue Fund — Special Appropriations (FMA section 39)

	2008	2007
	$'000	$'000
Administered investment of Public Money: Special Appropriations under FMA section 39		
Amount invested carried from previous period	**20,350,000**	18,150,000
Prior year investments redeemed in current year	**(20,350,000)**	(18,150,000)
Investments made during year(a)	**318,750,000**	255,600,000
Redemptions of current year investments	**(289,700,000)**	(235,250,000)
Amount invested carried to the next period	**29,050,000**	20,350,000
Budget estimate of expenditure - estimated actual	***292,166,000***	*232,861,000*

(a) Investment activity made under FMA section 39 is also disclosed in Note 26C.
FMA = *Financial Management and Accountability Act 1997*.

Note 26: Disclosures of appropriations (continued)

Note 26F: Special accounts (Administered)

Debt Retirement Reserve Trust Account

- Legal Authority — *Financial Management and Accountability Act 1997*, section 21.
- Purpose — for the payment and receipt of monies in accordance with the *Financial Agreement Act 1994*.

	2008	2007
	$'000	$'000
Balance carried from previous period	**422**	410
Interest amounts credited	**28**	23
Appropriations for reporting period	**30**	31
Other receipts:		
State and Territory contributions	**361**	93
Available for payments	**841**	557
Payments made:		
Debt repayments	**(394)**	(135)
Balance carried to next year	**447**	422
Balance carried represented by:		
Cash on call held in the Official Public Account	**447**	422
Total balance carried to next year	**447**	422

Note 26G: Assets held in trust (Administered)

Monies standing to the credit of the Debt Retirement Reserve Trust Account are held on behalf of the States and Northern Territory. These monies are held for the purposes prescribed by the *Financial Agreement Act 1994*.

Details of balances, payments and receipts in relation to the Debt Retirement Reserve Trust Account are provided in Note 26F: Special accounts (Administered).

Note 27: Reporting of outcomes

Note 27A: Net cost of outcome delivery

	Outcome 1	Outcome 1
	2008	2007
	$'000	$'000
Expenses		
Administered expenses	**5,351,002**	5,395,006
Departmental expenses	**7,512**	8,383
Total expenses	**5,358,514**	5,403,389
Costs recovered from provision of goods and services to the non-government sector		
Administered	**-**	-
Departmental	**-**	-
Total costs recovered	**-**	-
Other external revenue		
Administered		
Interest	**2,995,083**	3,133,681
Other	**2,266**	256
Gains (losses)	**(116,894)**	1,015,642
Total administered	**2,880,455**	4,149,579
Departmental		
Other	**1,464**	1,329
Total departmental	**1,464**	1,329
Total other external revenue	**2,881,919**	4,150,908
Net cost of outcome	**2,476,595**	1,252,481

Note 28: Major departmental revenue and expenses by output group and output

The AOFM delivers a single output — debt management. The Income Statement provides the major classes of departmental revenue and expenses attributable to this output.

Note 29: Major classes of administered revenue and expenses by outcome

The AOFM delivers a single outcome — to enhance the Commonwealth's capacity to manage its net debt portfolio, offering the prospect of savings in debt servicing costs and an improvement in net worth of the Commonwealth over time. The Administered Schedule of Income and Expenses Administered on Behalf of Government provides the major classes of administered revenue and expenses attributable to this outcome.

Note 30: Communications Fund

The AOFM currently acts as an agent for the Department of Broadband, Communications and the Digital Economy (DBCDE) in making investments on behalf of the Communications Fund. These investments and their earnings are reported by DBCDE and not the AOFM.

The Communications Fund was established by Part 9C of the *Telecommunications (Consumer Protection and Service Standards) Act 1999*. The Communications Fund consists of a special account and investments.

***Telecommunications (Consumer Protection and Service Standards) Act 1999* (Part 9C)**	**DBCDE (Responsible Agency) 2008 $'000**	**DBCDE (Responsible Agency) 2007 $'000**
Opening Balance — 1 July	**2,215,986**	2,084,595
Investment earnings receipts	**140,592**	131,583
Expense payments	**(159)**	(192)
Balance of investments (at cost) — 30 June	**2,356,419**	2,215,986

This table is prepared on a cash basis, showing net receipts and payments.

In the 2008-09 Budget it was announced that the Communications Fund would close during the year and its assets would be transferred to the Building Australia Fund, which will be managed by the Future Fund Board of Guardians.

Note 31: Events occurring after reporting date

There have been no significant events occurring after the reporting date that would materially affect these financial statements.

AOFM

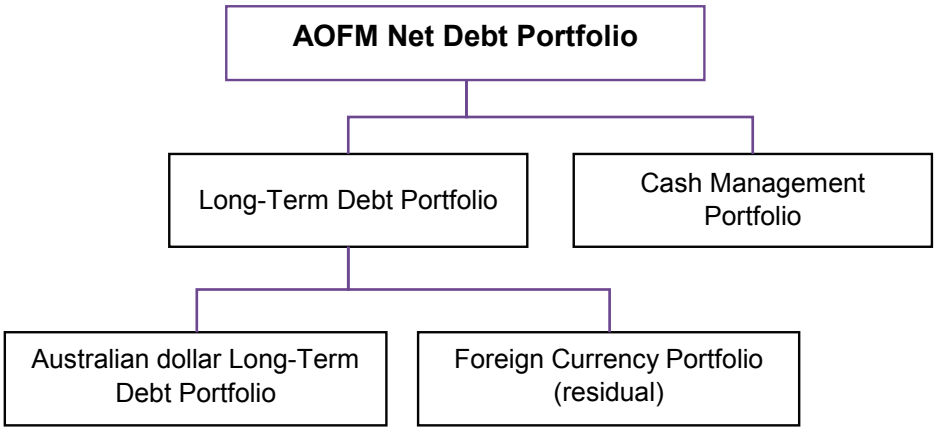
PART 5
OTHER INFORMATION

OTHER INFORMATION

Structure of the AOFM's portfolio

The components of the Australian Government's balance sheet managed by the AOFM as at the end of June 2008 were Commonwealth Government Securities (Treasury Bonds, Treasury Indexed Bonds and other securities), term deposits placed with the Reserve Bank of Australia (RBA) and interest rate swaps.[1] Together they comprised the AOFM's net debt portfolio. The portfolio included a number of sub-portfolios, as shown in Figure 1.

Figure 1: Portfolio structure



The basic division of the portfolio has been between the Long-Term Debt Portfolio and the Cash Management Portfolio. This recognises the very different risks and management approach required for a relatively stable portfolio of long-term continuing debt compared to a portfolio of short-term assets and liabilities that is subject to significant volatility due to within-year mismatches in the timing of government receipts and outlays.

The Long-Term Debt Portfolio consisted of a Foreign Currency Portfolio and an Australian dollar Long-Term Debt Portfolio. The Government no longer undertakes borrowings in foreign currencies and the Foreign Currency Portfolio holds only a residual amount of debt from a single US dollar denominated loan.

1 The AOFM also administers housing loans to the States under the Commonwealth-State Housing Agreements and invests monies belonging to the Communications Fund on behalf of the Department of Broadband, Communications and the Digital Economy.

The Australian dollar Long-Term Debt Portfolio consisted of Australian dollar Commonwealth Government Securities (CGS) debt, excluding any debt issued for cash management purposes. The volume of the portfolio was adjusted over the course of the financial year to smooth the impact of discontinuities that would otherwise be produced by large transactions in the issuance of Treasury Bonds and maturities. This was achieved through short-term internal transfers between the Australian dollar Long-Term Debt Portfolio and the Cash Management Portfolio.

All liabilities and assets not within the Long-Term Debt Portfolio were held in the Cash Management Portfolio. The Cash Management Portfolio manages the within-year variability in the Australian Government's financing requirement and any surplus assets that may accumulate from time to time.

Funding

Table 1 places the AOFM's debt and cash management activities in 2007-08 in the context of the overall flow of funds for the Australian Government General Government Sector. Flows managed by the AOFM are shown in purple.

Table 1: General Government Sector funding requirement and funding sources

Source of funds	Actual 2007-08 ($billion)	Use of funds	Actual 2007-08 ($billion)
Headline budget balance	28.2		
Debt issuance[a]		**Debt redemption**[a]	
Treasury Bonds	5.0	Maturing CGS debt	2.9
Treasury Indexed Bonds	0.0	Early CGS debt repurchases	..
Treasury Notes (net change in outstandings)	0.0	Other general government sector redemptions (net)	0.2
Total	**5.0**	**Total**	**3.1**
		Other applications of funds	
		Swap interest (net)	0.1
		Other (net)[b]	..
		Total	**0.1**
		Financial assets	
		Change in Official Public Account balance at the RBA	0.4
		Change in term deposits at the RBA	8.7
		Change in other general government sector investments	20.8
		Total	**30.0**
Total	**33.2**	**Total**	**33.2**

(a) Cash flows rather than face value of securities.
(b) Includes other general government sector flows not elsewhere classified.
(c) Not all totals may sum exactly due to rounding.
(d) .. not zero but less than $0.05 billion.

Appropriations and other sources of funding

Table 2 summarises the gross resources applied by the AOFM in 2007-08 and budgeted for 2008-09, both from appropriations and other sources and for recurrent and capital purposes.

Agency recurrent funding is used to meet operating expenses such as employee remuneration and supplier payments.

Administered recurrent funding is used to meet operating expenses such as interest on Australian Government debt and swap interest payments.

Capital funding is used to meet the cost of maturing Australian Government debt and to make investments for the purposes of debt management.

Table 2: AOFM gross appropriations and other funding

	Budget(a) 2007-08 ($'000)	Actual 2007-08 ($'000)	Budget 2008-09 ($'000)
FUNDING FOR CURRENT PURPOSES			
ADMINISTERED EXPENSES			
Annual appropriations	10	-	10
Special appropriations	6,004,712	5,468,650	5,019,539
Total administered appropriations	**6,004,722**	**5,468,650**	**5,019,549**
DEPARTMENTAL			
Annual appropriations	8,489	8,489	8,467
Total revenue from government (appropriations) contibuting to price of agency outputs	**8,489**	**8,489**	**8,467**
Percentage of total price of outputs	**87.6%**	**83.0%**	**90.7%**
Revenue from other sources			
Other sources	1,201	1,733	867
Total revenue from other sources	**1,201**	**1,733**	**867**
Total price of agency outputs	**9,690**	**10,222**	**9,334**
Total resourcing - recurrent purposes	**6,014,412**	**5,478,872**	**5,028,883**
FUNDING FOR CAPITAL PURPOSES(b)			
ADMINISTERED			
Special appropriations	295,095,978	321,672,516	297,264,000
Total administered appropriations	**295,095,978**	**321,672,516**	**297,264,000**
AGENCY			
Agency equity injections(c)	**-**	**-**	**-**
Total resourcing - capital purposes	**295,095,978**	**321,672,516**	**297,264,000**
Total resourcing for AOFM Outcome(d)	**301,110,390**	**327,151,388**	**302,292,883**
Administered	301,100,700	327,141,166	302,283,549
Departmental	9,690	10,222	9,334
	Budget(a) 2007-08	**Actual 2007-08**	**Budget 2008-09**
Average staffing level (number)	33	29	33

(a) The Budget figure for 2007-08 is the 'estimated actual 2007-08 balance' reported in the *Portfolio Budget Statements 2008-09*.
(b) Excludes repayments of debt made on behalf of the State and Territory governments through the Debt Retirement Reserve Trust Account, a special account governed by the *Financial Agreement Act 1994*.
(c) During 2007-08 the AOFM did not use any agency equity injections.
(d) Refer to Part 1: AOFM overview for discussion on AOFM's outcome.

Advertising and market research

During the 2007-08 financial year, total payments of $36,652 were made by the AOFM to advertising agencies, market research organisations, polling organisations, direct mail organisations or media advertising organisations. The payments were made to media advertising organisations for recruitment advertising.

Discretionary grants

No discretionary grants are administered by the AOFM.

Freedom of information

Section 8 of the *Freedom of Information Act 1982* requires agencies to publish information about:

- their organisation and decision making powers;
- what arrangements they make for public involvement in their work;
- what types of documents they hold; and
- how the public can access these documents.

Freedom of information matters in respect of the AOFM are handled by the Treasury and the statement required under section 8 of the *Freedom of Information Act 1982* appears in the Treasury Annual Report. In this material, references to 'Department' encompass the AOFM. Additional details that relate specifically to the AOFM are provided below.

Organisation and decision-making

Details of the AOFM's organisational structure are provided in Figure 1 in Part 1 of this report. Its functions and decision-making are outlined in the section on AOFM role, functions, outcome and output structure in Part 1 of this report and the section on senior management committees in Part 3. The Treasurer has delegated the powers to AOFM officials under the following legislation:

- *Commonwealth Inscribed Stock Act 1911* and the Commonwealth Inscribed Stock Regulations;
- *Loans Securities Act 1919*;
- *Financial Management and Accountability Act 1997*; and

- other Acts with regard to appropriations as set out in Note 26C of the financial statements included in this report.

The Minister for Finance and Deregulation has delegated certain powers under the *Financial Management and Accountability Act 1997* and the *Financial Management and Accountability Regulations* to the Chief Executive Officer of the AOFM.

The Minister for Broadband, Communications and the Digital Economy and the Minister for Finance and Deregulation have authorised the Chief Executive Officer of the AOFM to make and realise investments for the Communications Fund under the *Telecommunications (Consumer Protection and Service Standards) Act 1999*.

Arrangements for public involvement

The AOFM consults informally with financial market participants affected by its activities. It also obtains advice from the AOFM Advisory Board, described in Part 3 of this report, which includes three members from the financial sector. Information on the Agency can be found on its website www.aofm.gov.au and enquiries can be addressed to it by mail or email. The AOFM does not issue Commonwealth Government Securities directly to the public, but small parcels of these securities may be purchased or sold through the Reserve Bank of Australia. Larger volumes may be traded through professional financial institutions.

Documents held by the AOFM

The AOFM holds correspondence, contracts and agreements, records of transactions, analysis and advice, financial and statistical data, and drafts and internal working documents prepared by its staff and relating to its functions of issuing and managing debt, investment of public monies and cash management. It also holds personnel records, organisation and staffing records, financial and expenditure records, and office procedures and instructions.

The AOFM places an indexed list of its policy file titles on the AOFM website every six months.

Access to documents

Applicants seeking access under the *Freedom of Information Act 1982* to AOFM documents should apply in writing to:

The Secretary
The Treasury
Langton Crescent
PARKES ACT 2600
Attention: Freedom of Information Coordinator

If a member of the public requests a document and the Treasury approves access, the Treasury will provide copies of documents after the applicant pays any charges.

Alternatively, applicants may arrange to inspect documents at the Treasury, Langton Crescent, Parkes, ACT between 9.00 am and 5.00 pm, Monday to Friday (except public and public service holidays).

An application fee of $30 or a written request, pursuant to subsection 30A(1) of the *Freedom of Information Act*, that the application fee be waived should accompany requests. Telephone enquiries should be directed to the Freedom of Information Coordinator, telephone 02 6263 2111, between 9.00 am and 5.00 pm Monday to Friday (except public or public service holidays).

Officers of the SES in Treasury can grant or refuse requests for access to documents under section 23 of the *Freedom of Information Act*. In accordance with section 54 of the Act, an applicant may, within 30 days of receiving notification of a decision under the Act, apply to the Secretary to the Treasury, seeking an internal review of a decision to refuse a request. The prescribed fee of $40 should accompany the application. Executive Directors are authorised under section 23 to consider and make decisions on applications for internal review.

Freedom of information activity

The AOFM received no requests for access to documents under the *Freedom of Information Act* in 2007-08.

Ecologically sustainable development

The Treasury provides procurement and facilities management services for the AOFM under a Service Level Agreement. The following statement, prepared by Treasury, describes these services. References in it to Treasury or the Department include the AOFM.

The Treasury's operations continue to have an impact on the environment through the use of electricity, petrol, water, paper and other materials consumed, and through the generation of waste.

During the year, the Chief Executive Instructions governing Environmental Management were issued to reflect the Treasury's commitment to improving environmental practices in energy management, procurement, technology, work practices and staff activities. These instructions provide guidance to Treasury staff to improve the sustainability of the Treasury's operations.

Energy management

The general office lighting system is part of the building management system and lighting is programmed to operate only during normal working hours. The after hours lighting system has manually operated switches which run for two hours. Additionally, infrared motion detection devices control lighting in areas not in constant use, such as conference and meeting rooms.

Recycling

The Treasury recycles paper and cardboard products, which are collected by a local recycling firm. Classified waste paper is pulped and paper hand towels are recycled. Bins are provided in staff kitchens to separate recyclable items. During 2007-08, the Treasury recycled 196.7 cubic meters of used paper hand towels and 82.5 cubic meters of co-mingled glass and plastics from staff kitchens. Staff kitchens also have sealed compost waste containers. In 2007-08 the Treasury recycled over 2,991 kilograms of compostable waste. The Treasury participates in the recycling of toner cartridges and recycled around 744 kilos during 2007-08.

Water

The tenancies within the Treasury building are not metered separately for water consumption. The landlord has installed flow restrictors on taps and dual flushed toilets where the Treasury is the tenant.

GLOSSARY

Accrual cost

A method of accounting based on recording revenue and expenses when they are incurred, regardless of when cash is exchanged.

Bank Bill Swap Rates (BBSW)

Reference rates for bank bills accepted by approved banks published each business day by the Australian Financial Markets Association.

Basis point

One hundredth of one per cent.

Benchmark

An index or notional portfolio used as a point of reference for the management of an actual portfolio or the measurement of its performance.

Bid-ask spread

The difference between the price (or yield) at which a market maker is willing to buy and sell a particular financial product or instrument.

Book value

(also known as carrying amount) The amount at which an asset or liability is recognised in the balance sheet. Under a fair value methodology, measurement is by reference to current market rates. Under an historic cost methodology, measurement is by reference to market value rates at the time the transaction giving rise to the asset or liability was conducted. The AOFM's assets and liabilities are measured at fair value, except for Australian Government loans to the States for housing, which are measured at historic cost.

Cash Management Portfolio

During 2007-08, the AOFM allocated its net debt between a Long-Term Debt Portfolio and a Cash Management Portfolio. The Cash Management Portfolio contains short-term assets and liabilities and is used to manage the within-year variability in the Government's cash flows.

Commonwealth Government securities (CGS)

Debt obligations of the Commonwealth evidenced by the issue of securities or, increasingly, issued as inscribed stock. CGS on issue are predominantly Treasury Bonds and Treasury Indexed Bonds but also include small residual volumes of Australian Savings Bonds, Peace Saving Certificates and War Saving Certificates.

Coupon rate

The rate of fixed interest payment on a bond. In the case of Treasury Bonds coupon interest is payable semi-annually and the coupon rate is set on the date of announcement of first issuance of the bond line.

Credit risk

The risk of financial loss arising from a counterparty to a transaction defaulting on its financial obligations under that transaction. Credit risk is contingent on both a default taking place and there being pecuniary loss as a result. The AOFM faces credit risk in relation to its interest rate swap and investment transactions.

Credit spread

Is the difference in yield between different securities due to different credit quality. The credit spread reflects the additional net yield an investor can earn from a security with more credit risk relative to one with less credit risk.

Discount

The amount by which the value of a security is less than its face, or par, value.

Discounting

Calculating the present value of a future amount.

Duration

Duration (expressed in years) represents the 'effective term' of a bond. It is the weighted average life of a bond or a portfolio of bonds. The weights are the relative cash flows associated with the bond or portfolio (the coupon payments and principal), discounted to their present value. See modified duration.

Exposure

The amount of money at risk in a portfolio. Exposure to a risk is calculated by measuring the current mark-to-market value that is exposed to that risk.

Face value

The amount of money indicated on a security, or inscribed in relation to a security, as being due to be paid on maturity.

Fixed leg

The component of an interest rate swap that provides interest at a fixed rate.

Fixed rate

An interest rate calculated as a constant percentage of the face value or notional principal and generally payable quarterly semi-annually or annually. Treasury Bonds pay a fixed coupon rate semi-annually.

Floating leg

The component of an interest rate swap that provides for the payment of interest at a floating rate.

Floating rate

An interest rate that varies according to a particular indicator such as BBSW (Bank Bill Swap Reference Rate). For example, the floating leg of an interest rate swap may provide for the interest paid to be reset each six months in accordance with the BBSW.

Foreign Debt Portfolio

The non-domestic currency component of the Long-Term Debt Portfolio. Following the elimination of the foreign currency derivatives exposure, this portfolio now consists of a single US dollar denominated loan issued in the 1980s.

Funding risk

The risk that an issuer is unable to raise funds, as required, in an orderly manner and without financial penalty. For the Australian Government, funding risk encompasses both long-term fund raising to cover future budget needs and the short-term mismatches in the timing of government outlays and receipts.

Futures basket

A collection of like financial products or commodities, grouped together, that are used to define a futures contract. For example, 3- and 10-year Treasury Bond futures baskets consist of collections of Treasury Bond lines that have an average term to maturity of approximately three and ten years respectively.

Futures contract

An agreement between two parties that commits one party to buy an underlying financial instrument or commodity and one party to sell a financial instrument or commodity at a specific price at a future date. The agreement is completed at a specified expiration date by physical delivery or cash settlement or offset prior to the expiration date. In Australia standardised futures contracts are traded on the Sydney Futures Exchange. Futures contracts traded on the Sydney Futures Exchange include contracts for 3-year and 10-year Treasury Bonds.

Historic cost

Basis of measurement where an asset or liability is recorded at fair value on initial recognition and after initial recognition by amortisation of the initial value using market rates at the time the transaction giving rise to the asset or liability was conducted.

Interest rate risk

The risk that the value of a portfolio or security changes due to a change in interest rates. For example, the market value of a bond price drops as interest rates rise.

Issuance

The sale of debt securities in the primary market.

Kangaroo bonds

Australian dollar denominated bonds issued in the Australian capital market by foreign borrowers.

Liquidity

The capacity of a debt instrument to be easily sold and converted into cash. A liquid market allows the buying or selling of large quantities of an instrument without significant movement in price.

Liquidity also refers to the ability to meet cash payment obligations.

Liquidity risk

The risk that a financial instrument will not be able to be purchased or sold readily.

Long-Term Debt Portfolio

During 2007-08, the AOFM allocated its net debt between a Long-Term Debt Portfolio and a Cash Management Portfolio. The Long-Term Debt Portfolio contains ongoing domestic and foreign currency liabilities and assets.

Market risk

The risk that the price (value) of a financial instrument or portfolio of financial instruments will vary as market conditions change. In the case of a debt issuer such as the AOFM, the principal source of market risk is from changes in interest rates.

Market value

The amount of money for which a security trades in the market at a particular point of time.

Modified duration

A measure of the sensitivity of the market value of a debt security to a change in interest rates. It is measured as the percentage change in the market value of a debt instrument in response to a one percentage point change in nominal interest rates. Portfolios with higher modified durations have more stable interest costs through time but have a more volatile market value through time. Modified duration is related to duration by the equation:

$$\text{Modified duration} = \frac{\text{Duration (years)}}{1 + \text{yield to maturity}}$$

However, at times, 'modified duration' is abbreviated to 'duration', desirably only in contexts where this will not lead to confusion.

Net debt portfolio

The AOFM's net debt portfolio comprises CGS on issue (excluding Australian Government holdings), term deposits at the Reserve Bank of Australia, and interest rate swaps administered by the AOFM. This portfolio represents a subset of Australian Government net debt.

Nominal debt

Debt that is not indexed to inflation. Treasury Notes and Treasury Bonds are examples of nominal debt.

Nominal interest rate

Interest rate that has not been adjusted for the effects of inflation (in contrast to the 'real' interest rate).

Operational risk

The risk of loss, whether direct or indirect, arising from inadequate or failed 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, legal risk, accounting risk, personnel risk and reputation risk.

Overnight Indexed Swap (OIS)

A fixed for floating interest rate swap in which one party agrees to pay the other party a fixed interest rate in exchange for receiving the average overnight cash rate recorded over the term of the swap. The terms to maturity of such swaps are typically between one week to one year. Financial market participants enter into overnight indexed swaps to manage their exposures to movement in the overnight cash rate.

Overnight indexed swaps are quoted by reference to the fixed interest rate leg of the swap. For example, the 3 month OIS rate is the interest rate for the fixed leg of an overnight indexed swap with a term to maturity of 3 months. Interest rates for term deposits placed by the AOFM with the RBA are set by reference to quoted rates for overnight interest swaps.

Present value

The amount that corresponds to today's value of a payment to be received in the future. If the opportunity cost of funds, or discount rate is 10 per cent, the present value of $100 to be received in two years is $\$100 \times [1/(1 + 0.10)^2] = \$82.64$.

Primary market

The market where bonds are issued for the first time and the sale proceeds go to the issuer. For example, the primary market for Treasury Bonds is when the bonds are sold at tender by the AOFM on behalf of the Australian Government.

Real interest rate

Interest rate that has been adjusted for the effects of inflation. For example, if the coupon interest rate on a bond is 6.5 per cent and the inflation rate is 3 per cent then the real rate of interest on that bond is 3.5 per cent.

Repo

A repurchase agreement under which the seller of a security agrees to buy it back at a specified time and price.

Repricing risk

The risk that interest rates have increased when maturing debt needs to be refinanced. Whenever the AOFM enters the market to borrow funds, it is exposed to repricing risk. Similarly, the use of interest rate swaps to reduce the duration of the portfolio, by receiving a fixed rate and paying a floating rate, increases the level of repricing risk.

Risk premium

The difference between the return available on a risk-free asset and the return available on a riskier asset.

Secondary market

The market where securities are bought and sold subsequent to original issuance.

Securities lending

An activity whereby securities are lent to a financial market participant for a fee. This activity may be conducted to alleviate temporary market shortages of specific lines of stock.

Securities Lending Facility

A facility established by the AOFM in 2004 that uses repurchase agreements to lend Treasury Bonds to market participants for short periods when they are not readily available from other sources. The facility is operated by the Reserve Bank of Australia on behalf of the AOFM.

Short-dated exposure

The proportion of the portfolio that will have its interest rate reset in the short term and thereby has the potential to create variability in annual debt interest payments. A portfolio with high short-dated exposure will tend to have more volatile annual interest payments than a portfolio with low short-dated exposure.

Spread

The difference between two prices or rates.

Swap

A financial transaction in which two counterparties agree to exchange streams of payments occurring over time according to predetermined rules. The AOFM transacts interest rate swaps to reduce the debt service cost of its debt portfolio.

Tender

A method of issuance whereby debt is sold through auction. The amount, coupon and maturity date of the stock are announced by the issuer. Registered participants then bid for their desired amounts of stock at interest rates at which they are prepared to buy. Bids are accepted from lowest interest rate (yield) upward until the issue amount has been filled. Stock is therefore allocated in order of lowest yield (and highest price).

Tenor

The tenor of a financial instrument is another name for its term to maturity.

Term premium

The margin over the expected path of cash rates that investors require to compensate them for investing at fixed interest in long-term debt.

Treasury Bond

A medium- to long-term debt security issued by the Australian Government that carries an annual rate of interest (the coupon) fixed over the life of the security, payable in six monthly instalments (semi-annually) on the face, or par, value of the security. The bonds are repayable at face value on maturity.

Treasury Indexed Bond

A medium- to long-term debt security which was issued by the Australian Government in two forms (Capital Indexed and Interest Indexed) from 1985 until 2003. With Capital Indexed Bonds, the capital value of the security, on which a fixed rate of interest applies, varies over time according to movements in the Consumer Price Index (CPI). At maturity, the adjusted capital value of the bonds is paid. Interest Indexed Bonds have all matured. Interest on these bonds varied over time according to movements in the CPI. The bonds were repayable at face value on maturity.

Treasury Note

A short-term debt security issued by the Australian Government at a discount and redeemable at par on maturity. The 'interest' payable on the Notes is represented by the difference between their issue value and their par or face value. Treasury Notes are issued to cover short-term mismatches between the Australian Government's outlay and revenue streams that cannot be funded by other means, such as changes in the AOFM's holdings of term deposits with the Reserve Bank of Australia.

Two-way price

The provision by a market-maker of the prices (or yields) at which they are prepared to buy and sell a particular financial product or instrument. That is, the quoting of both a bid and an offer.

UBS Australian Bank Bill Index

A performance benchmark designed to represent the performance of a passively managed short-term money market portfolio. This index has an average term to maturity of approximately 45 days which is commensurate with the average term to maturity of assets comprising major cash management trusts.

Yield curve

The graphical representation of the relationship between the yield on debt securities of the same credit quality but different term to maturities on a specific date. When securities with longer terms to maturity have a higher yield than securities with shorter terms to maturity, the curve is said to have a positive slope. In the opposite case, the slope is said to be negative or inverse.

Acronyms

AASB	Australian Accounting Standards Board
ANAO	Australian National Audit Office
AOFM	Australian Office of Financial Management
APEC	Asia-Pacific Economic Cooperation
APS	Australian Public Service
AUD	Australian dollar
BBSW	Bank Bill Swap Rate
CEO	Chief Executive Officer
CGS	Commonwealth Government securities
CPI	Consumer Price Index
EL	Executive Level (APS Classification)
FBT	Fringe Benefit Tax
FMA	*Financial Management and Accountability Act 1997*
FMO	Finance Minister's Orders
GDP	Gross Domestic Product
GST	Goods and Service Tax
IT	Information technology
LTDP	Long-term Debt Portfolio
OECD	Organisation for Economic Co-operation and Development
OPA	Official Public Account
RBA	Reserve Bank of Australia
RITS	Reserve Bank Information and Transfer System
SES	Senior Executive Service
USD	United States dollar

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CONTACT DETAILS

Enquiries

Enquiries regarding this report may be directed to:

Liaison Officer
Australian Office of Financial Management
Treasury Building
Langton Crescent
PARKES ACT 2600

Telephone: (61-2) 6263 1111
Fax: (61-2) 6263 1222
Email: enquiries@aofm.gov.au

Internet address

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