Quarterly Report
For period ended 30 June 2014

LGFA New Zealand Local Government Funding Agency

1. COMMENTARY ON OPERATIONS FOR THE QUARTER

Key points to note during the June quarter:

- LGFA margins to both NZGB and Swap consolidated during the quarter following the significant improvement over the previous quarters. This was not unsurprising given the large amount of issuance during the quarter by highly rated entities, the large contraction in LGFA margins since establishment and the volatile market conditions during the quarter.
- The successful debut of our longest dated LGFA bond so far – the April 2023 maturity – was offered in each of the three tenders held in the June quarter, with $355 million issued by the end of the quarter.
- A continuing focus on overseas marketing activity resulted in offshore investor holdings reaching 18% of our total bonds outstanding.
- Mark Butcher was appointed after an extensive recruitment process by Hobson Leavy to replace Phil Combes who retired as Chief Executive on 1 July 2014. Mark commences with LGFA effective 1 August 2014.

The June quarter was a busy period for LGFA issuance with three LGFA bond tenders held during the quarter (April, May and June) compared to only one tender in the March quarter.

Results of LGFA Bond Tender Number 19

Tender Date: 02 April 2014
Settlement Date: 07 April 2014

Series Offered	5.00% 15 Mar 2019	6.00% 15 May 2021	5.500% 15 April 2023
Total Amount Offered ($million)	10	40	65
Total Amount Allocated ($million)	10	40	65
Total Number of Bids Received	7	10	44
Total Amount of Bids Received ($million)	36	48	201
Total Number of Successful Bids	4	9	15
Highest Yield Accepted (%)	4.850	5.390	5.520
Lowest Yield Accepted (%)	4.820	5.210	5.445
Highest Yield Rejected (%)	4.870	5.490	5.60
Lowest Yield Rejected (%)	4.850	5.390	5.52
Weighted Average Accepted Yield (%)	4.830	5.251	5.480
Weighted Average Rejected Yield (%)	4.863	5.453	5.551
Amount Allotted at Highest Accepted Yield as Percentage of Amount Bid at that Yield*	33	40	70
Coverage Ratio	3.62	1.20	3.09

Highlights of LGFA's nineteenth bond tender were:

- An average bid cover ratio of 2.5 times; a below average result despite a relatively small tender.

- The outstandings of our May 2021 bond exceeded $1 billion following the April tender. Along with the March 2019 maturity, we now have two bonds that have reached this key liquidity target.

Margins over NZGBs and mid-swap levels at the tender were:

LGFA Spreads to NZGBs/Swap (bps) for Bond Maturity	Tender No.19 – 2 April 2014	
	NZGB spread	Swap spread
Mar 2019	61	19
May 2021	81	39
April 2023	87	48

- Margins over NZGBs improved again in tender number 19 with a new record low for our March 2019s. Margins over swap were unchanged for the March 2019s and 3bps wider for the May 2021s.

Results of LGFA Bond Tender Number 20

Tender Date: 14 May 2014
Settlement Date: 19 May 2014

Series Offered	6.00% 15 Dec 2017	5.00% 15 Mar 2019	6.00% 15 May 2021	5.500% 15 April 2023
Total Amount Offered ($million)	10	10	25	155
Total Amount Allocated ($million)	10	10	25	155
Total Number of Bids Received	8	6	18	62
Total Amount of Bids Received ($million)	43	28	78	298
Total Number of Successful Bids	3	3	9	29
Highest Yield Accepted (%)	4.425	4.670	5.070	5.240
Lowest Yield Accepted (%)	4.420	4.640	5.000	5.155
Highest Yield Rejected (%)	4.555	4.725	5.110	5.590
Lowest Yield Rejected (%)	4.425	4.670	5.070	5.24
Weighted Average Accepted Yield (%)	4.423	4.649	5.048	5.214
Weighted Average Rejected Yield (%)	4.486	4.701	5.089	5.304
Amount Allotted at Highest Accepted Yield as Percentage of Amount Bid at that Yield*	33	40	43	91
Coverage Ratio	4.30	2.80	3.12	1.92

Highlights of LGFA's twentieth bond tender were:

- An average bid cover ratio of 2.24 times; a below average result although the tender size at $200 million was the largest tender since June 2013.

- The weighted average yield on the 2021s fell 20 bps to 5.05% (from 5.25% last time). There was an even more pronounced fall in yield on the April 2023 bond (down to 5.21% from 5.48% previously). Global interest rates had fallen over the weeks prior to the tender as concerns persisted about future economic conditions in both the United States and China.

Margins over NZGBs and mid-swap levels at the tender were:

LGFA Spreads to NZGBs/Swap (bps) for Bond Maturity	Tender No.20 – 14 May 2014	
	NZGB spread	Swap spread
Dec 2017	54	15
Mar 2019	64	23
May 2021	87	41
April 2023	90	45

- Margins over NZGBs set another record low for the 2017s, but rose by 3-6 bps for the other maturities. Despite a 3 bp increase in the NZGB margin for the 2023s, we were very pleased with this result in light of the substantial volume offered to the market.

- Margins over swap improved by 3 bps for the 2023s and were virtually unchanged for the 2017s. Swap margins deteriorated by 2 bps and 4 bps for the 2021s and 2019s respectively; a reasonable result given how much these margins have improved over the last six months.

Results of LGFA Bond Tender Number 21

Tender Date: 18 June 2014
Settlement Date: 23 June 2014

Series Offered	5.00% 15 Mar 2019	6.00% 15 May 2021	5.500% 15 April 2023
Total Amount Offered ($million)	10	10	135
Total Amount Allocated ($million)	10	10	135
Total Number of Bids Received	9	6	53
Total Amount of Bids Received ($million)	35	53	281
Total Number of Successful Bids	4	1	29
Highest Yield Accepted (%)	4.870	5.100	5.360
Lowest Yield Accepted (%)	4.780	5.100	5.270
Highest Yield Rejected (%)	5.000	5.210	5.480
Lowest Yield Rejected (%)	4.870	5.120	5.360
Weighted Average Accepted Yield (%)	4.828	5.100	5.327
Weighted Average Rejected Yield (%)	4.915	5.142	5.418
Amount Allotted at Highest Accepted Yield as Percentage of Amount Bid at that Yield*	71	100	13
Coverage Ratio	3.50	5.30	2.08

Highlights of LGFA's twenty-first bond tender were:

- An average bid cover ratio of 2.4 times; a below average result but in line with recent tenders held during the quarter.

- Weighted average yield on the 2023s rose 12 bps to 5.33%, reflecting slightly higher interest rates over the past month following the RBNZ's increase in the OCR.

- The week that LGFA issued was a busy period for highly rated issuance (almost $2 billion) with World Bank, NIB, KBN and Rentenbank all issuing Kauri bonds, along with

NZDMO tendering $300 million of NZGBs. While it is positive to see strong interest in NZD issuance, this volume of issuance probably meant spreads were a few points wider to swap than they might have been otherwise.

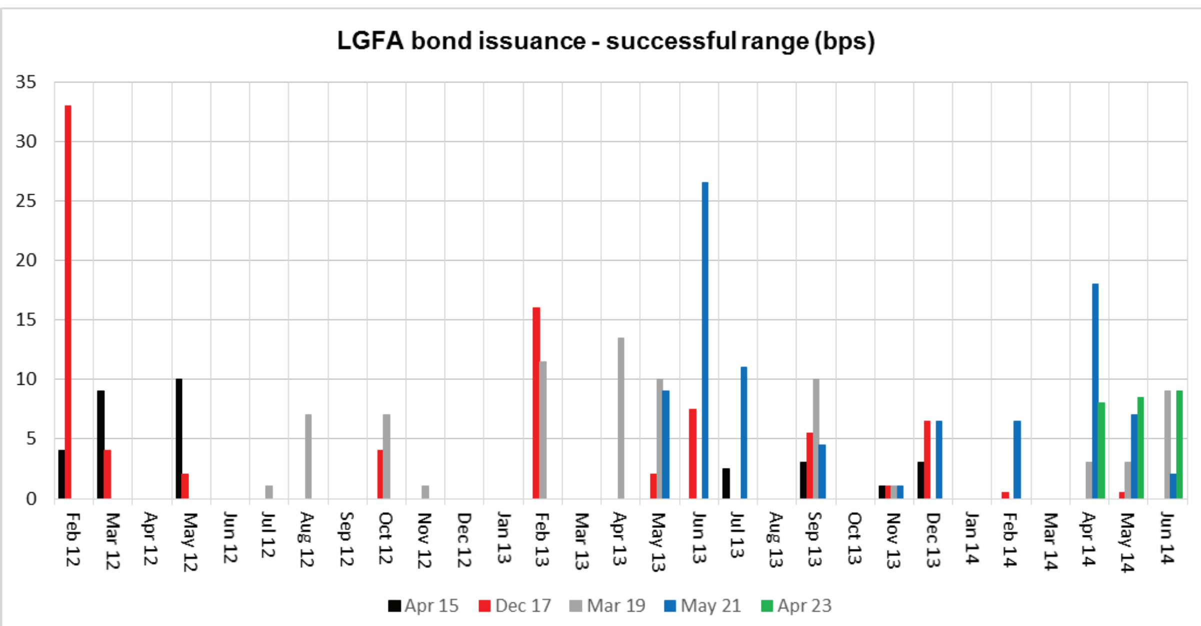
Margins over NZGBs and mid-swap levels at the tender were:

LGFA Spreads to NZGBs/Swap (bps) for Bond Maturity	Tender No.21 – 18 June 2014	
	NZGB spread	Swap spread
Mar 2019	69	29
May 2021	78	39
April 2023	87	51

- Margins over NZGBs set a record low for the 2021s, and equalled the low for the 2023s established at their launch in April 2014. However, the NZGB margin for our 2019s was 5 bps higher than last tender.

- Margins over swap improved by 2 bps for the 2021s, but deteriorated by 6 bps for both the 2019s and 2023s (relative to the previous tender). However, for councils who borrowed in the 2023 maturity on a FRN basis, the pricing was only 1.75 bps higher than the last tender.

We have included a chart of the successful bid range for all of our bonds (for all tenders), which provides a good guide to the market conditions in which we are tendering. In general, the lower the successful bid range (difference between the highest and lowest successful bids), the better the tender.



Summary of council borrowing margins

The following table outlines the total borrowing margin applicable to councils borrowing on a floating rate basis (i.e. LGFA's margin over swap plus the base margin and credit margins) at the tenders held during the quarter.

Tender No.19 – 2 April 2014

Council Credit Rating Bands	Mar 2019	May 2021	Apr 2023
AA	34.00	55.00	62.50
AA-	39.00	60.00	67.50
A+	44.00	65.00	72.50
Unrated	64.00	85.00	92.50

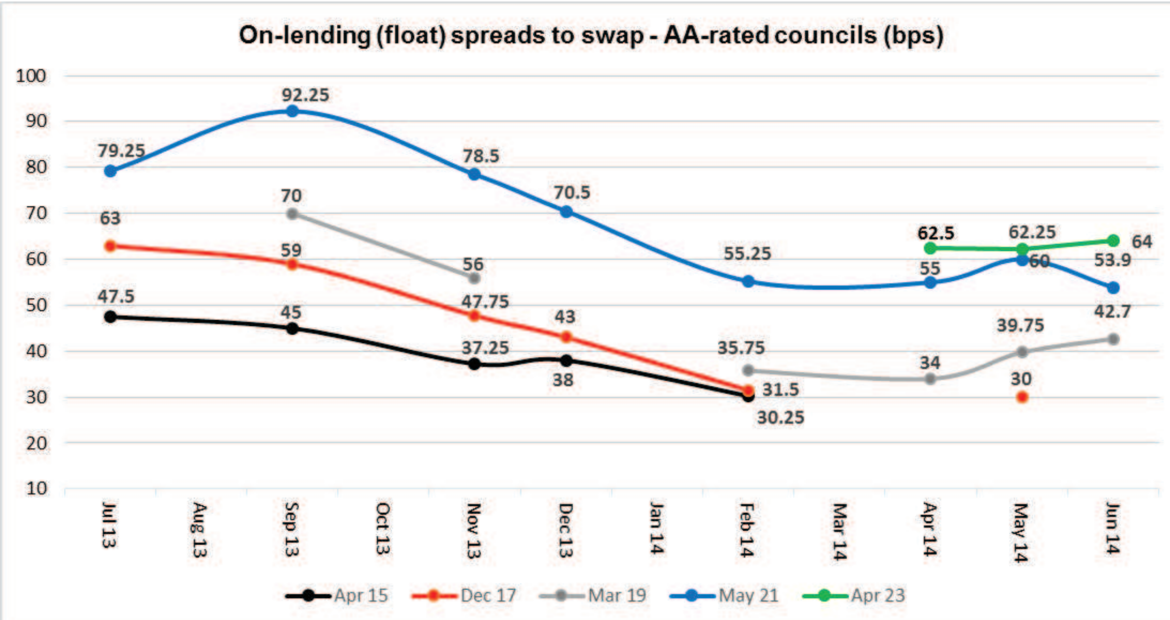
Tender No.20 – 14 May 2014

Council Credit Rating Bands	Dec 2017	Mar 2019	May 2021	Apr 2023
AA	32.50	39.75	60.00	62.25
AA-	37.50	44.75	65.00	67.25
A+	42.50	50.75	70.00	72.25
Unrated	62.50	70.75	90.00	92.25

Tender No.21 – 18 June 2014

Council Credit Rating Bands	Mar 2019	May 2021	Apr 2023
AA	42.70	53.90	64.00
AA-	47.70	58.90	69.00
A+	52.70	63.90	74.00
Unrated	72.70	83.90	94.00

The following chart shows the total borrowing margin charged to AA rated councils (borrowing on a floating rate basis) at the eight tenders held to date in 2013/14. Over the past year, borrowing margins charged to councils have been steadily declining for all maturities (as a general trend).



PERFORMANCE AGAINST OBJECTIVES AND PERFORMANCE TARGETS

Primary Objective

LGFA operates with the primary objective of optimising the debt funding terms and conditions for participating local authorities. Among other things this includes:

- *Providing estimated savings in annual interest costs for all Participating Local Authorities of at least 30 basis points, based on the methodology set out in LGFA's Annual Report 2011-2012*

  LGFA measures the pricing performance of bond tenders against two key benchmarks:

  - LGFA aims to reduce its margin over New Zealand Government bonds (NZGBs) in accordance with its Statement of Intent (SOI) performance target.

  - LGFA also aims to minimise its margin over swap rates to provide cost effective funding to councils.

  We have met our primary objective by achieving significant improvement in the pricing of our benchmark 15 December 2017 and 15 March 2019 bonds since they were first issued. These bonds are regarded as our benchmark bonds because they have large volumes outstanding, the most liquidity and greatest frequency of issuance.

  Over the course of the twelve months ended 30 June 2014:

  - LGFA margins to NZGB improved by 12 bps and 5 bps respectively for the December 2017 and March 2019 maturities.

- LGFA margins to swap improved by 18 bps and 17 bps respectively for our December 2017 and March 2019 bonds.

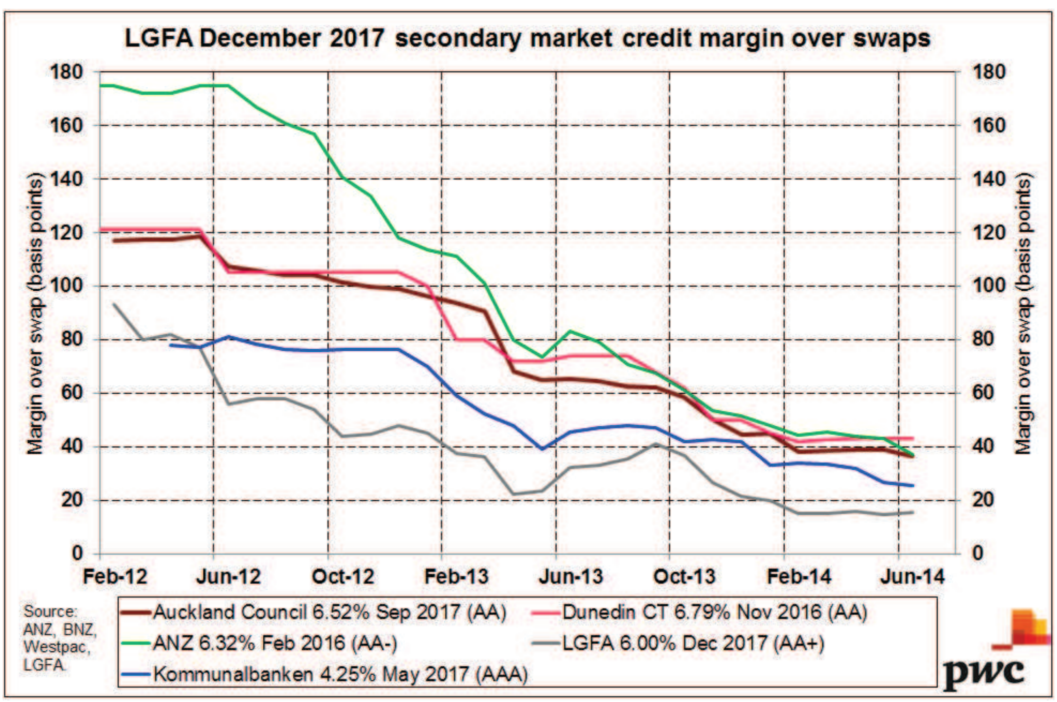
These secondary market pricing movements are summarised in the following tables:

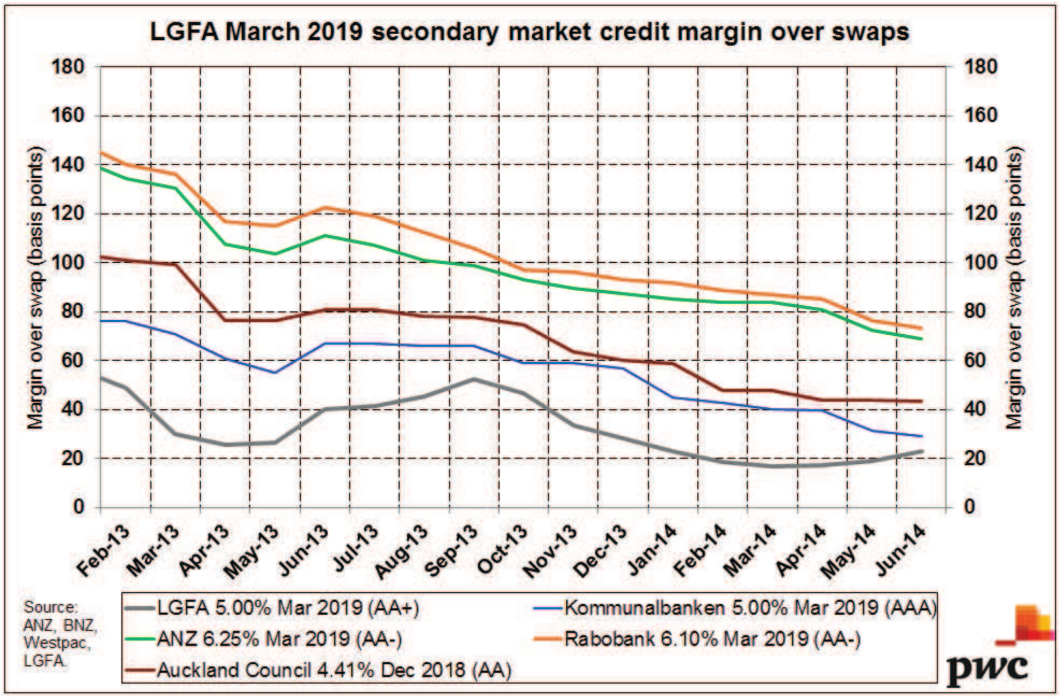
Margins – 15 December 2017	30 Jun 2013 (bps)	30 June 2014 (bps)	Pricing movement
LGFA margin to NZ Government Bonds	73	61	12
NZGB margin to swap	(40)	(46)	(6)
LGFA margin to swap	33	15	18

Margins – 15 March 2019	30 Jun 2013 (bps)	30 June 2014 (bps)	Pricing movement
LGFA margin to NZ Government Bonds	77	72	5
NZGB margin to swap	(37)	(49)	(12)
LGFA margin to swap	40	23	17

There was a substantial improvement in our swap margins during the 2013/14 year. Based on this trend, we are confident that LGFA is on track to meet its long-term interest cost savings target of at least 30 bps.

In recent quarters, our estimate of annual interest cost savings has slipped below the 30 bps target. This is because swap margins for our benchmark councils (Auckland and Dunedin) also improved, largely in line with LGFA. These two councils have both been able to issue securities at favourable pricing following the series of successful LGFA tenders held since 6 November 2013.





From the charts above we estimate that as at end June 2014, LGFA was saving AA rated councils approximately:

- 18 to 28 bps in annual interest costs on a December 2017 maturity, and
- 23 bps in annual interest costs on a March 2019 maturity.

The basis for these estimates is set out in the following table:

Margins as at 30 June 2014	December 2017 maturity (bps)	March 2019 maturity (bps)
AA rated councils margin to swap*	37 to 48	49
Less: LGFA margin to swap	(15)	(23)
LGFA Funding Advantage	22 to 33	28
Less: LGFA Base Margin	(15)	(15)
LGFA Net Funding Advantage	8 to 18	13
Add: 'LGFA Effect' **	10	10
Total saving for AA rated councils	**18 to 28**	**23**

* *For the 2017 bond, the benchmark councils are Auckland (40 bps) and Dunedin (45 bps). For the 2019 bond, the benchmark is Auckland. Dunedin does not have a 2019 bond on issue.*

** *The 'LGFA effect' represents the estimated conservative reduction in AA rated council's margin to swap as a result of LGFA operations. From May to June 2012, the margin to swap for AA rated councils fell by 10 bps, with no corresponding move in swap spreads for other borrowers. This suggests that potential access to cost-effective LGFA funding has enabled these councils to reduce their borrowing margin by around 10 bps.*

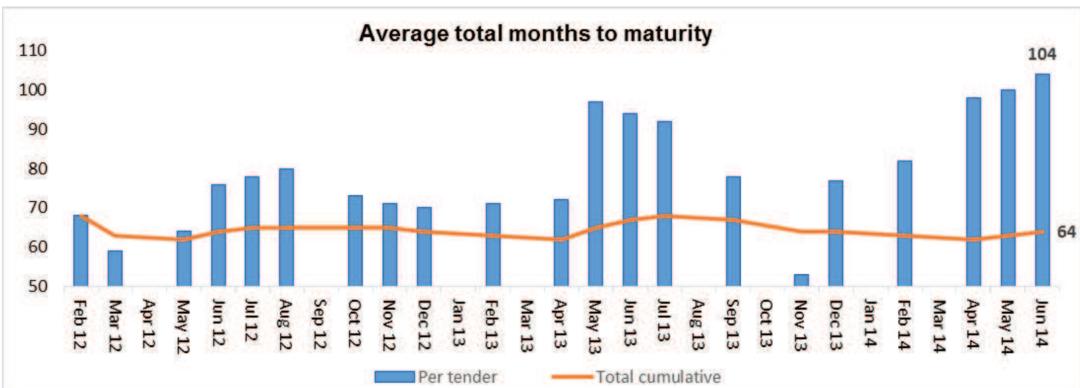
- *Making longer-term borrowings available to Participating Local Authorities*

  Over the course of the quarter, LGFA continued to offer two maturities of five years and longer to participating councils:

  - A new nine year maturity was successfully issued in all three tenders held during the quarter. The 15 April 2023 maturity, first issued at the nineteenth bond tender held on 2 April 2014, and

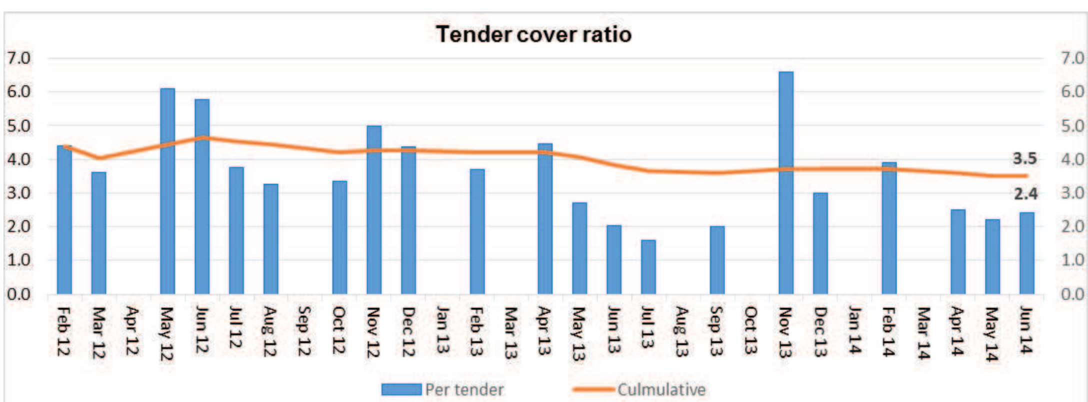
  - 15 May 2021 bond (seven years), first issued at the twelfth bond tender held on 15 May 2013.

  The following graph shows the average months to maturity for bonds issued at tender, and the aggregate average months to maturity for all bonds outstanding at each tender:



- *Enhancing the certainty of access to debt markets for Participating Local Authorities, subject always to operating in accordance with sound business practice*

  Access to debt markets has been enhanced by the consistently strong cover ratios achieved at most LGFA bond tenders held to date. Our cover ratio (i.e. ratio of total amount bid to total amount offered) for each tender has been:



  From the table, it is important to note that:

  - Total bids received have amounted to $13.04 billion in the first twenty one tenders;

- The average cover ratio has been 3.5 times; and

- Our cover ratio in the three tenders held during the June quarter of 2.3 times was well below average and this reflected three influences. Firstly there was less bidding as a result of smaller tranche sizes of some maturities tendered i.e. of the ten tranches offered across the three tenders held in the quarter, six tranches were for $25 million or less. Secondly, offshore investor demand for LGFA bonds came through in the secondary market rather than at tender. Finally the longer dated maturity (April 2023) attracted less interest from bank investors who prefer maturities that are less than five years.

Additional objectives

LGFA has a number of additional objectives which complement the primary objective. These objectives will be measurable and achievable and the performance of the company in achieving its objectives will be reported annually. These additional objectives are to:

- *Operate with a view to making a profit sufficient to pay a dividend in accordance with its stated Dividend Policy set out in section 6*

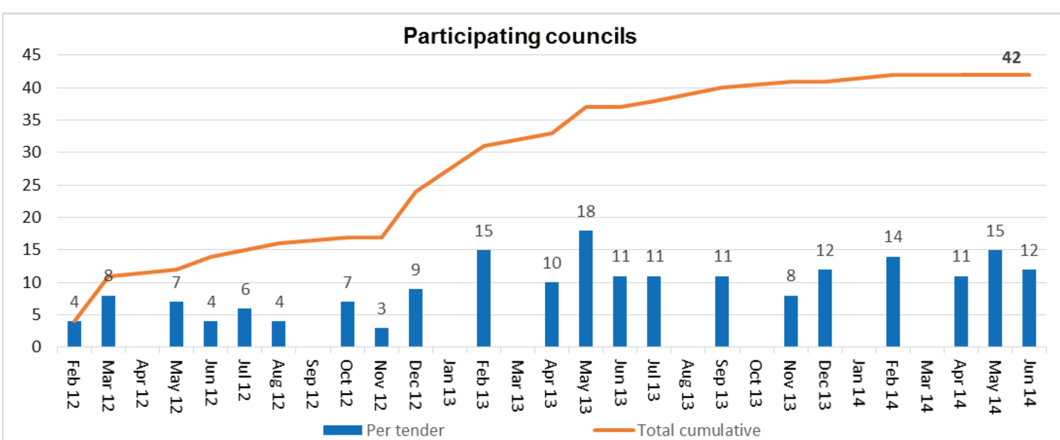
  LGFA's policy is to pay a dividend that provides an annual rate of return to shareholders equal to LGFA cost of funds plus 2%.

  Assuming a cost of funds of 5% during 2013/14, LGFA anticipates paying an annual rate of return to shareholders of 7%. This equates to a total dividend payment of $1.750 million on $25 million of paid-up ordinary shares.

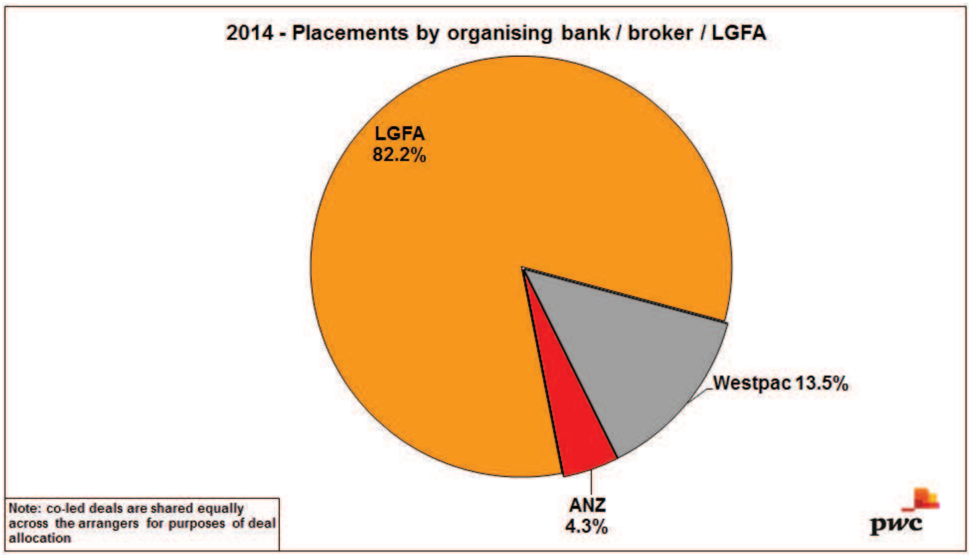
  Net operating profit in the year ended 30 June 2014 is forecast to be $6.9 million (before dividend), so performance to date gives rise to no concerns that would lead LGFA to alter its guidance around dividend payments.

- *Provide at least 50% of aggregate long-term debt funding for Participating Local Authorities*

  Strong council support for LGFA is demonstrated in the following graph which shows the progression of council participation from LGFA's commencement of issuance in February 2012:



The chart below from PricewaterhouseCoopers shows the breakdown by organising bank or LGFA of new local government debt issuance for the first six months of 2014. Our share of new long-term borrowing by all councils (including non-members of LGFA) was recorded 82.2% compared to 76% in calendar year 2013.



- *Ensure its products and services are delivered at a cost that does not exceed the forecast for issuance and operating expenses set out in section 4*

  LGFA's expected actual issuance and operating expenses for the year ended 30 June 2014 are compared with forecast in the following table:

Twelve months ended	Expected actual 30 June 2014 $m	SOI Forecast 30 June 2014 $m
Issuance and on-lending expenses	1.450	1.350
Operating expenses	1.830	1.850
Total expenses	**3.280**	**3.200**

  Expected actual expenses for the year-ended 2013/14 are $80k over the SOI forecast. Approved issuer levy expenses of $375k, being $135k over the SOI forecast of $240k, was a primary driver for the increase in actual.

- *Maintain LGFA's credit rating equal to the New Zealand Government sovereign rating where both entities are rated by the same Rating Agency*

  - On 26 November 2013, Fitch affirmed LGFA's local currency credit rating at AA+ and foreign currency credit rating at AA. The outlook on both ratings is stable.

  - On 7 November 2013, Standard & Poor's affirmed LGFA's local currency credit rating at AA+ and foreign currency credit rating at AA. The outlook on both ratings is stable.

- LGFA's credit ratings from both Fitch and Standard & Poor's are the same as the New Zealand sovereign ratings.

- *Achieve the Financial Forecasts set out in section 4*

  LGFA's expected actual financial results (for key items set out in Section 4 of the SOI), for the year ended 30 June 2014 are compared with forecast in the table below.

Twelve months ended	Expected actual 30 June 2014 $m	SOI Forecast 30 June 2014 $m
Net interest income	10.200	9.836
Total expenses	3.280	3.200
Operating profit	**6.920**	**6.636**

- *Achieve the Dividend Policy set out in section 6*

  Refer to our earlier comments on this issue.

- *Comply with its Treasury Policy, as approved by the Board*

  The Treasury Policy limits for Value at Risk (VaR) and Partial Differential Hedge (PDH) were breached during May 2014. Refer Attachment 1 for a detailed explanation of the breaches.

Performance Targets

Four performance targets are specified for LGFA in the SOI. Progress against each of these targets is discussed below, including an explanation of any material variances.

Performance Measure	Full Year Target	Result as at 30 June	Expect to meet target?
Average cost of funds relative to NZGS	<0.50%	0.68%	No. Refer to (i) below
Average margin above LGFA's cost of funds	<0.25%	0.15%	Yes
Annualised issuance and operating expenses	<$3.2 million	$3.280 million	No. Refer to (ii) below
Lending to participating councils	>$3,400 million	$3,696 million	Yes. Refer to (iii) below

(i) Average cost of funds

There are two key reasons for LGFA's relative cost of funds averaging 18 bps over the target level of 50bps:

- We issued a relatively large amount of longer date LGFA bonds in the second half of the year. Of the $645 million issued, almost 88% were for terms of seven years or longer.

Maturity	H2 Issuance ($m)
Apr 2015	10
Dec 2017	30
Mar 2019	40
May 2021	210
Apr 2023	355
Total Issuance	**645**

- While offshore investor interest in LGFA bonds is clearly increasing, we do not yet have a "critical mass" of these investors to drive down our NZGS margin towards the 50 bps target. The focus remains on growing our offshore investor base.

  LGFA's weighted average margin to NZGS was relatively high at 85 bps for the June quarter 2014; a prime driver being the newly issued 2023 which represented 75% of total issuance over the quarter.

	Dec quarter 2012	Mar quarter 2013	Jun quarter 2013	Sep quarter 2013	Dec quarter 2013	Mar quarter 2014	June quarter 2014
Average cost of funds relative to NZGS	0.84%	0.76%	0.84%	0.97%	0.71%	0.74%	0.85%

(ii) Issuance and operating expenses

Total expenses for the twelve months ended 30 June 2014 amounted to $3.274 million against a full year target of less than $3.2 million. The significant contributor to this variance was Approved Issuer Levy (AIL) payments of $376k (compared to a budget of $240k) due to an increase in holdings of LGFA bonds by offshore investors.

(iii) Lending to participating councils

Lending to councils for the 2013/14 year was $1.216 billion comprising $470 million of on-lending to councils in the June quarter, $172 million of on-lending to councils in just one tender during the March quarter 2014, $264 million of loans made to councils in the December quarter 2013, and $310 million of on-lending in the September quarter 2013 (against a forecast per quarter of $230 million). Total council loans of $3.696 billion as at 30 June 2014 exceeded our SOI target of $3.445 billion.

2. DETAILS OF EVENTS OF REVIEW

There have been no events of review in respect of any Participating Local Authority.

ATTACHMENT 1
Value at Risk (VaR) / Partial Differential Hedge (PDH) Limit Breach

The LGFA PDH and VaR limits were exceeded over the period 15 May to 27 May 2014.

This is the first breach of Treasury Policy limits since LGFA commenced operations in February 2012.

	PDH		VaR	
	Limit	Utilisation	Limit	Utilisation
15-May	25,000	41,876	150	293
16-May	25,000	41,965	150	293
19-May	25,000	41,105	150	292
20-May	25,000	41,164	150	292
21-May	25,000	41,186	150	292
22-May	25,000	40,989	150	291
23-May	25,000	40,989	150	291
26-May	25,000	41,088	150	291
27-May	25,000	41,153	150	291

The PDH and VaR limit breaches were the consequence of NZDMO executing incorrect swaps on 14 May 2014 for tender 20. The swap volumes transacted by NZDMO were in error and different to those correctly instructed by LGFA.

The breach was picked up by LGFA when reviewing the NZDMO end of day reports for 23 May.

Following discussion with NZDMO, the incorrect components of the swaps were closed out for value 27 May at market value. As a consequence of market movements from tender day, the swaps were in-the-money and on close out LGFA made a realised gain of $250,000 (approx). For accounting purposes, this gain was treated as a reduction of the cost of establishing the original hedge transaction on 14 May 2014.

When identified, the limit breaches were discussed with the LGFA Board Chairman, including the process for rectification.

As a consequence of the limit breaches, LGFA and NZDMO have agreed procedural changes to mitigate the risk of a similar future breach of limits.

Finally, this error highlights the risk of possible disconnect for transactions as a consequence of the separation of functions between the two organisations. Centralising all tender processes within LGFA will tighten controls and timeliness over error detection across the tender transaction life cycle.