Quarterly Report
For period ended 30 June 2013

LGFA New Zealand Local Government Funding Agency

1. COMMENTARY ON OPERATIONS FOR THE QUARTER

On 10 April 2013 LGFA held its eleventh bond tender. A total of $165 million was issued, bringing bond outstandings to $1.950 billion.

Table 1: Results of LGFA Bond Tender Number 11

Tender Date: 10 April 2013
Settlement Date: 15 April 2013

Series Offered	6.00% 15 Apr 2015	5.00% 15 Mar 2019
Coupon Rate:	6.00%	5.00%
Amount Offered:	$10million	$155 million
Total Bids Submitted:	$50 million	$734 million
Total Number of Bids Submitted:	5	42
Total Successful Bids:	0	$165 million
Total Number of Successful Bids:	0	26
Successful Range:	n/a	3.705%-3.84%
Weighted Average Successful Yield:	n/a	3.79%
Unsuccessful Range:	3.11%-3.20%	3.845%-3.90%
Weighted Average Unsuccessful Yield:	3.16%	3.86%

On 15 May 2013 LGFA held its twelfth bond tender. A total of $240 million was issued, bringing bond outstandings to $2.190 billion.

Table 2: Results of LGFA Bond Tender Number 12

Tender Date: 15 May 2013
Settlement Date: 20 May 2013

Series Offered	6.00% 15 Dec 2017	5.00% 15 Mar 2019	6.00% 15 May 2021
Total Amount Offered ($million)	10	15	215
Total Amount Allocated ($million)	10	15	215
Total Number of Bids Received	3	6	72
Total Amount of Bids Received ($million)	15	21	611
Total Number of Successful Bids	2	5	37
Highest Yield Accepted (%)	3.620	3.830	4.140
Lowest Yield Accepted (%)	3.600	3.730	4.050
Highest Yield Rejected (%)	3.630	3.840	4.310
Lowest Yield Rejected (%)	3.6300	3.840	4.150
Weighted Average Accepted Yield (%)	3.6100	3.7987	4.1150
Weighted Average Rejected Yield (%)	3.63	3.84	4.2187
Amount Allotted at Highest Accepted Yield as Percentage of Amount Bid at that Yield*	100	80	88

On 19 June 2013 LGFA held its thirteenth bond tender. A total of $285 million was issued, bringing bond outstandings to $2.475 billion. LGFA's debt program in 2013 is now expected to be around $1.5 billion (with $940 million issued in four tenders to date).

Table 3: Results of LGFA Bond Tender Number 13

Tender Date: 19 June 2013
Settlement Date: 24 June 2013

Series Offered	6.00% 15 Dec 2017	6.00% 15 May 2021
Total Amount Offered ($million)	15	270
Total Amount Allocated ($million)	15	270
Total Number of Bids Received	8	56
Total Amount of Bids Received ($million)	30	547
Total Number of Successful Bids	3	26
Highest Yield Accepted (%)	3.970	4.605
Lowest Yield Accepted (%)	3.895	4.340
Highest Yield Rejected (%)	4.135	4.850
Lowest Yield Rejected (%)	4.0950	4.610
Weighted Average Accepted Yield (%)	3.9283	4.4648
Weighted Average Rejected Yield (%)	4.115	4.7217
Amount Allotted at Highest Accepted Yield as Percentage of Amount Bid at that Yield*	100	60

*Individual allotments may vary due to rounding.

Highlights of LGFA's thirteenth bond tender were:

A bid cover ratio of 2.0 times ($577 million of bids received for $285 million of bonds offered). This result was well below the average bid cover ratio of 3.8 times achieved by LGFA to date. Interestingly enough, the introduction of our new May 2021 bond at the last two tenders has coincided with the two lowest cover ratios recorded. Because an 8 year maturity is too long for the major NZ bank balance sheets to invest in, we may have lost some cornerstone investors at recent tenders.

Marketing to offshore investors will help to counteract this reduction in domestic demand. In addition, the size of the last two tenders, and market volatility created by the QE tapering debate, also contributed to below average cover ratios.

Margins over NZGBs and mid-swap levels at the last three tenders were:

LGFA Spreads to NZGBs/Swap (bps)						
Bond Maturity	Tender No.13-19 June 2013		Tender No.12-15 May 2013		Tender No.11-10 April 2013	
	NZGB spread	Swap spread	NZGB spread	Swap spread	NZGB spread	Swap spread
May 2021	87	44	81	34	Not offered	Not offered
Mar 2019	Not offered	Not offered	75	28	84	30
Dec 2017	77	34	74	28	Not offered	Not offered

Our May 2021 margin over NZGBs weakened by 6 bps from last tender. Given the difficult market environment (QE tapering debate and NZDMO's poor tender the following day), and the fact that some supranational borrowers (eg EIB) sold off 30 bps during the June "mini-crisis", this was a satisfactory result. LGFA's December 2017 margin to NZGBs widened by only 3 bps, given the much smaller volume offered.

Swap spreads widened by 10 bps (May 2021s) and 6 bps (December 2017s) as NZDMO's swap spreads continue to weaken. Their 10 year swap spread peaked above 60 bps in early May 2013, but has since fallen back sharply to around 30 bps currently.

2. PERFORMANCE AGAINST OBJECTIVES AND PERFORMANCE TARGETS

Primary Objective

LGFA will operate with the ***primary objective*** of optimising the debt funding terms and conditions for Participating Local Authorities. Among other things this includes:

- *Providing debt to Participating Local Authorities at the lowest possible interest rates commensurate with the relevant maturity*

  LGFA has met its primary objective by continuing to achieve significant improvement in the pricing of our benchmark 15 December 2017 bond.

  The December 2017 maturity is regarded as our benchmark bond because it has a large volume outstanding, the most liquidity and longest history of issuance.

  During the June quarter 2013, the margin to NZGB for this maturity improved by a further 7 bps. However, a "mini crisis" in global bond markets, caused by speculation about the future of quantitative easing (QE) in the United States, also created significant volatility in New Zealand's debt market. In this difficult environment, NZDMO's swap spreads fell sharply to be 15 bps lower for the December 2017 maturity over the June quarter. In turn, this pushed LGFA's swap spread up by 8 bps in the past three months.

  In coming months there is now plenty of scope for LGFA bonds to improve their pricing performance as the market comes to terms with the future direction of US monetary policy.

  From the inaugural tender held on 15 February 2012 to date, there has been a substantial improvement of 56 basis points (bps) in the December 2017's margin to swap (as outlined in the table below):

Margins	15 Feb 2012 (bps)	30 June 2013 (bps)	Pricing Improvement (bps)
LGFA margin to NZGB	113	73	40
NZGB margin to swap	(24)	(40)	16
LGFA margin to swap	89	33	56

Some of this pricing improvement has resulted from LGFA's ongoing marketing activities, including:

- Embarking on a significant European investor marketing mission to the UK, Switzerland and Germany. The Chairman and Chief Executive of LGFA met with a number of private banks and institutional investors in these countries from 24-28 June 2013.

- Meeting with one of Asia's largest central banks in Sydney in early May 2013 (at their request) to update them on LGFA's performance in its first 18 months of operation.

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

  We continued to offer two maturities of five years and longer to participating councils:

  - 15 March 2019 bond (just under six years), first issued at the fourth bond tender held on 6 June 2012; and

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

- *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 (ie ratio of total amount bid to total amount offered) for each tender has been:

LGFA Tender	Volume Bid ($m)	Volume Offered ($m)	Cover Ratio (times)
1	1,320	300	4.4
2	959	265	3.6
3	855	140	6.1
4	752	130	5.8
5	546	145	3.8
6	245	75	3.3
7	922	275	3.4
8	648	130	5.0
9	327	75	4.4
10	922	250	3.7
11	784	165	4.8
12	647	240	2.7
13	577	285	2.0

From the table, it is important to note that:

- Total bids received have amounted to $9.5 billion in the first thirteen tenders;
- The average cover ratio has been 3.8 times; and
- Our lowest cover ratio to date (2.0 times) occurred at the last tender in difficult market conditions (where offering a large amount of a relatively new long maturity at the height of the QE tapering debate proved to be a challenging assignment).

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*

  Two key factors have contributed to LGFA performing ahead of budget during 2012/13:

  - Bond issuance to date ($2.475 billion) and on-lending activity ($2.481 billion) are currently running at around double the volume anticipated in the original business case for LGFA.
  - Overheads have been well contained.

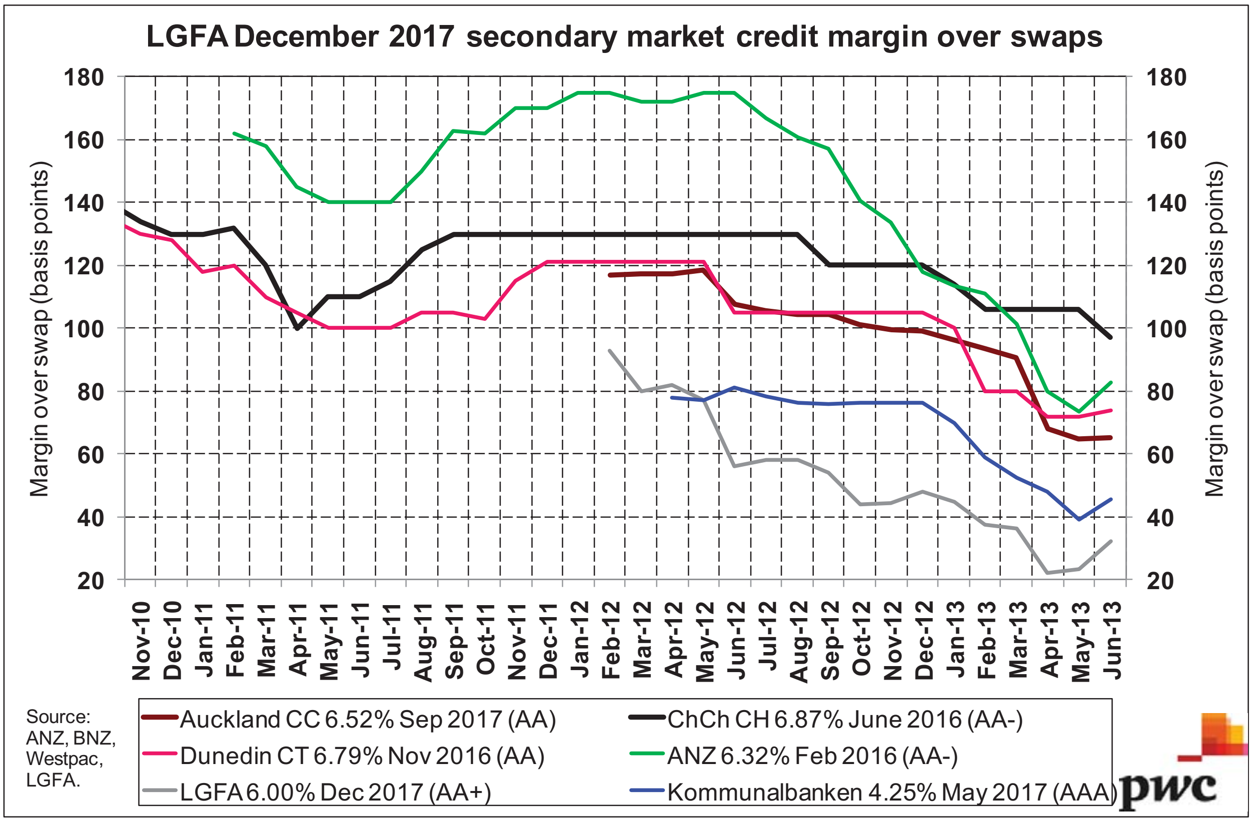
  As a result, LGFA anticipates being in a position to make a larger first dividend payment than forecast in the SOI.

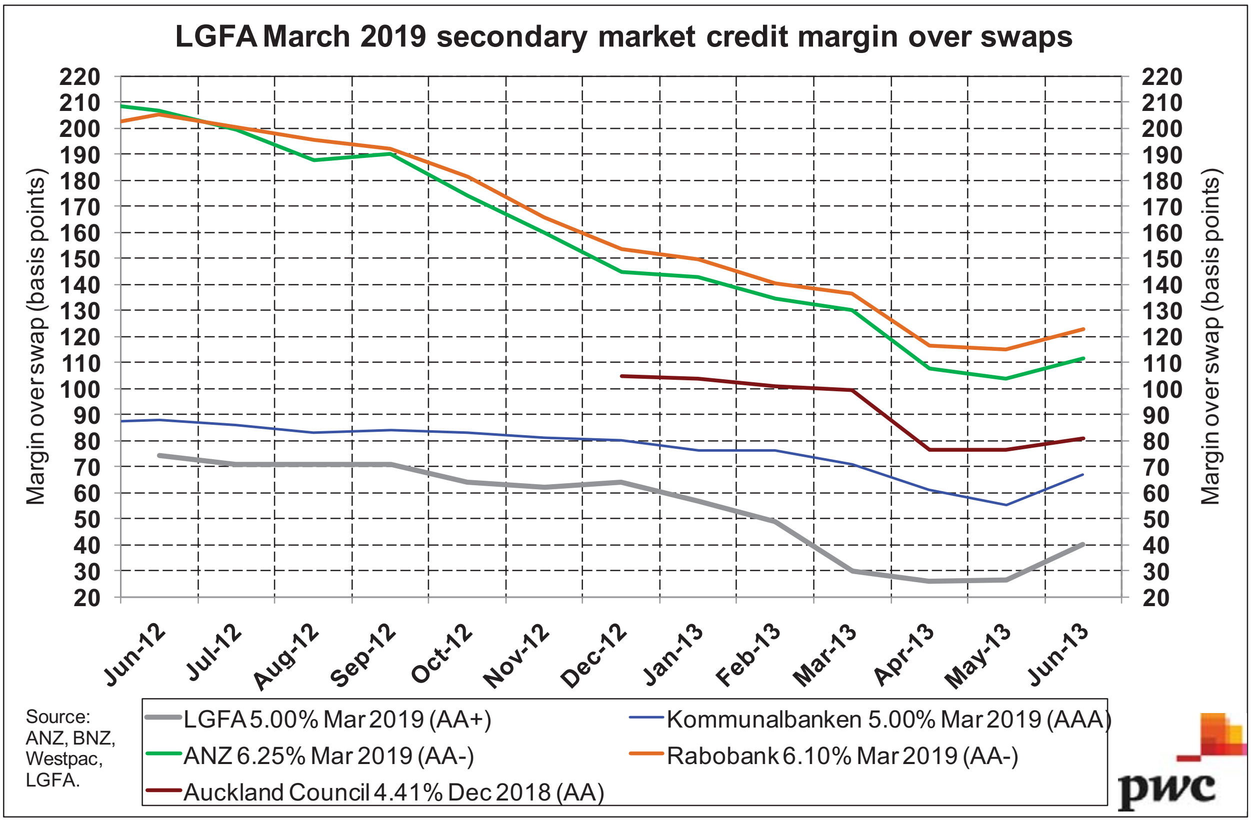
- *Become the primary source of debt funding for Participating Local Authorities*

  Councils have strongly supported LGFA. To date, 17 (out of 18) inaugural participating councils have borrowed from us. By 30 June 2013, another 21 councils had joined LGFA (12 as shareholders at the Second Opening on 30 November 2012, and 9 as borrowers in two "intakes" on 18 February and 5 April 2013). After the 19 June tender, 20 of these 21 new members had borrowed from LGFA. In all, 37 out of 39 participating councils had borrowed from LGFA by the end of the June quarter.

- *Operate in a manner to ensure LGFA is successful and sustainable in the long-term*

  The key to LGFA's long-term sustainability is to ensure that it can always fund councils at lower rates than they can fund themselves. To provide evidence of LGFA's performance against this objective, we have included two charts below (produced by PricewaterhouseCoopers). These charts compare LGFA's spread to swap against a number of other issuers for our December 2017 and March 2019 maturities.


LGFA December 2017 secondary market credit margin over swaps
Margin over swap (basis points)
Nov-10 Dec-10 Jan-11 Feb-11 Mar-11 Apr-11 May-11 Jun-11 Jul-11 Aug-11 Sep-11 Oct-11 Nov-11 Dec-11 Jan-12 Feb-12 Mar-12 Apr-12 May-12 Jun-12 Jul-12 Aug-12 Sep-12 Oct-12 Nov-12 Dec-12 Jan-13 Feb-13 Mar-13 Apr-13 May-13 Jun-13
Source: ANZ, BNZ, Westpac, LGFA.
Auckland CC 6.52% Sep 2017 (AA)
ChCh CH 6.87% June 2016 (AA-)
Dunedin CT 6.79% Nov 2016 (AA)
ANZ 6.32% Feb 2016 (AA-)
LGFA 6.00% Dec 2017 (AA+)
Kommunalbanken 4.25% May 2017 (AAA)
pwc


LGFA March 2019 secondary market credit margin over swaps
Margin over swap (basis points)
Jun-12 Jul-12 Aug-12 Sep-12 Oct-12 Nov-12 Dec-12 Jan-13 Feb-13 Mar-13 Apr-13 May-13 Jun-13
Source: ANZ, BNZ, Westpac, LGFA.
LGFA 5.00% Mar 2019 (AA+)
Kommunalbanken 5.00% Mar 2019 (AAA)
ANZ 6.25% Mar 2019 (AA-)
Rabobank 6.10% Mar 2019 (AA-)
Auckland Council 4.41% Dec 2018 (AA)
pwc

From the charts above we estimate that as at end June 2013, LGFA was saving AA rated councils approximately:

- 20 bps in annual interest costs on a December 2017 maturity.
- 30 bps in annual interest costs on a March 2019 maturity.

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

Margins as at 30 June 2013	**December 2017 maturity (bps)**	**March 2019 maturity (bps)**
AA rated councils margin to swap	63	80
Less LGFA margin to swap	(33)	(40)
LGFA Funding Advantage *Less LGFA Base Margin*	30 (20)	40 (20)
LGFA Net Funding Advantage Add "LGFA Effect" *	10 10	20 10
Total saving for AA rated councils	**20**	**30**

* *The 'LGFA effect' represents the estimated conservative reduction in AA rated councils 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.*

Educate and inform all Local Authorities (both participating and non-participating) on matters within the scope of LGFA's operations

During the quarter ended 30 June LGFA:

- Provided an update to all participating councils on the results of the latest LGFA bond tender. This new initiative is designed to provide timely information to our borrowers to assist them in formulating their debt management strategies.
- Participated in the annual Local Authority Workshop arranged by Bancorp. This event was held in Auckland in May 2013, and enabled LGFA to discuss its performance to date with a wide range of councils (both members and non-members of LGFA).
- Held regular discussions with PricewaterhouseCoopers and Bancorp (as key advisers to the local government sector) on various matters of interest to their council clients.

• *Become a leading participant in the New Zealand capital markets*

Our role as a leading participant in the New Zealand capital markets continues to be well recognised in major industry awards:

- LGFA won "Debt Issue of the Year" at the INFINZ Annual Awards Dinner held in Auckland on 8 May 2013 (attended by over 770 market participants). Our inaugural $300 million bond tender held on 15 February 2012 was judged as the best debt issue of the 2012 year.

- We are also in the process of entering the 2013 Deloitte Fast 50 competition. This is a business benchmarking competition that recognises growth achieved by large or small, public or private companies. LGFA's rapid growth in terms of revenue, profitability and balance sheet size should enable us to perform well in this competition.

- *Provide excellent service to Participating Local Authorities*

  Settlement of our twelfth bond tender took place on 20 May 2013. The settlement process was completed very smoothly, even though this was the largest (in terms of participation) and most complex (with four councils borrowing from us for the first time) tender to date. The May bond tender set two new records:

  - Highest number of participating councils (18); and

  - Equal highest number of individual Term Sheets (21).

  Settlement of our thirteenth bond tender taook place on 24 June 2013. This tender also set a new record for the highest volume of on-lending ($286 million), which beat the previous mark of $281 million set in October 2012.

- *Ensure excellent communication exists and be professional in its dealings with all its stakeholders*

  During the quarter ended 30 June, LGFA:

  - Met with the Shareholders' Council on 10 May 2013 in Wellington. The Chairman and Chief Executive of LGFA discussed a number of suggested changes to the draft SOI 2013/14 proposed by the Shareholders' Council. This was a very constructive meeting that focused on ways for LGFA to continuously improve its reporting to shareholders, particularly on the more technical aspects of our business.

  - Met with the Chairman of the Shareholders' Council on 7 June 2013 in Wellington. Key topics discussed at this meeting included proposed changes to the arrangements for filling casual vacancies on the Shareholders' Council, progress on amending the draft SOI 2013/14, and the timing of important future events (LGFA's first dividend payment, the next Annual General Meeting and a proposed Shareholders Day).

  - Participated in a Local Government Funding Agency Roundtable held in London on 25 June 2013. The meeting was organised by ANZ and KangaNews, and enabled two established agencies (Kommuninvest from Sweden and LGFA from New Zealand) to share experiences and ideas with representatives from the UK and France (who are looking to set up similar entities).

- *Ensure its products and services are delivered in a cost-effective manner*

  During the quarter ended 30 June, LGFA:

  - Charged a "base" margin to councils that averaged 0.23%, well below the maximum permitted of 0.40%; and

  - Restricted annual operating costs to $3.0 million for 2012/13; below the SOI target of $3.2 million.

- *Consult with Shareholders regarding the potential requirement for LGFA Borrowers to obtain comprehensive insurance cover*

  Following settlement of the thirteenth bond tender on 19 June 2013, LGFA has now on-lent $2.481 billion to councils. To date, there has been no requirement for borrowers to obtain or retain comprehensive insurance cover.

  - LGFA's current credit assessment approach is to consider insurance cover along with various business interruption risks (including risks to physical assets) as part of an overall credit risk assessment of individual councils. In this regard, LGFA is aware that self-insurance arrangements eg. via the accumulation of financial assets, may be as effective as external insurance cover.

  - If this becomes an issue, LGFA will undertake future consultation with shareholders on the appropriate level of insurance cover for borrowers.

- *Review the appropriateness of LGFA's "broker" business model*

  The success of the "broker" business model is evident from three key factors:

  - Overall profitability (ie the retained earnings position) has significantly exceeded budget in the first 18 months of operations;

  - Profitability has been achieved without the need for LGFA to take on significant interest rate risk eg. Value-at-Risk[1] is currently running at only 30% of policy limits; and

  - Significant improvement in the pricing of LGFA bonds has generated corresponding savings for AA rated council borrowers of around 30 bps in annual interest costs on a March 2019 maturity.

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

  - On 30 November 2012, 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 20 December 2012, 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 actual financial results (for key items set out in Section 4 of the SOI), for the 2012/13 financial year are compared with forecast in the table below.

[1] Value-at-Risk (VaR) is a statistical market risk management tool which seeks to determine the largest dollar loss likely to be suffered by LGFA over a 1 day period with a 95% confidence level.

	$m 2012/13 Actual	$m 2012/13 SOI Forecast
Total Net Income	6.53	3.9
Overheads	(3.00)	(2.7)
Net Profit	3.53	1.2
Borrower Notes Interest	(0.86)	(0.5)
Surplus*	2.67	0.7

**before dividend payment*

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

  Refer to our earlier comments on this issue.

Performance Targets

Six 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	Target	Result	Outcome (Target met?)
1	Average cost of funds relative to NZGS	<0.50%	0.84%	x
2	Average margin above LGFA's cost of funds	<0.40%	0.23%	√
3	Annualised operating overheads	<$3.2 million	$3.0 million	√
4	Lending to participating councils	>$900 million	$2,481 million	√
5	Number of council shareholders	≥30	30	√
6	Number of eligible borrowers	≥40	39*	x

* Although only 39 councils had joined LGFA as at 30 June 2013, 42 councils had been approved as borrowers by this date.

(i) Average cost of funds

There are two key reasons for LGFA's relative cost of funds averaging 34 bps over the target level of 50bps:

– We introduced a new May 2021 bond at our 15 May 2013 tender. Longer dated bonds price at a relatively higher margin above NZGS than shorter dated bonds, as the following table clearly shows.

LGFA MARGINS TO NZGS As at 30 June 2013	
Maturity	Margin (bps)
Apr 2015	45
Dec 2017	73
Mar 2019	77
May 2021	80

– A “mini crisis” in global bond markets during June 2013 (created by comments from US monetary authorities on their potential exit path from quantitative easing) adversely affected LGFA’s margins at the 19 June 2013 bond tender.

For these reasons, LGFA’s weighted average margin to NZGS actually increased from 76 bps in the March quarter to 84 bps in the June quarter.

It is interesting to note (from the table above) that our current weighted average spread to NZGS for all four LGFA maturities (applying a 25% weighting to each bond) is just 69 bps.

(ii) Number of eligible borrowers

Three councils joined LGFA on 5 April 2013. These councils are:

Ashburton District Council

Grey District Council

Nelson City Council

To date, Grey District Council is the only one to join LGFA as a borrower only.

We expect Tararua District Council to join LGFA as a borrower only prior to our next bond tender to be held on 31 July 2013.

Wairoa and Hurunui District Councils have also been approved as borrowers by the LGFA Board, but have yet to complete the necessary legal documentation to become members of LGFA. When this is completed, there will be a total of 42 eligible borrowers signed up with LGFA.

3. DETAILS OF EVENTS OF REVIEW

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