United Kingdom
Debt
Management
Office

Cheapside House
138 Cheapside
London EC2V 6BB

HC 579

United Kingdom
Debt
Management
Office

Annual Report and Accounts

1999 – 2000

The United Kingdom
Debt Management Office
is an Executive Agency of
HM Treasury

Cheapside House
138 Cheapside
London EC2V 6BB

Annual Report and Accounts

1999 – 2000

Presented to Parliament in Pursuance of the Exchequer and Audit Departments Act 1921
Ordered by the House of Commons to be printed 26th July 2000

The United Kingdom
Debt Management Office
is an Executive Agency of
HM Treasury

HC 579

London: The Stationery Office

£11.30

Contents

Contents

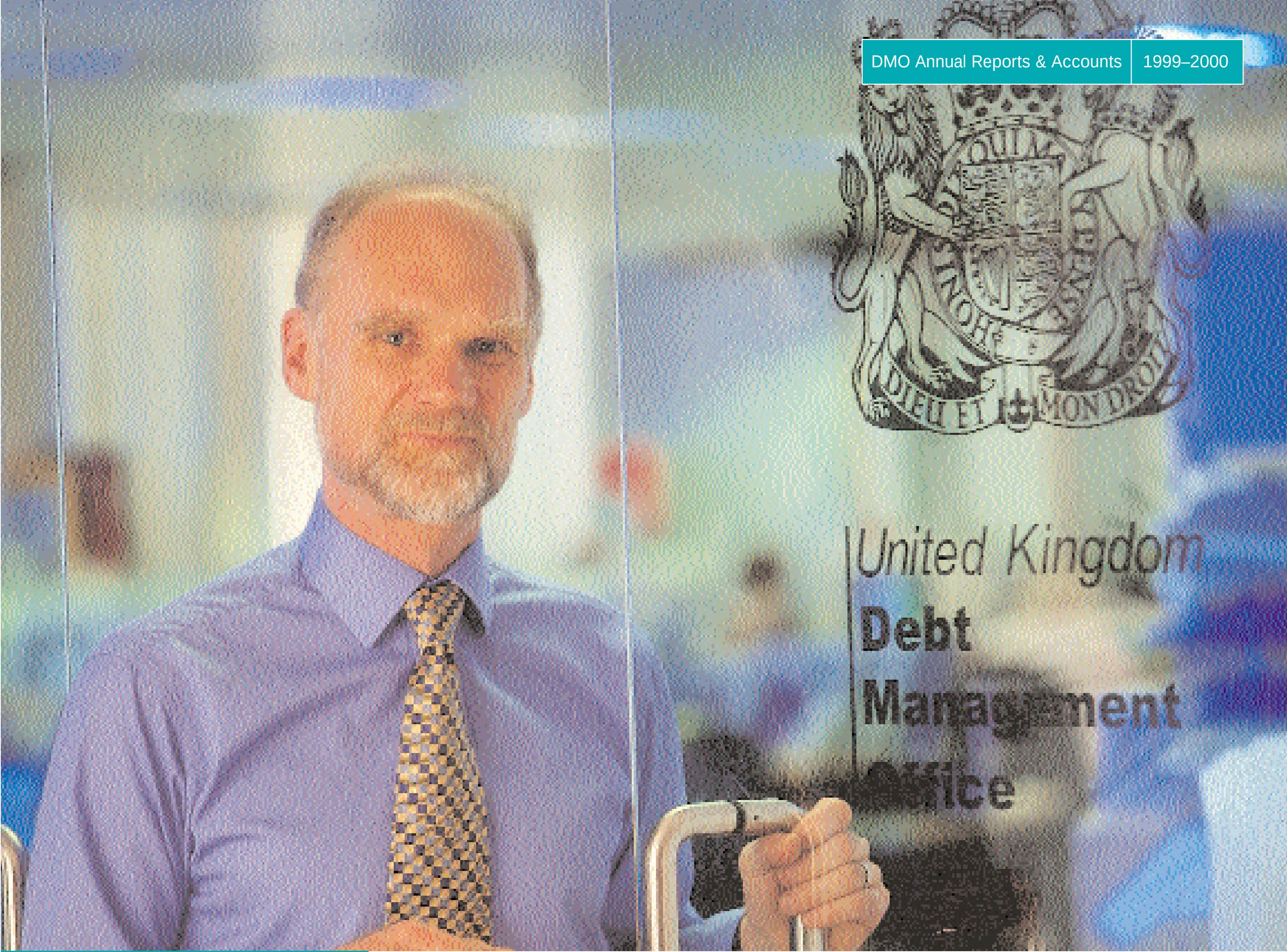
Chief Executive's foreword

1999-2000 – the second full year since the DMO was established – was one of both successful consolidation and achievement. We built on the foundations put down in the previous year, and significantly developed our capability.

In the gilts market, the DMO successfully met the Chancellor of the Exchequer's remit, and introduced a number of innovations, notably switch auctions. Although market liquidity was poor for much of the year, partly as a result of low issuance, the DMO was able to alleviate the pressures somewhat through its programme of switch auctions and conversions. We have developed the programme of consultation with the gilts market and extended our range of publications. Consultative papers were also published on standing repo, and the implications of electronic trading for our relationship with the market makers.

I am very grateful for the continuing positive feedback both from the market makers and investors and the constructive exchanges that we have had with them.

The DMO's major single task for the year was to develop its capability for Exchequer cash management. Since April 2000 the DMO has had full responsibility for meeting in the sterling money market the daily cash needs of the National Loans Fund, the fund that balances government income and expenditure. This task has entailed the design, development and testing of new systems that receive and enrich the daily cashflow forecasts from the Treasury, process the DMO's transactions and ensure a robust and secure operational environment. In turn, this has meant a substantial programme of work, not only within the DMO but also by our contractors and colleagues in the Treasury and the Bank of England. The new arrangements were given a transitional period in which to establish themselves; the Debt Management Account, through which all the DMO's transactions flow, commenced in November 1999, the DMO assumed responsibility for the weekly Treasury bill tender from January 2000 (although with the amounts on offer at each tender still decided by the Bank), and we started bilateral dealing in February 2000. When responsibility was formally transferred in April 2000 we and the Bank, who provided welcome assistance throughout, were able to make the change without any disruption to the market.

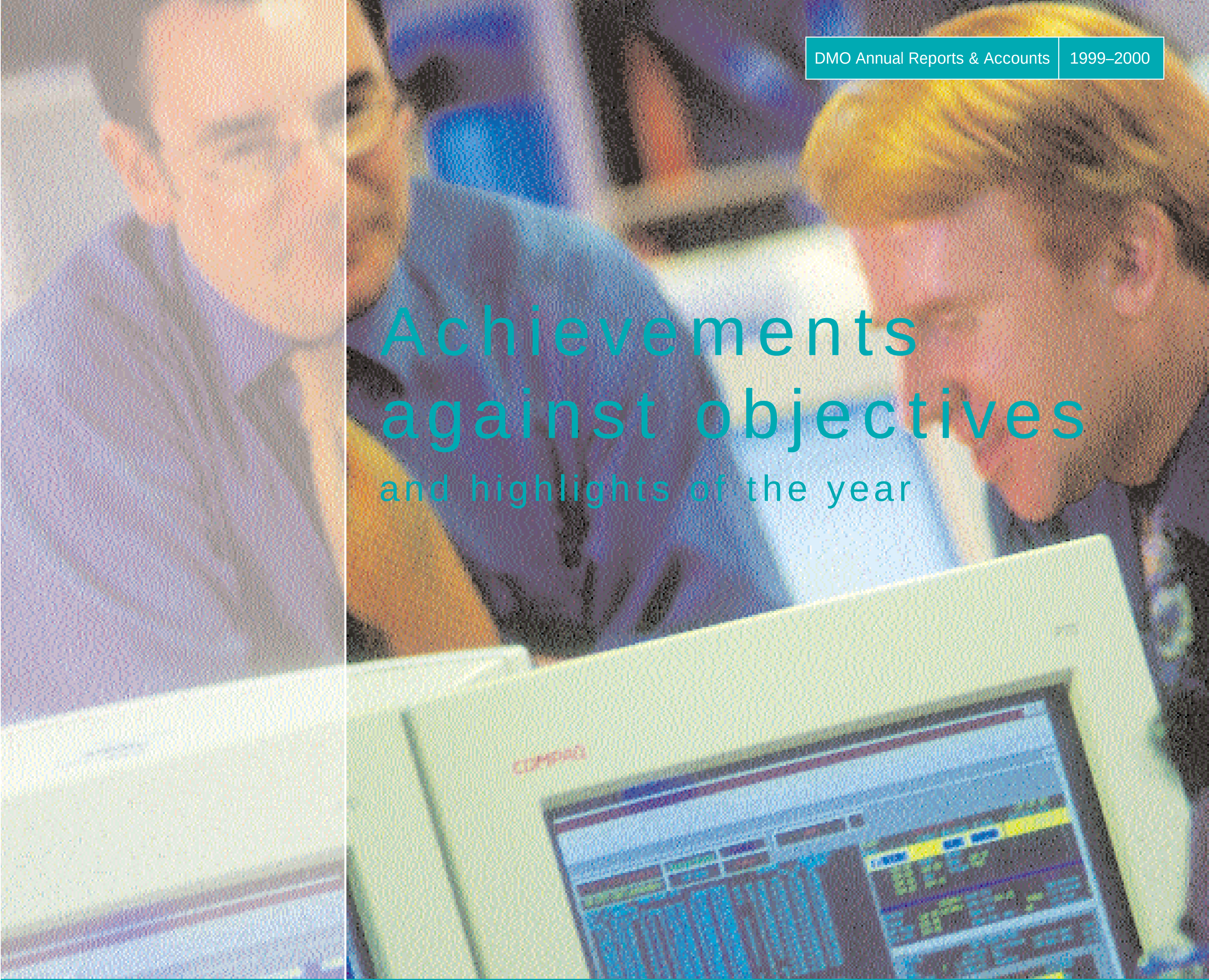


I have been pleased by the reception that we have been given in the money markets and we very much look forward to working with the others involved and developing the business relationship with our counterparties in the months ahead. In presentations and on paper we have tried to set out our policy and operational approach to this important new function, and we will continue to do so. The new arrangements were given an unexpectedly early - but entirely successful - test in handling the very large payments made in May by companies who had been successful in the auction for third generation mobile telephone licences.

The DMO substantially met all its formal targets for 1999-2000, as set out in detail in the pages that follow. For 2000-01, there are two main challenges: to meet our cash management objectives efficiently and effectively; and to try to ease the gilts market through a difficult period of low issuance and liquidity, but of rapid technological progress and market development. In this I know that I can rely upon a good working relationship with all those with whom we deal in the markets and in market institutions; and in the Government, Bank of England and FSA.

It has been an especially testing work year within the DMO. Although initial management, personnel and finance systems had been put in place in the previous year, many have had to be redesigned to reflect the very different operational capability required for cash management and the arrival of new staff. There has been a long programme of hard work in developing and embedding new systems, involving a range of contractors and consultants. But no-one has taken their eye off our primary responsibilities to the market and to meet our remit; much of the project work has had to be done after these daytime responsibilities have been met. Throughout the year I have been hugely grateful to the DMO's executive board and to the whole office for the professional and personal commitment they have continued to give to the DMO and to our customers.

Mike Williams



Achievements against objectives
and highlights of the year

1. To meet the annual remit set by Treasury Ministers for the sale of gilts, with high regard to long term cost minimisation, taking account of risk.

Successfully achieved:

- Gilt sales targets have been met through the conduct of four conventional and four index-linked gilt auctions.
- In addition, a conventional tap issue was held for market management reasons.

2. To offset, through its market operations, the expected outturn cash flow into or out of the NLF, on every business day; and in a cost-effective manner.

- Preparation was made over the year for the complete handover of Government cash management from the Bank of England to the DMO. Systems and IT development was more complex than originally envisaged, although the project kept to schedule from the middle of the calendar year. Full transfer of cash management responsibility was successfully achieved on 3 April 2000. Prior to that, milestones were:
  - the Debt Management Account (DMA) commenced operation on 15 November 1999 since when all transactions going through the DMA have met the required standards. NLF balances are checked and agreed with HM Treasury on a daily basis;
  - the DMO took over operational responsibility for weekly Treasury bill tenders on 14 January 2000;
  - bilateral dealings with cash market counterparties began in a limited way on 14 February 2000, facilitating the successful bedding-in of the DMO's systems and development of trading relationships with counterparties.

3. To advise Ministers on setting the remit to meet the Government's debt management objectives, and on any future modification to the Government's cash management objectives; and to report to Ministers on the DMO's performance against its remit, objectives and targets.

The DMO contributed specific advice in a number of areas on the remit:

- extent to which gilt issuance should be split between conventional and index-linked, and the extent of the bias towards longer-dated conventional gilts;
- size and timing of auctions;
- benchmark stocks and conversion candidates;
- the provision of further information to aid market transparency, with an indication of which maturity would be added to, or cut from, the scheduled auction calendar, in the event of a sufficient change in the financing requirement.

The DMO also reported performance against the remit to HM Treasury on a monthly basis, and on developments in the gilt portfolio and compliance against individual targets on a quarterly basis.

4. To develop policy on and promote advances in new instruments, issuance techniques and structural changes to the debt markets that will help to lower the cost of debt management, liaising as appropriate with the Bank of England, Financial Services Authority, London Stock Exchange, and other bodies; and to provide policy advice to Treasury Ministers and senior officials accordingly.

- The DMO issued a consultation document on the conduct of switch auctions on 7 July 1999 and published its final proposals on 13 September 1999. Switch auctions were designed to be a further tool to build up benchmark gilts in addition to conversion offers, at a time of low primary issuance. The first switch auction was held on 21 October 1999 and the second on 9 February 2000.

- The DMO issued a consultation paper on 24 January 2000 on how the DMO's relationship with the GEMMs might change as a consequence of new trading methods becoming a feature of the gilts market. The paper explored whether the current arrangements were still appropriate and how they might be modified to achieve the same end – investor access and ease of execution at tight prices across the full range of gilts – in a trading environment characterised by electronic trading systems. A number of considered responses was received, to which the DMO published its response on 23 June 2000.

5. To conduct its market operations, liaising as necessary with regulatory and other bodies, with a view to maintaining orderly and efficient markets and promoting a liquid market for gilts.

- The DMO was particularly aware of the difficulties associated with trading at the long end of the conventional gilt curve at times during 1999-2000 and issued by tap £400 million (nominal) of 6% 2028 on 6 August 1999 for market management reasons. The DMO also consulted the market about bringing forward the scheduled November 1999 (long) auction to October. The introduction of switch auctions (above) was also seen as an instrument to increase liquidity in benchmark stocks.

- The DMO conducted its market operations fully in compliance with its Operational Market Notices. It published a revised gilts market Operational Notice in September 1999 and the first Exchequer cash management Operational Notice in July 1999, with a revised version in January 2000.
- The DMO issued a paper in September 1999, clarifying the conditions under which it would undertake a special repo operation and seeking market participants' views on whether an automatic facility would be useful. After considering comments received, the DMO published its response on 22 February 2000 including its intention to introduce an automatic facility from 1 June 2000.

6. To provide, including in liaison with the Bank of England and CRESTCo, a high quality efficient service to investors in Government debt, and to deal fairly and professionally with market participants in the gilts and money markets, consistent with achieving low cost issuance.

- The DMO has introduced a new secure electronic data transfer system between itself and each of the GEMMs (GILTSWAN) to replace the original GEMSIS arrangements.
- A seventeenth GEMM, (Intercapital Gilt Trading) was appointed in January 2000. Intercapital specialises in retail customers.
- The DMO has negotiated a series of agreements to govern trading relationships between itself and its cash counterparties. The agreements cover two main areas: adherence to the DMO Exchequer cash management Operational Notice; and transactions in sale and repurchase agreements (repo). The DMO will not deal with any counterparty unless both agreements are in place.

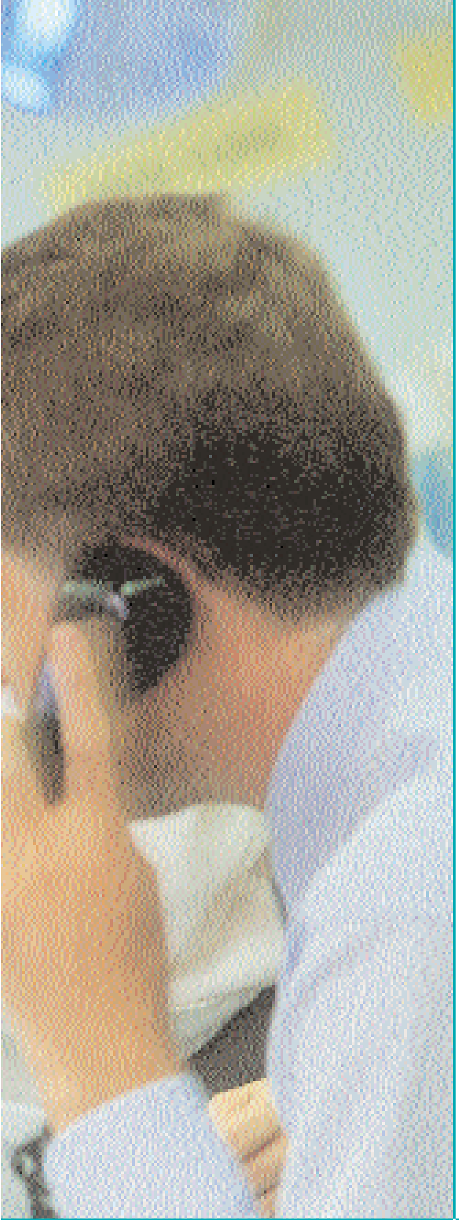
7. To contribute to the Treasury's work on the development of the strategy for the debt portfolio.

Together with HM Treasury and an external consultant, the DMO participated in a number of seminars to consider current academic research on optimal portfolio modelling. Particular developments have been:

- the Fiscal and Macroeconomic Policy Team at HM Treasury has been involved in the portfolio seminars, reflecting the importance of the interface with fiscal policy considerations;
- future work is centring on themes which include tax smoothing, portfolio simulations and cost at risk modelling.

8. To make information publicly available on the debt markets and DMO policies where that contributes, through openness and predictability, to efficient markets and lower costs of debt issuance.

- In addition to the annual Gilt Review, the DMO also publishes a quarterly review early in each month following the previous quarter (January, April, July and October). This publication reviews developments in the gilts market set in both the national and international context and provides updated information on the gilt portfolio. From April 2000, this publication also covers the DMO's Treasury bill issuance.
- On 30 September 1999 the DMO published an Investor's Guide to Gilts, aimed primarily at the institutional investor. The guide complements a retail investors' guide published jointly by the DMO and the Bank of England in July 1998. These publications are also available on the DMO website.
- The DMO has further developed its website during the year.
- A post-Budget briefing was held for gilts analysts.
- A large number of representatives of overseas Governments and agencies has visited the DMO during the year, to discuss the UK's experience, policies and institutional arrangements. DMO staff have also attended meetings of the EU and OECD.

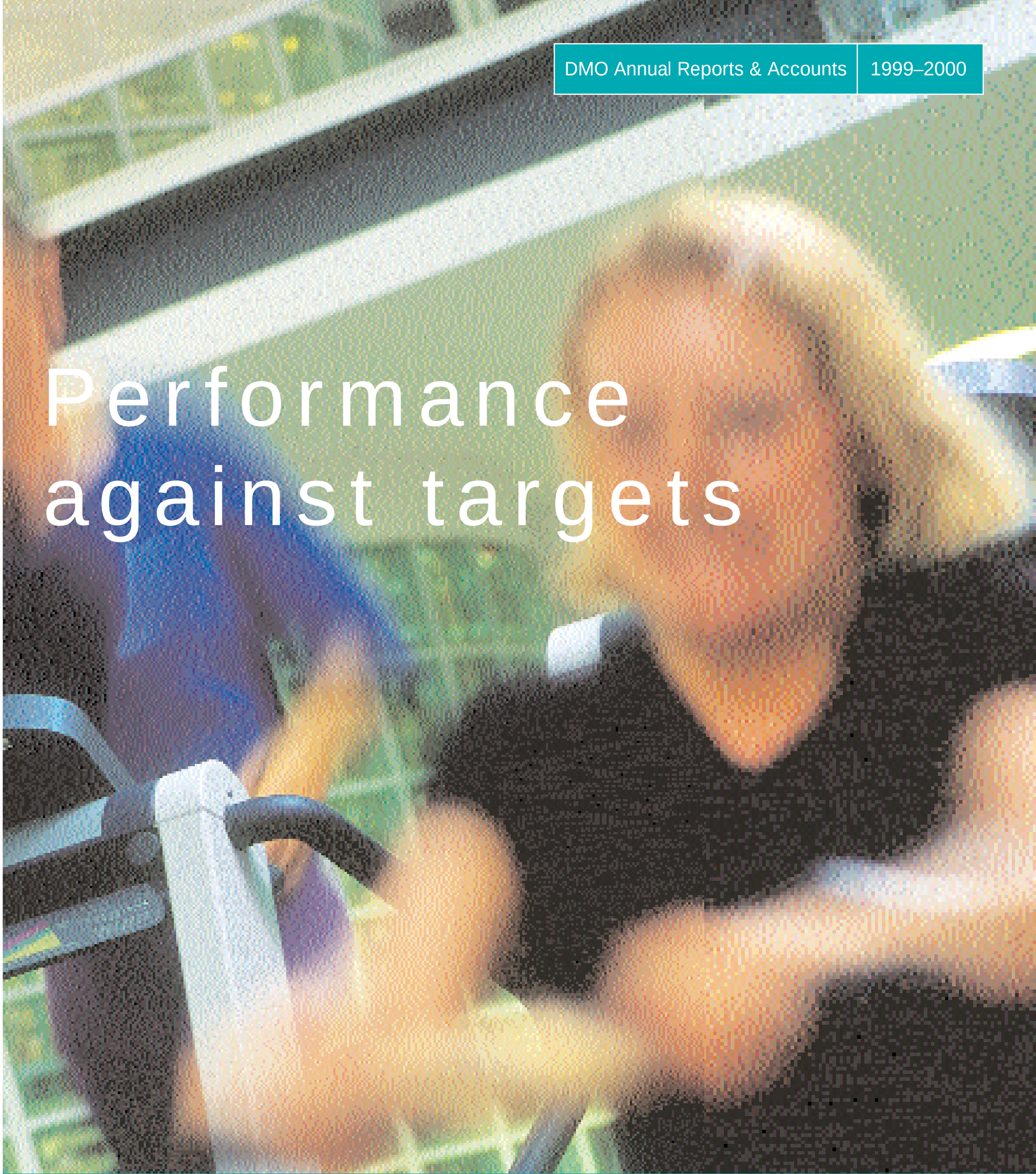


9. To resource, staff and manage the office to deliver its objectives effectively and efficiently and to ensure value of money in its administrative expenditure.

- The DMO kept within its annual budget despite major systems and process development – mostly in connection with preparation for Exchequer cash management. Staff numbers have been carefully controlled.
- Throughout the year the DMO worked towards Investors in People accreditation, which was successfully achieved in June 2000. Training and development systems have been enhanced to address monitoring, evaluation and planning at all levels. An upward feedback exercise was held. The performance management system was reviewed, as a result of which competence frameworks were introduced.
- Business continuity plans, including a remote disaster recovery facility, are in place.
- Procurement of an electronic filing system is under way.

10. To develop appropriate management, information and control systems with high regard to risk minimisation; and to ensure full and accurate presentation of accounting and other information.

- A rigorous internal control framework has been developed.
- An integrated general ledger system is in place, which links the front-end trade processing and settlement systems. Reconciliation with other operating systems is carried out daily. Full and accurate accounting and other control information is produced daily.
- The DMO's internal audit function is in place; an Audit Committee has been established, chaired by James Barclay, the DMO's recently appointed non-executive director, together with an audit charter and a risk-based audit programme.
- An automated control documentation system is in place.
- The DMO has established a Credit and Risk Committee; and, before the DMO took over responsibility for Exchequer cash management, its credit policies and procedures were endorsed by an external assessor, as being in line with good market practice taking account of the DMO's special circumstances.



Performance against targets

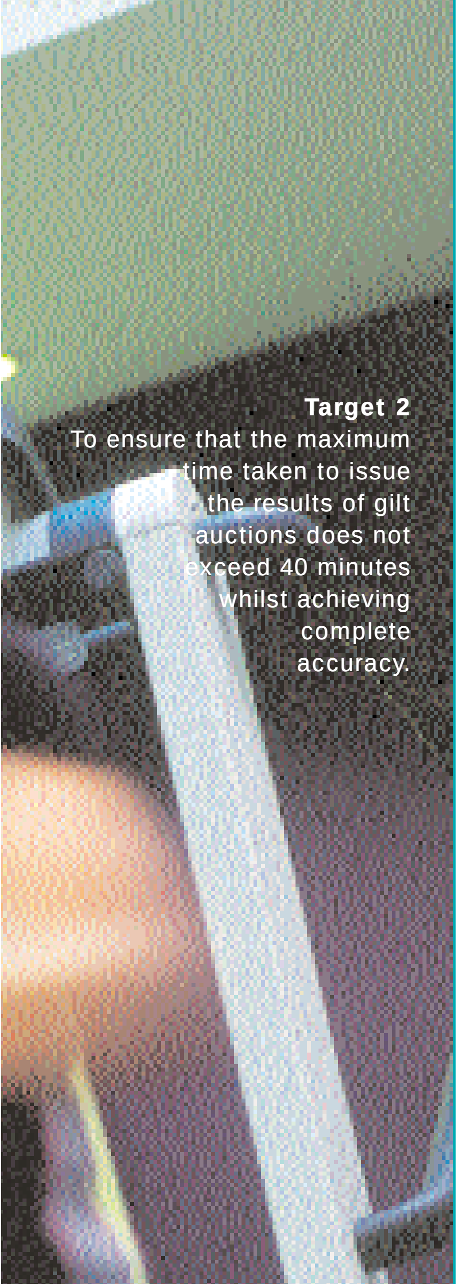
The DMO had a successful second year. After the previous year's seamless transition of gilts market responsibilities, the DMO continued fully to meet the requirements of its gilts remit, and with two exceptions (detailed below), its published targets. The DMO successfully introduced a novel operation - gilt switch auctions - designed to boost the size of benchmark issues, at a time of low primary issuance. Substantial progress was made in connection with the successful transfer of full responsibility for Exchequer cash management, which took effect on 3 April 2000.

Target 1
To ensure full compliance with the Government's remit for the issuance of debt to finance the Central Government Net Cash Requirement as set out in the Debt Management Report within the tolerances and subject to the review triggers notified separately to the Office.

The DMO complied fully with the remit for 1999-2000 as first issued in March 1999, and as subsequently revised on 20 April 1999 and on 9 November 1999 in the Pre-Budget Report. The revisions following the PBR involved the cancellation of the conventional gilt auction scheduled for March 2000 as a consequence of the publication of a lower gilt sales requirement of £14.2 billion (compared with £17.3 billion in the original remit). Gilt sales to the end of the year were £13.6 billion, slightly below the bottom end of the range of gilt sales (of £13.8 billion) planned at the time of the PBR (this was as a result of purchases of short-dated gilts by CRND - the Commissioners for the Reduction of the National Debt - on behalf of public sector funds that they manage).

In addition to the eight gilt auctions held, the first conventional gilt tap since 1996 (of £400 million nominal of 6% 2028) was issued on 6 August 1999 for market management reasons. Its use helped ease the prevailing exceptional trading conditions at the long end of the yield curve. One conversion offer was held increasing the size of the new 5-year benchmark (5% 2004) by £3.79bn to £6.29bn (nominal).

The first two gilt switch auctions were also held, the first increased the size of the 5-year benchmark to £7.41bn. The second increased the size of the 30-year benchmark (6% 2028) to £11.51bn.



Target 2
To ensure that the maximum time taken to issue the results of gilt auctions does not exceed 40 minutes whilst achieving complete accuracy.

This was successfully achieved in all cases except the auction of 6% 2028 in May 1999: the actual times were:

April 1999:	38 minutes ($4\frac{1}{8}$% IL 2030)
May 1999:	48 minutes (6% 2028)
June 1999:	30 minutes (5% 2004)
July 1999:	30 minutes ($2\frac{1}{2}$% IL 2011)
September 1999:	30 minutes ($5\frac{3}{4}$% 2009)
October 1999:	25 minutes ($2\frac{1}{2}$% IL 2016)
October 1999:	27 minutes (switch auction into 5% 2004)
November 1999:	32 minutes (6% 2028)
January 2000:	25 minutes ($2\frac{1}{2}$% IL 2024)
February 2000:	34 minutes (switch auction into 6% 2028)

The delay to the May 1999 auction announcement was primarily caused by the significantly higher than average number of bids received (at 250, this was two thirds greater than the average number received at auctions in the previous three years). The result of the 6% 2028 tap on 6 August was issued after 37 minutes.

Target 3
To establish, with a view to introduction in Q4 1999 (unless market consultation recommends Q1 2000) a system for managing the Exchequer's aggregate cash position which achieves cost-effective financing and is operationally robust, properly conducted, legally sound and subject to minimal credit risk (to the satisfaction of an external assessor).

Work to establish a cash management system in line with this target progressed significantly during the year in advance of the full introduction of cash management on 3 April 2000. The final quarter of 1999-2000 saw key transitional milestones successfully achieved:

– the DMO took over operational responsibility for weekly Treasury bill tenders on 14 January 2000;

– bilateral dealings with cash market counterparties began in a limited way on 14 February 2000, enabling the successful bedding-in of the DMO's systems and development of trading relationships with counterparties.

The DMO's credit policies and procedures were reviewed by KPMG before the start of cash management and they confirmed that, apart from issues arising out of the special circumstances of the DMO, these policies and procedures met good market practice.

Target 4
To achieve complete accuracy, within agreed accounting tolerances, in the recording and reporting of transactions through the Debt Management Account and in delivering money (and reconciling payments) to the National Loans Fund.

This target came into play only when the Debt Management Account commenced operation on 15 November. Since that date all transactions going through the DMA have met the required standards. NLF balances are checked and agreed with the Treasury on a daily basis. (The first account for the DMA will be prepared for the period November 1999 to March 2001, and will be subject to audit by the National Audit Office).

Target 5

To acknowledge all letters from the public within nine working days and for at least 95 per cent to be sent a substantive reply within four weeks.

41 letters were received in the financial year. All letters received were replied to in the required timeframe. The average response time for a substantive reply was 5 under days.

Target 6

To achieve less than ten breaches of the operational market notice (excluding any breaches which the Treasury accept were beyond the control of the Office).

There was only one breach of the operational market notice in the financial year, in connection with the June auction, when on the day after the auction, a discrepancy came to light between the price bid by one GEMM and that entered into the auction price/allocation model. It was subsequently resolved with the GEMM concerned.

Target 7

To ensure that the qualifications that the NAO have made in respect of the Gilt-Edged Official Operations Account are satisfactorily addressed in the running and presentation of the Debt Management Account.

See the reply to target 4 above.

Background

The DMO was established on 1 April 1998, with the aim '…to carry out the Government's debt management policy of minimising financing costs over the longer term, taking account of risk, and to manage the aggregate cash needs of the Exchequer in the most cost-effective way.'

In institutional terms, the DMO is legally and constitutionally part of HM Treasury, but, as an executive agency, it operates at arm's length from Ministers. The Chancellor of the Exchequer determines the policy and financial framework within which the DMO operates, but delegates to the Chief Executive operational decisions on debt and cash management, and day-to-day management of the office.

The separate responsibilities of the Chancellor and other Treasury Ministers, the Permanent Secretary to the Treasury and the DMO's Chief Executive are set out in a published Framework Document, which also sets out the DMO's objectives and its Chief Executive's lines of accountability. The Chief Executive is accountable to Parliament for the DMO's performance and operations, both in respect of its administrative expenditure and the Debt Management Account.

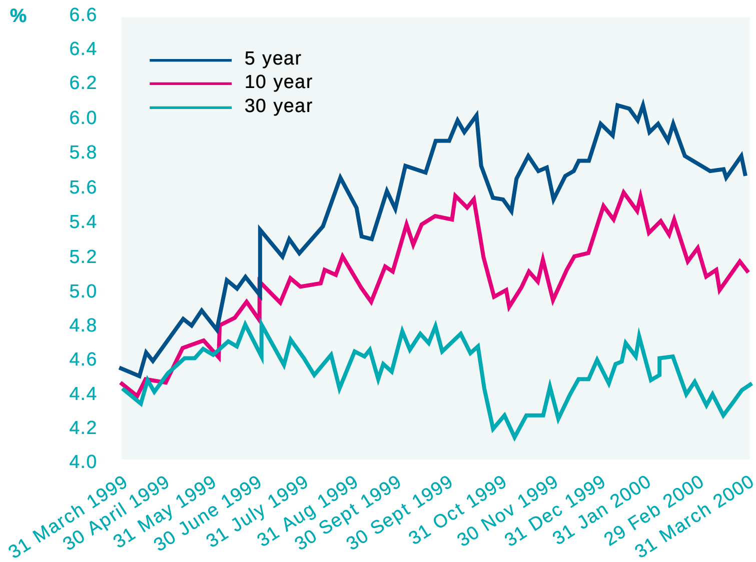
Gilts market review

1999 – 2000

Gilt yields rose from the lows of the previous year and the yield curve inverted significantly as international and UK economic data increasingly pointed to signs of resurgent economic growth. Interest rates began to rise in response.

The major structural change during 1999-2000 was the considerable out-performance of ultra-long dated gilts compared with short and medium-dated maturities. Through 1999-2000, the yield on the 30-year benchmark (6% 2028) rose by only 3 basis points (to 4.50%) whilst the yield on the 5-and 10-year benchmarks increased by 143 and 75 basis points respectively. The change in gilt yields over the year is shown in chart 1 opposite.

Chart 1. Conventional Benchmark gilt yields



Gilt yields began the financial year rising slowly but steadily as increasingly robust economic data (particularly in the US) helped push all yields higher.

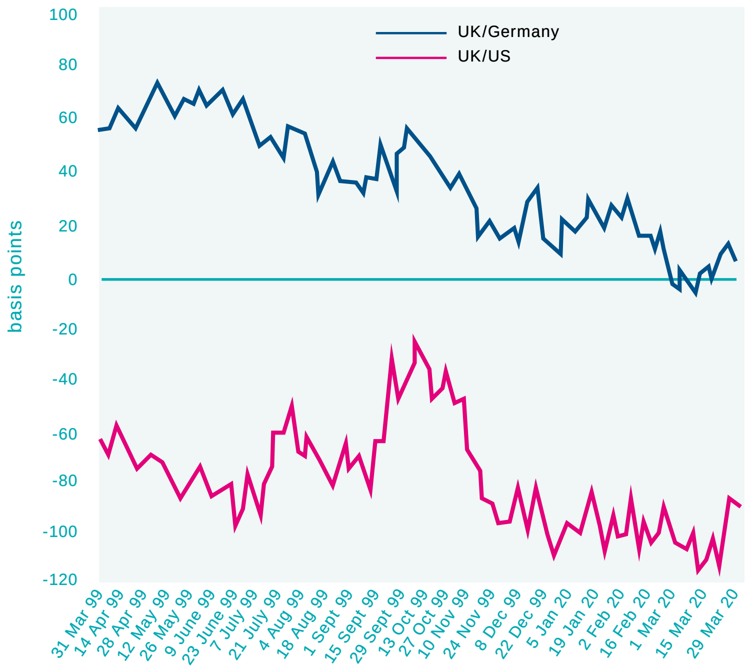
This direction continued through the summer period, as economic data continued to show signs of recovery in the major economies. The other key factor was growing evidence of trading difficulties at the long-end of the gilt curve, exacerbated by a shortage of supply relative to demand. Expectations of a transition to a period of rising interest rates were given impetus by MPC's decision to increase UK rates on 8 September 1999.

The final three months of 1999 saw the first sustained rally in the gilt market since the start of the year, with yields falling along the curve until mid-November. The trend was led, as throughout the year, by long-dated gilts. The yield on 6% 2028 reached a record intra-day low of 4.01% on 5 November. All yields then began to rise, in increasingly thin trade toward the Y2K period, as continuing robust economic data led to a growing expectation of further interest rate increases early in 2000.

Gilts fell back in January 2000 (taking yields to 4-month highs) against the backdrop of strong economic data, particularly in the UK and US, but rallied again in February, in part as further rate rises internationally were interpreted by the market as pre-emptive strikes against inflationary pressures.

Gilts have outperformed major overseas bond markets over the financial year. At ten years' maturity, yields moved from 62 to 80 basis points below US Treasuries and closed from 64 to 10 basis points above German Bunds (having traded as much as 10 basis points under Bunds in early March 2000).

Chart 2: International 10 year bond spreads



Financing Remit 1999-2000

The DMO's annual remit for 1999-2000 was published on 9 March 1999 in the Debt Management Report. It forecast gilt sales of £17.3 billion, based on a forecast Central Government Net Cash Requirement of £6.2 billion. Nine gilt auctions (five conventional and four index-linked) were planned.

As with the previous year, the main feature was a declining financing requirement. On 20 April 1999 the financing requirement was reduced by £1.7 billion as a result of a higher than forecast outturn for the 1998-99 Central Government Net Cash Requirement. However, the volume of planned gilt sales remained at £17.3 billion, with the change being absorbed through a reduction in planned Treasury bill issuance.

On 9 November 1999, a revised forecast for the Central Government Net Cash Requirement of £1.1 billion for 1999-2000, was published in the Pre-Budget Report. This change, with a lower contribution from National Savings and a further reduction in planned Treasury bill sales, resulted in a reduced gilt sales requirement and the cancellation of a conventional gilt auction. Planned gilt sales fell to a range of £13.8 - £14.6 billion.

The March 2000 Budget included a new forecast for the 1999-2000 Central Government Net Cash Requirement of a surplus of £5.8 billion. This reduced the Government's estimated financing requirement to £7.2 billion, against estimated gilt sales for the year of £13.8 billion. The effect of the changed forecast was entirely absorbed within a further reduction in the planned level of Treasury bills and other short- term debt.

The 1999-2000 gilt financing requirement (£ billion)*

	Budget 9 Mar 1999	20 Apr 1999	PBR 9 Nov 1999	Budget 21 Mar 2000	1999-00 Outturn Apr 2000
Central Government Net Cash Requirement (forecast)	6.2	6.2	1.1	-5.8	-9.2
Net financing for official reserves	2.4	2.3	2.3	2.2	2.2
Gilt redemptions	14.8	14.9	14.9	14.9	14.8
Gilt sales residual from 1998-99	-2.3	-4.1	-4.1	-4.1	-4.1
Financing requirement	21.0	19.3	14.2	7.2	3.7
Financed by:					
National Savings	0.1	0.1	-0.9	-1.0	-1.1
T- bills & other short term debt	3.6	1.9	0.8	-5.7	-8.8
Gilt Financing Requirement	17.3	17.3	14.2	13.8	13.6
Gilt sales estimated outturn				13.8	13.6

* Figures may not sum due to rounding.

The breakdown of gilt sales by type across the year was as shown below:

Gilt Type	March remit £bn	November remit £bn	Outturn £bn
Short conventional	5.0	2.4	2.0
Medium conventional	3.0	2.8	2.6
Long conventional	5.8	5.8 - 6.2	6.0
Index-linked	3.5	2.9 - 3.3	3.0
Total	17.3	13.8 - 14.6	13.6

* Figures may not sum due to rounding.

The results of the eight gilt auctions held in 1999-2000 are summarised below:

Date	Stock	Nominal Issued £bn	Cover	Tail (bp)	Lowest Accepted Price (LAP)	Yield at LAP
28 April 1999	4 1/8% IL 2030	0.5	0.94	*	£179.34	1.97%
26 May 1999	6% 2028	2.5	2.24	2	£120.20	4.72%
22 June 1999	5% 2004	2.5	2.01	2	£ 98.70	5.30%
22 July 1999	2 1/2% IL 2011	0.375	1.93	*	£225.50	2.19%
28 September 1999	5 3/4% 2009	2.75	2.54	1	£100.30	5.71%
27 October 1999	2 1/2% IL 2016	0.35**	2.65	*	£204.61	2.34%
24 November 1999	6% 2028	2.0	1.79	2	£128.60	4.27%
26 January 2000	2 1/2% IL 2024	0.35**	2.54	*	£187.01	1.93%

** Index-linked gilts are issued through a uniform price auction format.*
*** In both cases an additional £0.02 bn nominal was issued for separate sale to CRND.*

In addition, a conventional "tap" issue – the first since 1996 – was held in August 1999, as a market management response to difficult trading conditions at the long-end of the yield curve. The tap contributed approximately £0.5 billion to gilt sales during the year.

Date	Stock	Nominal issued £bn	Price when exhausted	Yield when exhausted
6 August 1999	6% 2028	£0.4	£125.30	4.45%

Resources

DMO Executive Board
from left to right (back)
Jo Whelan (Head of Markets)
Mike Williams (Chief Executive)
David Courts (Finance and Systems)
Paul Mills (Head of Policy and Analysis
Hamish Watson (Chief Gilts Dealer)
Jim Juffs (Head of Operations and Resources)

from left to right (front)
Dave Curtis (Head of Business Services)
Mike Ness (Chief Money Market Dealer)

James Barclay
non-executive director

1. Staff and recruitment

During the year staff numbers increased to over 35 people. Some of these are on loan or secondment from HM Treasury, other government departments and the Bank of England, and some are short-term contractors, but an increasing number has been recruited directly from the private sector.

All recruitment to new posts was carried out on the basis of fair and open competition and selection on merit in accordance with the guidance laid down by the Civil Service Commissioners. All candidates were selected solely on merit and in accordance with the DMO’s equal opportunities policies (see below).

2. Executive Board

During 1999-2000 the DMO comprised three main teams: policy and analysis, markets, and business services (although a re-organisation took place shortly after the end of the year.) In practice, most staff work flexibly across these areas as necessary. The heads of the main functional teams, and other senior staff with relevant experience and responsibilities, comprise the DMO’s Executive Board. All managerial and operational policy decisions of the DMO are subject to consideration and approval by the Executive Board.

3. Audit Committee

The DMO has established an Audit Committee as part of its development of internal risk management and control arrangements in line with best private sector practice. The Audit Committee has an external independent chairman, James Barclay, who has also joined the DMO’s Executive Board. James Barclay was Chairman and Chief Executive of Cater Allen Holdings Ltd between 1985 and 1998 (although now has no connection with that company); he brings a wealth of relevant experience, both from a market and business perspective, to the DMO.

4. Improving good practice and Investors in People

The DMO has established a continuing programme to improve management good practice and worked during the year towards Investors in People accreditation, which was achieved in June 2000.

5. Equal opportunities

The DMO is an equal opportunities employer. Policies are in place to ensure that no job applicant or member of staff receives less favourable treatment on grounds of sex, marital status, colour, racial origin, sexual orientation, age (except in relation to the retirement policy), religion or disability. The DMO attaches great importance to its equal opportunities policy, which it believes to be of benefit to itself and its employees.

6. Service Quality

The DMO does not provide services direct to the public, and so is not covered by existing arrangements for reporting service quality. However, as part of its sponsorship role HM Treasury sought views from the gilts market as to the standard of service provided by the DMO. Responses from market participants were very positive.

7. Financial performance

The DMO's net expenditure in 1999-2000 was £4.75 million, slightly less than that projected in its budget. Expenditure on running costs was £4.70 million. Within the total, expenditure on consultants was greater than planned – both on the cash management project (including IT support) and on pay and accounting systems. This was financed by underspends on other services, including those from the Treasury and (for settlement services) from the Bank of England. Pay-related costs were broadly in line with provision. Auction-related costs were much less than expected, but that benefit flows directly through to the NLF.

The DMO's work is distributed broadly across all strategic objectives; non-pay expenditure tends to support either office-wide infrastructure or market operations. Overall, the establishment of the cash management function absorbed a slightly higher proportion of budget than anticipated.

8. Manpower/employee relations

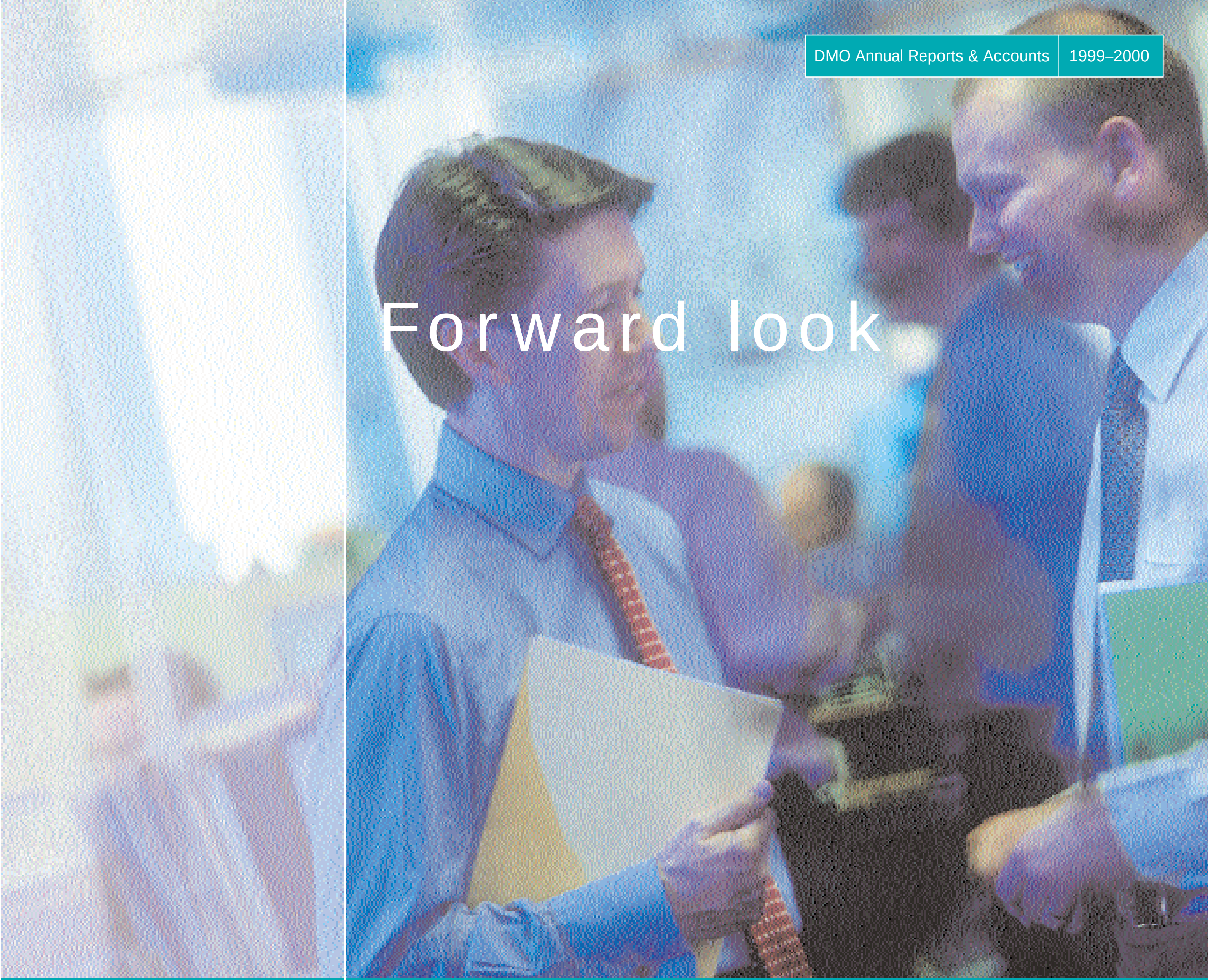
Trades unions are not represented within the DMO, although all staff are free to join an appropriate union and to play an active part in it. Because of its size, it is possible to discuss all matters affecting staff directly with the whole office, and this is done on a regular basis, with all staff being actively encouraged to contribute both formally and informally. For this and other reasons, the office has been able to establish good internal relations and involve all staff in key decisions.

9. HM Treasury services

In view of the DMO's on-vote agency status and the diseconomies of scale inherent in setting up a wide range of internal support systems given its initial small size, several key support services have to date been provided by the Treasury (for example, procurement, invoice processing and payment, payroll, library, security and health and safety.) As the office is growing in size and professional capability, however, some of these arrangements, particularly in relation to finance and procurement, are to be reviewed in 2000-01, with a view to taking them in-house by the start of 2001-02.

10. Auditors' details

As specified by the Exchequer and Audit Departments Act 1921, the National Audit Office is responsible for auditing the DMO's annual accounts.



Forward look

Financing Remit for 2000-01

The DMO's remit for 2000-01 was published with the Chancellor's Budget statement on 21 March 2000. For the first time, the remit extended to cash management as well as debt management objectives.

On the basis of a forecast central government cash surplus (a negative CGNCR) of £4.9 billion, gross gilt sales of £12.2 billion were planned. In the light of the strong demand from investors and the pressures on market liquidity, the DMO worked extensively with the Treasury to ensure that there could be more issuance than implied purely by the forecast financing requirement. Despite the substantial surplus it is important to maintain a healthy gilts market into the period ahead, not least because the Government is projected to move into cash deficit in 2002-03. Gross issuance was protected primarily by planning to restructure other Government liabilities, including buying back some less liquid gilts in the short to medium maturity areas.

An innovation this year, which has been widely welcomed by the market, was to publish in detail a number of further measures, totalling £9.7 billion, which could be called upon in the event that central government was in greater cash surplus than forecast. This allowed some further protection of the gilts issuance programme; and indeed when the CGNCR outturn for 1999-2000 was published on 20 April 2000, the £3.3 billion consequential adjustment needed to the financing requirement for 2000-01 was taken by drawing on this list of contingencies, and not on gilts sales.

The table below shows the financing arithmetic as presented in the Budget and as updated on 20 April and 12 June

	Budget: March 2000	20 April 2000	12 June 2000
Central Government Net Cash Requirement forecast	-4.9	-4.9	-4.9
Impact of Spectrum receipts:			-19.5
Replacing foreign currency debt*	3.5	3.5	9.5
Redemptions	18.6	18.6	18.6
Debt buy-backs	3.5	3.5	3.5
Residual from 1999-2000	-9.5	-12.8	-12.8
Financing requirement	11.2	7.9	-5.6
Less:			
National Savings contribution	-0.8	-0.8	-0.8
DMO cash deposit at Bank of England	-0.2	-0.2	-0.2
Original short term debt contingencies:			
Repayment of Ways and Means	-	-2.0	-2.0
Reduction in planned Treasury bill stock	-	-1.3	-2.0
Further reductions in net short-term debt			-10.7
Gilt sales planned	12.2	12.2	10.0
Of which:			
Short conventionals	0.0	0.0	0.0
Medium conventionals	2.2	2.2	0.0
Long conventionals	6.5	6.5	6.5
Index-linked	3.5	3.5	3.5

** including original remit financing (worth £3.6 bn on 12 June) and implementation of contingencies (worth £5.9 bn) both estimated at current exchange rates.*
(figures may not sum due to rounding)

In the event, however, these contingencies were swamped by the unexpectedly large proceeds from the auction of third generation mobile telephone licences. Total proceeds are likely to be £22.5 billion, compared with £3 billion assumed in the Budget forecast. The receipts may all flow through to the CGNCR in 2000-01 - providing cash receipts £19.5 billion in excess of those estimated in the Budget.

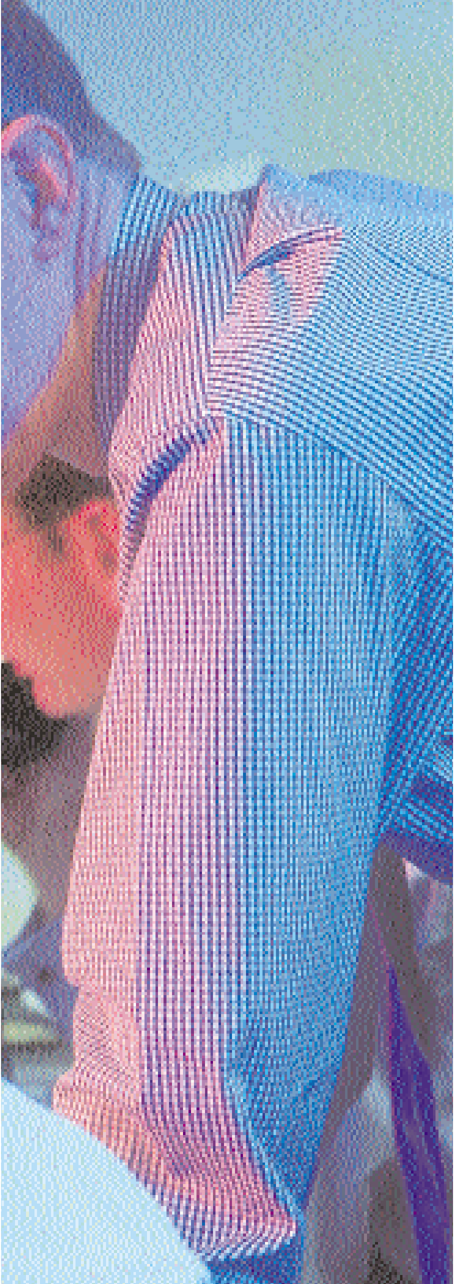
As a result HM Treasury set out the impact on the financing requirement in a reply to a Parliamentary question on 12 June 2000. Planned gilts sales were reduced by £2.2 billion to £10.0 billion, with the scheduled September conventional gilts auction being cancelled.

All the remaining contingencies outlined in the original remit were triggered: a further £5.9 billion of pre-financing of foreign currency debt and a further £0.7 billion reduction, to £8.0 billion, in the planned level of the Treasury bill stock at end-March 2001. The reduction in planned gilt sales and the exercise of the remaining contingencies accounted for £8.8 billion of the £19.5 billion additional spectrum proceeds, leaving £10.7 billion to be used to reduce the levels of net short-term debt. No decisions will be taken on the composition of this reduction until the Pre-Budget Report expected in the autumn.

The table below shows the planned mix of gilts sales under the revised 2000-01 remit and the progress of sales to the end of June.

Gilt type	Remit (£bn)	Net sales to end June (£bn)
Short conventionals	0.0	-0.2
Medium conventionals	0.0	-0.1
Long conventionals	6.5	2.4
Index-linked	3.5	0.9
Total	10.0	3.0

In the first quarter of the financial year, the DMO issued a further tranche of index-linked stock $2^1/_2$% Treasury 2020; and the first tranche of a new long stock $4^1/_4$% Treasury 2032. This new stock, the first new long since 1998 when 6% Treasury 2028 was first issued, was in direct response to requests from investors for a longer duration stock to help them better to match their liabilities. The issue was followed in June by a switch auction (from 8% Treasury 2015) into the new stock which took $4^1/_4$% 2032 to £4.55 bn in issue; the DMO has said that it will not be strippable until the amount in issue rises to £5 billion.



Gilts auction calendar

Date	Type
Wednesday 3 May 2000	$2\frac{1}{2}$% IL 2020
£375mn auctioned. Cover 2.30 times. Price £219.00. Real yield 1.92%.	
Wednesday 24 May 2000	$4\frac{1}{4}$% 2032
£2,500mn auctioned. Cover 1.63 times. Ave price £96.21. Ave yield 4.47%.	
Wednesday 26 July 2000	$2\frac{1}{2}$% IL 2013
Wednesday 25 October 2000*	Index-linked
Late November/early December 2000*	Conventional
Wednesday 24 January 2001	Index-linked
Wednesday 28 March 2001*	Conventional

** subject to confirmation following the Chancellor's decisions on the Budgetary timetable.*

Throughout 2000-01, the DMO will hold further switch auctions to maintain the liquidity of benchmark stocks, and also to facilitate index tracking by investors and will continue to keep under review opportunities for conversions.

The DMO published a consultative paper on reverse auctions in April as preparation for the buying in of some less liquid gilts, as a contribution to protecting new issuance. A response to the consultation was published in June and the first reverse auction is scheduled for 20 July.

The UK already has one of the most concentrated gilts market among major countries in terms of the limited number of bonds. The effect of these operations in 2000-01 is likely to continue this trend, which is important if liquidity is to be sustained in this period of low issuance.

Gilts Market Developments

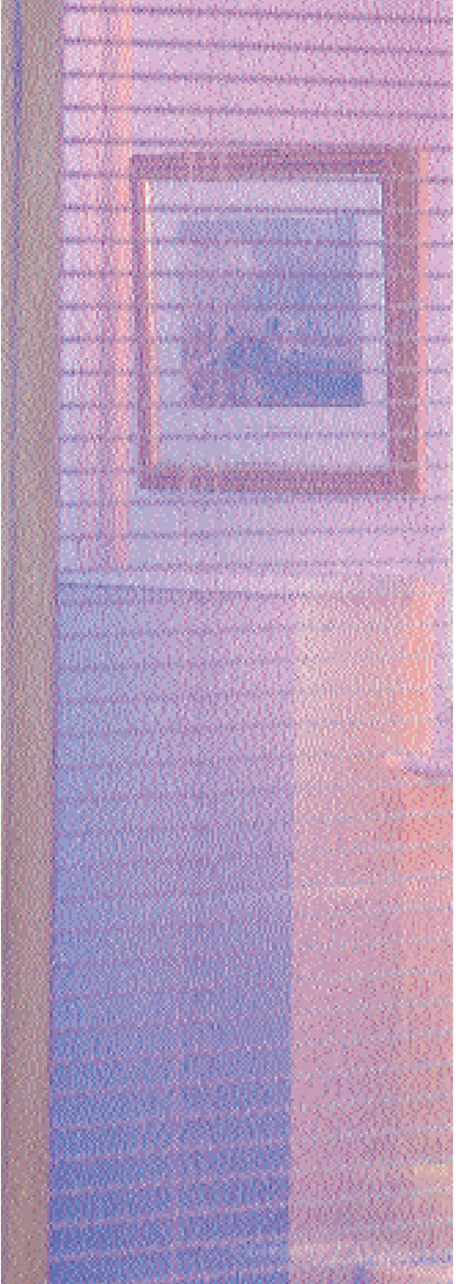
During 1999-2000, the number of recognised Gilt-Edged Market Makers (GEMMs) was increased to 17, with the formation of Intercapital Gilt Trading who specialise in providing market-making services to the retail end of the market. This development has been helpful in extending gilt market services to the wider investing community. Among the Inter-Dealer Brokers (IDBs), Garban ceased trading following its merger with Intercapital-WCLK, but Dowgate, a subsidiary company of King & Shaxson Bond Brokers Ltd, started business as an IDB shortly afterwards.

In April 1999, LIFFE's gilt futures contract moved from an open-outcry trading environment onto the exchange's electronic order book, LIFFE Connect, followed by the transfer of short sterling and Euribor contracts to Connect in November 1999. Although in the immediate aftermath there was some decline in use of the long gilt contract (average daily volume in April fell to 29,485 [1] contracts from 34,170 in March and 55,532 in February), that subsequently picked up again (48,393 in May and 41,900 in June) and market participants have generally welcomed the development.

Notwithstanding these positive developments, liquidity in the gilt market is currently poor. The volume of 'customer' business has declined from a peak weekly average of nearly £27 billion in October 1998, to a level in June 2000 of around £15 billion per week[2]. Volumes in long gilt futures tell a similar story. This is in part a reflection of the low level of issuance, but there is also considerable anecdotal evidence to suggest that intermediaries have become much less willing to take risk positions – no doubt a continuing reflection of the problems of hedge funds in Autumn 1998 – and that investors have become more driven to follow buy-and-hold strategies for regulatory or internal reasons. The lack of liquidity itself may inhibit the willingness of some peripheral investors to research the market.

[1] **Source: LIFFE**

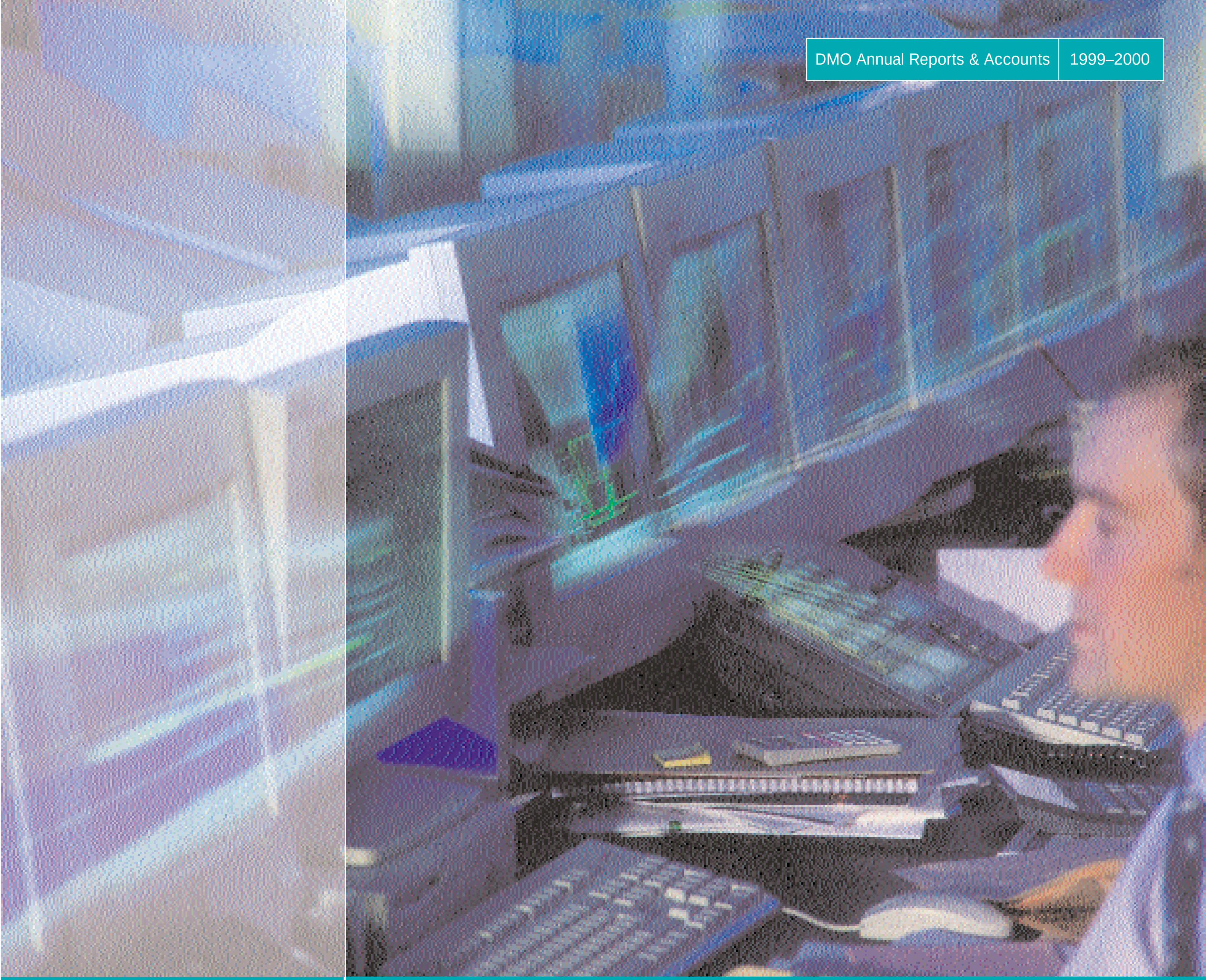
[2] **According to figures reported to the DMO by GEMMs.**



The DMO will continue to try and address these issues in its programme of issuance, switch auctions and conversions, as discussed above. However, the DMO also issued in January 2000 a paper discussing whether its interaction with the gilt market, and in particular with the Gilt-Edged Market Makers, should change in the light of the development of electronic trading systems. A number of new systems is being introduced into the fixed-income markets, and are likely to become a feature of the gilts market in the near future. These systems could greatly benefit market transparency, but there is a risk that they could undermine the objective of maintaining a liquid, efficient and orderly gilts market.

Following a review of the responses received, on 23 June 2000 the DMO issued a proposal that an inter-GEMM market with quote obligations in a designated set of benchmark stocks be established. This market would only be available to the GEMMs and would represent an extension to the existing inter-dealer broker (IDB) structure. In line with the balance of views expressed by the GEMMs themselves, this would require them to provide firm quotes in a subset of gilts in minimum size on a continuous basis to each other. The DMO believes that a committed market between the GEMMs would improve their access to liquidity and help them to fulfil their wider market-making obligations. This model should help to minimise entry barriers facing prospective GEMMs, thus helping to maintain a high degree of competition in the provision of market-making services. It should also facilitate and encourage the development of a range of other products in the wider market. Provisional timing for implementing this structure might be early 2001; the implementation date will be publicised in due course once the final specifications of the structure have been determined in the light of further consultation.

From 1 June 2000, and following an earlier consultation exercise, the DMO introduced a standing special repo facility. This allows extra gilt issuance, on the request of the market, to remove a market dislocation. The gilt issued will be repo-ed to each counterparty on an overnight basis and cancelled on return. Use of the facility will be at a substantial premium to the market rate; but the facility should nevertheless prevent the kind of disruption that can sometimes occur in less liquid markets.



Cash Management in 2000-01

The DMO formally took over responsibility for managing the Exchequer's daily cashflow on 3 April 2000. The DMO's objective was set out in HM Treasury's remit. Specifically the DMO's primary objective in carrying out its Exchequer cash management operations will be to offset, through its market operations, the expected cash flow into or out of the National Loans Fund on every business day; and to do so in a cost effective manner.

In doing so the DMO should:

- Balance cost and risk in its choice of strategies;
- Manage cash flows without influencing the level of short-term interest rates.

The DMO should also take account of:

- The operational requirements for the Bank of England for implementation of its monetary policy objectives;
- Its impact on the efficiency of the sterling money market.

The Exchequer's cash flow has a fairly regular seasonal and monthly pattern; but it is also subject to considerable uncertainty, associated largely with unpredictability in the timing of some tax and expenditure flows. The DMO's approach is to rough-tune the seasonal pattern of flows through the issue of Treasury bills and engaging in term repo. It seeks to fine tune floes on a weekly and daily basis, although the variation in the forecast of Exchequer flows means that there is often considerable business to be done on the day. Apart from the weekly issue of Treasury bills, most of the DMO's dealing is done on a bilateral basis, and mainly in the secured markets, although it has run some ad hoc Treasury bill and reverse repo tenders. Arrangement have been put in place with the Bank of England that are designed to cope with late changes in the forecast for the day without disadvantage to the market. HM Treasury also has in hand a programme to improve both the forecasting and monitoring of the daily cash flows.

An important part of the DMO's approach is to avoid being the cause of rates moving noticeably in one direction or another, distorting prices or trading patterns. In other words, the DMO is, and seeks to act as a price-taker, not a price setter. It is working with the market, responding to market developments, and balancing cost and risk in a way similar to others in the market.

Since it has taken this responsibility, the DMO has been encouraged by the positive response of others in the market. A constructive working relationship has been established with a range of counterparties. The DMO will continue to build on this co-operation and to encourage discussion of its approach and market developments generally.

The new arrangements were themselves given a somewhat unexpected test following the completion of the auction for third generation mobile telephone licences. As a result, payments of over £8 billion were made on one day in May by two of the successful companies. With the co-operation of the Bank of England and a number of core banks, arrangements were successfully put in place which had the effect of smoothing the money market impact of these substantial flows.

Resources

The DMO published its Business Plan for 2000-01 in April 2000. It set out a series of long term targets, derived from the DMO's strategic objectives. The DMO remains determined to meet its objectives to a high standard while maintaining its core values: being professional, goal-oriented, responsive and outward-looking, scrupulously fair, ready to take the initiative, and providing a good place to work. As in previous years, the changes in the DMO's external environment and the risks arising make it important to maintain flexibility, an open culture, high quality of staff and wide external contacts.

The DMO's long term targets are the basis of targets for the year ahead which are cascaded down to teams and individuals. However, the DMO is organised flexibly, and there is substantial working across the main business areas to ensure that relevant skills and resources are brought to bear. Training and development is central to ensuring that the DMO has the right skills available to a high standard. In June 2000, the DMO was accredited as an 'Investor in People'.

During the course of 1999-2000, the DMO recruited a number of additional staff, primarily from the private sector, to ensure that it had the specific skills for its cash management operations. At the start of the year there were over 35 staff in the office, although some of these were on short-term contracts. Total resources will be kept under review in the light of market needs and developments, although the DMO's administrative expenditure will be slightly lower in 2000-01 than the previous year, as the significant systems expenditure needed to establish cash management is now past.