Semi-Annual Report of the Kentucky Asset/Liability Commission

35TH EDITION

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For the period ending June 30, 2014

This report may be viewed at:

http://finance.ky.gov/services/ofm/Pages/semi-annualreports.aspx

The Commonwealth's Comprehensive Annual Financial Report (CAFR)

may be viewed at:

http://finance.ky.gov/services/statewideacct/Pages/ReportsandPublications.aspx

The Municipal Securities Rulemaking Board (MSRB) Electronic Municipal Market Access (EMMA) website is located at:

http://emma.msrb.org/

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INTRODUCTION

This is the Kentucky Asset/Liability Commission's (ALCo or the Commission) thirty-fifth semi-annual report pursuant to KRS 56.863 (11) for the period beginning January 1, 2014 through June 30, 2014. Several factors on both the state and national level had an impact on activity during the reporting period. The most significant factors were:

On the national level

- The economy grew at an annual rate of 1.9% over the last six months, but this growth increased from a partial weather-induced decline of 2.1% in the first quarter to 4.0% growth in the second quarter.
- The Federal Reserve has continued reducing the purchases of longer-term securities by $10 billion per meeting with the expectation of the end of Quantitative Easing in October of 2014.
- Geopolitical instability combined with weakness in European economies led to a sustained rally in treasury securities as the yield on the 10-year treasury dropped nearly 0.50% to 2.53%.
- Roughly 1.4 million jobs (on a net basis) were created over the last six months as the unemployment rate fell from 6.7% to 6.1%, the lowest rate in six years.

On the state level

- General Fund receipts totaled $9.462 billion for Fiscal Year (FY) 2014. General Fund receipts increased 1.2% for FY 2014 over the same period in FY 2013. General Fund receipts for FY 2014 were $90.9 million, or 1.0%, less than the official revenue estimate which projected 2.2% growth.
- Road Fund receipts for FY 2014 totaled $1.5604 billion. Road Fund receipts increased 4.6% for FY 2014 over the same period in FY 2013. Road Fund receipts for FY 2014 fell short of the official revenue estimate by $22.2 million, or 1.4%.
- Kentucky's seasonally adjusted unemployment rate stood at 7.4% at the end of June 2014, down from 8.4% one year ago.
- Implementation of bond authorizations from prior-year sessions of the General Assembly continues and is coming to a close as projects reach completion.
- The 2014 Regular Session of the General Assembly delivered House Bill 235 (Executive Branch Budget other than Transportation Cabinet) to the Governor on March 31, 2014 and House Bill 236 (Kentucky Transportation Cabinet Budget) on April 15, 2014. Together, the bills authorize bond financing for projects totaling a net amount of $1.364 billion to support various capital initiatives of the Commonwealth.

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MARKET OVERVIEW

Economically, the first six months of 2014 have been rather volatile. Consumer Spending accounted for roughly 70% of Gross Domestic Product. The combination of the "polar vortex" and increased medical expenditures held retail sales growth at 0% during January and February. Sales increased in March as the weather cleared but remained muted through the second quarter. This lack of activity led to a decline in real Gross Domestic Product of 2.1% in the first quarter and an increase up to 4.0% in the second quarter. While the second quarter increase was good news, the cumulative growth of 1.9% during the first half of the calendar year is well below earlier projections of 3.0% to 4.0% for the entire year.

Broader measures of consumer spending, specifically chained Personal Consumption, show that overall spending grew at nearly 2.8% during Calendar Year 2013 but has slowed to roughly 1.8% annualized growth during Calendar Year 2014. Between the 2001 recession and the 2008 recession, the economy grew at nearly 3.0% per year and even this level of growth was slow when compared with the decades of the 80s and the 90s. With personal consumption growing at sub 2% levels, the ability of the broader economy to grow rapidly is limited.

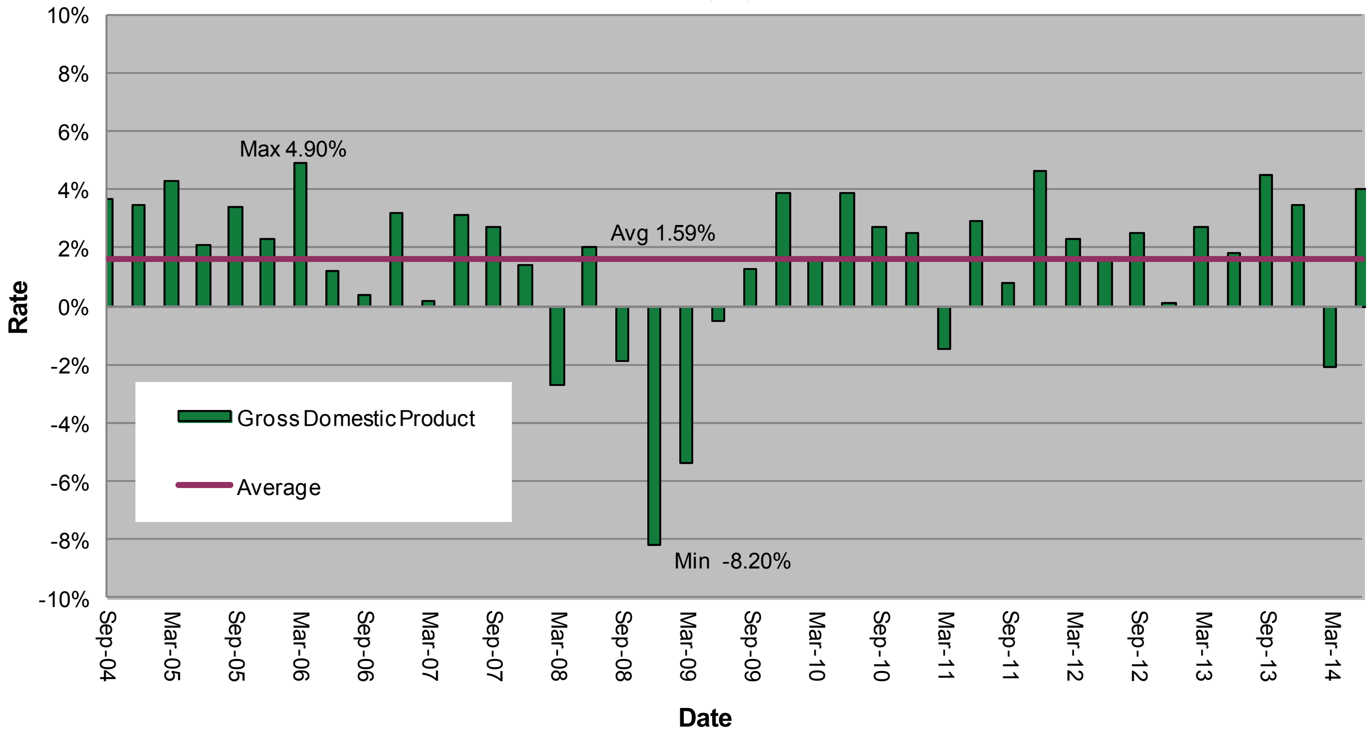
In order for consumers to spend more, either their incomes must rise or they must dip into savings. The most sustainable source for increased spending is from increasing income. The growth in Personal Income since the beginning of 2009 has averaged 2.8% annually. However, when adjusting for inflation of 1.6% annualized over the same period, growth of real income of slightly over 1% does not support a booming economy. The economy has averaged adding over 200,000 new jobs per month since July of 2012 with the pace increasing over the last nine months. There are questions surrounding the quality of the new jobs being added, as many are actually part-time jobs, but the trend is clearly in the right direction.

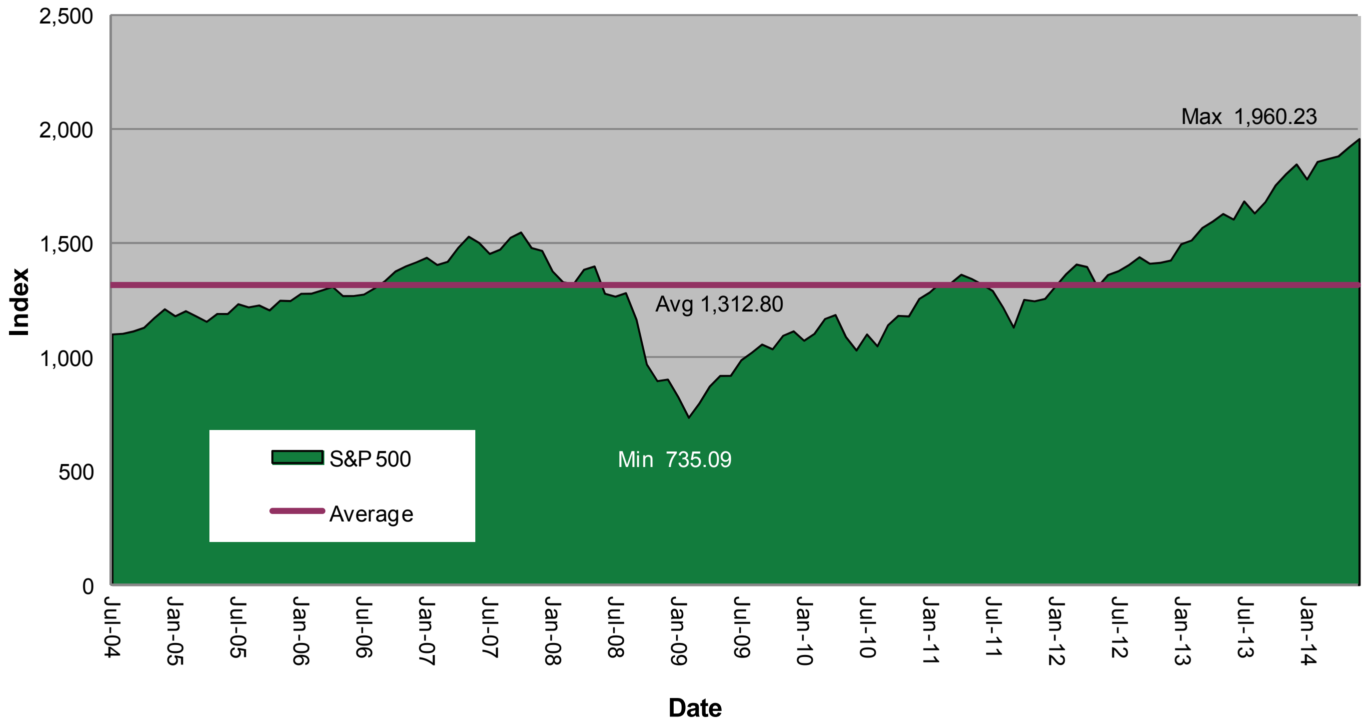
Ever since the onset of the Great Recession in 2008, the Federal Reserve has acted aggressively to use monetary policy to stimulate the economy. The rate on Fed Funds has remained near 0% since December 16, 2008, and the Federal Reserve has undertaken several rounds of Quantitative Easing (QE). QE consists of purchasing longer term (over 2 years to maturity) treasury and agency mortgage-backed securities (MBS). The current manifestation of QE began as purchasing $45 billion per month of treasuries and $40 billion per month of MBS plus reinvestment of all maturities and pay downs. At the end of Calendar Year 2013, the Federal Reserve began tempering these purchases by $10 billion at each meeting. On the current schedule, QE should end in October of 2014.

By slowing Quantitative Easing, the Federal Reserve is indicating that they believe the economy is returning to healthy, sustainable growth. The Federal Reserve has also stated that at some point after the end of QE, short term rates will rise to more normal levels. There have been numerous discussions at the Federal Reserve on exactly how operationally to push short term rates up, so in the future, Fed Funds may no longer be the best approach for measuring short term interest rates. As the Federal Reserve tapered purchases and moved closer to raising interest rates, most market participants expected longer term rates to begin rising. The exact opposite has happened as the yield on the 10-year Treasury has dropped by 50 basis points over the last six months to 2.53% on June 30, 2014. Theoretically, falling long term interest rates are an indication of a weakening economy, but this trend may instead be driven by certain technical factors including demand from long term investors and China. This trend should be monitored going forward.

INVESTMENT MANAGEMENT

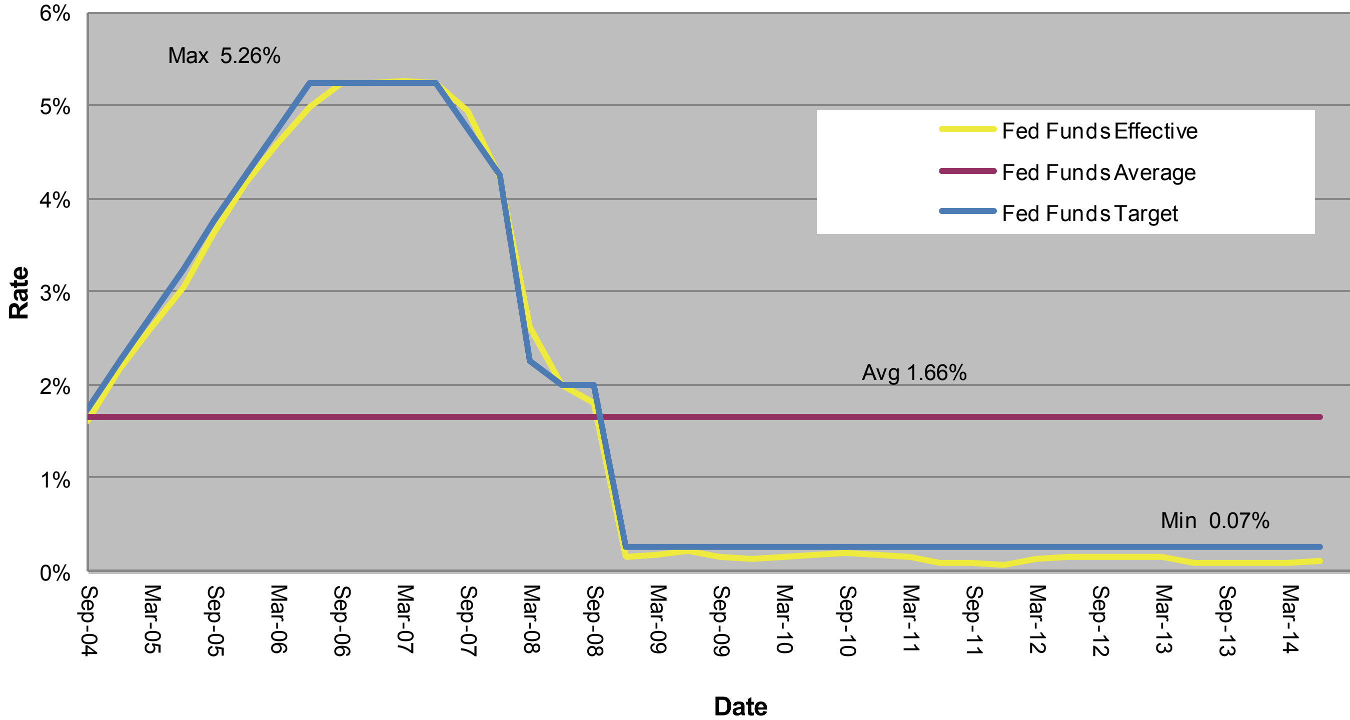
Real Gross Domestic Product & S&P 500

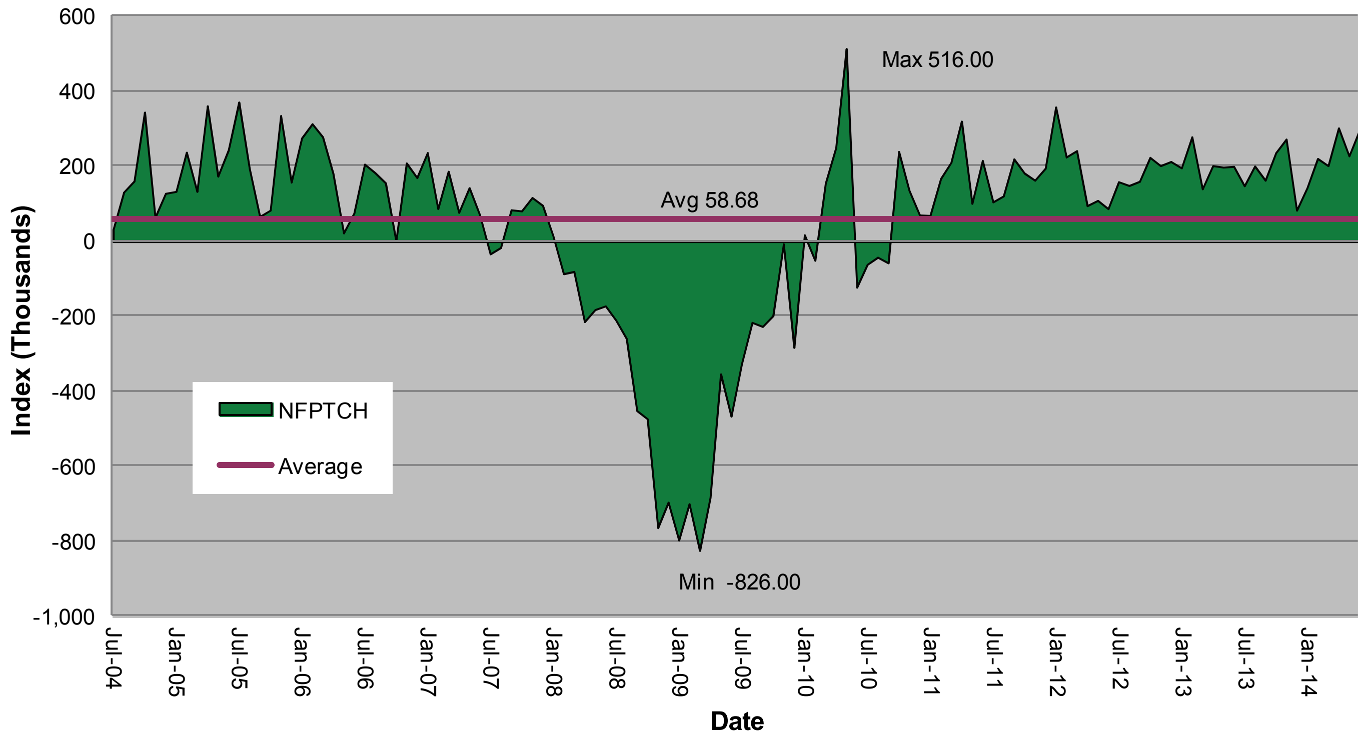




INVESTMENT MANAGEMENT

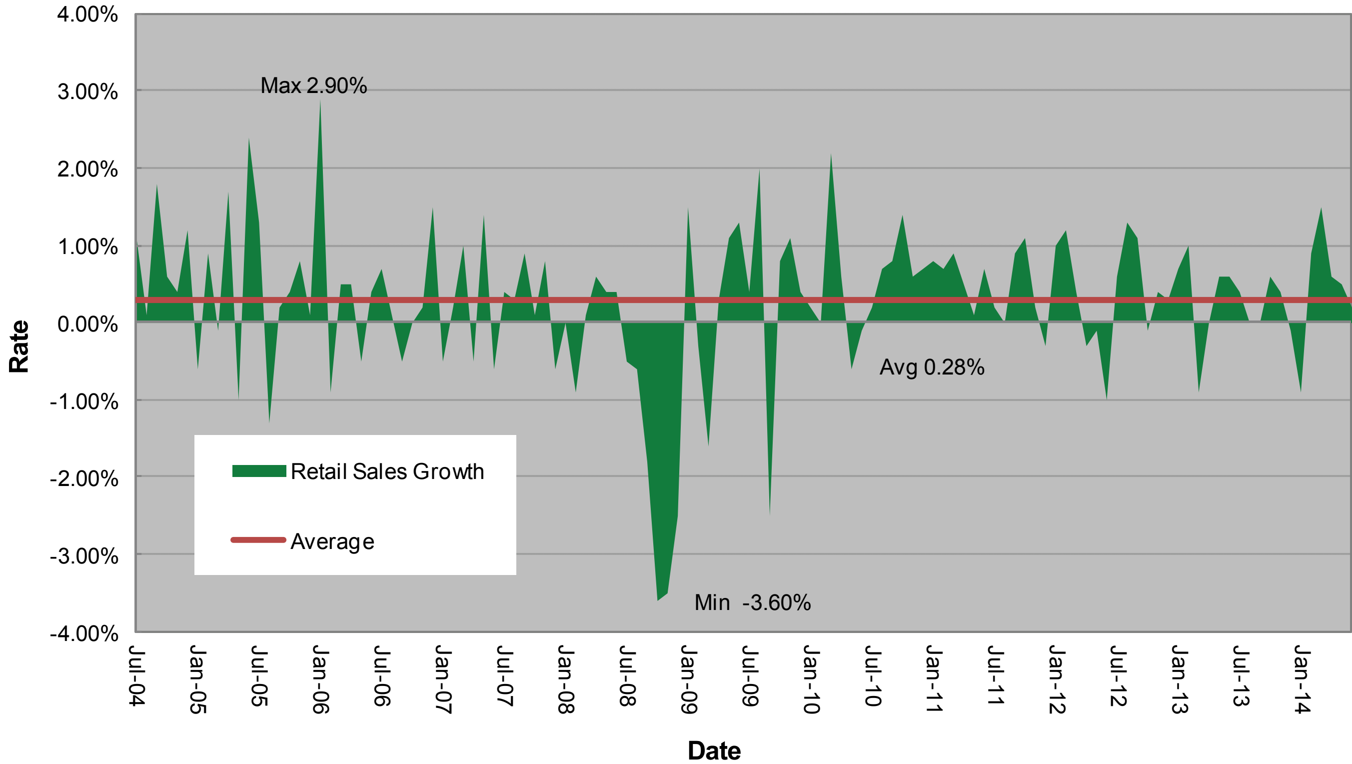
Federal Funds Target Rate & NonFarm Payrolls

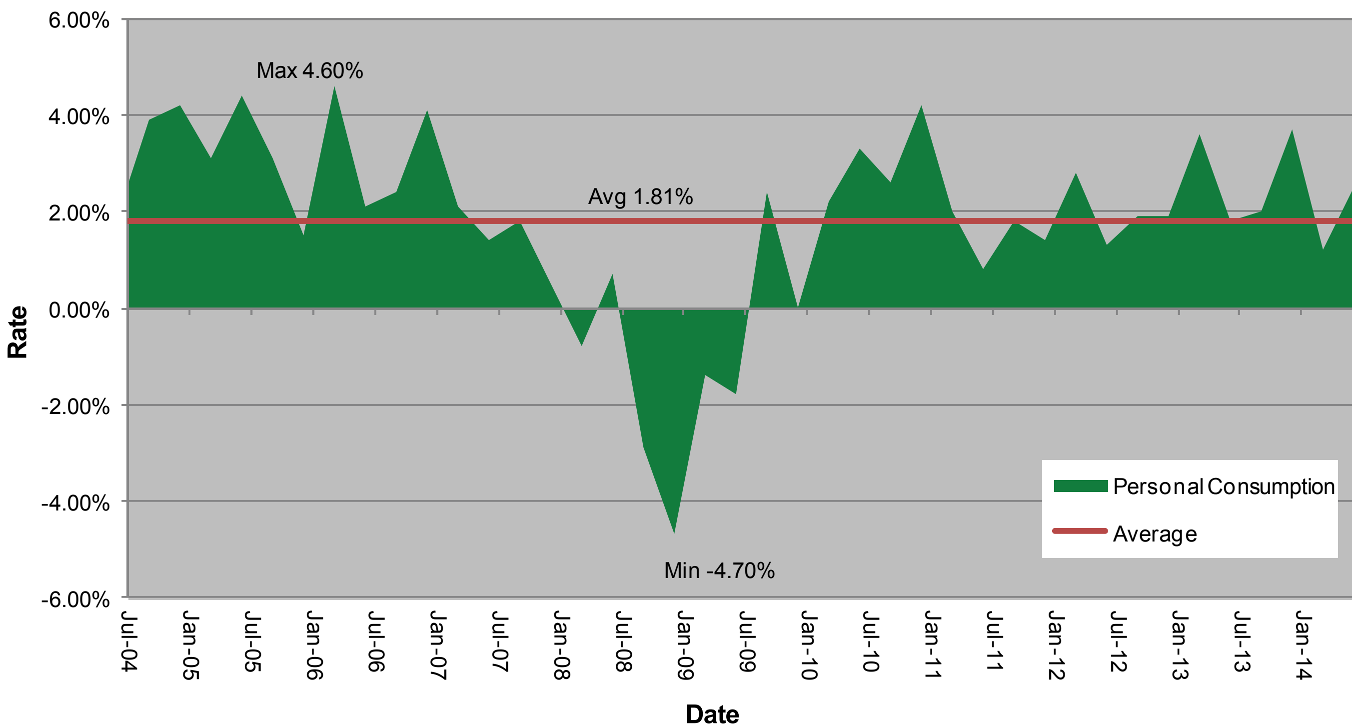




INVESTMENT MANAGEMENT

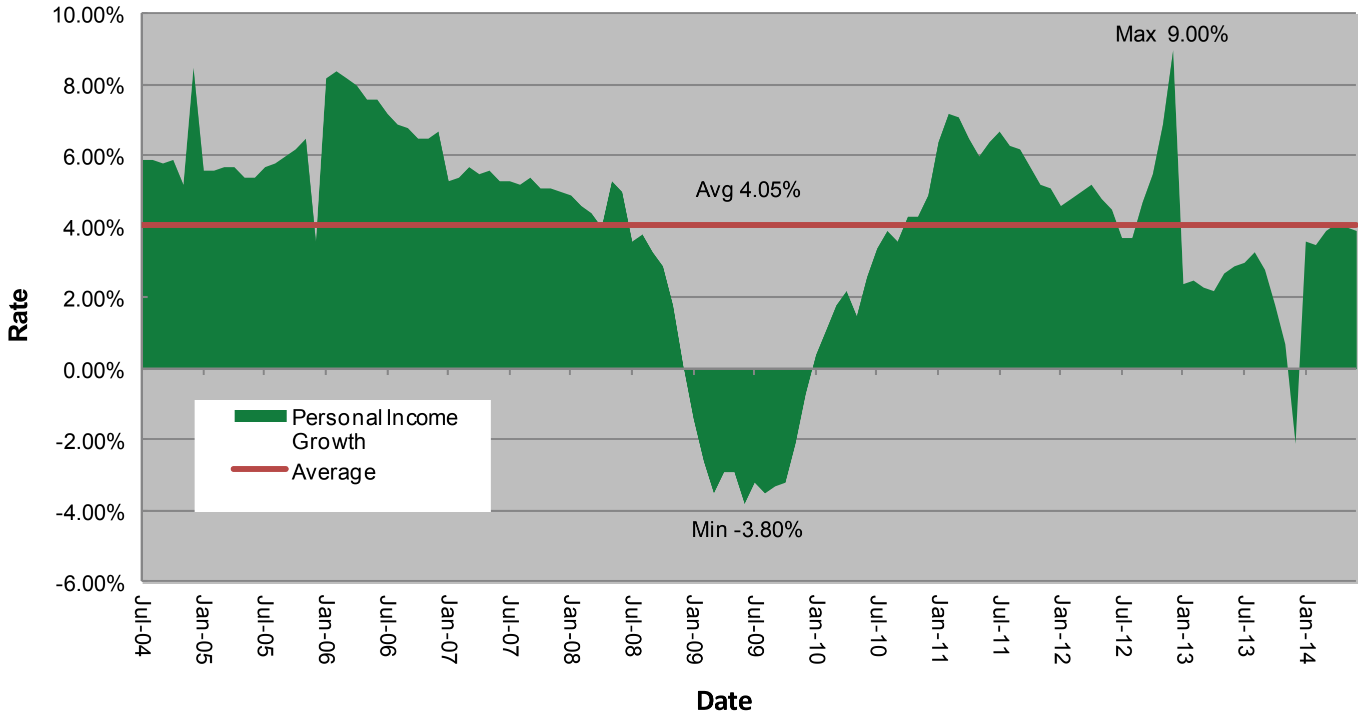
Retail Sales Growth & Personal Consumption

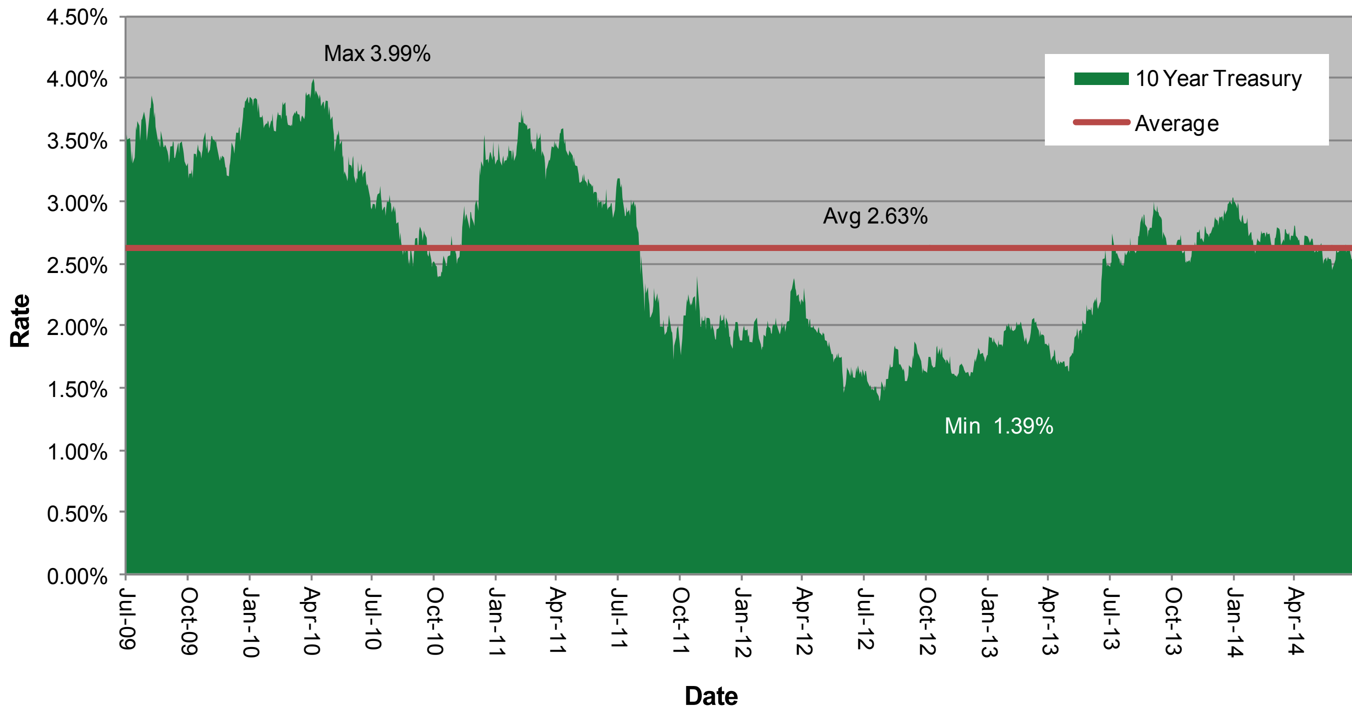




INVESTMENT MANAGEMENT

Personal Income Growth & 10 Year Treasury





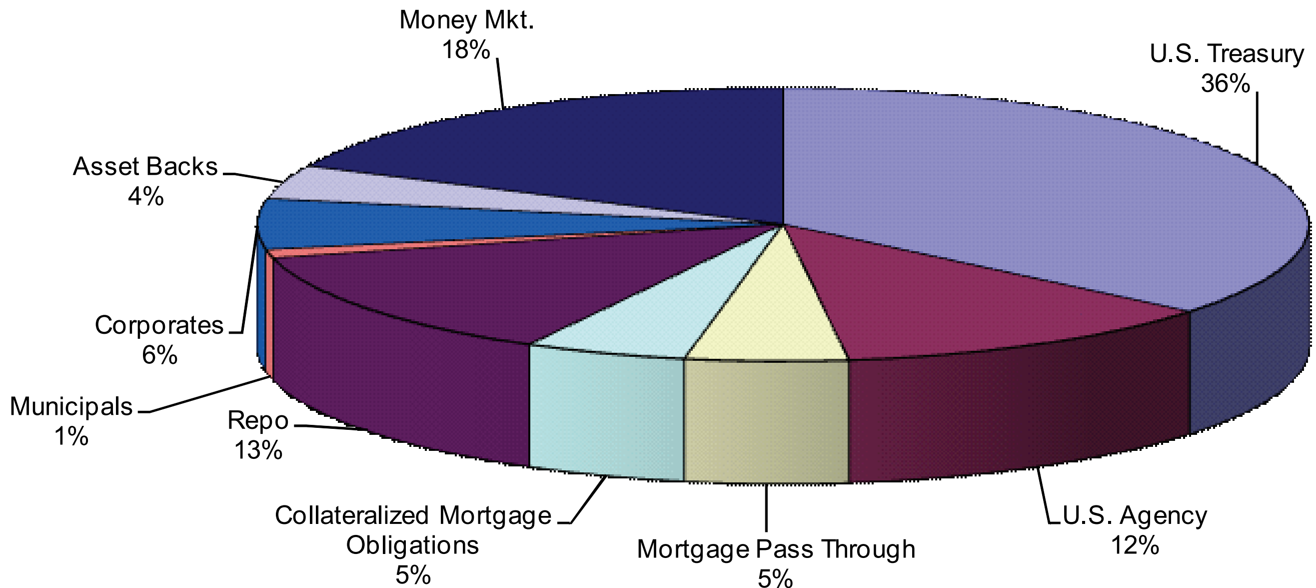
INVESTMENT MANAGEMENT

PORTFOLIO MANAGEMENT

For Fiscal Year 2014, the Commonwealth's investment portfolio averaged $3.4 billion. As of June 30, 2014, the portfolio was invested in U.S. Treasury Securities (36 percent), U.S. Agency Securities (12 percent), Mortgage Pass Through Securities (5 percent), Collateralized Mortgage Obligations (5 percent), Repurchase Agreements (13 percent), Municipal Securities (1 percent), Corporate Securities (6 percent), Asset-Backed Securities (4 percent), and Money Market Securities (18 percent). The portfolio had a market yield of 0.36 percent and an effective duration of 0.82 years.

The total portfolio is broken down into four investment pools. The pool balances as of June 30, 2014, were: Short Term Pool - $267 million, Limited Term Pool - $1.28 billion, Intermediate Term Pool - $2.529 billion, and Bridges Pool - $506 million.

For Fiscal Year 2014, total investment income was $19.7 million compared to $4.3 million for Fiscal Year 2013. The increase in investment income was caused by a rather large rally in the bond market as well as higher investable balances in the second half of the fiscal year.



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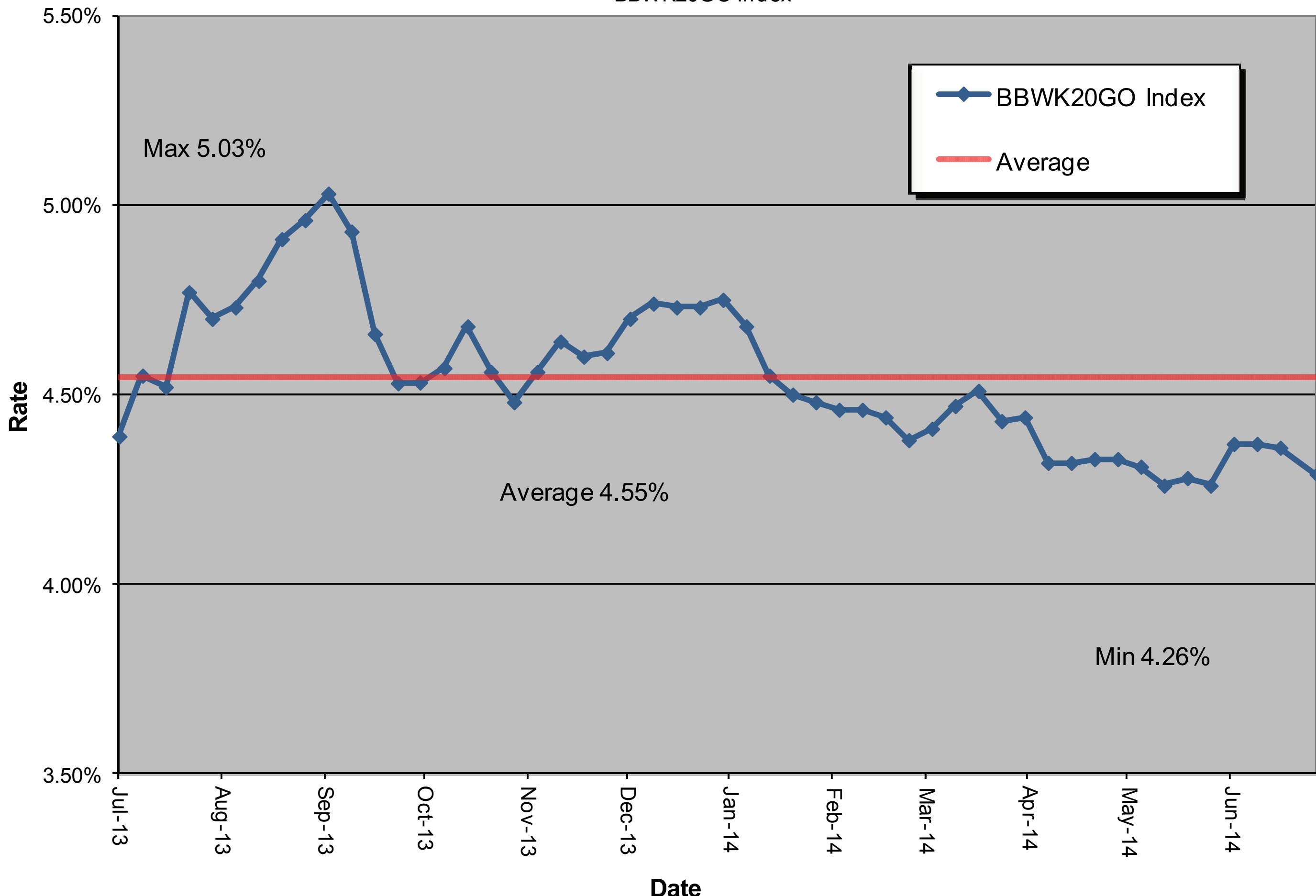
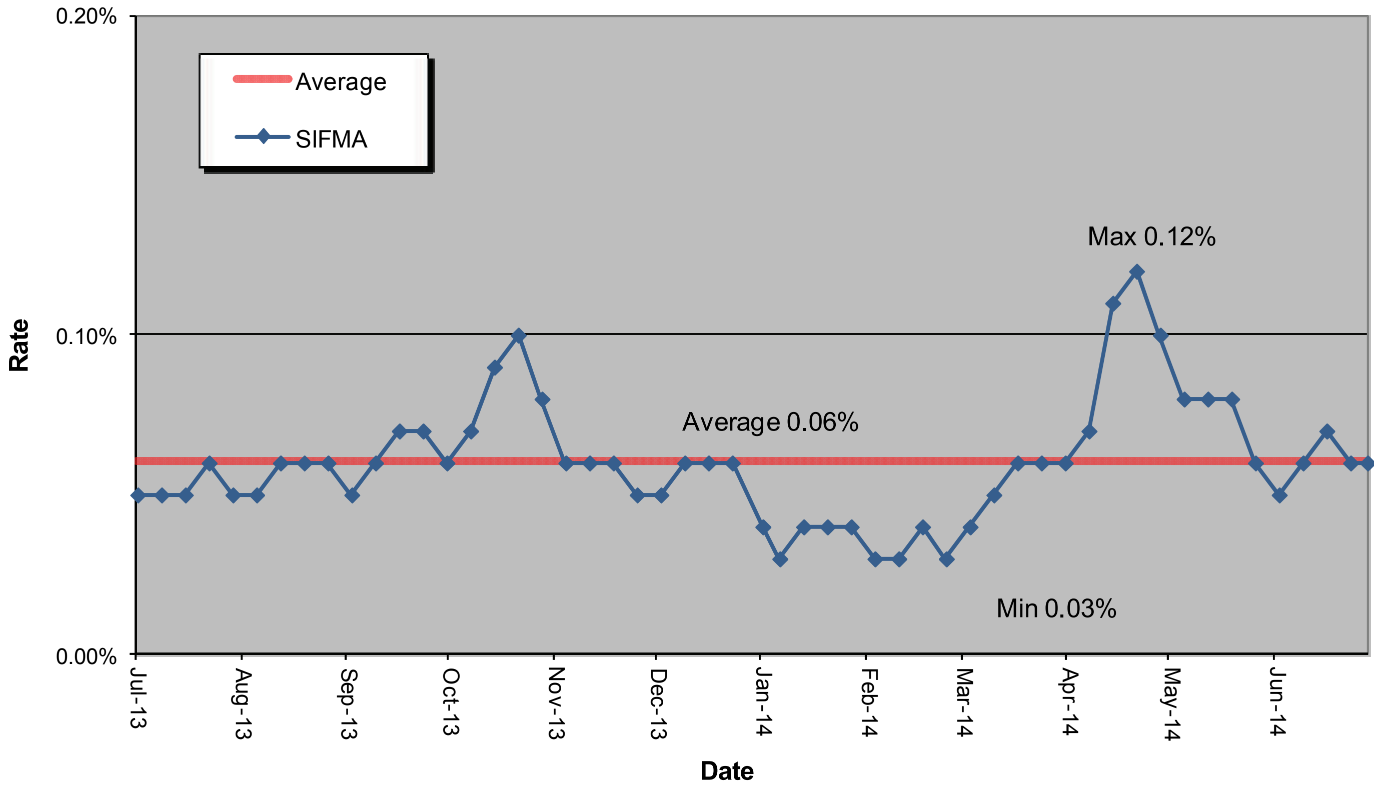
Tax-Exempt Interest Rates and Relationships

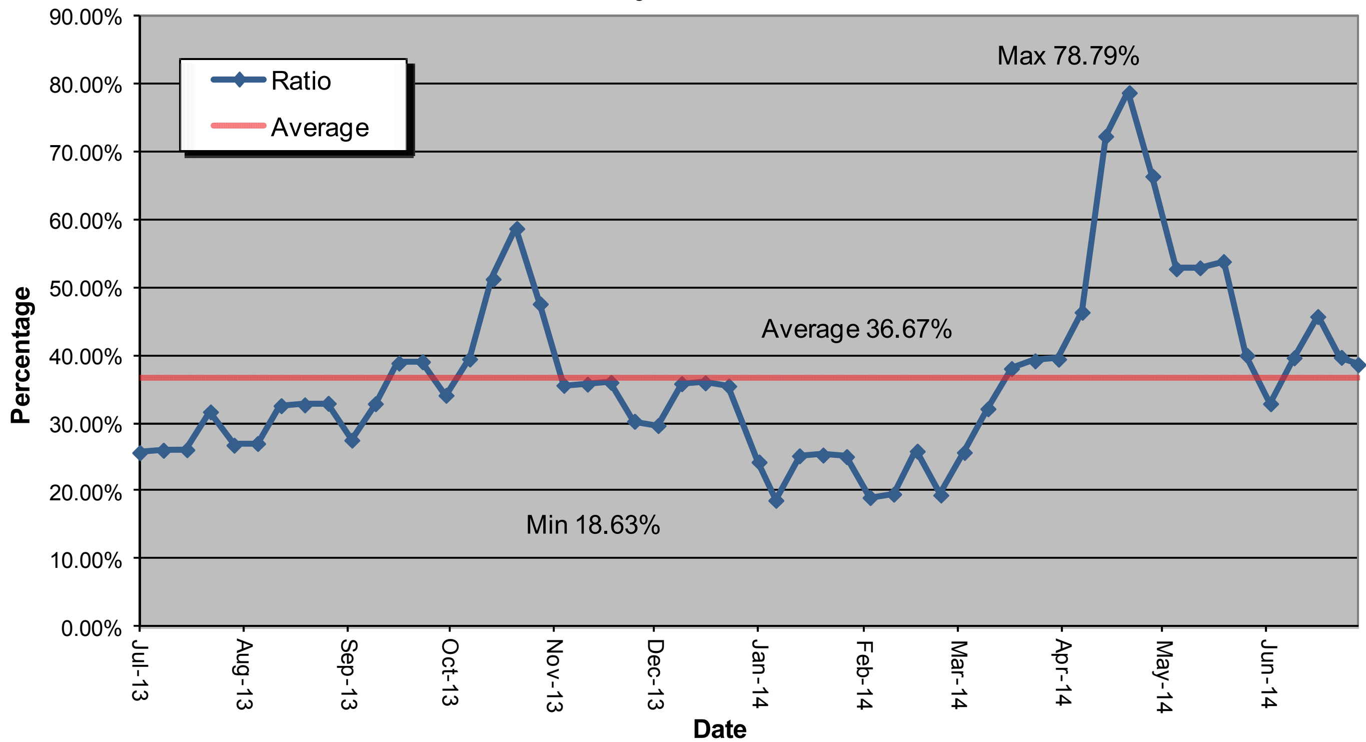
The Bond Buyer 20-year General Obligation Index averaged 4.41% for the reporting period from January 2014 through June 2014 and 4.55% for Fiscal Year 2014. The fiscal year high was 5.03% in September 2013, and the fiscal year low was 4.26% in May 2014 with the fiscal year end at 4.29%.

The Securities Industry and Financial Markets Association (SIFMA) Municipal Swap Index averaged 0.06% for the reporting period from January 2014 through June 2014 and 0.06% for Fiscal Year 2014. The fiscal year high was 0.12% in April 2014 and the fiscal year low was 0.03% in January and February 2014. The 30-day USD London Interbank Offered Rate (LIBOR) averaged 0.154% for the reporting period from January 2014 through June 2014 and 0.166% for Fiscal Year 2014. The fiscal year high was 0.196% in July 2013, the fiscal year low was 0.148% in May 2014, and it ended the fiscal year at 0.155%. During the fiscal year, SIFMA traded at a high of 78.79% of the 30-day LIBOR in April 2014, at a low of 18.63% in January 2014, and at an average of 36.67% for the year. The fiscal year ended with SIFMA at 38.66% of the 30-day LIBOR.



SIFMA & SIFMA/LIBOR Ratio





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The 2014 Regular Session of the General Assembly delivered House Bill 235 (Executive Branch Budget other than Transportation Cabinet) to the Governor on March 31, 2014 and House Bill 236 (Kentucky Transportation Cabinet Budget) to the Governor on April 15, 2014, establishing an Executive Branch Budget for the biennium ending June 30, 2016. Governor Beshear took final action on House Bill 235 on April 11, 2014 and took final action on House Bill 236 on April 25, 2014. Together, the bills authorize bond financing for projects totaling $1.364 billion to support various capital initiatives of the Commonwealth, net $105 million in previously authorized General Fund debt de-authorized in House Bill 235. Of the total authorization, $742.77 million is General Fund supported, $721.28 million is supported by Agency Restricted Fund appropriations, and $5.0 million is Road Fund supported.

The 2013 Regular Session of the General Assembly delivered House Bill 7 to the Governor on February 20, 2013 authorizing a list of capital projects for the Kentucky state universities. Governor Beshear took final action on House Bill 7 on February 21, 2013. The bill authorized bond financing for various university capital projects totaling $363.3 million to support various capital initiatives of the state universities, which are Agency Fund supported, of which $9.6 million is still authorized to be issued.

In addition, House Bill 238 was signed by the Governor on March 22, 2013 authorizing an Agency Fund bond supported capital project for the Judicial Branch in conjunction with the Administrative Office of the Courts for financing of the Phase I E-Case and Docket Management system capital project totaling $28.1 million to be issued through Kentucky State Property and Buildings Commission or the Kentucky Asset/Liability Commission. An interim loan through the State's Master Lease program has been put in place for a portion of this authorization until the project is ready for permanent financing.

The 2012 Regular Session of the General Assembly delivered House Bill 265 (Executive Branch Budget other than Transportation Cabinet) to the Governor on March 30, 2012 and House Bill 2 (Kentucky Transportation Cabinet Budget) to the Governor on April 20, 2012, establishing an Executive Branch Budget for the biennium ending June 30, 2014. Governor Beshear took final action on House Bill 265 on April 13, 2012 and took final action on House Bill 2 on May 2, 2012. Together, the bills authorized bond financing for projects totaling $238.86 million to support various capital initiatives of the Commonwealth. Of the total authorization, $182.86 million is General Fund supported, $12.5 million is supported by Road Fund appropriations, $43.5 million is Agency Restricted Fund supported. In addition, the 2012 Regular Session authorized $152.4 million of Funding Notes to finance the state-supported share of healthcare benefit contributions for Fiscal Years 2013 and 2014 to the Kentucky Teachers' Retirement System. A portion of the General Fund and the Agency Restricted Fund authorizations listed above have been permanently financed.

The 2010 Extraordinary Session of the General Assembly delivered House Bill 1 (Executive Branch Budget other than Transportation Cabinet) to the Governor on May 28, 2010 and House Bill 3 (Kentucky Transportation Cabinet Budget) to the Governor on May 29, 2010, establishing an Executive Branch Budget for the biennium ending June 30, 2012. Governor Beshear took final action on the bills on June 4, 2010. Together, the bills authorized bond financing for projects totaling $1.980 billion to support various capital initiatives of the Commonwealth. Of the total authorization, $507.4 million was General Fund supported, $522.5 million was supported by Road Fund appropriations, $515.3 million was Agency Restricted

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Fund supported, and $435 million was Federal Highway Trust Fund supported and designated for the Lake Barkley and Kentucky Lake Bridges Project and the Louisville-Southern Indiana Ohio River Bridges Project. A portion of the General Fund, Road Fund, Agency Restricted Fund, and Federal Fund authorizations listed above have been permanently financed.

As of June 30, 2014, the unissued balances of bond authorizations from the General Assembly prior to and including 2014 were:

General Fund - $851.94 million

Road Fund - $217.5 million

Agency Restricted Fund - $776.48 million

Federal Highway Trust Fund - $180 million

Interim note financing through ALCo has not been available over the past few years due primarily to increased funding costs related to credit facilities for this type of program. However, ALCo continues to analyze potential interim borrowing structures and may look to re-establish this type of program in the future, if economically beneficial, to provide interim construction financing for the balance of the authorizations discussed above as well as future authorizations, as necessary.

Ratings Update

The rating agencies continually monitor the Commonwealth's budgetary policies and actual performance in areas such as revenue, the economy, pensions, and debt management. Unemployment and the softening in the national and state economies over the past few years have continued to put pressure on the Commonwealth's credit ratings.

In February 2014, Moody's downgraded certain stand-alone grant anticipation revenue vehicle (GARVEEs) backed by appropriations from the Federal Highway Trust Fund (HTF) including those issued by the Kentucky Asset/Liability Commission from "Aa3" rating to "A1" and kept the rating outlook at "negative". The downgrade reflects changes in federal liquidity management which increase the risk of interruption of timely payments of federal transportation aid due to states and transit entities. These include the government's recurring episodes of threatened debt ceiling expirations, government shutdowns, and the threat of depletion of the Highway Trust Fund balance later in the year due to the Fund's persistent structural imbalance. Moody's continues to realize that transportation infrastructure is essential to economic functioning of the U.S. economy; a long history of uninterrupted flow of federal funds to states and, to a lesser degree, mass transit agencies; strong leverage constraints and debt service coverage ratios for stand-alone highway GARVEEs; moderate leverage constraints and debt service coverage ratios for mass transit; and strong management of cash flow and federal reimbursement process by transportation agencies and the Federal Highway Administration (FHWA). However, Moody's also realizes the increased need for liquidity protections given new risks of timely federal payments and reimbursements to states and transit entities; large structural imbalance between federal fuel tax revenues and authorized federal transportation spending necessitates General Fund support, which has become less reliable in light of federal budgetary pressure; shorter two-year duration of current transportation reauthorization compared to prior ones increases the likelihood of future changes to the program with potential negative effect on amount and timing of funds available for debt service; lack of federal obligation to continue the federal aid highway program; and the fact that nothing prevents the federal government from making programmatic changes detrimental to bondholders. The negative outlook on the standalone GARVEEs reflects continuing uncertainty surrounding future level

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and structure of federal transportation funding. Authorization for MAP-21 expires September 30, 2014 and the balances in the HTF may be depleted earlier barring congressional action. The rating could be lowered further if there is a discontinuation or significant reduction in the federal transportation grant program; the expectation that there will be a lapse in reauthorization of federal transportation spending; federal action or inaction that results in interrupted cash flows to states; or a sharp decline in underlying HTF revenues caused by economic stress, tax inefficiency or redirection of fuel taxes to the General Fund.

In June 2014, Moody's affirmed their "Aa2" issuer rating on the Commonwealth and the "Aa3" and "A1" ratings on outstanding General Fund and Agency Fund lease supported bonds, respectively. Moody's also revised the rating outlook from "negative" to "stable". Moody's noted that the rating reflects the Commonwealth's record of proactive financial control and an economy that has benefited from auto sector recovery. Kentucky's low per-capita income levels, above-average state debt and very large unfunded pension liabilities contribute to a below-average credit profile compared to most other states. Moody's notes that the Commonwealth's revenues have improved since the economic downturn, and the budget is close to structural balance after significant expense cuts over the past three budget cycles. The Commonwealth has recently passed reforms to its general employee's pension plan, but the reform did not address the teachers' retirement system, which also has a growing unfunded liability. Kentucky's outlook is stable based on the expectation it will continue to manage its finances responsibly and work to improve the financing of teacher pensions, against a background of continued below-average state economic growth. Moody's recognizes the Commonwealth's economic and revenue stabilization, partly reflecting a welcome recovery in the auto manufacturing sector as well as history of proactive financial control including close revenue monitoring and timely response to budget imbalances. However, Moody's notes a slow fiscal recovery after depletion of available reserves and use of deficit financing during economic downturn, low per-capita income, above-average debt ratios and large unfunded pension liabilities. Factors that would improve the rating are sustained economic and revenue growth, with structural balance in state finances and limited reliance on non-recurring resources, build-up and maintenance of reserves, and significant improvement in pension funding levels. Factors that would result in a rating downgrade include sustained economic slowing, even after a national upturn, resulting in weaker revenue performance that strains commonwealth finances; depletion of reserves with no replenishment in step with other comparably rated states; continued reliance on non-recurring resources, particularly use of additional deficit financing, to balance the commonwealth's budget; and failure to address declining pension system funded levels.

Also in June 2014, Moody's downgraded certain GARVEEs backed by appropriations from the Federal Highway Trust Fund, including those issued by the Kentucky Asset/Liability Commission from "A1" rating to "A2" and revised the rating outlook to "stable". The downgrade of the standalone GARVEE programs reflects a growing structural imbalance in the Federal Highway Trust Fund, uncertain timing and magnitude of U.S. General Fund support and increased risk of payment interruption or reduction. The HTF structural imbalance is the result of political unwillingness to provide a sustainable source of long-term funding for federal transportation investments. Fuel tax revenues have been stagnant in recent years and are projected to decrease in the future, while the demand for federal investment

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will likely grow. The imbalance has led to a shortened authorization period that increases the frequency of reauthorization risk. Factors external to the HTF, such as federal government shutdown and Treasury cash management actions related to a debt ceiling impasse, have also increased event risk. The stable outlook reflects that the lower rating level incorporates risks related to the potential temporary delay or reduction in grants due to a shortfall this summer, the structural imbalance in the Highway Trust Fund, and reauthorization risk. The stable outlook incorporates Moody's expectation that Congress will provide stop-gap funding this summer to prevent a shortfall in the Highway Trust Fund and maintain spending at or near current levels for the time being. Moody's does recognize that transportation infrastructure is essential to economic functioning; long history of flow of federal funds to states and, to a lesser degree, mass transit agencies exists; the considerable U.S. General Fund support in recent years that has led to improving pledged revenues; strong leverage constraints and debt service coverage ratios for stand-alone highway GARVEEs; and strong management of cash flow and the federal reimbursement process by states and transit agencies. However, Moody's also noted additional concerns, such as a trend of secular decline in gas taxes which fund about 70% of the federal aid program's current spending level and the increased likelihood of disruption of federal payment process for programs that lack reserve funds or other structural protections against liquidity events.

In February 2014, Fitch Ratings affirmed their ratings of "A+" with a "stable" outlook on certain stand-alone GARVEEs backed by appropriations from the Federal Highway Trust Fund issued by the Kentucky Asset/Liability Commission. One of the key rating drivers cited is the uncertainty of the future of the Federal program. The Commission's receipt of funds from the FHWA to pay debt service depends on the strength, stability and reliability of the Federal program that authorizes outlays from the HTF. With the passage of MAP-21, Fitch revised its view of the strength of the Federal program to midrange from strong based on uncertain future policy regarding authorization levels beyond 2014 and the long-term solvency of the HTF. Additional leverage is limited by a strong additional bonds test (ABT) of 4.0x maximum annual debt service (MADS). The 12-year maturity of each note series helps mitigate reauthorization risk. The Notes have no backup pledge of state funds or debt service reserve fund, but the Commission would use available cash balances in a delay of federal funding.

In April 2014, Fitch Ratings affirmed their implied General Obligation (GO) Rating or Issuer Rating of "AA-" as well as affirmed the rating of "A+" with a "stable" outlook on certain General Fund and Road Fund lease supported bonds. In their review, they noted the Commonwealth's reduced financial flexibility as fund balances have been depleted amidst revenue shortfalls during the recession, continued reliance on nonrecurring budget items, weak pension funding levels, the Commonwealth's above average debt position, and continued use of debt financing for operations. They also noted that fiscal pressures either on an operating basis or caused by the demands of long-term liabilities, particularly increasing needs of the employee retirement system. Fitch Ratings did note that Kentucky's economy appears to be rebounding from the recession but remains exposed to a generally contracting manufacturing presence. In May 2014, Fitch Ratings again affirmed their implied GO Rating or Issuer Rating of "AA-" and affirmed their "A+" rating on certain General Fund and Road Fund lease supported bonds.

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In February 2014, Standard & Poor's (S&P) affirmed their ratings of "AA" with a "stable" outlook on certain GARVEEs backed by appropriations from the Federal Highway Trust Fund issued by the Kentucky Asset/Liability Commission. The rating reflects the opinion of S&P that the credit strengths of a state grant anticipation revenue vehicle program with consistently high debt service coverage, sound bond provisions, and a well-defined process for assuring annual deposits of pledged receipts into the note payment fund, as outlined in the financing and lease agreement between the state agency and the Commission as well as the Memorandum of Agreement (MOA) with the FHWA, which details approval of each bond project as authorized for federal reimbursement of debt service payments and a long history of Kentucky maximizing its share of federal aid transportation grants. The stable outlook reflects the expectation that the longstanding federal aid highway program will continue to receive significant funding and that Kentucky will receive its historical share of annual distributions. The outlook also reflects the expectation that federal reimbursement revenue and state transportation fund revenues will continue to provide strong debt service coverage on the Commonwealth's GARVEE debt. Significant declines in debt service coverage, whether as a result of additional debt or otherwise, could result in a downgrade.

In May of 2014, S&P affirmed the Commonwealth's Issuer Credit Rating ("ICR") as "AA-" and its ratings of "A+" with a "negative" outlook on certain Agency Fund and General Fund lease supported bonds. The negative outlook continues to reflect S&P's concern over pension funded levels, which have declined and are likely to continue declining due to lower-than-actuarially required funding of pension liabilities and budgetary pressures associated with funding post-retirement benefits. Although S&P views the Commonwealth's pension reform efforts and the inclusion of full Actuarially Required Contribution (ARC) funding for Kentucky Employees' Retirement System (KERS) and State Police Retirement System (SPRS) in the biennial budget as positive, S&P believes the Commonwealth is still facing a sizable pension liability related to Kentucky Teachers' Retirement System (KTRS) that was not addressed in previous reform efforts. Should there be some progress in addressing KTRS in the upcoming budgetary session or should funding levels stabilize or begin to improve, S&P could revise the outlook to stable. However, continued declines in funded levels in the absence of meaningful pension reform efforts could lead S&P to lower our rating.

Also in May of 2014, S&P affirmed their ratings of "AA+" with a "stable" outlook on certain Road Fund lease supported bonds, specifically issued through the Turnpike Authority of Kentucky. The rating reflects their view on the pledge of lease payments to pay debt service, further supported by a lien created on motor fuel taxes and surtaxes on gasoline and other motor fuels in the event that the lease is not renewed; the strong coverage of debt service obligations from Road Fund revenue; the Road Fund revenues' sole support of transportation-related purposes, greatly reducing the risk of non-appropriation; debt service representing a first budget obligation; the Turnpike Authority of Kentucky's limited capital needs and rapid amortization, which will likely help preserve coverage; and the strong bond provisions, which include a 2x additional bonds test. The stable outlook reflects S&P's expectation that debt service coverage from future road revenues available for debt service will remain strong despite some potential areas of revenue pressures. The outlook also reflects S&P's expectation that appropriations will continue to be made without interruption, thus preventing the need to turn to motor fuel taxes. S&P expects that the Road Fund will continue to

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maintain consistently strong coverage levels. However, factors that could pressure the rating include reduced revenues due to a weaker economic environment, declining motor vehicle usage revenue tied to the recently adopted legislation, or both, as well as increased bond issuances that would cause coverage levels to decrease.

Tax and Revenue Anticipation Notes (TRAN)

No General Fund TRAN was issued for Fiscal Year 2015. As in the previous five fiscal years, current reinvestment yields on TRAN proceeds would not be significantly higher than the cost of funds for a TRAN. At this time, borrowing internally from the state investment pools continues to be the most efficient and cost-effective way to provide short-term liquidity to the General Fund.

Fiscal Year	TRAN size	Economic Benefit
1998	200	3.2
1999	300	4.7
2000	400	7.3
2001	550	6.5
2002	650	4.3
2003	500	0.3
2004	NA	NA
2005	500	2.8
2006	600	6.0
2007	150	2.8
2008	350	5.9
2009	400	7.1
2010	NA	NA
2011	NA	NA
2012	NA	NA
2013	NA	NA
2014	NA	NA
2015	NA	NA

($ in millions)

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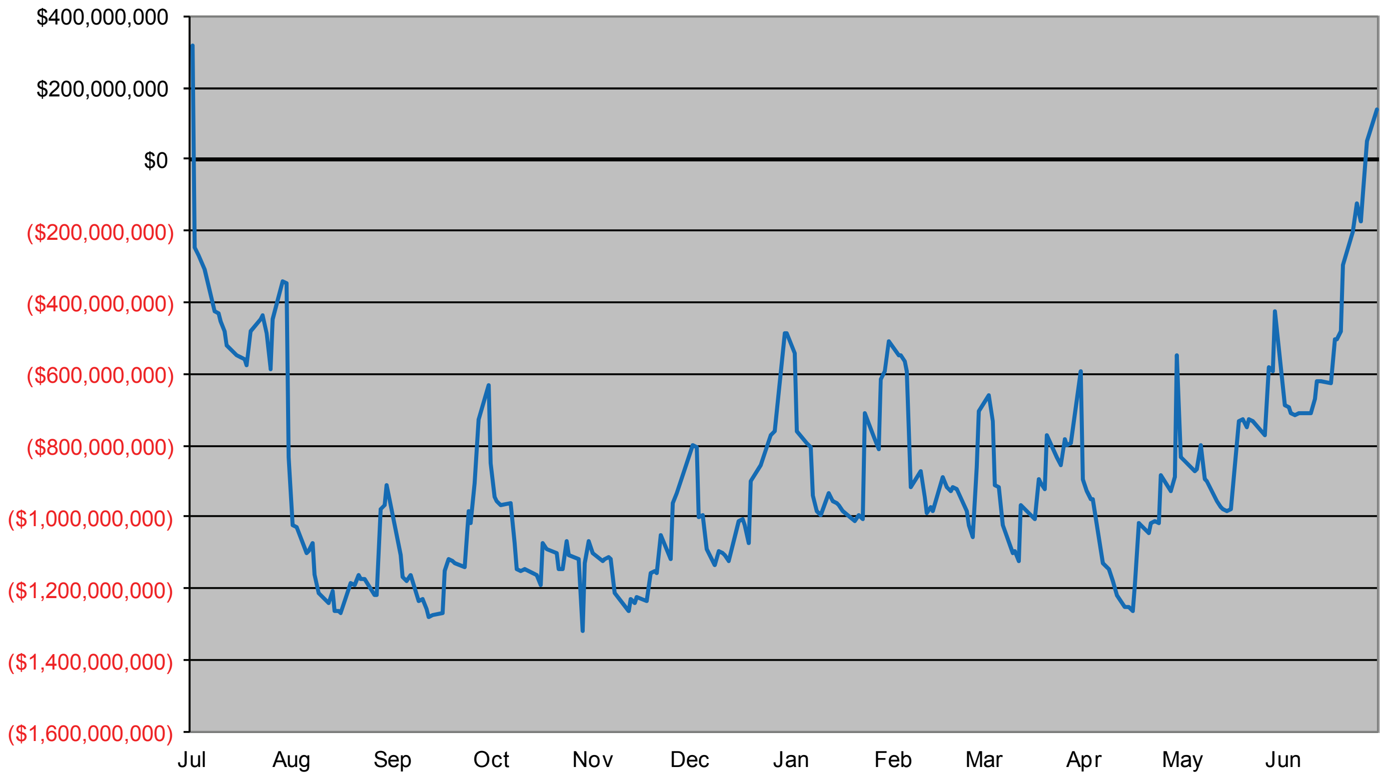

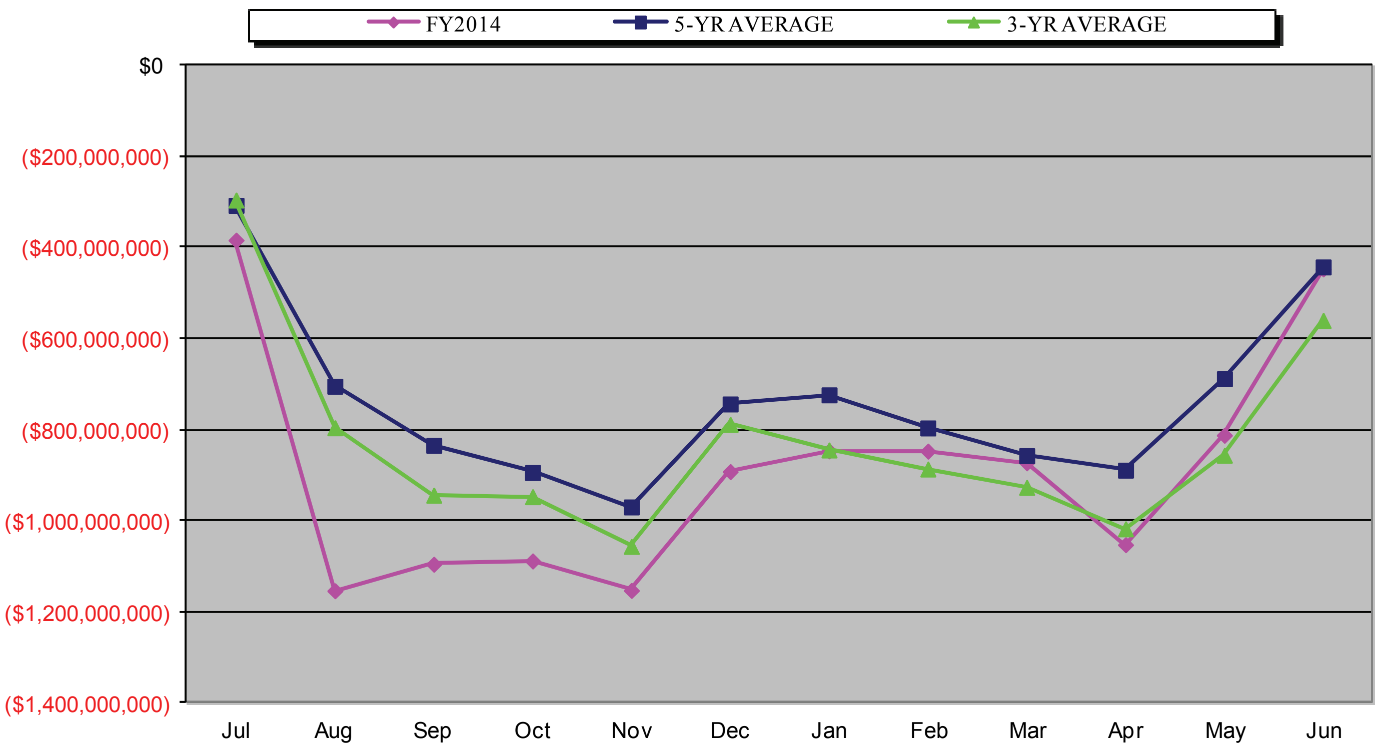

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FINANCIAL AGREEMENTS

As of June 30, 2014, ALCo had four financial agreements outstanding, with a net notional exposure amount of $204.620 million. These financial agreements are described in the section below and the terms of these transactions are detailed in Appendix A. No additional financial agreements were executed during the reporting period.

General Fund – Floating Rate Note Hedges

In May 2007, ALCo issued $243.08 million of Floating Rate Notes (FRNs) to permanently finance $100 million of General Fund bond supported projects and to advance refund certain outstanding SPBC bonds for present value savings. The ALCo transaction entailed issuing four FRNs, each paying a rate of interest indexed to 3-Month LIBOR plus a fixed spread. Integrated into the transaction were four separate interest rate swaps which perfectly hedge the floating rates on the FRNs and lock in a fixed rate payable by ALCo on the transaction. The terms of the four interest rate swaps exactly match the notional amount, interest rate, and amortization schedule of the four FRNs and allowed ALCo to elect "super-integrated" tax status on the transaction, whereby it receives similar tax treatment as a fixed rate bond issue under IRS rules.

Under the FRN transaction, the Notes and interest rate swaps were each insured under separate policies by FGIC, which maintained an Aaa/AAA credit rating at the time from Moody's and S&P. Under the terms of the original interest rate swaps, the counterparty (Citibank) could optionally terminate the agreements if the insurer's claims paying rating fell below an A3/A- level. Subsequent to the transaction, FGIC was downgraded multiple times by the credit rating agencies and currently are no longer rated. In December 2008, MBIA (rated A2 by Moody's at the time) reinsured FGIC's municipal insurance portfolio providing additional coverage on the transaction. However, MBIA Insurance Corporation's credit rating was also subsequently downgraded on multiple occasions and is currently rated B3/B by Moody's and S&P. In February of 2009, MBIA established a new U.S. public finance financial guaranty insurance company known as National Guaranty Public Finance Corporation (National). National, at no additional charge, provided reinsurance on the FRNs and related swaps. However, on December 22, 2010, S&P downgraded National from A to BBB leaving both of National's claims paying ratings below the required A3/A- level (National is currently rated A3 by Moody's).

In early 2011, ALCo spent considerable time working with Citibank and other parties analyzing a variety of remedies that would prevent the potential early termination of the interest rate swaps. After much consideration, ALCo determined the preferred remedy was one offered by Citibank whereby the remaining notional amount of each interest rate swap would be assigned to a new counterparty under the existing financial terms and at no cost to ALCo or the Commonwealth. On February 14, 2011, ALCo, Citibank and the new counterparty, Deutsche Bank AG, executed the assignment of the remaining notional balances of each swap to Deutsche Bank. The terms of the new interest rate swaps with Deutsche Bank were identical to the original swaps, with two exceptions; 1) the new swaps were not insured and there were no insurer provisions contained in the new agreements, and 2) the credit rating triggers under the automatic termination provisions were now symmetrical for both counterparties (ALCo and Deutsche Bank) at A3/A-. Under the original swaps, ALCo's credit rating triggers were Baa2/BBB, but rating recalibrations by the rating agencies, whereby municipal issuers are now rated on the same scale as corporations and other debt issuing entities, have facilitated the need for equal credit rating triggers for both parties. Subsequent to the current reporting period, the credit rating triggers were lowered to Baa3/BBB- for both counterparties. Also, subsequent to the reporting period, Moody's downgraded Deutsche Bank senior long-term debt and deposit ratings from A2 to A3 in late July 2014.

Details related to the interest rate swaps as of June 30, 2014 are presented in Appendix A.

DEBT MANAGEMENT

ASSET/LIABILITY MODEL

General Fund

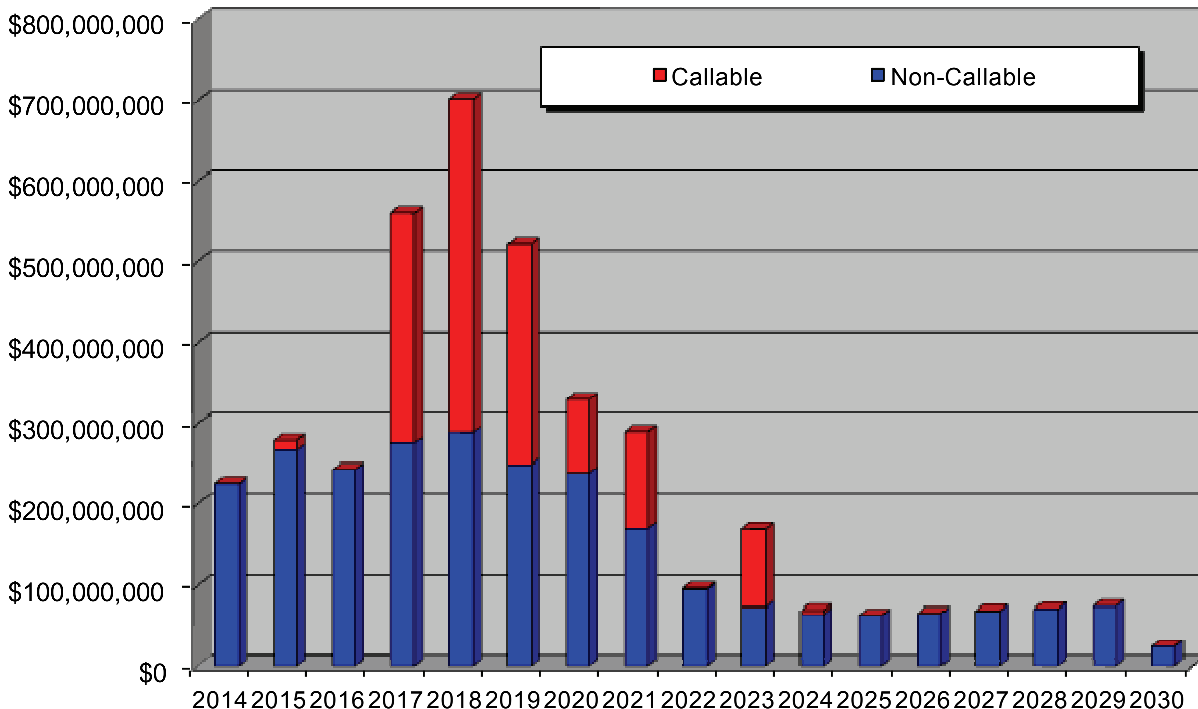
The total SPBC debt portfolio as of June 30, 2014 had $3.855 billion of bonds outstanding with a weighted average coupon of 5.09 percent and a weighted average life of 7.05 years. The average coupon reflects an amount of taxable bonds issued under the Build America Bond Program during 2009 and 2010 as well as continued investor preference for tax-exempt callable premium bonds in the current market at a yield lower than par or discount coupon bonds. The $1.297 billion callable portion had a weighted average coupon of 5.08 percent.

The SPBC debt structure has 35 percent of principal maturing in 5 years and 70 percent of principal maturing in 10 years. The ratios are outside of the rating agencies' proposed target of 27-30 percent due in 5 years and 55-60 percent maturing within 10 years, primarily influenced by prior debt restructuring and the minimal amount of long-term new money permanent financings within the last few years.

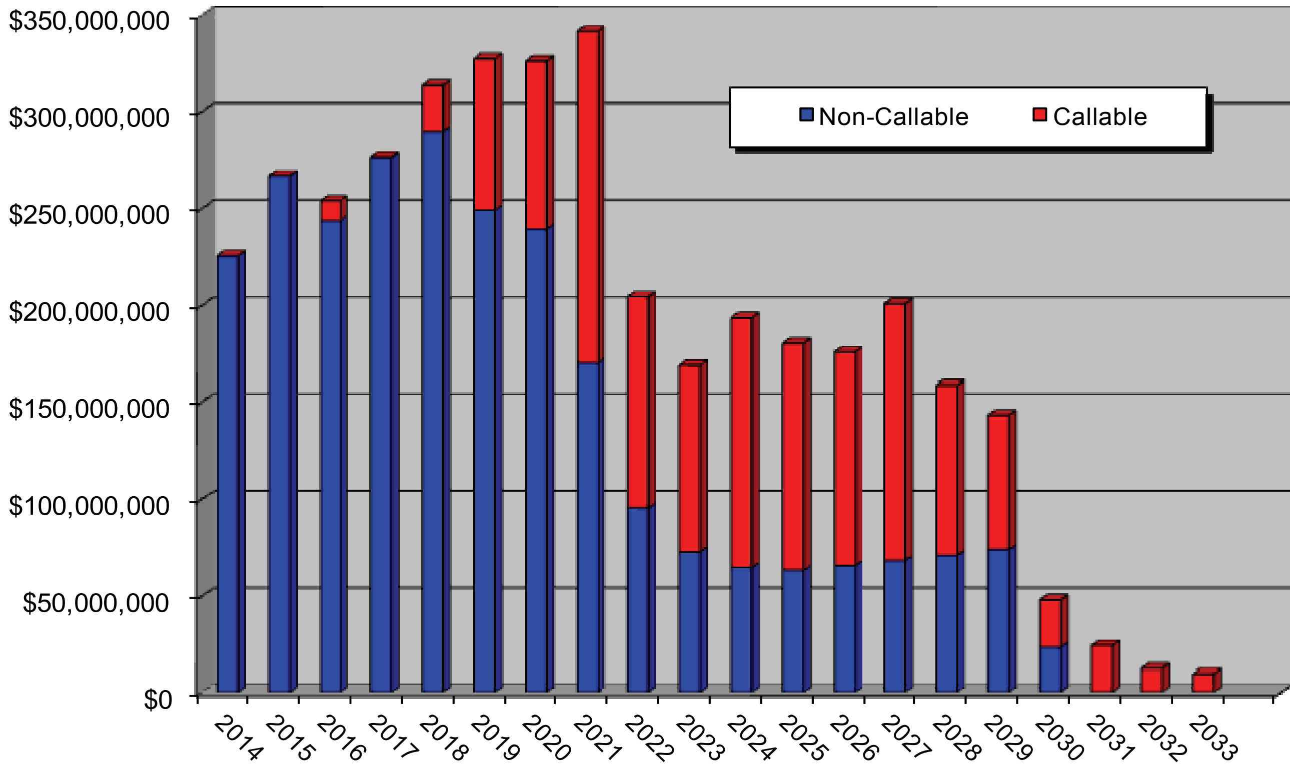
The General Fund had a high balance of $315.5 million at the beginning of Fiscal Year 2014 and a low of negative $1.321 billion on October 29, 2013.

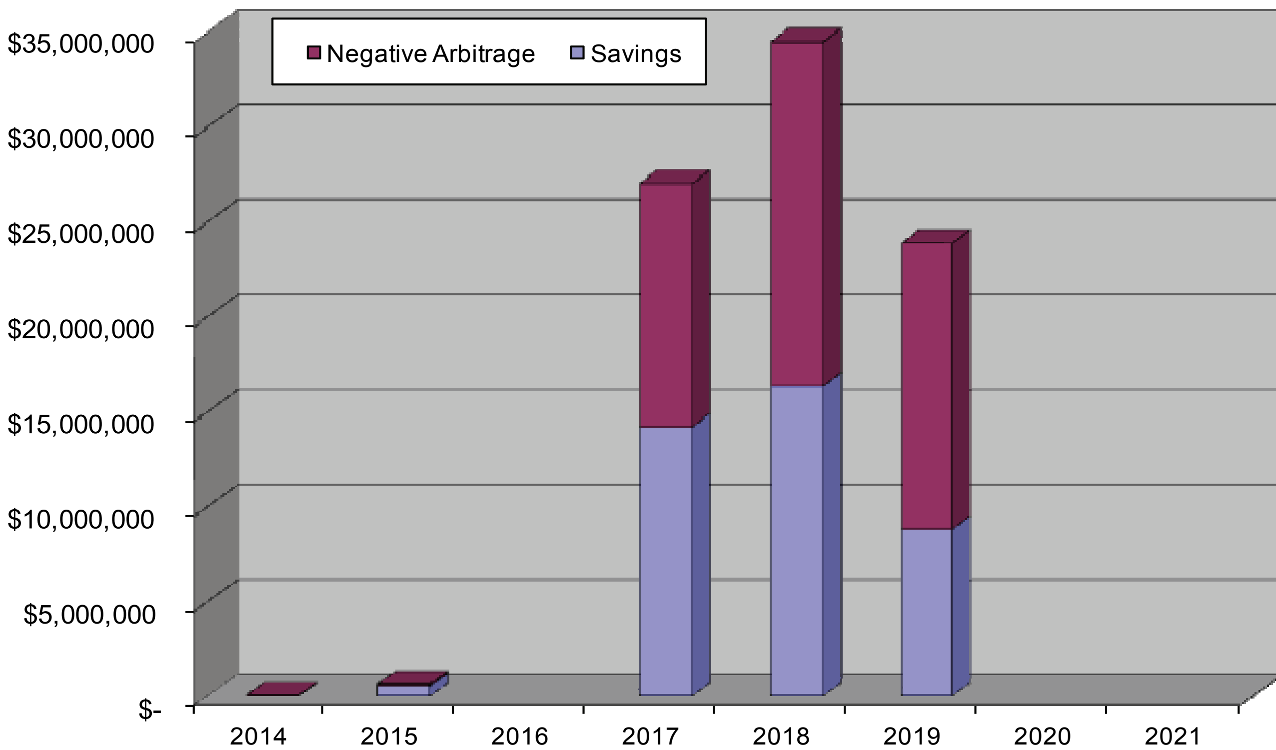
The average and median balances were a negative $891.4 million and a negative $959.2 million, respectively. Since the General Fund continued to have a negative available cash balance for the fiscal year to date, there is little, if anything, that can be done from an asset management point of view beyond current actions.

From a liability management perspective, total General Fund debt service, net of credits was $661.9 million for Fiscal Year 2014. In addition, General Fund debt service of $7.7 million was provided for the Eastern State Hospital financing that was issued through the Lexington-Fayette Urban County Government in 2011. Net interest margin will continue to be negative due to low cash balances versus outstanding fixed rate debt, low level of interest rates, and the callability of the debt portfolio.



DEBT MANAGEMENT





DEBT MANAGEMENT

Road Fund

The Road Fund average daily cash balance for Fiscal Year 2014 was $606.7 million compared to $626.7 million for Fiscal Year 2013. The Road Fund cash was invested in the Intermediate Term Investment Pool which had a duration of 1.3 years as of June 30, 2014. The Road Fund earned $4.0 million on a cash basis for Fiscal Year 2014 versus a negative $0.4 million for Fiscal Year 2013. The continued relatively low level of investable balances at certain times during the fiscal year limits the investment opportunities.

As of June 30, 2014, the Turnpike Authority of Kentucky (TAK) had $1.455 billion of bonds outstanding with a weighted average coupon of 4.81 percent and an average life of 8.73 years.

Road Fund debt service paid in Fiscal Year 2014 was $150.1 million, resulting in a net interest margin (investment income earned year-to-date less debt service paid) of negative $146.1 million. The negative amount stems from the level of investable balances and a general low level of interest rates on the investment side in addition to the limited callability of fixed rate obligations on the liability side.

SPBC 107

In mid-May 2014, SPBC issued SPBC Road Fund Revenue Bonds, Project No. 107 Series A and Taxable Series B for $10,485,000. The proceeds of the Project 107 Bonds will provide permanent financing for $10.5 million of Road Fund supported Economic Development projects for public use airports in the Commonwealth that were authorized in the 2010 Extraordinary Session of the General Assembly by House Bill 3 and will pay for costs of issuing the Bonds.

The SPBC 107 Bonds received ratings of Aa2/A+/A+ from Moody's, S&P, and Fitch, respectively. The SPBC 107 transaction achieved a very attractive All-In True Interest Cost of 3.172% for the Series A Bonds with an average life of 12.41 years and an All-In True Interest Cost of 2.488% for the Series B Bonds with an average life of 4.33 years. All bonds were sold via competitive sale with Acacia Financial Group serving as financial advisor and Peck, Shaffer & Williams, a division of Dinsmore & Shohl LLP, as bond counsel. There were ten bidders on the Series A Bonds, and the winning bidder was Morgan Stanley with a True Interest Cost of 3.092448%. There were ten bidders on the Series B Bonds, and the winning bidder was PNC Capital Markets with a True Interest Cost of 2.294915%.

TAK 2014 Series A

In June 2014, the Turnpike Authority of Kentucky issued $121,325,000 of Economic Development Road Revenue Refunding Bonds (Revitalization Projects), 2014 Series A. The 2014 Series A Bonds advance refunded certain outstanding Economic Development Road Revenue Bonds (Revitalization Projects) 2005 Series B having an aggregate principal amount of $132,410,000. The refunding generated net present value savings of $15,867,035.22 to the Road Fund or 11.98% of the refunded bonds. The 2014 Series A Bonds, delivered on June 25, 2014, are non-callable with a final maturity of July 1, 2025.

The bonds received ratings of Aa2/AA+/A+ from Moody's, S&P and Fitch, respectively. The transaction was sold via negotiated sale with Goldman Sachs serving as senior managing underwriter and Peck, Shaffer & Williams, a division of Dinsmore and Shohl LLP, as bond counsel. The transaction was sold on schedule and received strong interest from both retail and institutional investors resulting in a cost effective All-In True Interest Cost of 2.275% and an average life on the bonds of 6.88 years.

ALCo 2014 GARVEEs

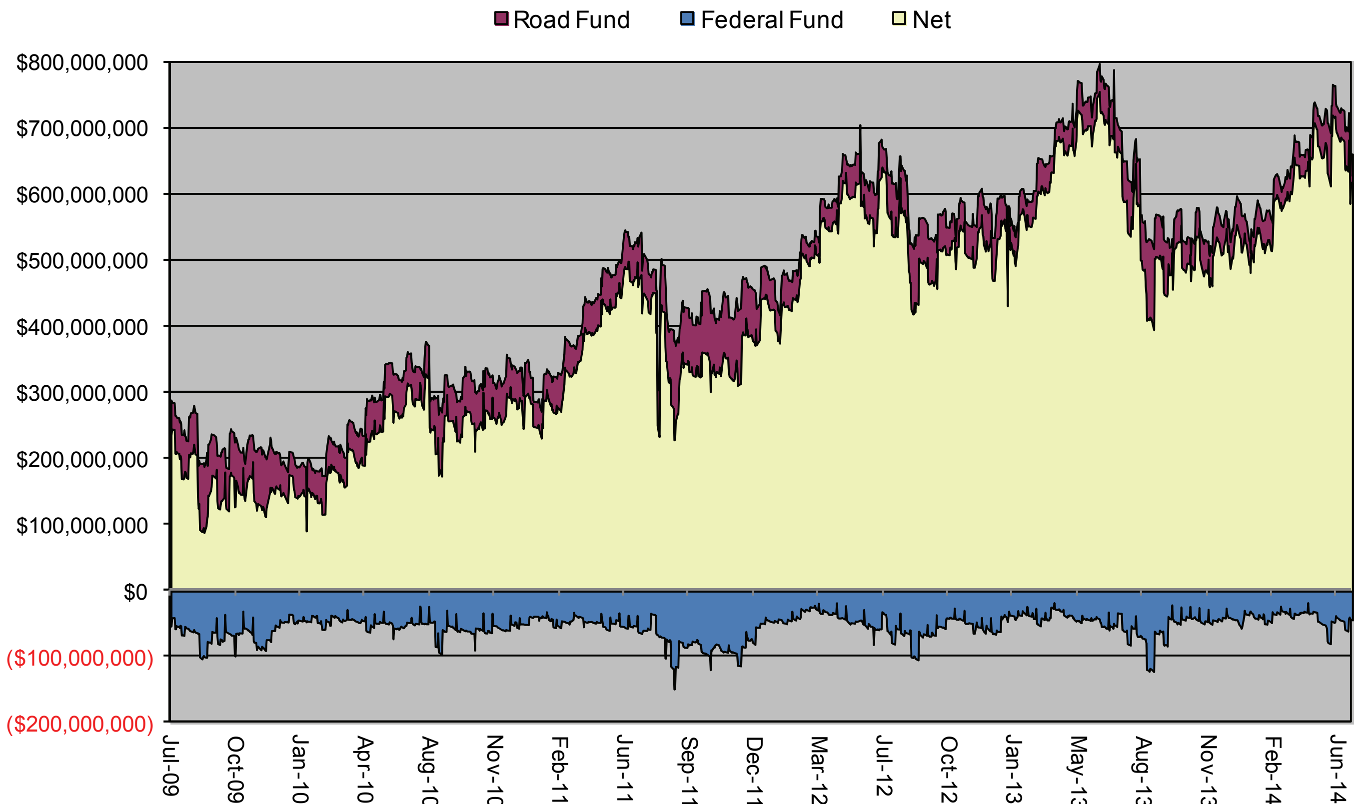
In March of 2014, ALCo issued $132,175,000 of Project Notes, 2014 Federal Highway Trust

DEBT MANAGEMENT

Fund First Series A and $39,765,000 of Project Notes, 2014 Federal Highway Trust Fund First Refunding Series B (GARVEEs). The proceeds of the 2014 Series A Notes will provide permanent financing for $150 million of the $330 million of authorized but unissued notes authorized by House Bill 3 of the 2010 Extraordinary Session of the General Assembly for the purpose of financing expenditures for the US-68/KY-80 Lake Barkley and Kentucky Lake Bridges Project, and the proceeds of the 2014 Series B Notes will advance refund certain outstanding Project Notes, 2005 Federal Highway Trust Fund First Series of the Kentucky Asset/Liability Commission for economic savings. The proceeds of the 2014 Notes will also pay for costs of issuing the Notes.

The structure of the transaction was essentially a 12-yr wrapped debt financing with serial bonds with maturities beginning in 2023 for the Series A Project Notes to help level, or smooth out, the GARVEE debt portfolio.

The Notes received ratings of A1/AA/A+ from Moody's, S&P and Fitch, respectively. The transaction was sold via negotiated sale with Goldman Sachs serving as senior managing underwriter and Kutak Rock LLP as bond counsel. The transaction achieved attractive rates with an All-In True Interest Cost of 3.147% with an average life on the notes of 9.286 years. The Series B Project Notes achieved $2,370,583.23 in net present value savings, or 5.669% savings of refunded notes.



DEBT MANAGEMENT

SUMMARY

ALCo's approach to managing the Commonwealth's interest-sensitive assets and interest-sensitive liabilities has provided tremendous flexibility and savings in financing the Commonwealth's capital construction program.

Since its inception, ALCo has been instrumental in adding incremental returns on investment income to the Commonwealth's investment portfolio. ALCo has continued to manage General Fund intra-year cashflow deficits through its TRAN program when cost effective. Until Fiscal Year 2010, ALCo had issued a General Fund TRAN each fiscal year since 1998 (with the exception of FY 2004), providing millions of dollars of incremental gains for the General Fund over this time (see Debt Management TRAN section for details). In addition, ALCo's management approach to project funding has allowed the Commonwealth to take advantage of short-term yields and achieve millions of dollars in budgetary savings through debt service lapses.

Over the past five years, the high cost of acquiring credit/liquidity support for short-term borrowing programs when compared to the low cost of long-term financing favored long-term financing structures. However, ALCo does and will continue to analyze the cost effectiveness of potential interim financing options during near term.

As always, ALCo continues to analyze potential opportunities for savings and to evaluate new financing structures which offer the Commonwealth the ability to diversify risk within its portfolio while taking advantage of market demand for various new or unique products.

APPENDIX

APPENDIX A

ALCo Financial Agreements	ALCo FRN Series A Hedge	ALCo FRN Series A Hedge	ALCo FRN Series B Hedge	ALCo FRN Series B Hedge
Fund Source	General Fund	General Fund	General Fund	General Fund
Hedge	2017 FRN	2027 FRN	2021 FRN	2025 FRN
Counter Party	Deutsche Bank AG	Deutsche Bank AG	Deutsche Bank AG	Deutsche Bank AG
Counter-Party Ratings *(Moody's / S&P / Fitch)*	A3/A/A+	A3/A/A+	A3/A/A+	A3/A/A+
Termination Trigger	Baa3/BBB-	Baa3/BBB-	Baa3/BBB-	Baa3/BBB-
Swap Type	Fixed Pay	Fixed Pay	Fixed Pay	Fixed Pay
Benchmark	67% 3M LIBOR + 40	67% 3M LIBOR + 53	67% 3M LIBOR + 52	67% 3M LIBOR + 55
Reset	Quarterly	Quarterly	Quarterly	Quarterly
Notional Amount	10,390,000	56,985,000	66,310,000	70,935,000
Amortize (yes/no)	yes	yes	yes	yes
Original Execution Date	5/16/2007	5/16/2007	5/16/2007	5/16/2007
Start Date	5/31/2007	5/31/2007	5/31/2007	5/31/2007
Assignment Date	2/14/2011	2/14/2011	2/14/2011	2/14/2011
Mandatory Early Termination				
End Date	11/1/2017	11/1/2027	11/1/2021	11/1/2025
Fixed Rate pay-(rec)	3.839%	4.066%	4.042%	4.125%
Day Count	30/360	30/360	30/360	30/360
Payment Dates	February 1, May 1, August 1, November 1			
Security Provisions	General Fund Debt Service Appropriations			
Current Market Valuation June 30, 2014 (negative indicates payment owed by ALCo if terminated)	(617,580)	(7,851,373)	(8,143,332)	(12,160,218)
Interest Earnings (not applicable)				
Total	not applicable	not applicable	not applicable	not applicable

Swap Summary

As of June 30, 2014

Total Notional Amount Executed

General Fund	Road Fund
243,080,000	0

Net Exposure Notional Amount

General Fund	Road Fund
204,620,000	0

Total Notional Amount Executed by Counter Party

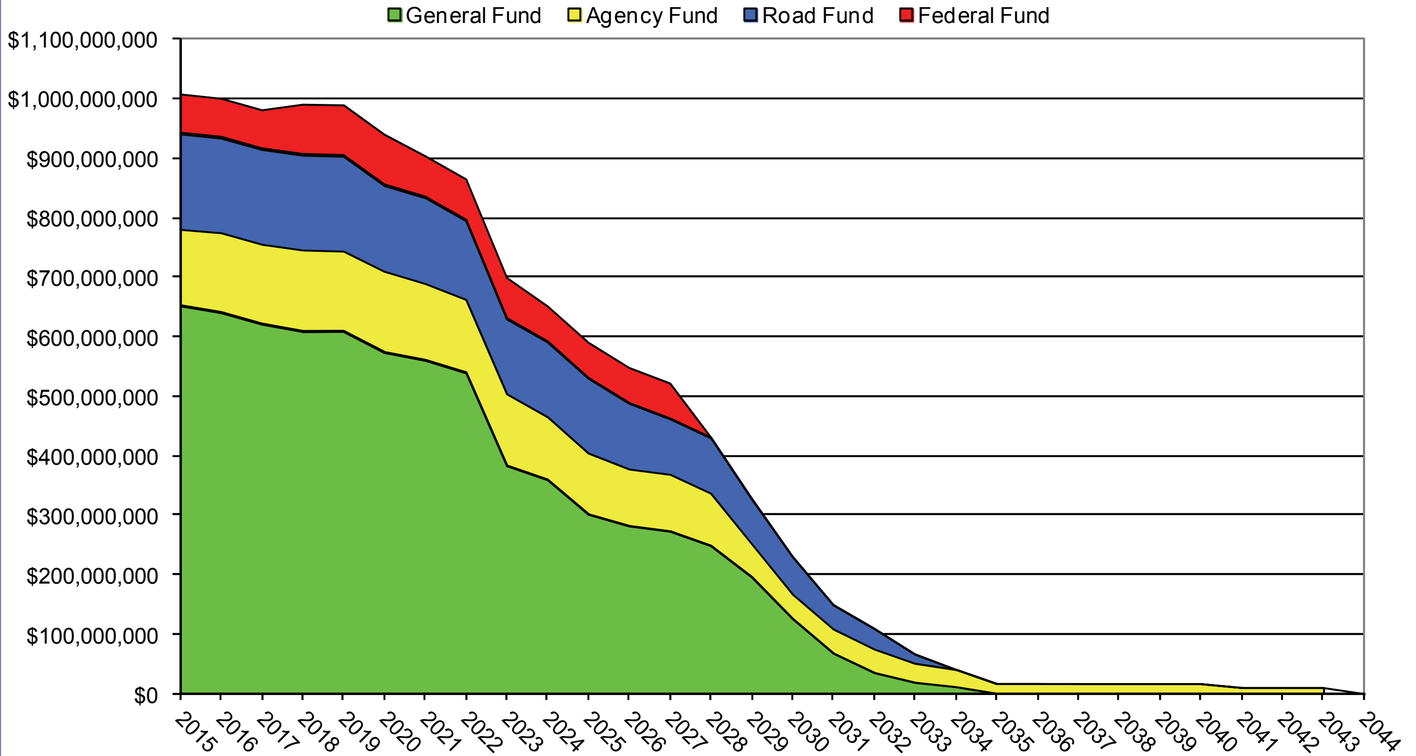
Deutsche Bank (assigned from Citibank on 2/14/2011)

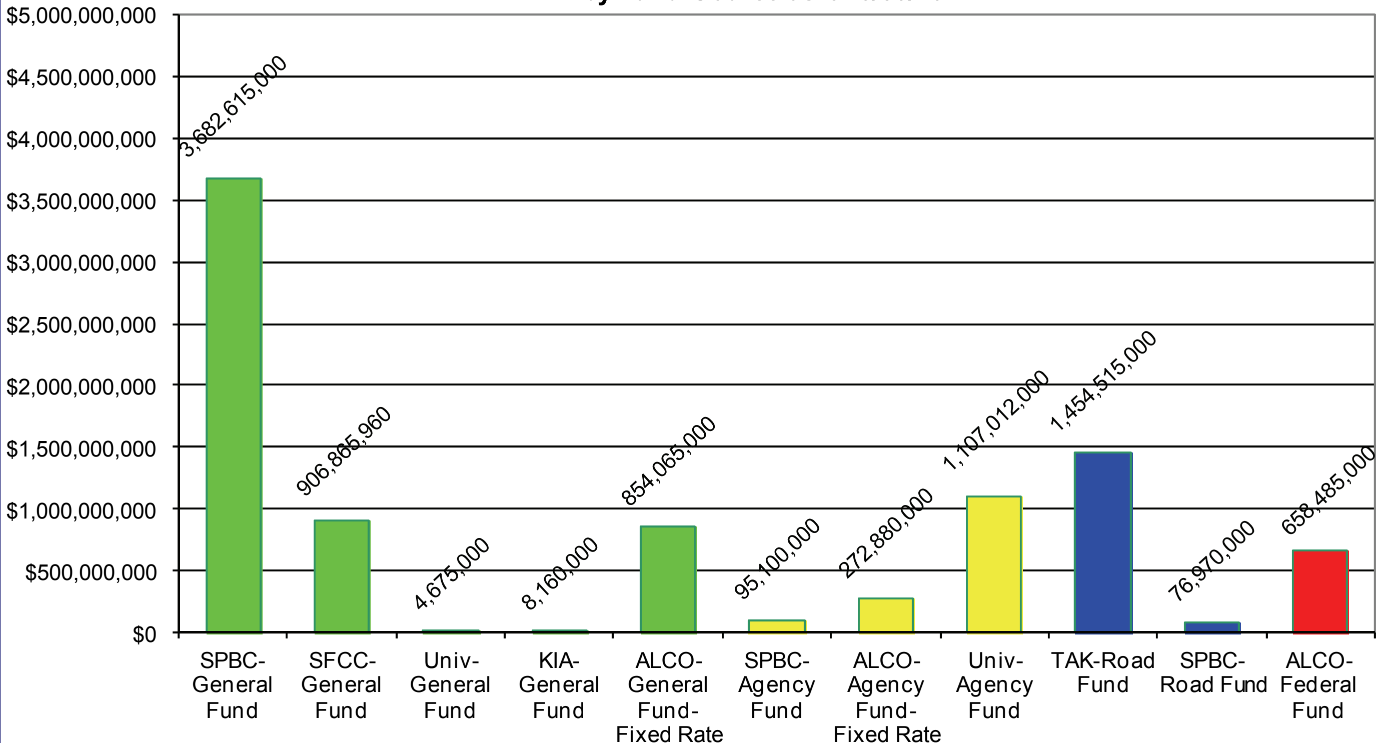
243,080,000

	Debt: General Fund	Debt: Road Fund	10 Percent Net Exposures: General Fund	10 Percent Net Exposures: Road Fund
Bonds Outstanding	4,536,680,000	1,531,485,000	453,668,000	153,148,500
Authorized but Unissued	851,942,200	217,500,000	85,194,220	21,750,000
Total	5,388,622,200	1,748,985,000	538,862,220	174,898,500

Investment Pool Balances: Other Funds	Investment Pool Balances: Net Road Fund	10 Percent Investment Portfolio: Other Funds	10 Percent Investment Portfolio: Net Road Fund
3,460,067,849	615,899,761	346,006,785	61,589,976

APPENDIX B





*This data does not include debt issued for judicial center projects and paid for by the Administrative Office of the Courts in the Court of Justice or debt issued by the Lexington-Fayette Urban County Government for the Eastern State Hospital.

APPENDIX C

COMMONWEALTH OF KENTUCKY
ASSET/LIABILITY COMMISSION
SCHEDULE OF NOTES OUTSTANDING
AS OF 06/30/2014

FUND TYPE SERIES TITLE		AMOUNT ISSUED	DATE OF ISSUE	MATURITY DATE	PRINCIPAL OUTSTANDING
General Fund Project & Funding Notes					
2005 1st Series		$81,850,000	6/2005	5/2025	$53,860,000
2007 A, B Series		$243,080,000	5/2007	11/2027	$204,620,000
2010 1st Series-KTRS Funding Notes		$467,555,000	8/2010	4/2020	$247,760,000
2011 1st Series-KTRS Funding Notes		$269,815,000	3/2011	4/2022	$208,665,000
2013 1st Series-KTRS Funding Notes		$153,290,000	2/2013	4/2023	$139,160,000
	FUND TOTAL	**$1,215,590,000**			**$854,065,000**
Agency Fund Project Notes					
2005 1st Series		$11,275,000	6/2005	6/2025	$7,700,000
2005 Series A-UK Gen Recpts		$107,540,000	11/2005	10/2025	$83,865,000
2006 Series A-UK Gen Recpts		$66,305,000	10/2006	10/2022	$44,775,000
2007 Series A-UK Gen Recpts		$77,905,000	11/2007	10/2027	$66,090,000
2007 Series B-UK Gen Recpts		$80,245,000	11/2007	10/2027	$70,450,000
	FUND TOTAL	**$343,270,000**			**$272,880,000**
Federal Hwy Trust Fund Project Notes					
2005 1st Series		$139,635,000	6/2005	9/2014	$12,640,000
2007 1st Series		$277,910,000	9/2007	9/2019	$171,650,000
2010 1st Series		$89,710,000	3/2010	9/2022	$89,710,000
2013 1st Series		$212,545,000	8/2013	9/2025	$212,545,000
2014 1st Series		$171,940,000	3/2014	9/2026	$171,940,000
	FUND TOTAL	**$891,740,000**			**$658,485,000**
ALCo NOTES TOTAL		**$2,450,600,000**			**$1,785,430,000**

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Creating Financial Value for the Commonwealth