Semi-Annual Report of the Kentucky Asset/Liability Commission

32ND EDITION

Steven L. Beshear

Governor

Commonwealth of Kentucky

Lori H. Flanery

Secretary

Finance and Administration Cabinet

Ryan Barrow

Executive Director

Office of Financial Management

For the period ending December 31, 2012

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) thirty-second semi-annual report pursuant to KRS 56.863 (11) for the period beginning July 1, 2012 through December 31, 2012. 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 U.S. economy continues to recover from the 2008/2009 recession with thirteen consecutive quarters of growth until the fourth quarter of 2012 which saw Gross Domestic Product (GDP) decline by 0.1%.

- The unemployment rate has fallen to 7.8% as nonfarm payrolls average 176,500 new jobs per month over the last six months.

- The Federal Reserve continues to target Federal Funds in the range of 0.00% to 0.25% and has announced additional quantitative easing. The Fed will purchase $40 billion of agency mortgage backed securities plus $45 billion of treasury securities per month, while re-investing any pay-downs.

- The sovereign credit problems in Europe stabilized somewhat as various central banks and other groups have pledged to support sovereign and bank debt and certain countries have instituted austerity programs.

- The housing market has definitely turned positive as sales, prices, and new construction have all turned upwards; although, they remain well below pre-financial crisis levels.

On the state level

- General Fund receipts increased 3.8% for the first six months of Fiscal Year (FY) 2013 compared to the same timeframe in FY 2012.

- Road Fund receipts increased 3.4% for the first six months of FY 2013 compared to the same timeframe in FY 2012.

- Implementation of bond authorizations from prior sessions of the General Assembly continues and is coming to a close as projects reach completion. Appendix D contains information on the remaining General Fund authorized but unissued bond funded capital projects covered under the ALCo 2012 Line of Credit (See page 18.).

- Kentucky's seasonally adjusted unemployment rate stood at 8.1% at the end of December 2012, down from 9.0% one year ago.

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MARKET OVERVIEW

The economy in the United States fell during the fourth quarter of 2012 as real GDP declined by 0.1% based on the preliminary release from the Bureau of Economic Analysis. This comes at the end of a string of thirteen consecutive quarters of positive but below trend growth. In spite of negative growth, there is some underlying strength that could indicate future advances.

Two primary factors led to the decline in growth. First, overall government spending was down 15% during the quarter with most of that due to a 22.2% decline in defense spending. The last time defense spending fell this much during a quarter was at the end of the Vietnam War. The second primary factor was inventories. Inventory growth fell from $60 billion in the third quarter to only $20 billion in the fourth quarter resulting in a 1.27% decline in headline growth.

The largest bright spot in the report is personal consumption. Consumption is responsible for roughly 70% of economic activity within the United States. Since the end of the recession in 2009, consumption has grown about 2.1% (annualized) per quarter, with the majority of that growth during 2010. In the second and third quarter of 2012, consumption growth dropped to roughly 1.5%. During the fourth quarter, consumption had grown to 2.2%. This growth, above the average over the last three years, occurred at the same time as Hurricane Sandy struck the northeast, limiting spending.

A meaningful portion of consumption is auto sales. Auto sales are reported monthly at an annual rate. In other words, the monthly numbers are the rate of sales for an entire year, if the monthly level of sales continued for the next 11 months. Annualized sales reached a low of nine million vehicles at the beginning of 2009. Annual sales have grown to roughly 15 million vehicles per year which is approaching the pre-recession level of roughly 16.5 million.

The housing market has also clearly reached a bottom and is now contributing to economic growth. The most direct impact of housing on the economy is through new construction. Housing starts measures the annualized rate of residential units in which construction has begun each month. Starts were running below 600,000 units for most of 2009, 2010, and the beginning of 2011. In December 2012, housing starts reached 954,000 clearly confirming an up-trend but still below the pre-recession peak of nearly 2.3 million. The potentially larger but less direct impact of housing on the economy is through refinancing activity as people pull equity out of their homes to fund other purchases. House prices must be rising to create the opportunity for cash out refinancing. As measured by the year-over-year Case-Shiller Composite, prices began growing in June of 2012 and have steadily risen since then.

The Federal Reserve Board has aligned monetary policy to grow the economy. The Federal Reserve has maintained the Federal Funds rate at between 0.00% and 0.25% and pledged to do so until unemployment falls to 6.5%, from the current level of 7.8%. Additionally, the Federal Reserve has implemented another round of Quantitative Easing. This program consists of purchasing $40 billion per month of agency mortgage-backed securities and $45 billion per month of treasury securities in addition to re-investment of any maturing securities. The unique aspect to this program, is that the Federal Reserve has not announced an end date or amount. They intend to continue at this rate as long as it takes to support the economy. Many people believe that this program, along with the previous Quantitative Easing programs, is largely responsible for the positive performance of the stock market.

The headwinds that the economy is facing are largely related to actions by the federal government. The Fiscal Cliff compromise increased employment taxes by 2.0% of salary up to a cap. Additionally, income taxes on high earners and taxes on dividends and capital gains have risen.

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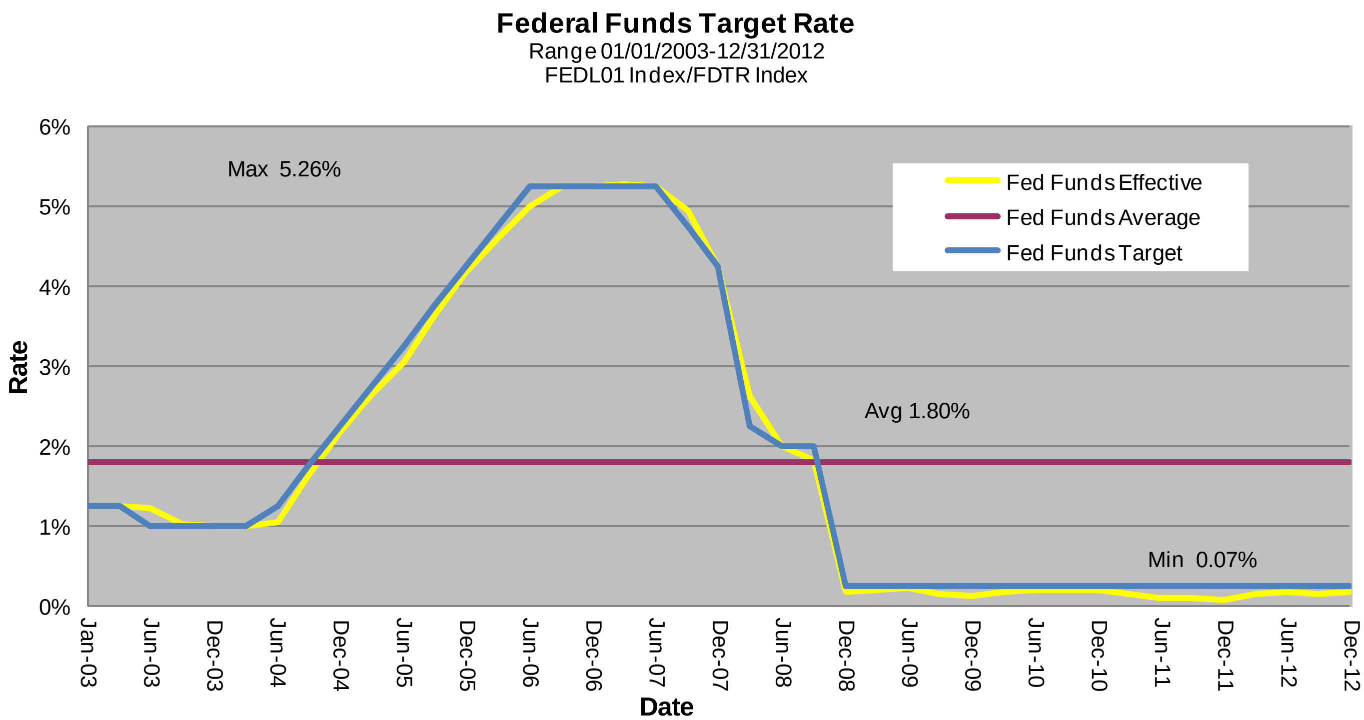
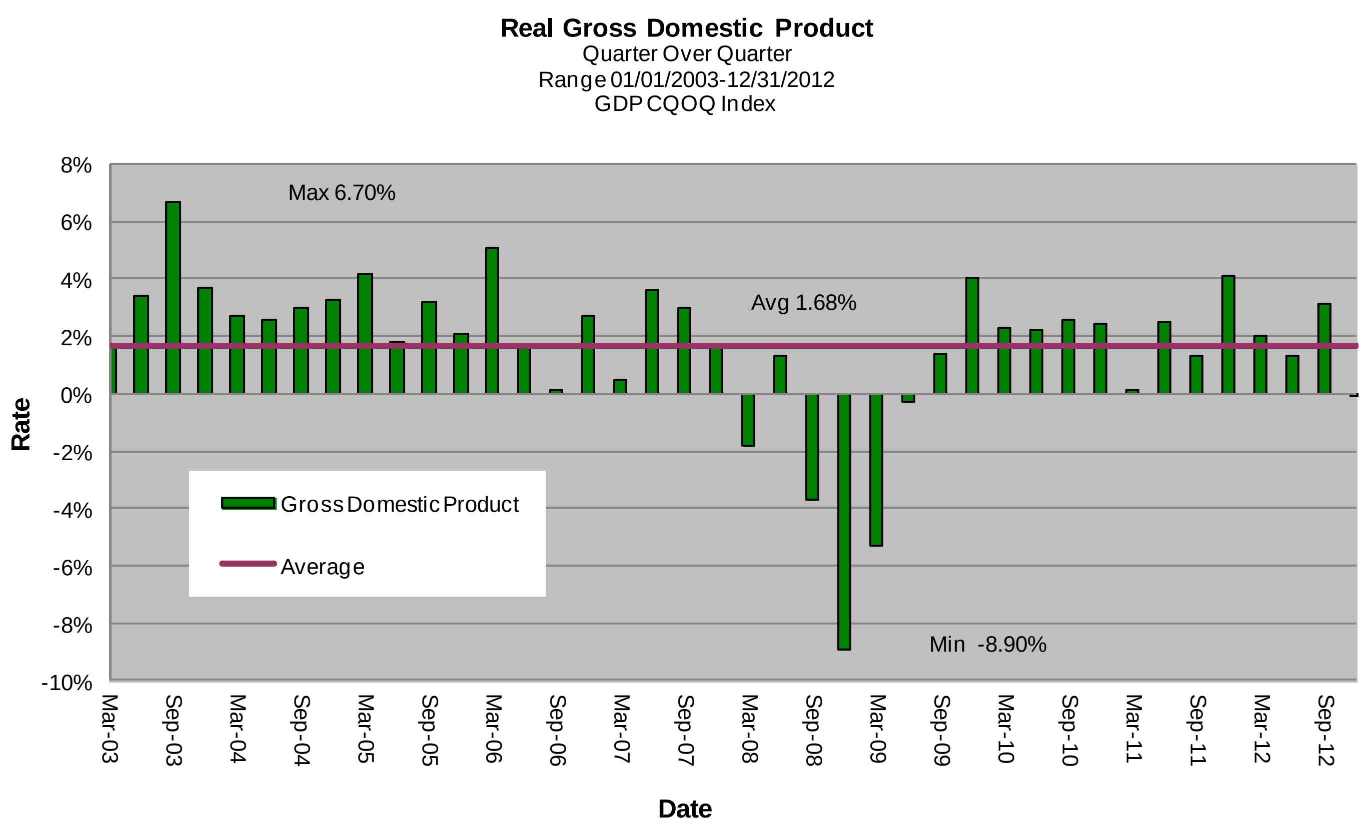
Federal Funds Target Rate & Real Gross Domestic Product





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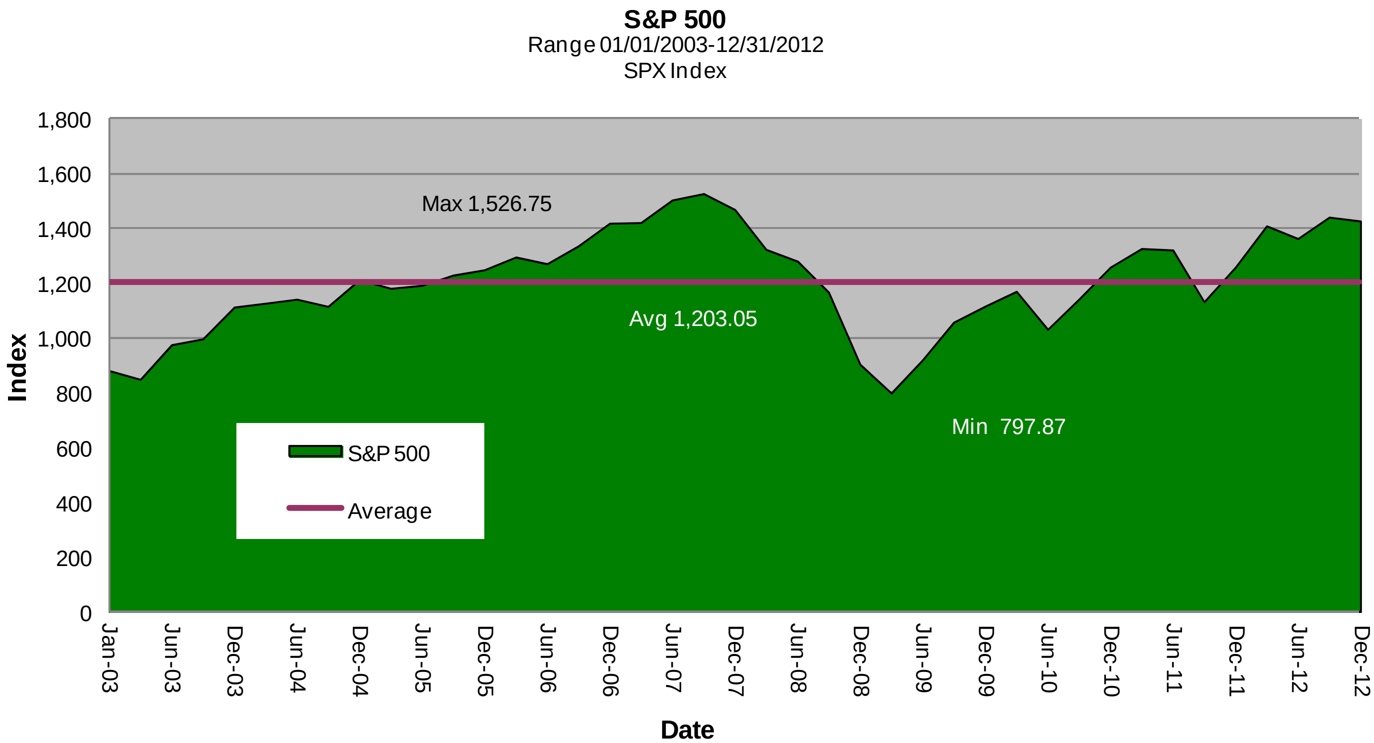
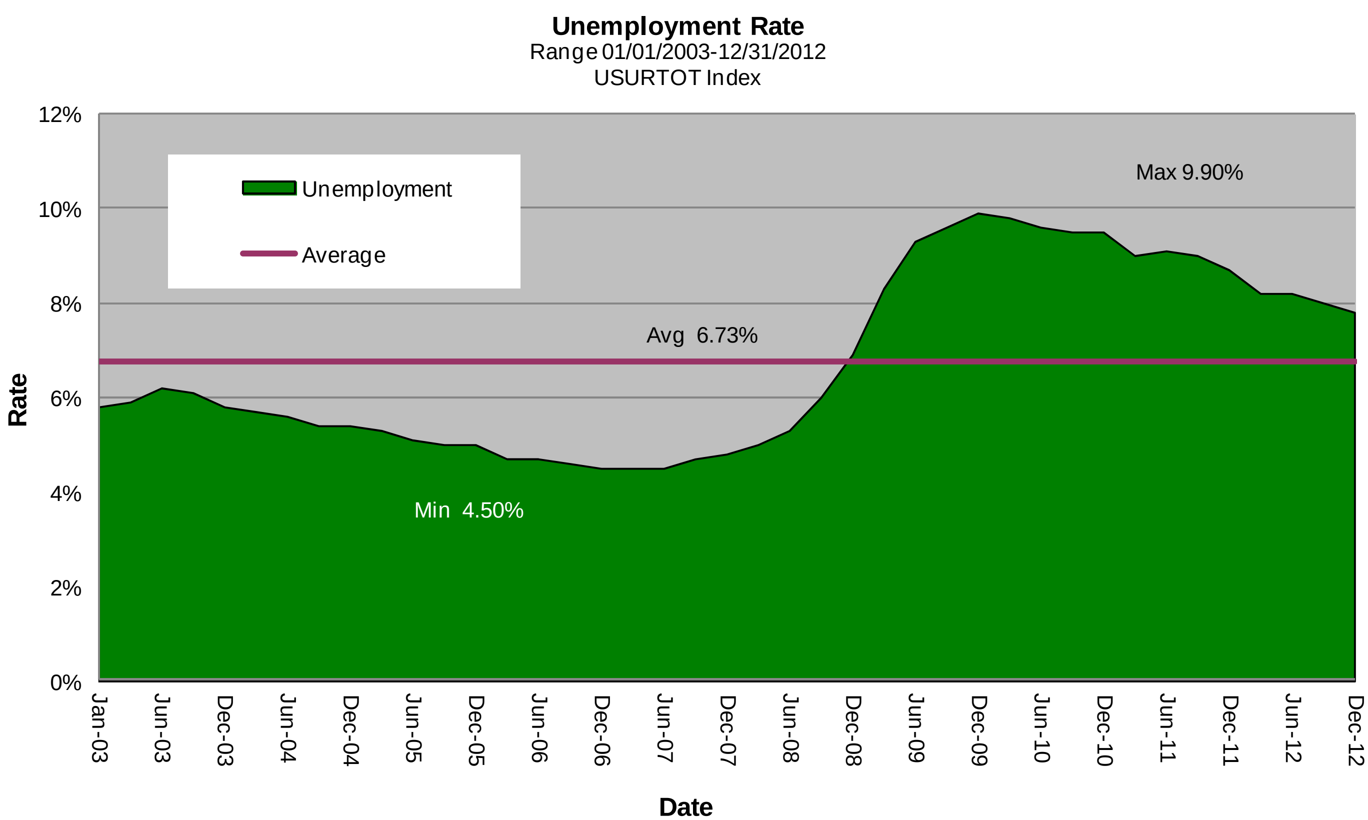
S&P 500 & Unemployment Rate





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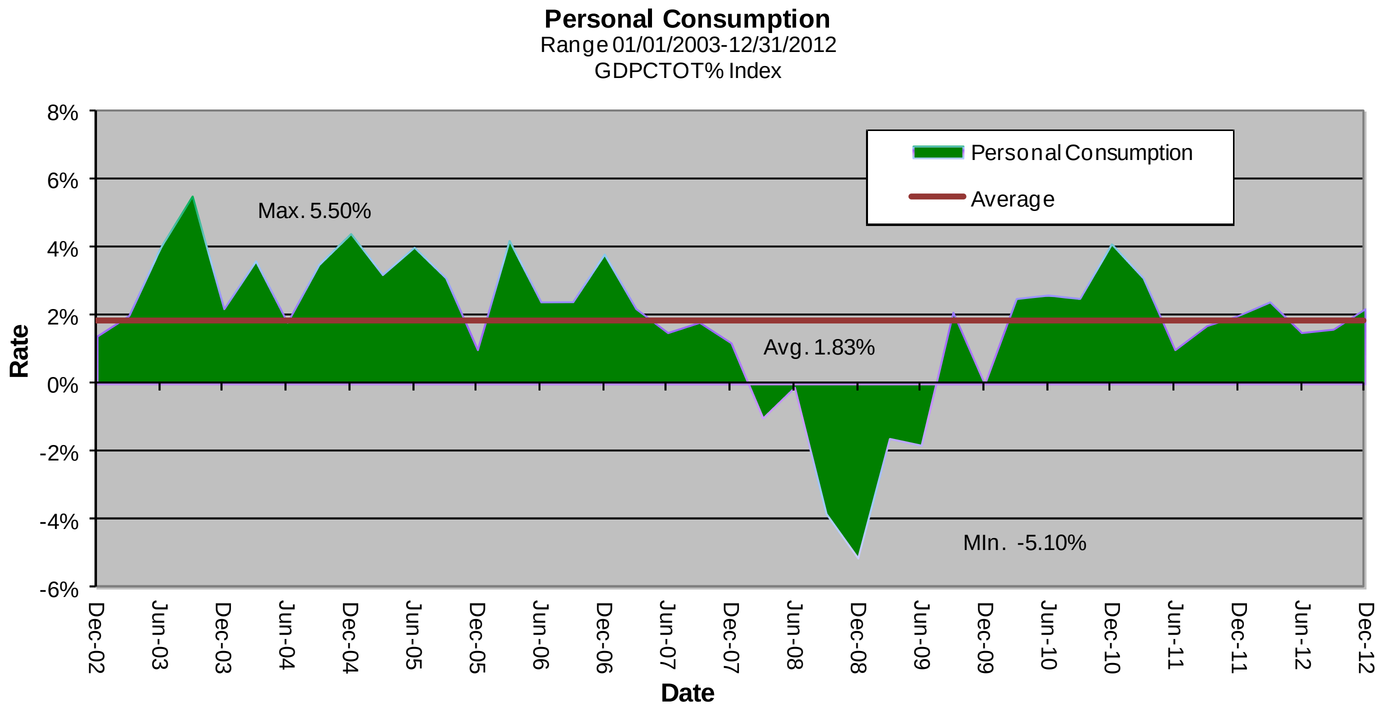
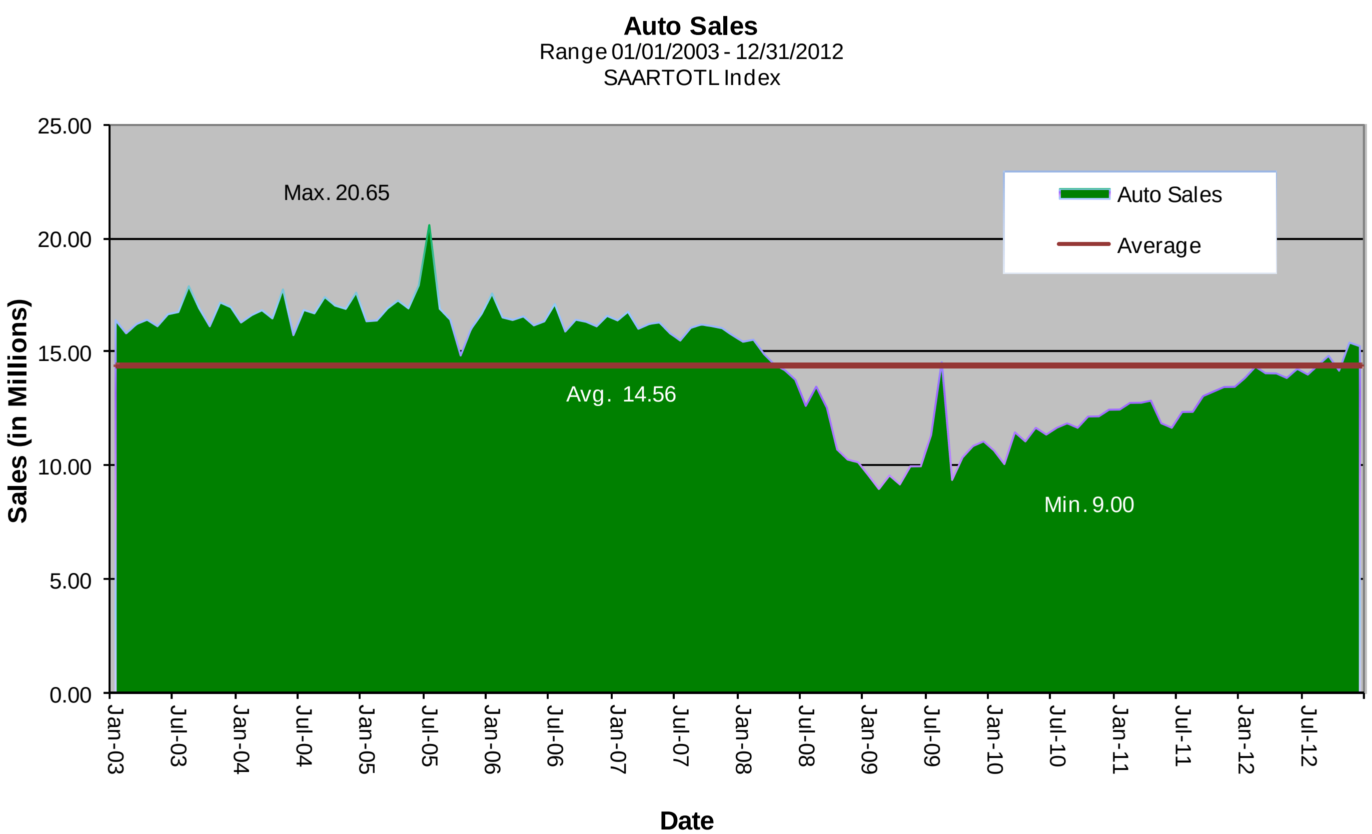
Personal Consumption & Auto Sales





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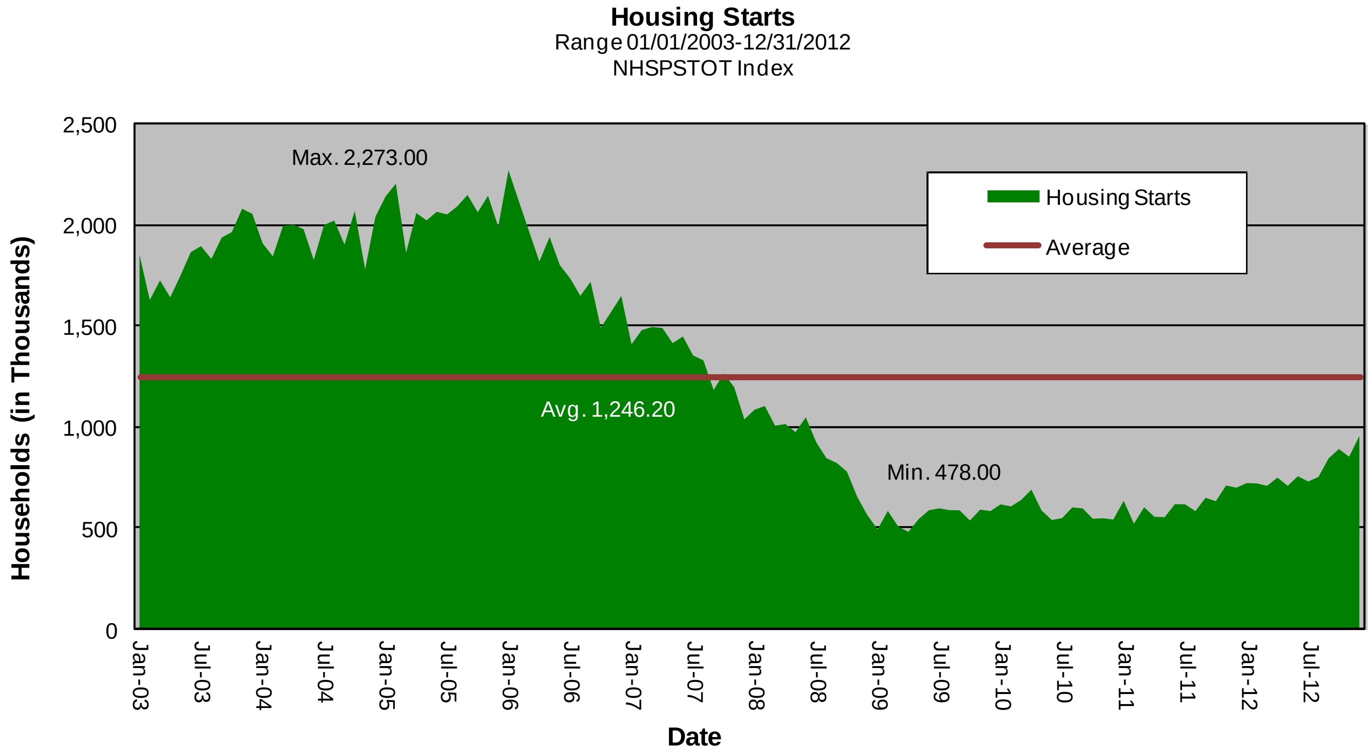
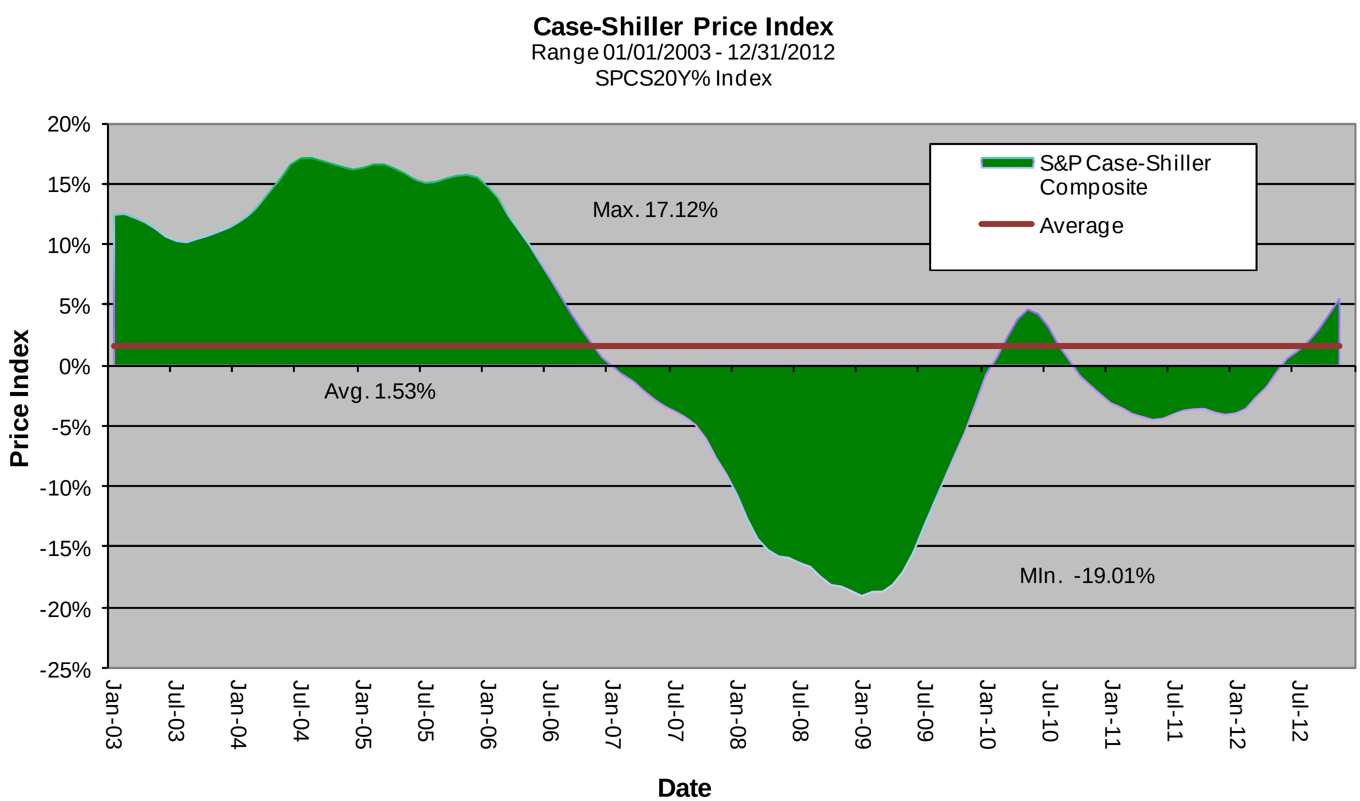
Housing Starts & Case-Shiller Price Index





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This will have some impact on current consumption, but it is not clear how much. During the first quarter of 2013, the federal government will face the debt ceiling, sequestration, and continuing pressure to control spending. An actual reduction in spending may have the effect of depressing growth. Most economists are predicting some short-term reduction to growth from these actions, but the magnitude is unclear.

PORTFOLIO MANAGEMENT

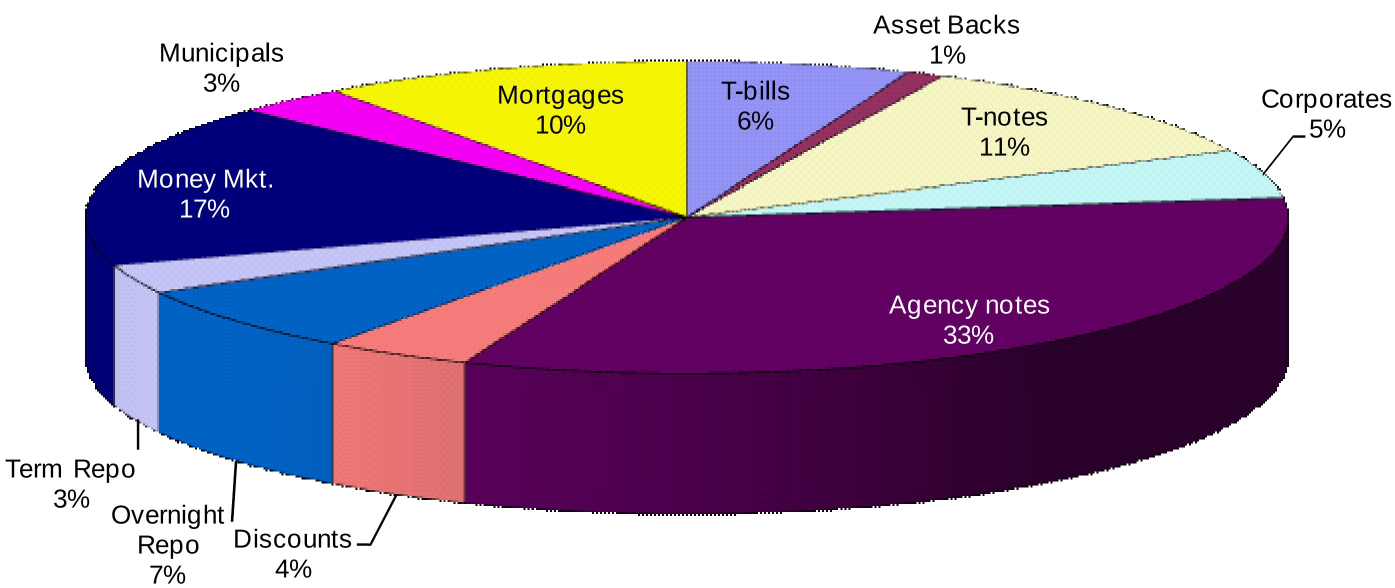
For the six months ended December 31, 2012, the Commonwealth's investment portfolio averaged $3.1 billion. As of December 31, 2012, the portfolio was invested in U. S. Treasury Securities (17 percent), U. S. Agency Securities (37 percent), Mortgage Pass Through Securities (1 percent), Collateralized Mortgage Obligations (9 percent), Repurchase Agreements (10 percent), Municipal Securities (3 percent), Corporate Securities (5 percent), Asset-Backed Securities (1 percent), and Money Market Securities (17 percent). The portfolio had a market yield of 0.40 percent and an effective duration of 0.97 years.

The total portfolio is broken down into three investment pools. The pool balances as of December 31, 2012, were: Short Term Pool - $205 million, Limited Term Pool - $841 million, and Intermediate Term Pool - $2,385 million.

For the six months ending December 31, 2012, total investment income was $14.6 million compared to $16.3 million for the six months ended December 31, 2011.

OFM engaged PFM Asset Management LLC ("PFM") to conduct an evaluation of existing statutes and regulations, general investment functions, portfolio performance benchmarks, reporting and suggested best practices. PFM has made their recommendations to OFM and the State Investment Commission, and the approved recommendations not requiring statutory changes are currently being implemented while the recommendations requiring statutory changes are expected to be filed for authorization in the 2013 Regular Session of the General Assembly.

Distribution of Investments as of December 31, 2012



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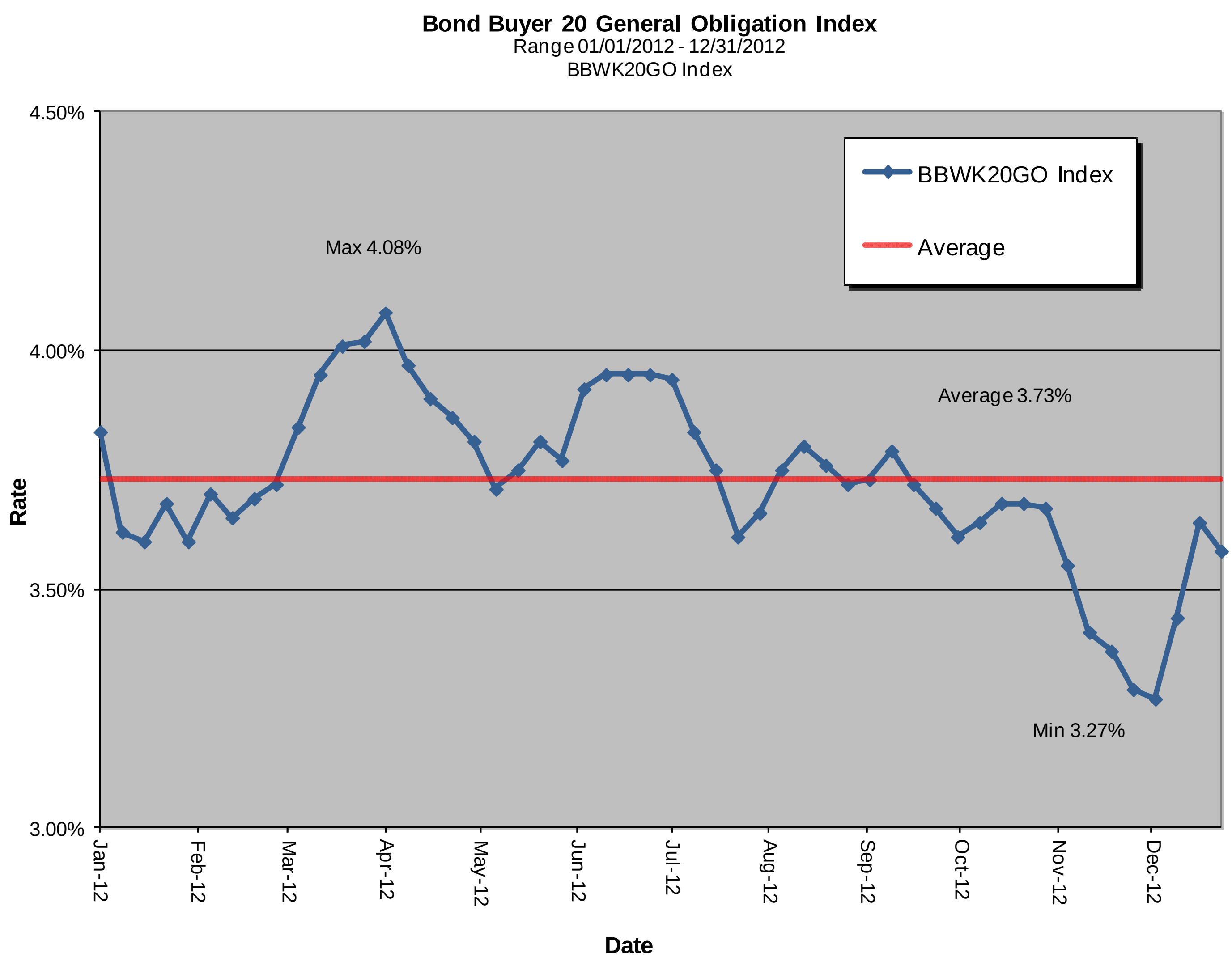
Tax-Exempt Interest Rates and Relationships

The Bond Buyer 20-year General Obligation Index averaged 3.73% for Calendar Year 2012. The high was 4.08% in April 2012 and the low was 3.27% in December 2012 with the year end at 3.58%.

The Securities Industry and Financial Markets Association (SIFMA) Municipal Swap Index averaged 0.16% for Calendar Year 2012. The high was 0.26% in April 2012, the low was 0.06% in January 2012, and it ended the year at 0.13%. The 30-day USD London Interbank Offered Rate (LIBOR) averaged 0.236% for Calendar Year 2012. The Calendar Year high was 0.296% in January 2012, the low was 0.207% in November 2012, and it ended the year at 0.208%. During the year, SIFMA traded at a high of 108% of the 30-day LIBOR in April 2012, at a low of 20% in January 2012, and at an average of 70% for the year. The year ended with SIFMA at 61% of the 30-day LIBOR.



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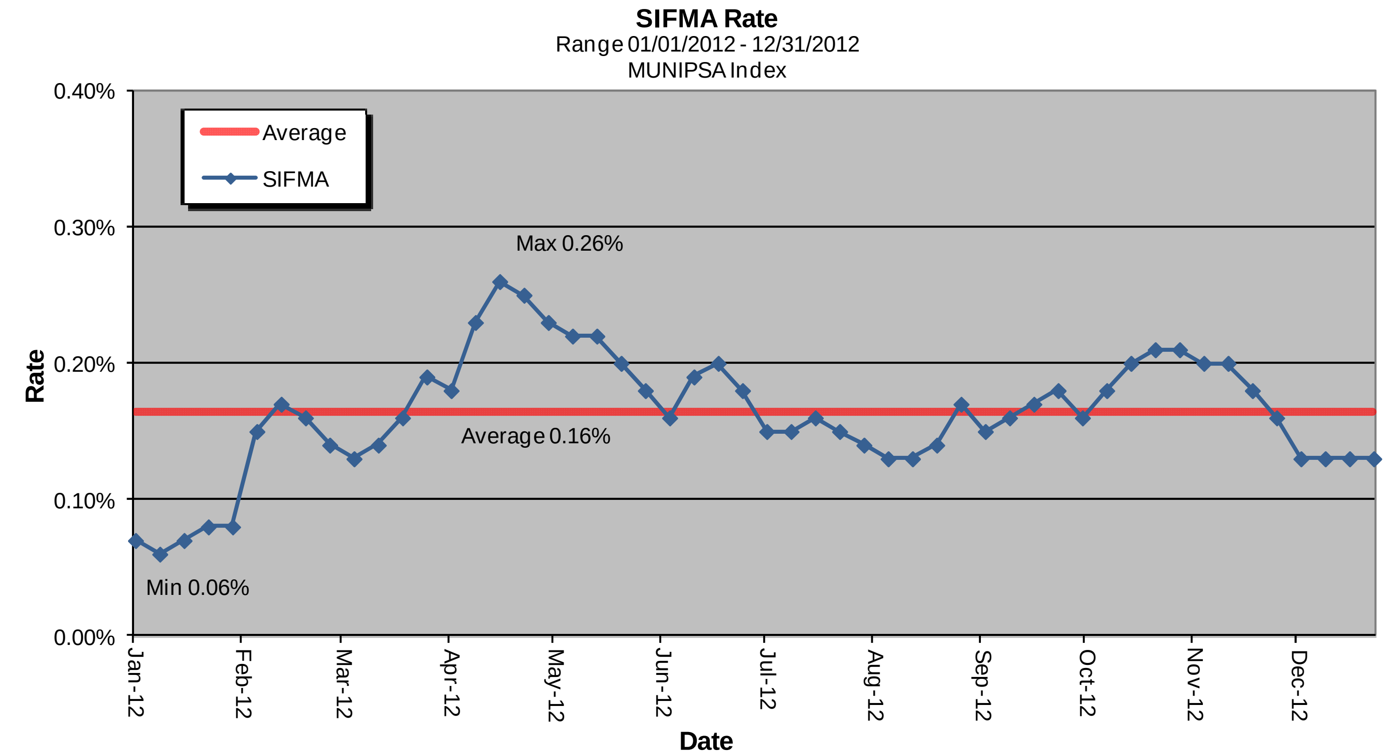
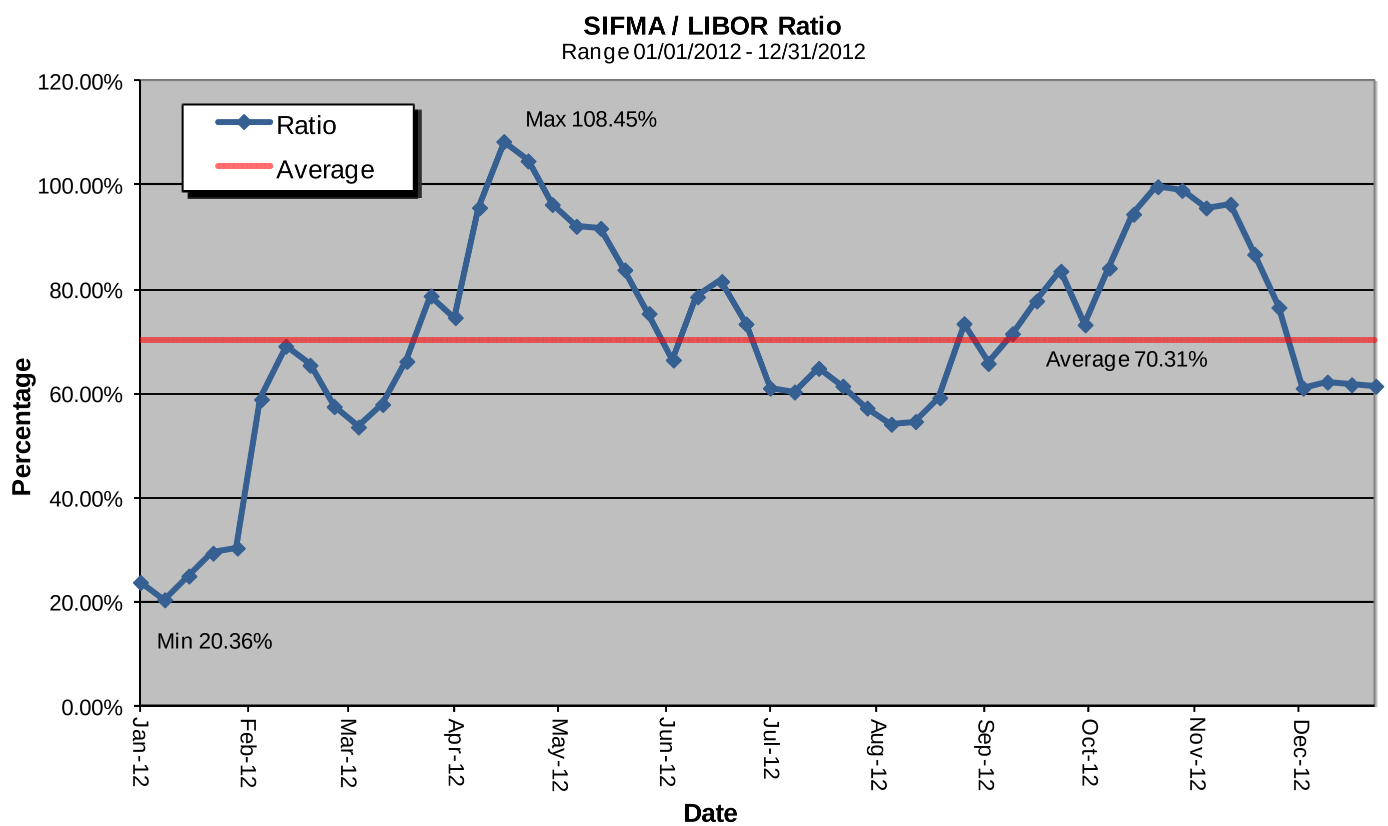
SIFMA and SIFMA/LIBOR Ratio





DEBT MANAGEMENT

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 authorize bond financing for projects totaling $1,980.2 million 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 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, and Agency Restricted Fund authorizations listed above have been permanently financed.

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 authorize 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. A portion of the Agency Restricted Fund authorization listed above has been permanently financed. 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. All of the authorized but unissued General Fund supported bond authorized projects are eligible for interim funding through a line of credit, or direct bank loan, with Citibank, N.A. that closed on June 27, 2012 through ALCo (see further explanation under section "*ASSET/LIABILITY MODEL*: General Fund").

As of December 31, 2012, the unissued balances of bond authorizations from the General Assembly prior to and including 2012 were:

General Fund - $623.36 million (includes $152.4 million of Funding Note authorization for the Kentucky Teachers' Retirement System)

Road Fund - $423 million

Agency Restricted Fund - $65.97 million

Federal Highway Trust Fund - $566 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 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 November of 2012, Moody's downgraded certain stand-alone grant anticipation revenue vehicle

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(GARVEE) bonds backed by appropriations from the Federal Highway Trust Fund, including those issued by the Kentucky Asset/Liability Commission from "Aa2" rating to "Aa3" and revised the rating outlook to "negative". The downgrade of the standalone GARVEE programs reflects increased credit challenges related to two primary factors: (1) the shorter duration of the current highway funding reauthorization and the possibility that more frequent reauthorizations could disrupt or reduce the funds available to pay the bonds; and (2) the structural imbalance of the Federal Highway Trust Fund (FHTF), which further increases programmatic risks of GARVEEs. The negative outlook on the standalone GARVEE programs is negative due to the uncertainty around future federal reauthorizations and funding levels. Moody's does recognize that transportation infrastructure is essential to economic functioning of the U.S. and has defense benefits; that there is a long history of uninterrupted flow of federal funds to states, and the high leverage constraints and debt service coverage ratios for stand-alone highway GARVEEs. However, Moody's also notes the shorter two-year duration of current transportation reauthorization compared to prior authorizations increases the likelihood of future changes that negatively affect funds available for debt service, including funding reductions and program suspensions; that the federal government is under no obligation to continue the federal aid highway program and nothing prevents the federal government from making programmatic changes detrimental to bondholders; and the insufficiency of ongoing fuel tax revenues to fund federal transportation needs necessitates general fund support, which has become less likely in light of federal budgetary pressure.

In September of 2012, Fitch Ratings downgraded certain stand-alone grant anticipation revenue vehicle (GARVEE) bonds backed by appropriations from the Federal Highway Trust Fund, including those issued by the Kentucky Asset/Liability Commission from "AA-" rating to "A+" and revised the rating outlook to "stable". Fitch Ratings recognizes that although the Commonwealth's GARVEE bonds have strong debt service coverage ratios and ample protection, future Federal policy is less certain; funding levels are less predictable; and the program is more dependent on frequent action to extend authorization and on continued transfers from the general fund that will likely need to be continued indefinitely barring an increase in the Federal gas tax or a significant reduction in spending. No long-term plan has been created to address the sustainability of the Federal program or solvency of the Federal Highway Trust Fund.

In November of 2012, Fitch Ratings downgraded their ratings on the Commonwealth's General Fund and Road Fund lease supported bonds from "AA-" to "A+" and downgraded certain Agency Fund lease supported bonds from "A+" to "A". 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. Fitch Ratings revised its outlook to "stable".

In November of 2012, S&P affirmed its "A+" rating on the Commonwealth's General Fund, Road Fund, and Agency Fund lease supported bonds. S&P noted that the rating reflected their view of the risks associated with lease appropriation debt and the general creditworthiness of the Commonwealth of Kentucky. S&P also affirmed the Commonwealth's "AA-" issuer credit rating and noted that the Commonwealth's economic base is experiencing a healthy recovery, good fiscal management with a demonstrated willingness to restrain spend-

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ing and make midyear adjustments, and a moderately high debt burden but also notes the sizeable unfunded pension liabilities as an ongoing concern. S&P also reiterated their "stable" rating outlook on the Commonwealth's issuer credit rating and General Fund lease appropriation rating, which they have maintained since June of 2009.

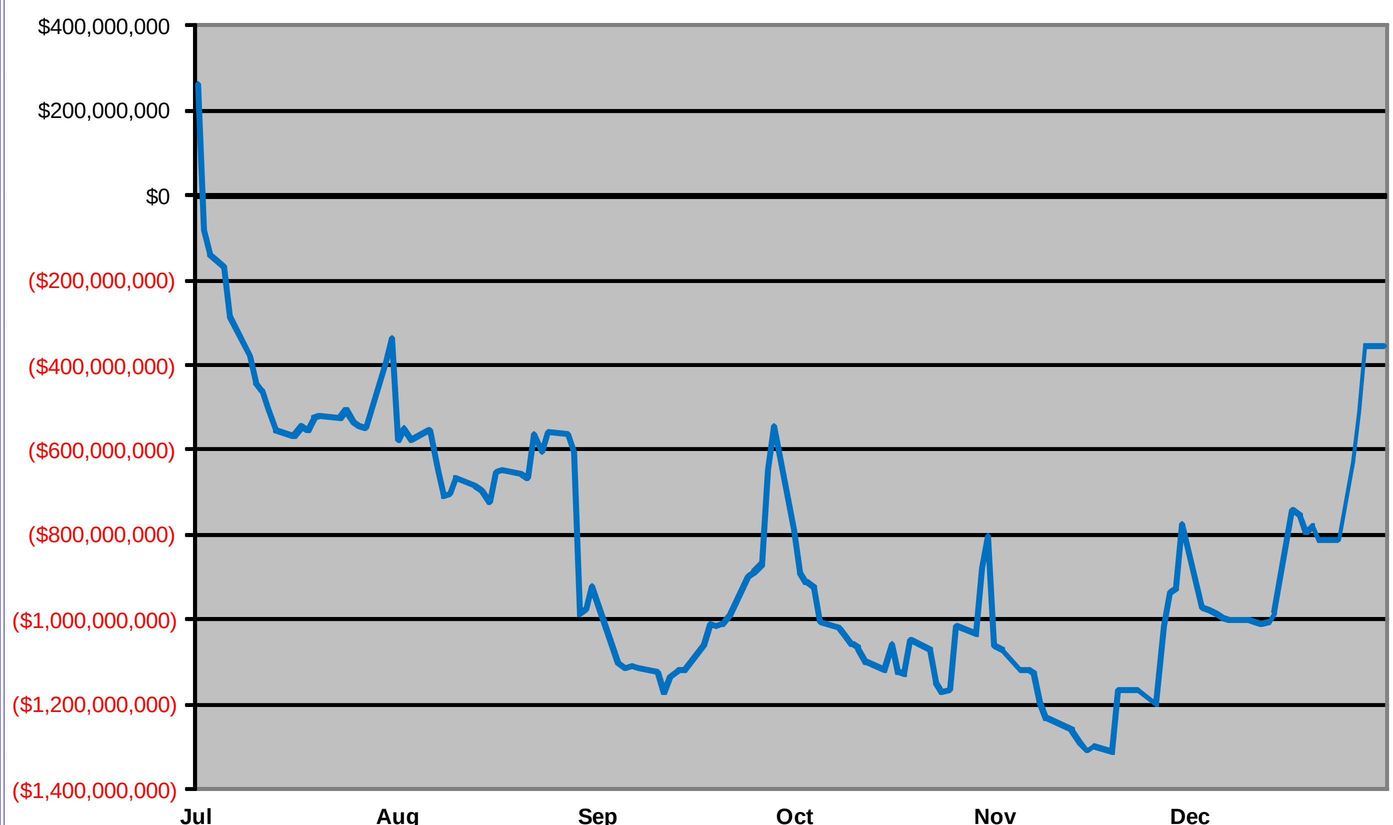
Tax and Revenue Anticipation Notes (TRAN)

No General Fund TRAN was issued for Fiscal Year 2013. As in the previous three 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

($ in millions)

General Fund Cash Balance
Fiscal Year 2013



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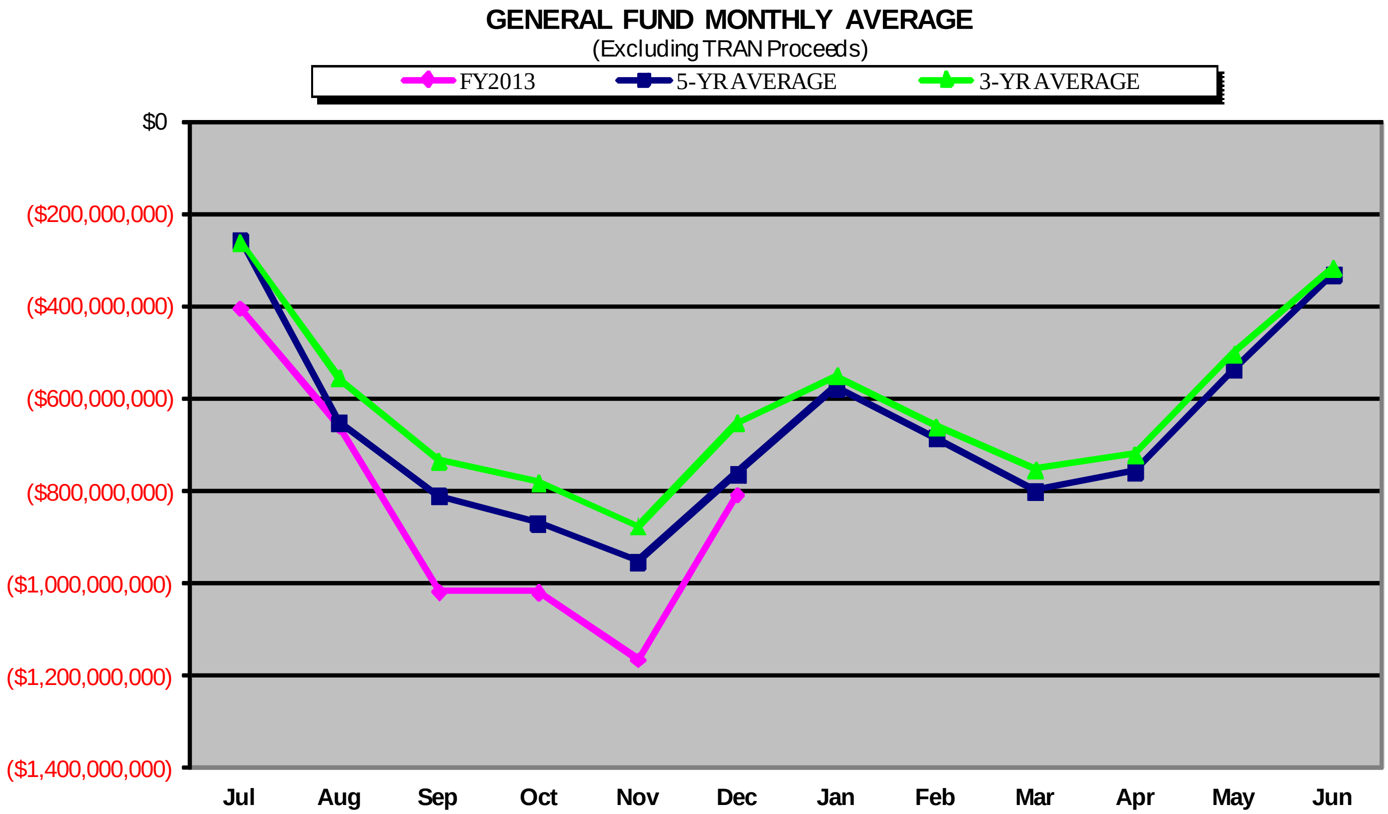

FINANCIAL AGREEMENTS

As of December 31, 2012, ALCo had four financial agreements outstanding, with a net notional exposure amount of $210.665 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 transaction entailed ALCo 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 out hedged the floating rates on the FRNs and locked 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 In-

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surance 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 Public Finance Guarantee 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 Baa2 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 are identical to the original swaps, with two exceptions; 1) the new swaps are not insured and there are no insurer provisions contained in the new agreements, and 2) the credit rating triggers under the automatic termination provisions are now symmetrical for both counterparties (ALCo and Deutsche Bank) at A3/A-. Under the original swaps, ALCo's credit rating trigger was 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.

Details related to the interest rate swaps as of December 31, 2012 are presented in Appendix A.

ASSET/LIABILITY MODEL

General Fund

The total SPBC debt portfolio as of December 31, 2012 had $3,963 million of bonds outstanding with a weighted average coupon of 5.05 percent and a weighted average life of 7.83 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 $1,204 million callable portion had a weighted average coupon of 5.10 percent.

The SPBC debt structure has 32 percent of principal maturing in 5 years and 70 percent of principal maturing in 10 years. The first ratio is approximately in line with the rating agencies' proposed target of 27-30 percent due in 5 years, and the second ratio is approximately in line with the rating agencies' proposed target of 55-60 percent maturing within 10 years, primarily influenced by debt restructuring and the minimal amount of long-term new money permanent financings issued within the last two years.

The General Fund had a high balance of $261.9 million at the beginning of Fiscal Year 2013 and a low of negative $1.3 billion on November 19, 2012.

The average and median balances were a negative $836 million and a negative $921 million, respectively. Since the General Fund continued to have 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 is expected to be $631.4 million for Fiscal Year 2013. Net interest margin will continue to be negative due to low cash balances versus outstanding fixed

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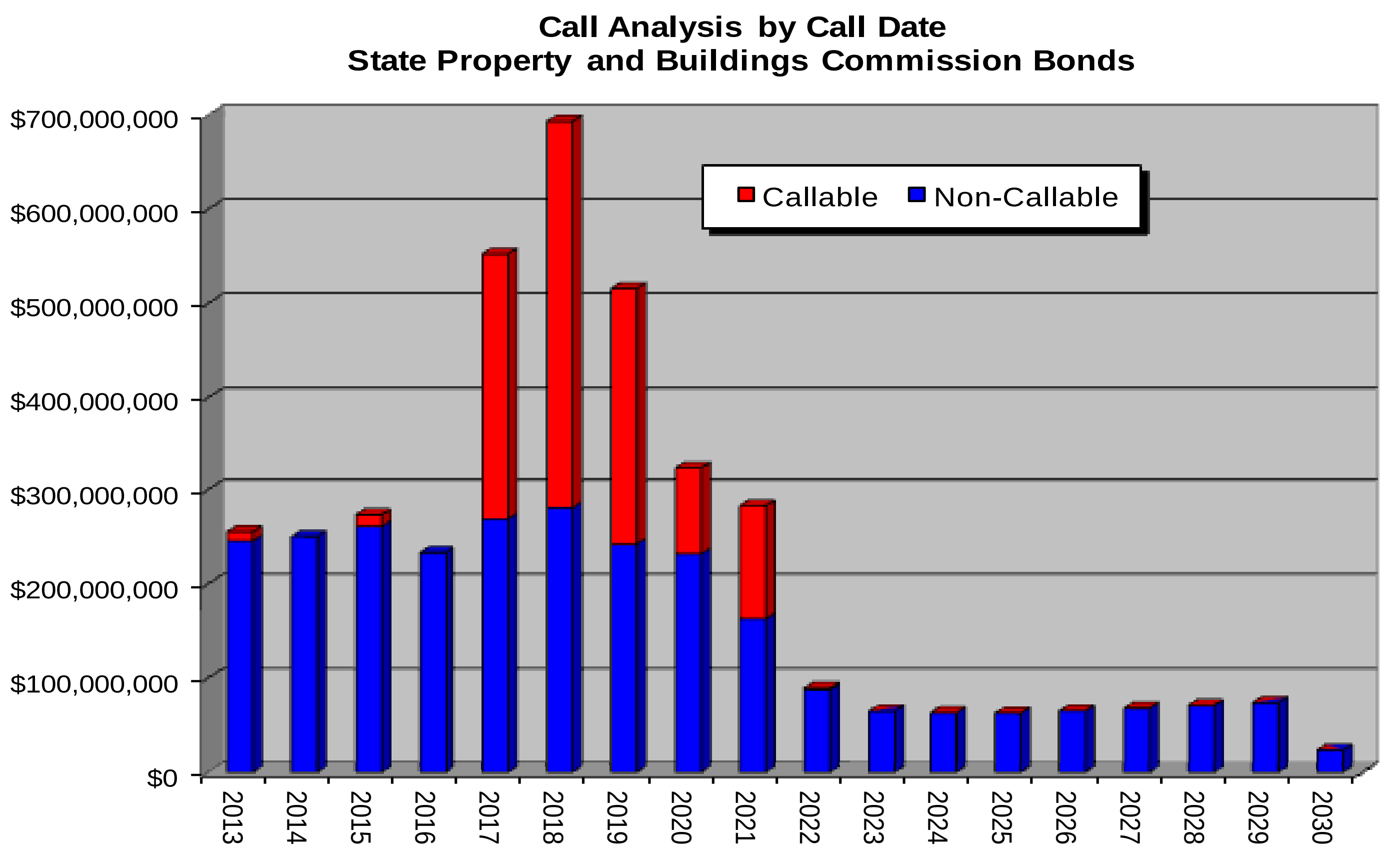
rate debt, low level of interest rates, and the callability of the debt portfolio.

ALCo 2012 Line of Credit (Direct Loan)

In June of 2012, ALCo entered into a line of credit (direct loan) privately placed with a commercial lending institution ("CitiBank, N.A.") in an amount not to exceed $65 million. An initial draw of $35 million took place at closing on June 27, 2012. The line of credit was used to (1) provide interim financing for all currently authorized but unissued General Fund bond capital projects (which amounts to approximately $371 million in authorized projects) and (2) pay for costs of issuance.

The line of credit was issued on a tax-exempt basis with a final maturity of July 1, 2013 and has interest payment dates on February 1 and August 1. Kutak Rock LLP acted as counsel to ALCo, and Nixon Peabody LLP acted as bank counsel to Citibank, N.A. The lender was determined by a competitive negotiation process with the current pool of 3 (three) rotating senior managing underwriters for ALCo Project Notes contracted through June 30, 2012. The cost of funds was 50 basis points or 0.50% on amounts drawn on the loan and 30 basis points or 0.30% on amounts undrawn on the loan. The next draw is anticipated to be in February 2013. The loan will be taken out with permanent financing in the form of tax-exempt bonds in the future, likely to be issued through the State Property and Buildings Commission in late Spring or Summer of 2013.



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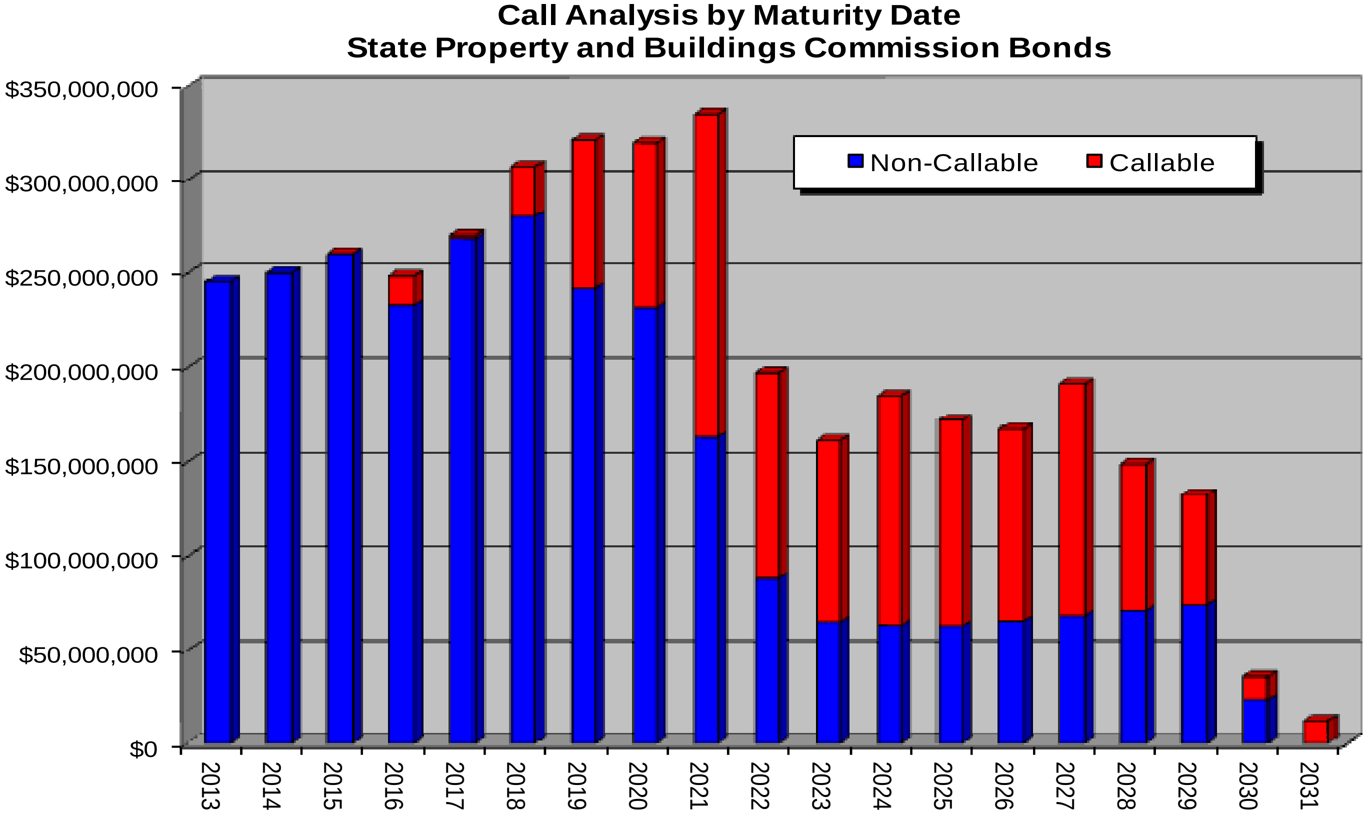

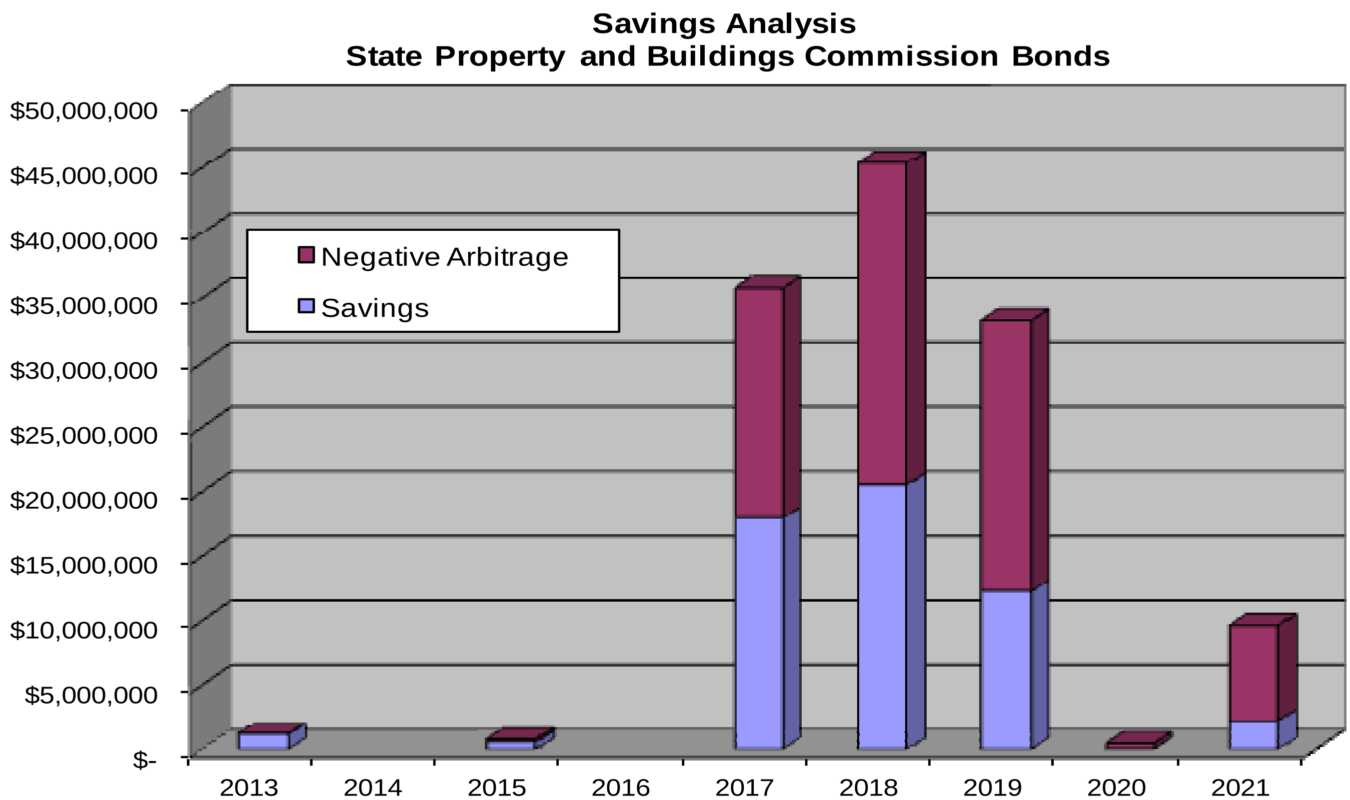

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Agency Fund

SPBC 102, SPBC 103 and SPBC 104

In mid-November 2012, SPBC sold three separate Agency Fund transactions. SPBC 102 was a transaction with the University of Kentucky ("UK") for $5,070,000 in Revenue Refunding Bonds. The transaction advance refunded a portion of the Commission's outstanding State Property and Buildings Commission Revenue and Revenue Refunding Bonds, Project No. 80, Series A. SPBC 103 was a transaction with Eastern Kentucky University ("EKU") for $4,810,000 in Revenue Refunding Bonds. The transaction included an advance refunding of a portion of the Commission's outstanding State Property and Buildings Commission Revenue and Revenue Refunding Bonds, Project No. 80, Series A along with a current refunding of the Commission's outstanding State Property and Buildings Commission Revenue Bonds, Project No. 75. SPBC 104 was a transaction with the Kentucky State Fair Board ("KSFB") for $31,860,000 in Revenue Refunding Bonds. The transaction was to advance refund the Commission's outstanding State Property and Buildings Commission Revenue Bonds, Project No. 81 and the State Property and Buildings Commission Revenue Bonds, Project No. 86.

The SPBC 102 and SPBC 103 bonds were both sold in two series. The Series A bonds were sold on a tax-exempt basis and the Series B Bonds were sold on a taxable basis. The SPBC 104 bonds were sold as a single series on a tax-exempt basis.

The SPBC 102 bonds received ratings of Aa3/A+/A+ from Moody's, S&P, and Fitch, respectively. The SPBC 103 bonds received ratings of A2/A+/A+ with a negative outlook from Moody's. The SPBC 104 bonds received ratings of A1/A+/A. Moody's has a stable outlook on SPBC 102 and negative outlooks on both SPBC 103 and 104 while S&P and Fitch have stable outlooks on all three transactions.

The SPBC 102 transaction achieved an All-In True Interest Cost of 2.016% with an average life of 6.04 years to provide $680,088 in net present value savings for UK while SPBC 103 achieved an All-In True Interest Cost of 2.013% with an average life of 4.538 years to provide $587,245 in net present value savings for EKU. SPBC 104 achieved an All-In True Interest Cost of 2.111% with an average life of 6.495 years to provide $4.498 million in net present value savings for KSFB. All bonds were sold via negotiated sale with Morgan Stanley serving as senior managing underwriter and Peck Shaffer & Williams LLP as bond counsel. All transactions closed on December 4, 2012.

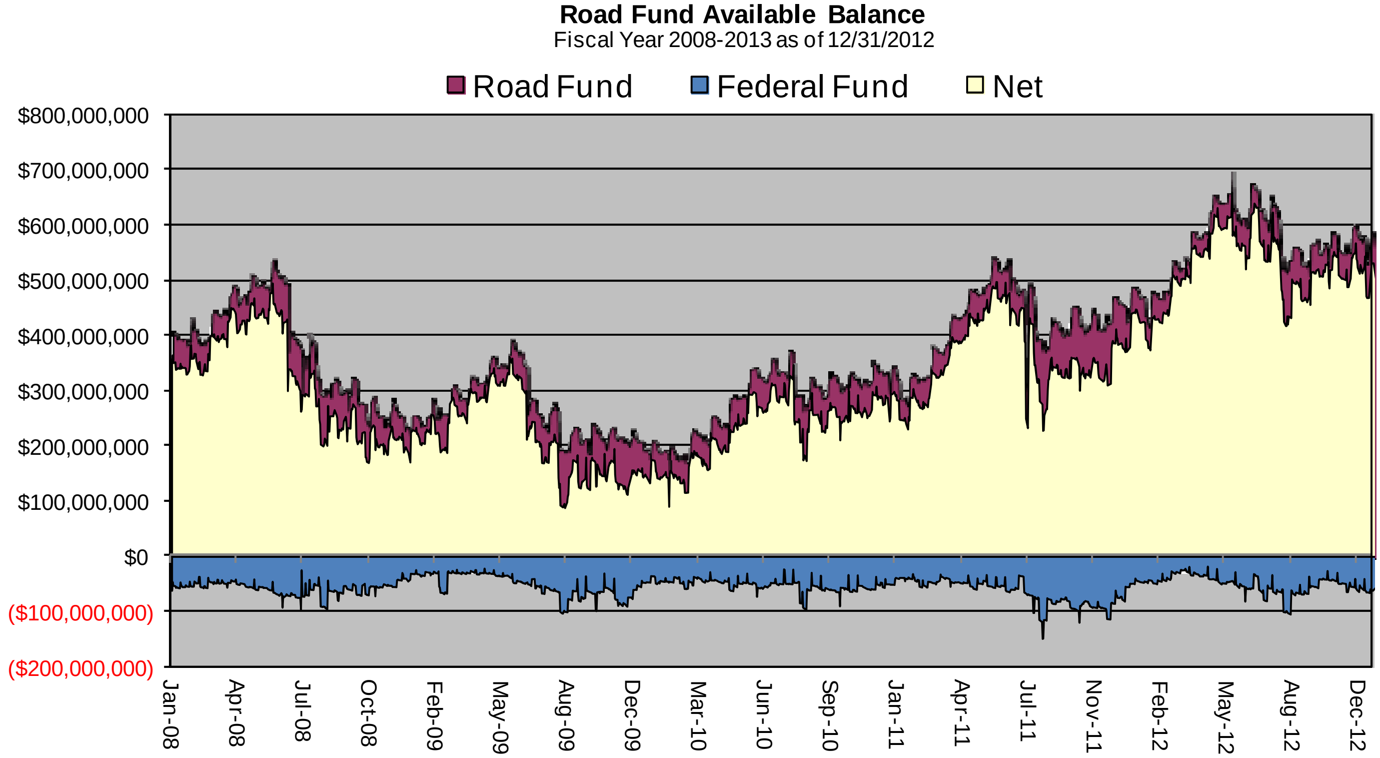
Road Fund

The Road Fund average daily cash balance for the first half of Fiscal Year 2013 was $577 million compared to $435 million for the first half of Fiscal Year 2012. The Road Fund cash was invested in the Intermediate Term Investment Pool which had a duration of 1.37 years as of December 31, 2012. The Road Fund earned $2.1 million on a cash basis for the first half of Fiscal Year 2013 versus $0.2 million for the first half of Fiscal Year 2012. The continued relatively low level of investable balances at certain times during the fiscal year limits the investment opportunities.

As of December 31, 2012, the Turnpike Authority of Kentucky (TAK) had $1,422 million of bonds outstanding with a weighted average coupon of 4.835 percent and an average life of 8.923 years.

TAK Road Fund debt service paid in Fiscal Year 2013 is expected to be $128.9 million, resulting in a net interest margin (investment income earned year-to-date less debt service paid) of negative $126.8 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.

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 Fiscal Year 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 three to four 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. As discussed previously in this report, a line of credit in the form of a direct loan was set up through Citibank, N.A. for the remaining authorized but unissued General Fund supported bond projects to provide an inexpensive form of interim financing which has allowed the Commission to prevent substantial negative arbitrage on the reinvestment of proceeds as well as prevent significant costs with liquidity facility fees. With a considerable amount of capital financing currently remaining for the Road Fund, 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)*	A2/A+/A+	A2/A+/A+	A2/A+/A+	A2/A+/A+
Termination Trigger	A3/A-	A3/A-	A3/A-	A3/A-
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	12,745,000	59,945,000	67,040,000	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 December 31, 2012 (negative indicates payment owed by ALCo if terminated)	(1,187,003)	(11,594,930)	(12,058,005)	(17,197,204)
Interest Earnings (not applicable)				
Total	not applicable	not applicable	not applicable	not applicable

Swap Summary

As of December 31, 2012

	Total Notional Amount Executed		Net Exposure Notional Amount	
	General Fund	Road Fund	General Fund	Road Fund
	243,080,000	0	210,665,000	0

Total Notional Amount Executed by Counter Party

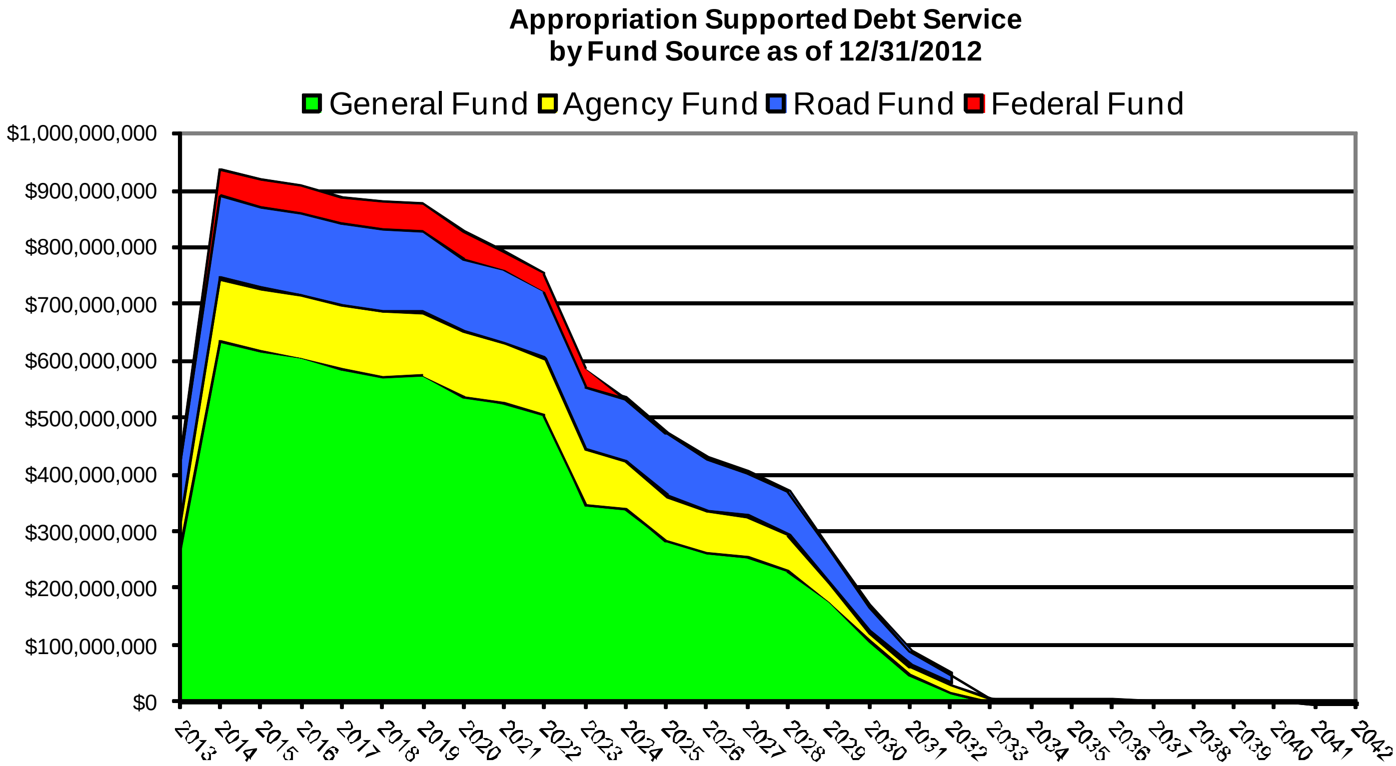
Deutsche Bank (assigned from Citibank on 2/14/2011)

243,080,000

	Debt		10 Percent Net Exposures	
	General Fund	Road Fund	General Fund	Road Fund
Bonds Outstanding	4,693,220,000	1,499,640,000	469,322,000	149,964,000
Authorized but Unissued	470,959,840	423,000,000	47,095,984	42,300,000
Total	5,164,179,840	1,922,640,000	516,417,984	192,264,000

Investment Pool Balances		10 Percent Investment Portfolio	
Other Funds	Net Road Fund	Other Funds	Net Road Fund
2,899,243,101	532,008,609	289,924,310	53,200,861

APPENDIX B



Appropriation Supported Debt Service
by Fund Source as of 12/31/2012
General Fund
Agency Fund
Road Fund
Federal Fund
$1,000,000,000
$900,000,000
$800,000,000
$700,000,000
$600,000,000
$500,000,000
$400,000,000
$300,000,000
$200,000,000
$100,000,000
$0
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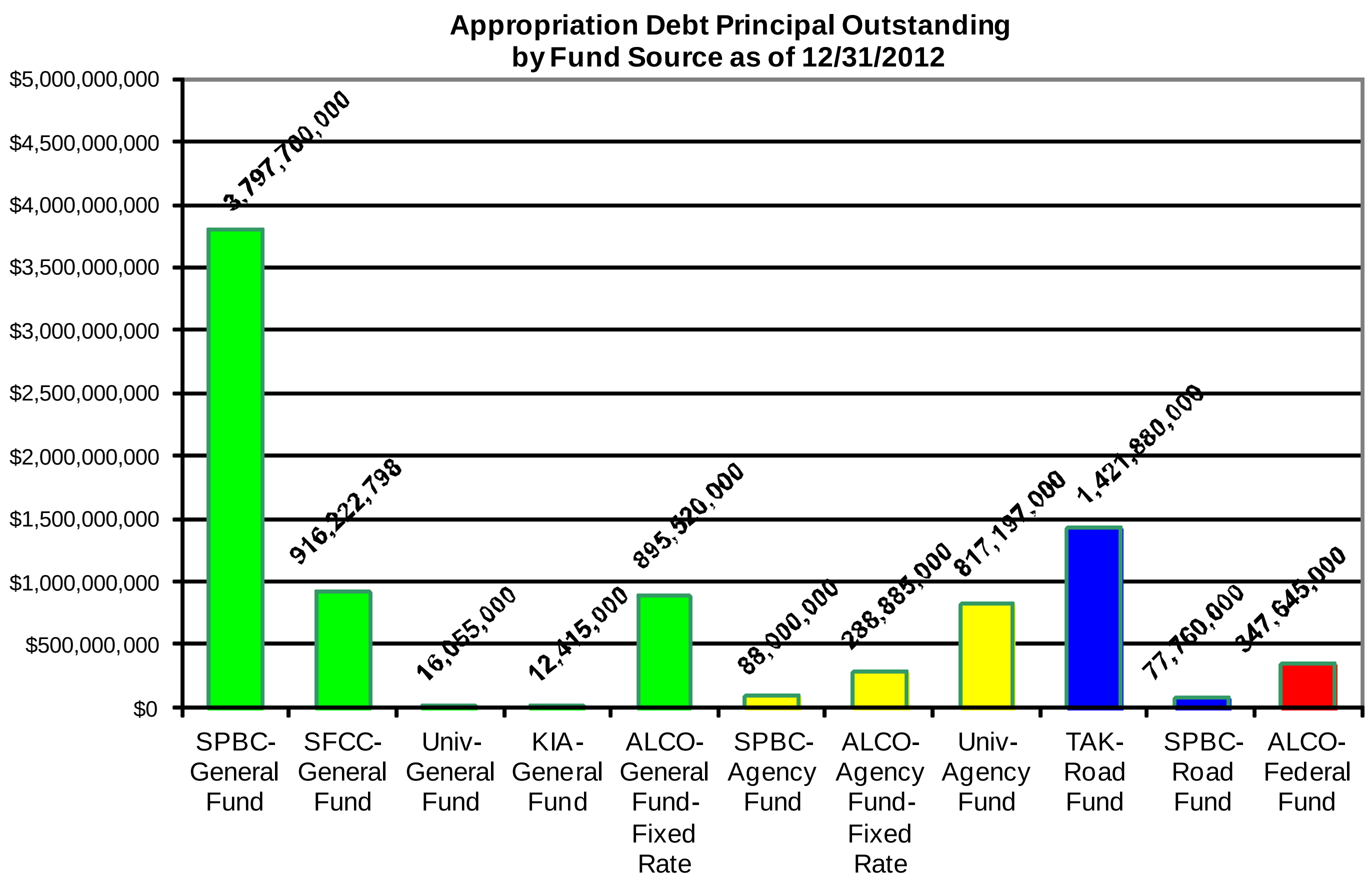

Appropriation Debt Principal Outstanding
by Fund Source as of 12/31/2012
$5,000,000,000
$4,500,000,000
$4,000,000,000
$3,500,000,000
$3,000,000,000
$2,500,000,000
$2,000,000,000
$1,500,000,000
$1,000,000,000
$500,000,000
$0
3,797,700,000
916,222,798
16,055,000
12,415,000
895,520,000
88,000,000
288,885,000
817,197,000
1,421,880,000
77,760,000
347,645,000
SPBC-General Fund
SFCC-General Fund
Univ-General Fund
KIA-General Fund
ALCO-General Fund-Fixed Rate
SPBC-Agency Fund
ALCO-Agency Fund-Fixed Rate
Univ-Agency Fund
TAK-Road Fund
SPBC-Road Fund
ALCO-Federal Fund

APPENDIX C

COMMONWEALTH OF KENTUCKY
ASSET/LIABILITY COMMISSION
SCHEDULE OF NOTES OUTSTANDING
AS OF 12/31/12

FUND TYPE SERIES TITLE	AMOUNT ISSUED	DATE OF ISSUE	MATURITY DATE	PRINCIPAL OUTSTANDING
General Fund Project & Funding Notes				
2003 Series A	$171,260,000	7/2003	7/2013	$4,260,000
2005 1st Series	$81,850,000	6/2005	5/2025	$60,935,000
2007 A, B Series	$243,080,000	5/2007	11/2027	$210,665,000
2010 1st Series-KTRS Funding Notes	$467,555,000	8/2010	4/2020	$363,930,000
2011 1st Series-KTRS Funding Notes	$269,815,000	3/2011	4/2022	$255,730,000
2012 Line of Credit	$35,000,000	6/2012	7/2013	$35,000,000
FUND TOTAL	**$1,268,560,000**			**$930,520,000**
Agency Fund Project Notes				
2005 1st Series	$11,275,000	6/2005	6/2025	$8,710,000
2005 Series A-UK Gen Receipts	$107,540,000	11/2005	10/2025	$88,980,000
2006 Series A-UK Gen Receipts	$66,305,000	10/2006	10/2022	$48,895,000
2007 Series A-UK Gen Receipts	$77,905,000	11/2007	10/2027	$69,270,000
2007 Series B-UK Gen Receipts	$80,245,000	11/2007	10/2027	$73,030,000
FUND TOTAL	**$343,270,000**			**$288,885,000**
Federal Hwy Trust Fund Project Notes				
2005 1st Series	$139,635,000	6/2005	9/2017	$66,495,000
2007 1st Series	$277,910,000	9/2007	9/2019	$191,440,000
2010 1st Series	$89,710,000	3/2010	9/2022	$89,710,000
FUND TOTAL	**$507,255,000**			**$347,645,000**
ALCo NOTES TOTAL	**$2,119,085,000**			**$1,567,050,000**

APPENDIX D

General Fund Authorized But Unissued Bond Funded Capital Projects Covered Under ALCo 2012 Line of Credit

Session Authorized	Agency	Project Description	Bond Authorization
2005	Governor's Office of Agricultural Policy	Kentucky Agriculture Finance Corporation - Loan Pool	2,000,000
2005	Kentucky Community Technical College System	LCC Classroom/Lab Building	20,000,000
2006	Kentucky Infrastructure Authority	Infrastructure for Economic Development Fund for Coal-Producing Counties	10,000,000
2006	Economic Development-Financial Incentives	Economic Development Bond Pool	17,500,000
2006	Finance-Facilities and Support Services	Capital Plaza Complex - Renovation and Design	2,500,000
2007(2nd)	Economic Development-Financial Incentives	Energy Bonds*	95,000,000
2008	Agriculture	Animal Shelters	400,000
2008	Department for Local Government	Flood Control Matching Funds	2,200,000
2008	Natural Resources	Kentucky Heritage Land Conservation Fund - Additional	3,311,040
2008	Kentucky Community Technical College System	LCC Classroom/Lab Building-Additional for Eastern St Hospital Site	4,000,000
2010 Special	Kentucky Infrastructure Authority	Ky Infrastructure Authority- Fund A Federally Assisted Wastewater Revolving Loan Program	17,700,000
2010 Special	Kentucky Infrastructure Authority	Ky Infrastructure Authority-Fund F Drinking Water Revolving Loan Program	9,000,000
2010 Special	Kentucky Infrastructure Authority	Infrastructure for Econ-Dev Fund for Coal Producing Counties 06-08 Add'l	955,100
2010 Special	Kentucky Infrastructure Authority	Infrastructure for Econ-Dev Fund for Non-Coal Producing Counties 06-08 Add'l	1,250,000
2010 Special	Kentucky Infrastructure Authority	Infrastructure for Econ-Dev Fund for Coal Producing Counties 08-10 Add'l	4,240,000
2010 Special	Kentucky Infrastructure Authority	Infrastructure for Econ-Dev Fund for Non-Coal Producing Counties 08-10 Add'l	10,584,700
2010 Special	Department for Local Government	Flood Control — Matching Fund 2010-2012	3,000,000

APPENDIX D

General Fund Authorized But Unissued Bond Funded Capital Projects Covered Under ALCo 2012 Line of Credit

Session Authorized	Agency	Project Description	Bond Authorization
2010 Special	Economic Development-Financial Incentives	Economic Development Bonds - Base Realignment and Closure (BRAC)	26,495,000
2010 Special	Economic Development-Financial Incentives	Economic Development Bonds	7,500,000
2010 Special	Economic Development-Financial Incentives	Kentucky Economic Development Finance Authority Loan Pool*	25,000,000
2010 Special	Environmental Protection	State Owned Dam Repair - 2010-2012	2,000,000
2010 Special	Finance and Administration-Department of Revenue	Comprehensive Tax System - Additional	4,500,000
2010 Special	Health and Family Services-Behavioral Health	Oakwood Specialty Clinic	1,964,000
2010 Special	Energy & Environment-Office of Secretary	Ky Heritage Land Conservation Fund - Additional	15,000,000
2012	Kentucky Infrastructure Authority	KIA FUND A - Federally Assisted Wastewater Program 2012-2014	1,500,000
2012	Kentucky Infrastructure Authority	KIA FUND F - Drinking Water Revolving Loan Program 2012-2014	2,200,000
2012	Department for Local Government	Flood Control Matching Fund 2012-2014	2,000,000
2012	Department of Veterans' Affairs	Construct Fourth State Veteran's Nursing Home	14,000,000
2012	Energy and Environment Cabinet	Maxey Flats Cap	17,000,000
2012	Energy and Environment Cabinet	State-Owned Dam Repair 2012-2014	2,500,000
2012	Finance and Administration Cabinet	Maintenance Pool 2012-14	6,000,000
2012	Finance and Administration Cabinet	Statewide Microwave Network (KEWS) Maintenance	2,200,000
2012	Finance and Administration Cabinet	Parking Garage Maintenance	1,500,000
2012	Finance and Administration Cabinet	Council of State Government's Building Complex	5,500,000
2012	Health and Family Services Cabinet	Maintenance Pool 2012-14	5,000,000
2012	Health and Family Services Cabinet	Electrical Systems Upgrade at Western State Hospital- Design	960,000
2012	Health and Family Services Cabinet	Medicaid Eligibility System	5,000,000

APPENDIX D

General Fund Authorized But Unissued Bond Funded Capital Projects Covered Under ALCo 2012 Line of Credit

Session Authorized	Agency	Project Description	Bond Authorization
2012	Justice and Public Safety Cabinet	Demolition and Construction of Training Academy Building	2,000,000
2012	Justice and Public Safety Cabinet	Maintenance Pool 2012-14	5,500,000
2012	Tourism Cabinet	Maintenance Pool 2012-14	6,000,000
2012	Tourism Cabinet	Upgrade Wastewater System-Fort Boonesborough	2,000,000
2012	Kentucky State Fair Board	Parking Garage Maintenance	2,000,000
2012	Murray State University	Acquire Land/Design New Breathitt Veterinary Center**	2,000,000
			370,959,840

* To be sold on a taxable basis.
** H.B. 265 Reallocated $2 million of bond authorization from the Kentucky Agriculture Heritage Center Project authorized in the 2008 Session of the General Assembly to this project.

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REPORT PREPARED BY:

OFFICE OF FINANCIAL MANAGEMENT

Commonwealth of Kentucky
702 Capitol Ave Ste 76
Frankfort, KY 40601
Phone: 502-564-2924
Fax: 502-564-7416

Creating Financial Value for the Commonwealth