# Semi-Annual Report of the Kentucky Asset/Liability Commission

34TH 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, 2013***

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-fourth semi-annual report pursuant to KRS 56.863 (11) for the period beginning July 1, 2013 through December 31, 2013. 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**

- Growth in economic activity accelerated during the second half of Calendar Year 2013 as Real Gross Domestic Product grew by 3.7% for the six months ended on December 31, 2013.
- The unemployment rate continues to fall ending the year at 6.7%; although, questions exist about how much of this decline is due to increased employment versus decreased participation in the labor force.
- The Federal Reserve Board has begun the process of "tapering" purchases of long-term securities while holding the Federal Funds rate at 0.00% to 0.25% and indicating an extended period of low rates.
- December of 2013 showed a meaningful drop in a number of economic indicators such as job creation, retail sales, and leading economic indicators; although, some portion of the drop may be weather related.

**On the state level**

- General Fund receipts increased 1.2% for the first six months of Fiscal Year (FY) 2014 compared to the same timeframe in FY 2013. However, FY 2013 revenues included one-time tax amnesty collections.
- Road Fund receipts increased 7.0% for the first six months of FY 2014 compared to the same timeframe in FY 2013.
- Implementation of bond authorizations from prior-year sessions of the General Assembly continued.
- The Consensus Forecasting Group (CFG) met on December 19, 2013. The CFG's official estimate of General Fund revenues for FY 2014 was revised to $9,548.1 million, an increase of $24.2 million from the official enacted estimate. General Fund official revenue estimates for FY 2015 are $9,794.3 million and $10,046.6 million for FY 2016. General Fund revenues are projecting a growth rate of 2.6% for FY 2015 and a growth rate of 2.6% for FY 2016.
- The CFG also revised the official estimate for Road Fund revenues for FY 2014 to $1,582.6 million, a $14.4 million increase from the official enacted estimate. Road Fund revenue estimates for FY 2015 are $1,546.7 million and $1,558.4 million for FY 2016. Road Fund revenues are projecting a decline of -2.3% for FY 2015 and a growth rate of 0.8% for FY 2016.
- Kentucky's seasonally adjusted unemployment rate stood at 8.0% at the end of December 2013, down from 8.1% one year ago.

# INVESTMENT MANAGEMENT

## *MARKET OVERVIEW*

During Calendar Year 2013, the economy grew at the second fastest pace for a calendar year since 2005 with most of that growth occurring during the second half of the year. The overall pace as measured by the change in Real Gross Domestic Product was 2.7% for the entire year while growth during the second half of the year was nearly 3.7% (versus 1.8% in the first half of the year). This rate of growth has led to optimism that the overall economy is beginning to accelerate from the tempered recovery experienced from the 2008/2009 recession.

The employment picture was improving considerably until the end of the calendar year. Overall, the economy was creating roughly 200,000 jobs per month, as measured by the change in nonfarm payrolls, through most of the year. The number for December came in at only 75,000 jobs. At the same time, the national unemployment rate dropped from 7.9% in December 2012 to 6.7% in December 2013. The rate of new job creation, by itself, is not strong enough to create such a large drop in the unemployment rate. There are two possible explanations for this divergence. The payroll number comes from a survey of established businesses while the unemployment rate comes from a survey of households. It is not uncommon for these two measures to diverge.

The other possible explanation for the divergence is the labor force participation rate. The participation rate is the number of people employed or looking for work as a percent of total population. This rate had been increasing for decades in large part due to more women entering the workforce. The rate peaked in 2000 at 67.3%. The participation rate had fallen to about 66% prior to the Great Recession in 2008 and 2009. Since then the rate has dropped considerably to only 62.8%, a level last seen in 1978. The unemployment rate has fallen, at least in part, because numerous people have dropped out of the labor force. There are questions about whether this is due to discouraged workers giving up looking for work or if this is driven by demographic changes (baby boomers approaching retirement). Whether the divergence in new job creation and the unemployment rate is due to short-term cyclical factors or long-term demographics will have a meaningful impact on economic activity for years to come.

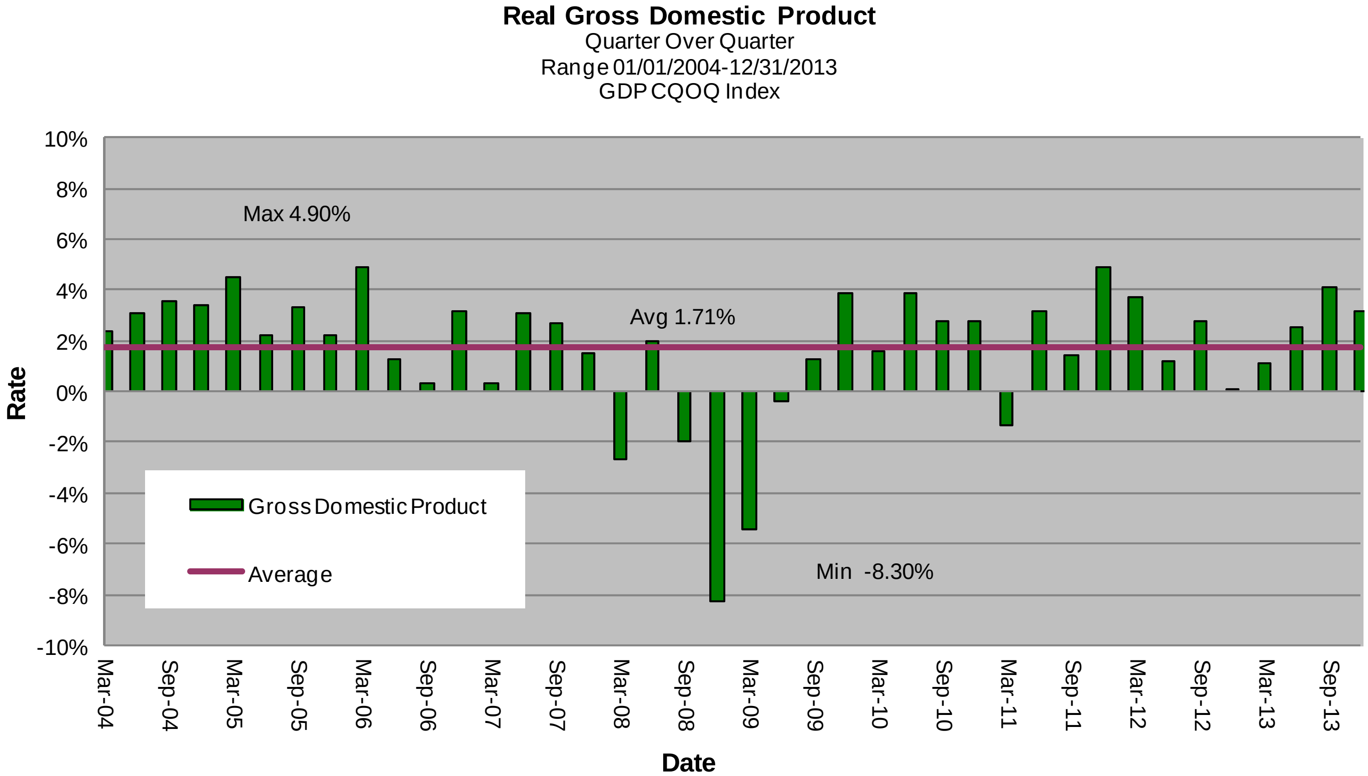
The Federal Open Markets Committee (FOMC) of the Federal Reserve System has held the Federal Funds rate at 0.00% to 0.25% for over five years since December 16, 2008. However, at the December 18, 2013 meeting, a meaningful change in policy was announced. The FOMC decided to reduce the amount of longer term bonds purchased from $85 billion per month to $75 billion per month. They further indicated that, subject to future economic conditions, they plan to reduce the purchases "in further measured steps at future meetings". Most market participants believe this "tapering" means an additional $10 billion reduction per meeting.

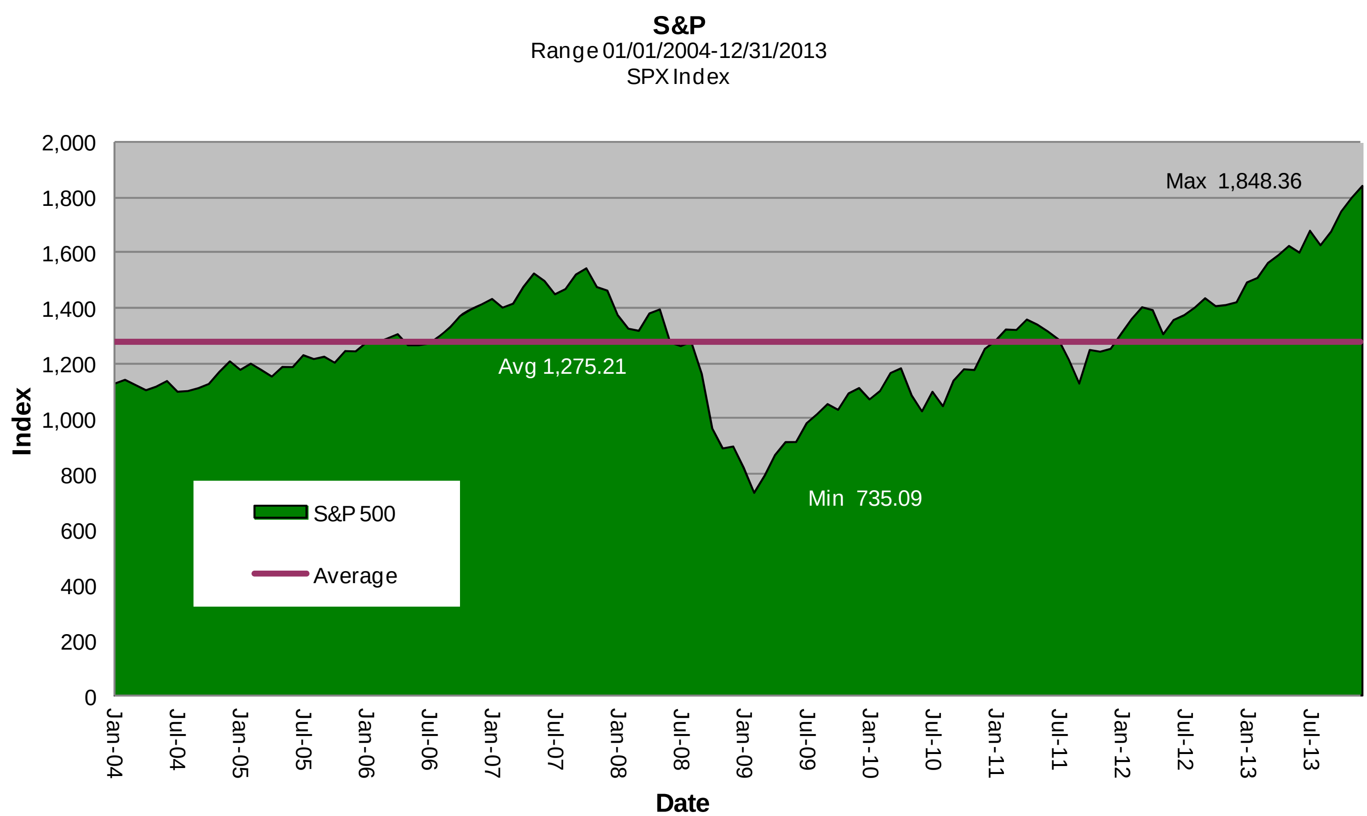
This small change in the amount of purchases is a substantial change in Monetary Policy. The FOMC has taken the first step in unwinding the "extraordinary measures" enacted during the financial crisis and in allowing free markets to begin pricing financial assets. As the Fed began discussing the end of this program over the summer, longer term interest rates jumped, some as much as 1.00%. The actual execution of the beginning of the tapering had a lesser impact on markets. Going forward, the end of manipulation of longer term rates will generate greater volatility in rates as the market prices securities based more on the expectations of future economic performance.

As a final point, December was unusually cold across much of the United States, January 2014 even more so. This partially contributed to a number of economic indicators falling at the end of the year. As mentioned, job creation slowed dramatically in December. Vehicle sales decreased from 16.3 million in November to only 15.3 million in December, both on an annualized basis. Retail Sales dropped from 0.7% growth to only 0.2% growth in December. The monthly growth in Housing Starts declined sharply from 22.7% to -9.8%. The index of leading indicators fell from 0.8% to 0.1%. A variety of indicators dropped during the month (with further declines in January). Going forward, if these are all due to inclement weather, the data series should rebound sharply once the weather improves. If not, the economy could experience slower growth than expected. Regardless, these changes may distort seasonal adjustments of economic indicators for several years to come.

# INVESTMENT MANAGEMENT

## Real Gross Domestic Product & S&P 500

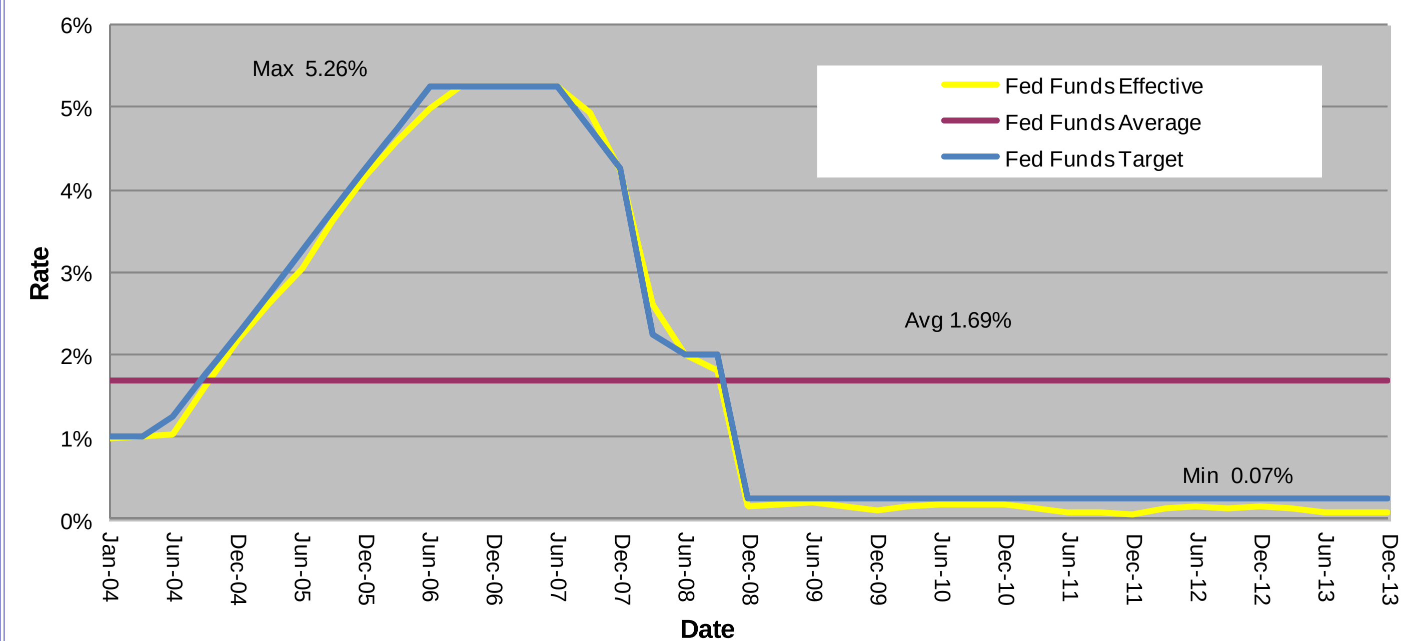


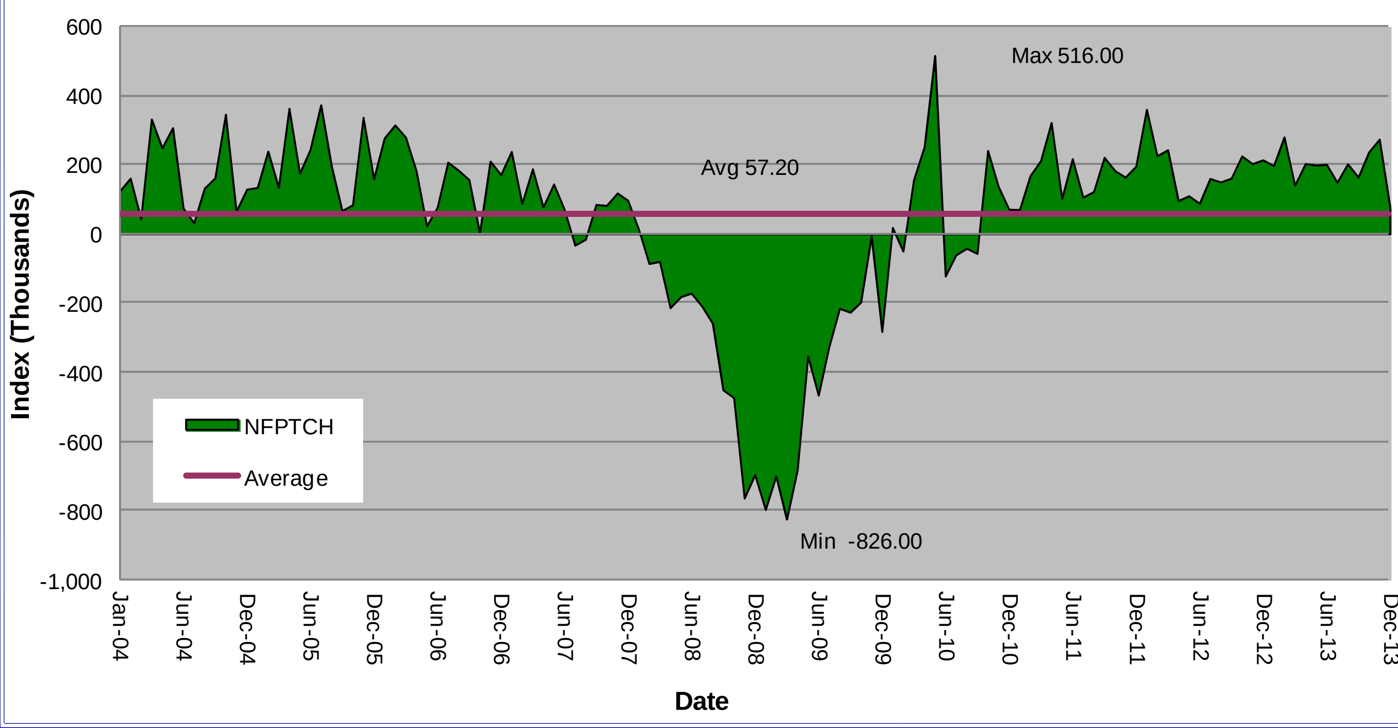
# INVESTMENT MANAGEMENT

## Federal Funds Target Rate & NonFarm Payrolls

**Federal Funds Target Rate**
Range 01/01/2004-12/31/2013
FEDL01 Index/FDTR Index

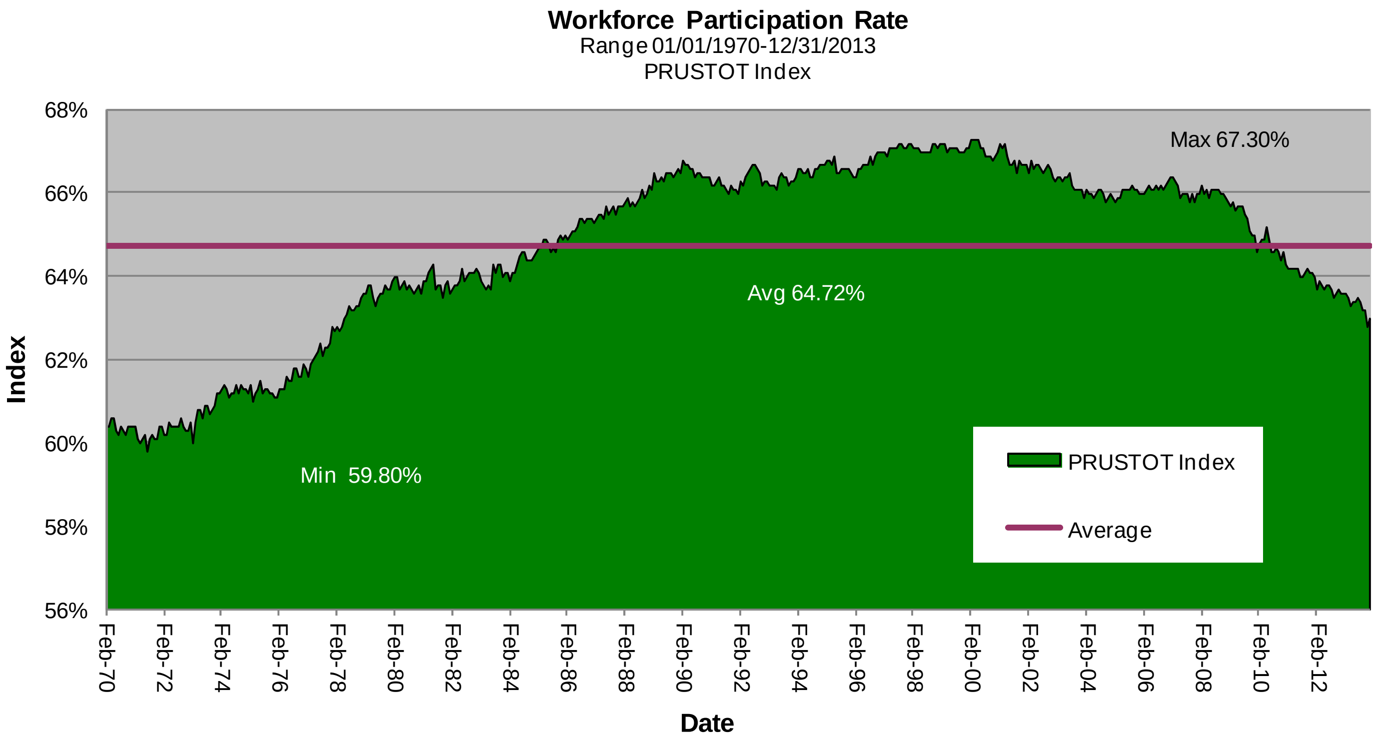


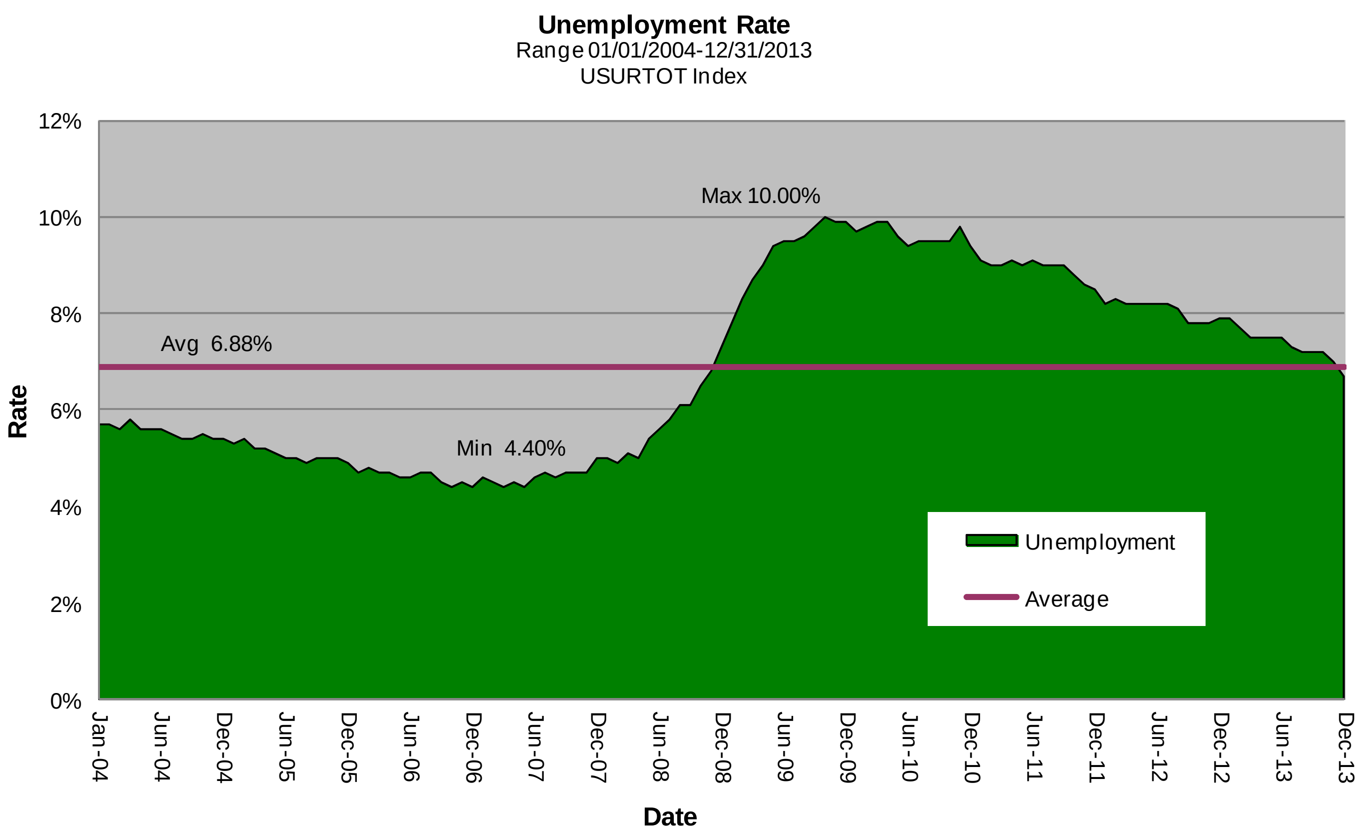

**Nonfarm Payrolls**
Range 01/01/2004-12/31/2013
NFPTCH Index



# INVESTMENT MANAGEMENT

## Workforce Participation Rate & Unemployment Rate



# INVESTMENT MANAGEMENT

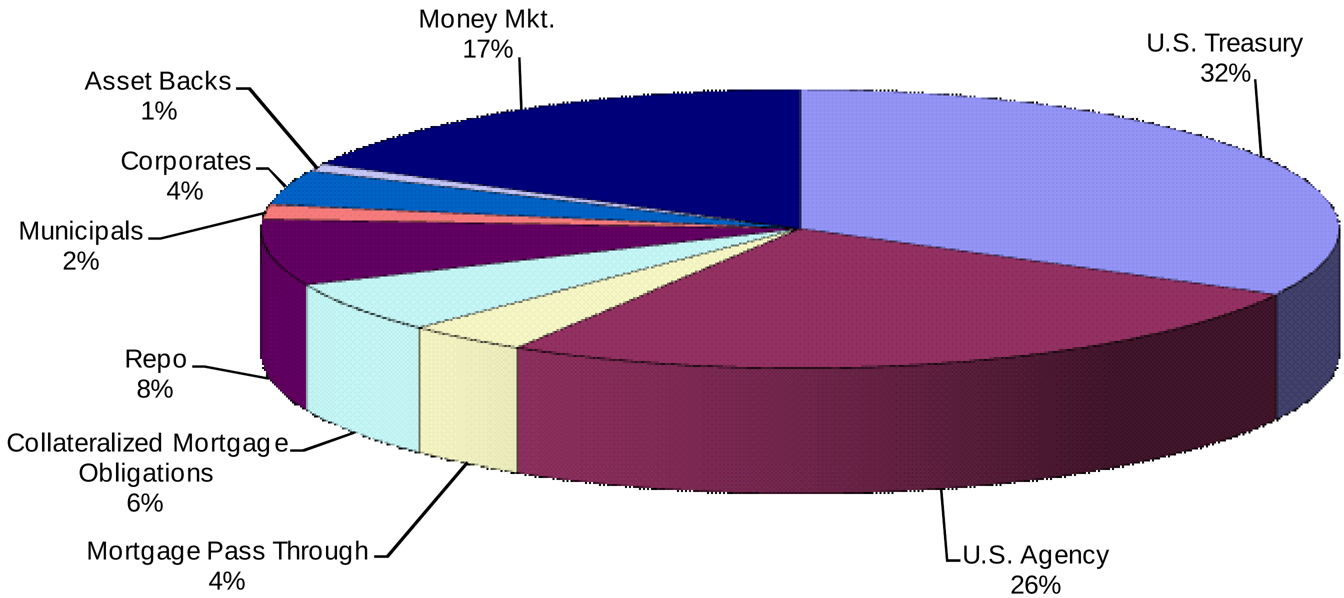
## *PORTFOLIO MANAGEMENT*

For the six months ended December 31, 2013, the Commonwealth's investment portfolio averaged $3.0 billion. As of December 31, 2013, the portfolio was invested in U. S. Treasury Securities (32 percent), U. S. Agency Securities (26 percent), Mortgage Pass Through Securities (4 percent), Collateralized Mortgage Obligations (6 percent), Repurchase Agreements (8 percent), Municipal Securities (2 percent), Corporate Securities (4 percent), Asset-Backed Securities (1 percent), and Money Market Securities (17 percent). The portfolio had a market yield of 0.56 percent and an effective duration of 1.13 years.

The total portfolio is broken down into four investment pools. The pool balances as of December 31, 2013, were: Short Term Pool - negative $20 million, Limited Term Pool - $837 million, Intermediate Term Pool - $2,295 million, and Bridges Pool - $652 million.

For the six months ended December 31, 2013, total investment income was $3.9 million compared to $14.6 million for the six months ended December 31, 2012. The reduction in investment income was caused by an increase in interest rates related to the tapering, reduction of long-term bond purchases, by the Federal Reserve.

**Distribution of Investments as of December 31, 2013**

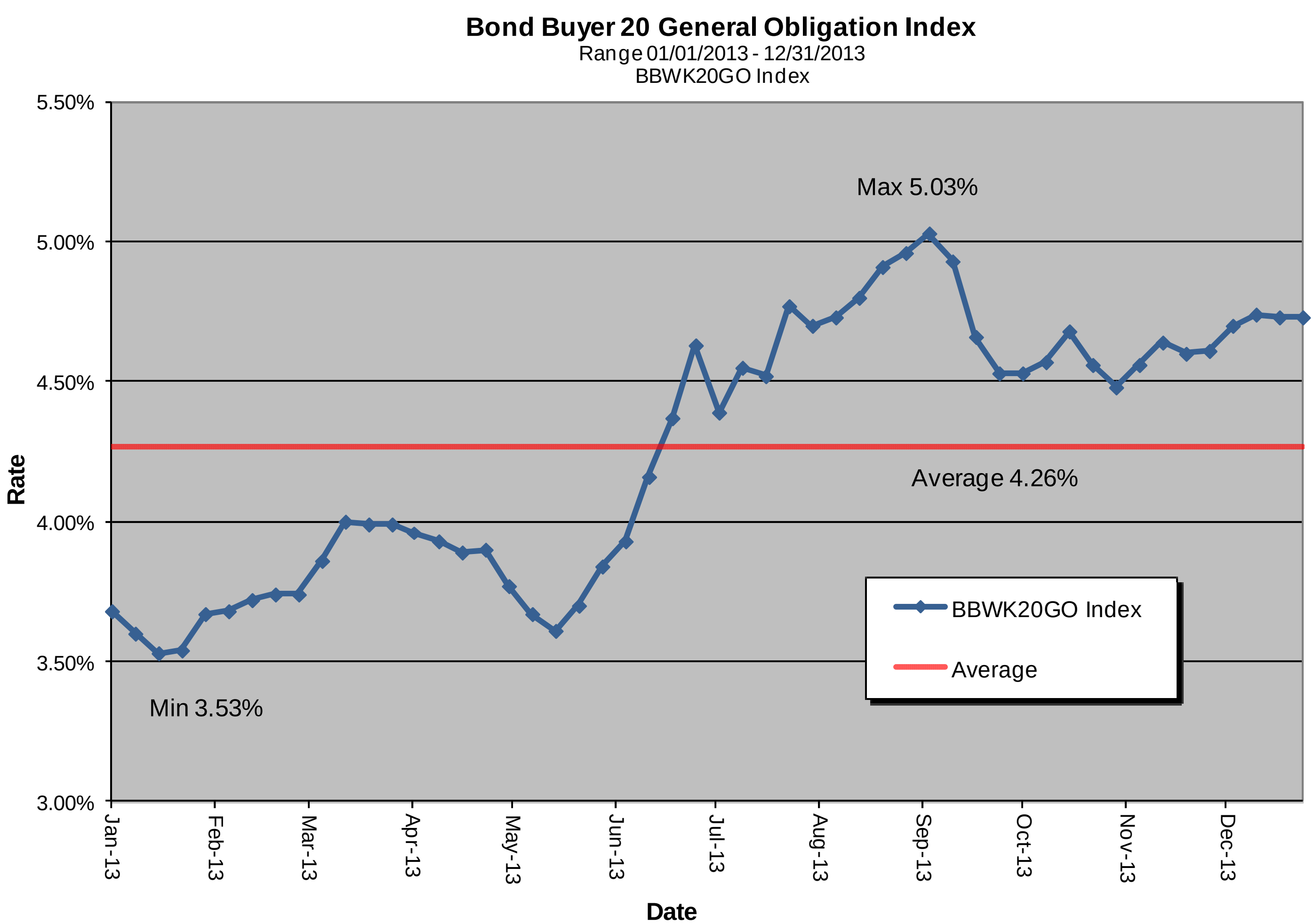


# INVESTMENT MANAGEMENT

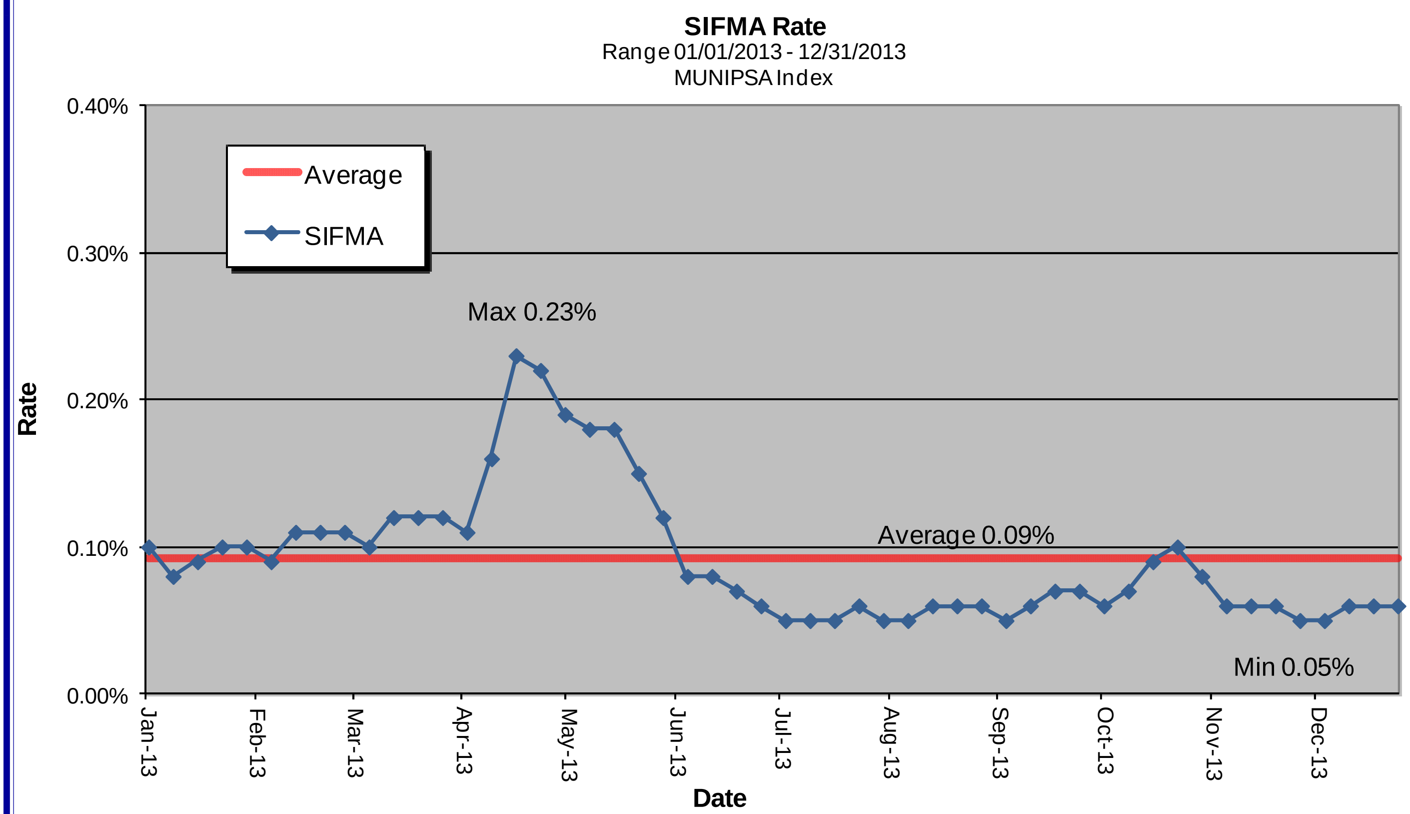
## *Tax-Exempt Interest Rates and Relationships*

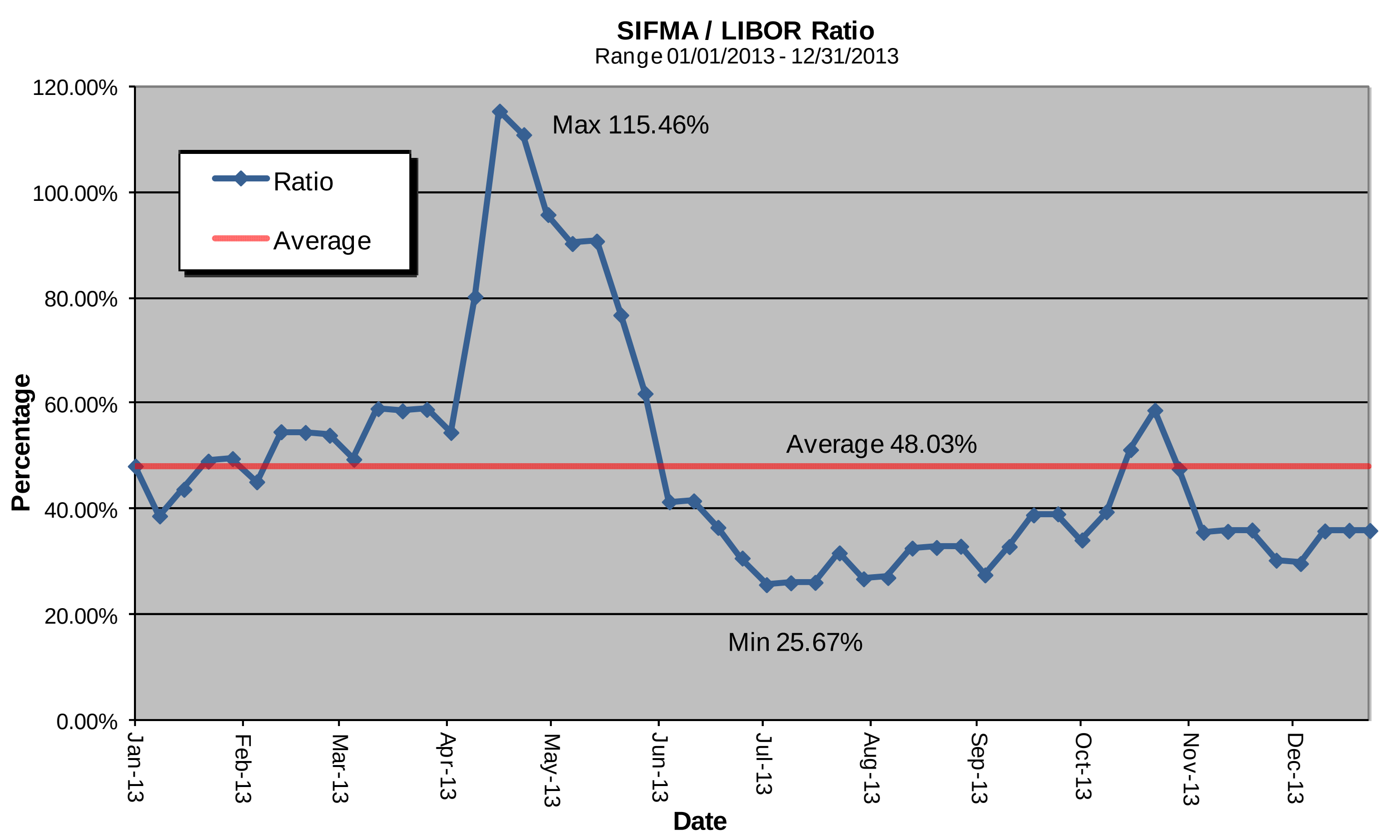
The Bond Buyer 20-year General Obligation Index averaged 4.26% for Calendar Year 2013. The high was 5.03% in September 2013, and the low was 3.53% in January 2013 with the year end at 4.73%.

The Securities Industry and Financial Markets Association (SIFMA) Municipal Swap Index averaged 0.09% for Calendar Year 2013. The high was 0.23% in April 2013, the low was 0.05% at several times throughout the reporting period, and it ended the year at 0.06%. The 30-day USD London Interbank Offered Rate (LIBOR) averaged 0.189% for Calendar Year 2013. The Calendar Year high was 0.208% in January 2013, the low was 0.165% in November 2013, and it ended the year at 0.167%. During the year, SIFMA traded at a high of 115.46% of the 30-day LIBOR in April 2013, at a low of 25.67% in January 2013, and at an average of 48.03% for the year. The year ended with SIFMA at 35.93% of the 30-day LIBOR.



# SIFMA & 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 authorized 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, Agency Restricted Fund, and Federal 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, and $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 authorization listed above has been permanently financed.

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 authorizes 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 $259.6 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 Phase I E-Case and Docket Management system capital project totaling $28.1 million to be issued through the 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.

As of December 31, 2013, the unissued balances of bond authorizations from the General Assembly prior to and including 2013 were:

General Fund - $214.17 million

Road Fund - $223 million

Agency Restricted Fund - $320.68 million

Federal Highway Trust Fund - $330 million

# DEBT MANAGEMENT

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. Unfunded liabilities in the state pension funds, the softening in the national and state economies over the past few years, and the debt portfolio have continued to put pressure on the Commonwealth's credit ratings.

In July of 2013, Fitch Ratings affirmed their ratings of "A+" with a "stable" outlook on certain stand-alone grant anticipation revenue vehicle (GARVEE) notes 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 Title 23 funds from the Federal Highway Administration (FHWA) to pay debt service depends on the strength, stability and reliability of the Federal program that authorizes outlays from the Highway Trust Fund (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 plans to use available cash balances in a delay of federal funding. In August of 2013, Fitch Ratings affirmed their ratings 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 July 2013, S&P affirmed their ratings of "AA" with a "stable" outlook on certain stand-alone grant anticipation revenue vehicle (GARVEE) notes 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 additional debt plans that are expected to yield continued high debt service coverage. The stable outlook reflects their expectation that the long-standing Federal Highway Trust Fund program will continue to receive significant funding and that Kentucky will receive its historical share of annual Title 23 distributions. The outlook also reflects the expectation that federal reimbursement revenue and state transportation fund revenues will continue to pro-

# DEBT MANAGEMENT

vide 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 September of 2013, S&P affirmed their ratings of "AA+" with a "stable" outlook on certain Road Fund lease supported bonds. 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 authority'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 our expectation that appropriations will continue to be made without interruption, thus preventing the authority's need to turn to motor fuel taxes. S&P expects that the Road Fund will continue to 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 adopted legislation, or both, as well as increased bond issuances that would cause coverage levels to decrease.

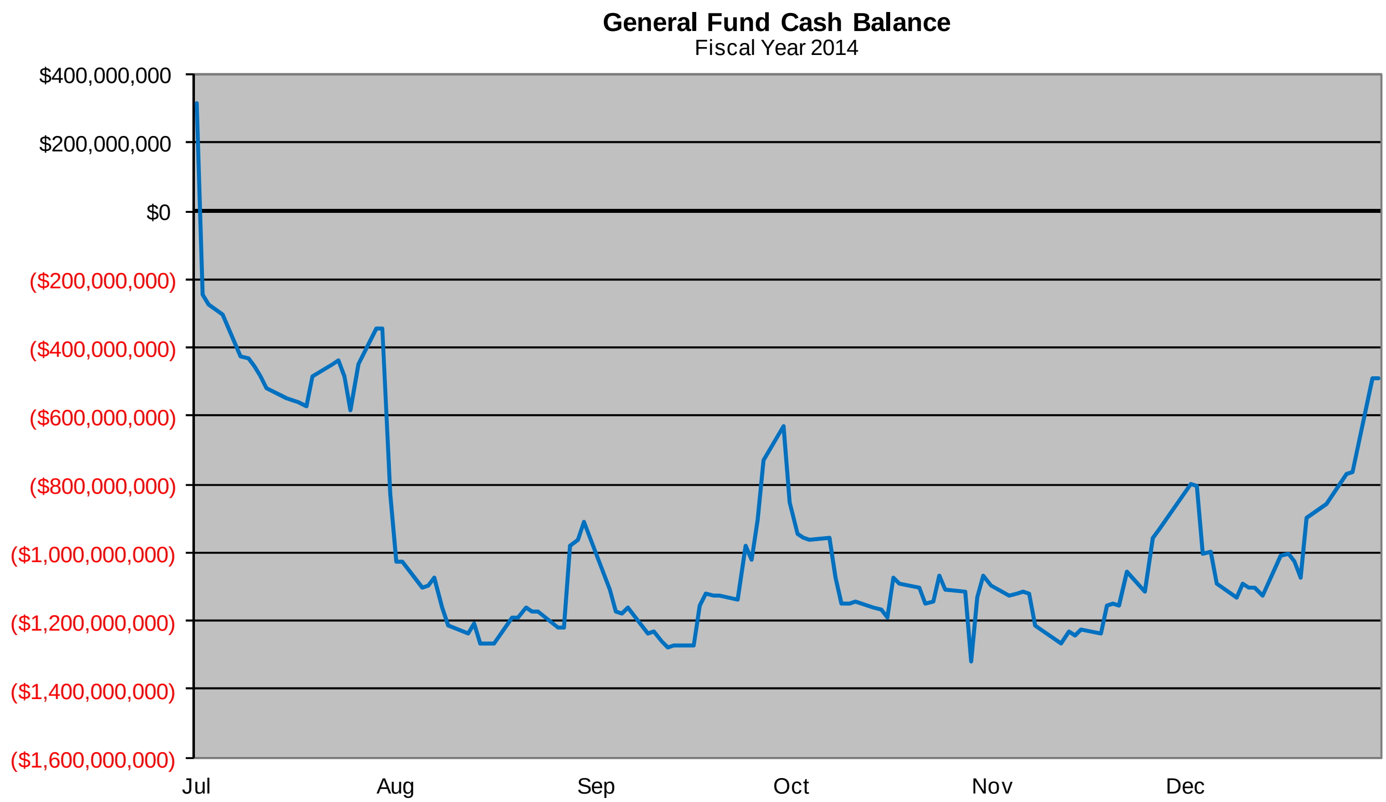
## *Tax and Revenue Anticipation Notes (TRAN)*

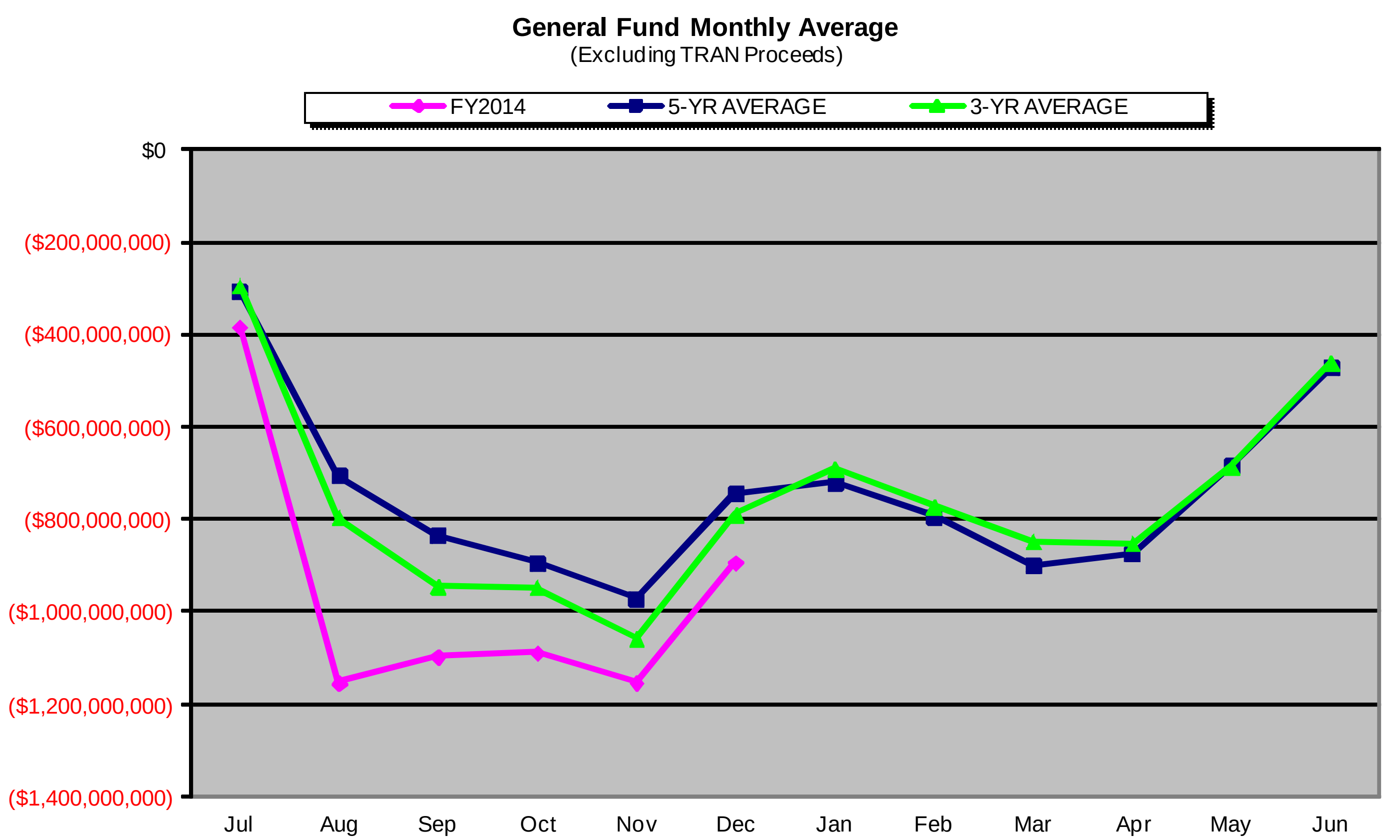
No General Fund TRAN was issued for Fiscal Year 2014. As in the previous four fiscal years, current reinvestment yields on TRAN proceeds would not be significantly higher than the cost of funds for a TRAN. At this time, borrowing internally from the state investment pools continues to be the most efficient 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 |

**($ in millions)**

# DEBT MANAGEMENT



# DEBT MANAGEMENT

## *FINANCIAL AGREEMENTS*

As of December 31, 2013, 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 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 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 Baa1 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, 2013 are presented in Appendix A.

# DEBT MANAGEMENT

## ASSET/LIABILITY MODEL

### General Fund

The total SPBC debt portfolio as of December 31, 2013 had $3,873 million of bonds outstanding with a weighted average coupon of 5.09 percent and a weighted average life of 7.49 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 $1,292 million callable portion had a weighted average coupon of 5.09 percent.

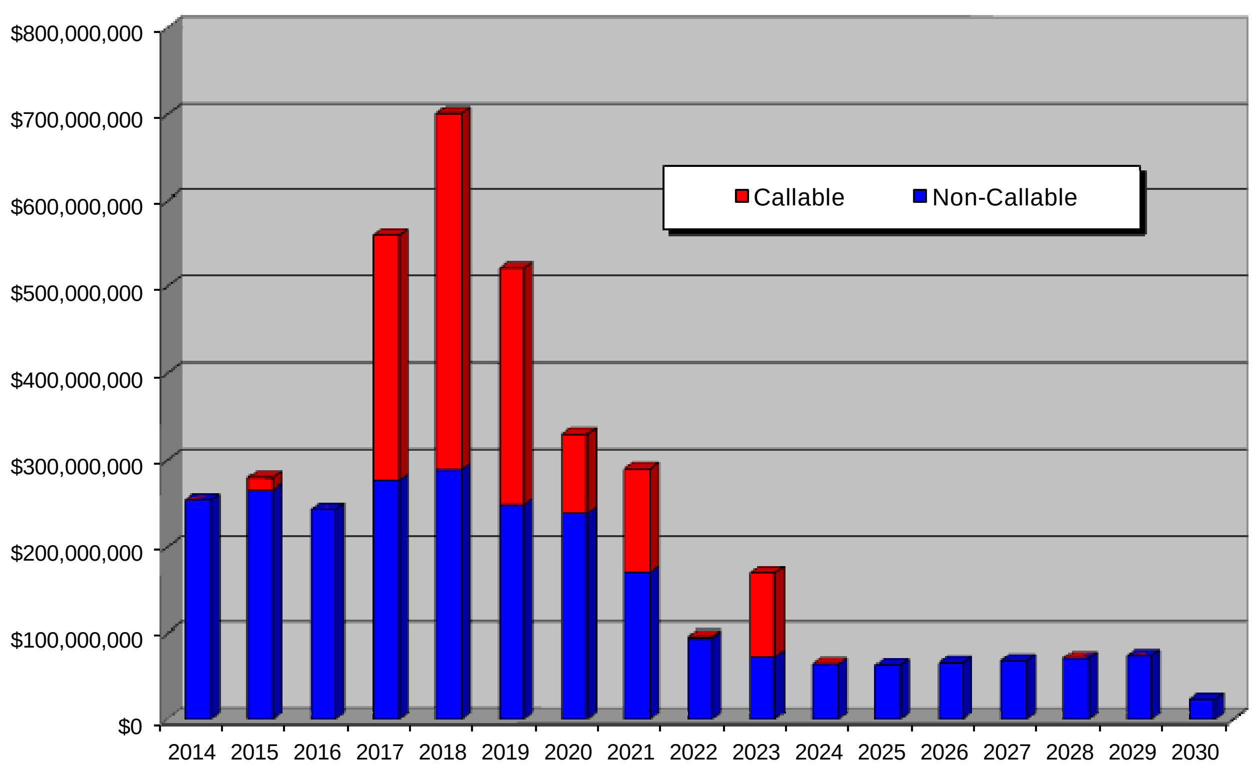
The SPBC debt structure has 35 percent of principal maturing in 5 years and 70 percent of principal maturing in 10 years. The ratios are outside of the rating agencies' proposed target of 27-30 percent due in 5 years and 55-60 percent maturing within 10 years, primarily influenced by debt restructuring 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.

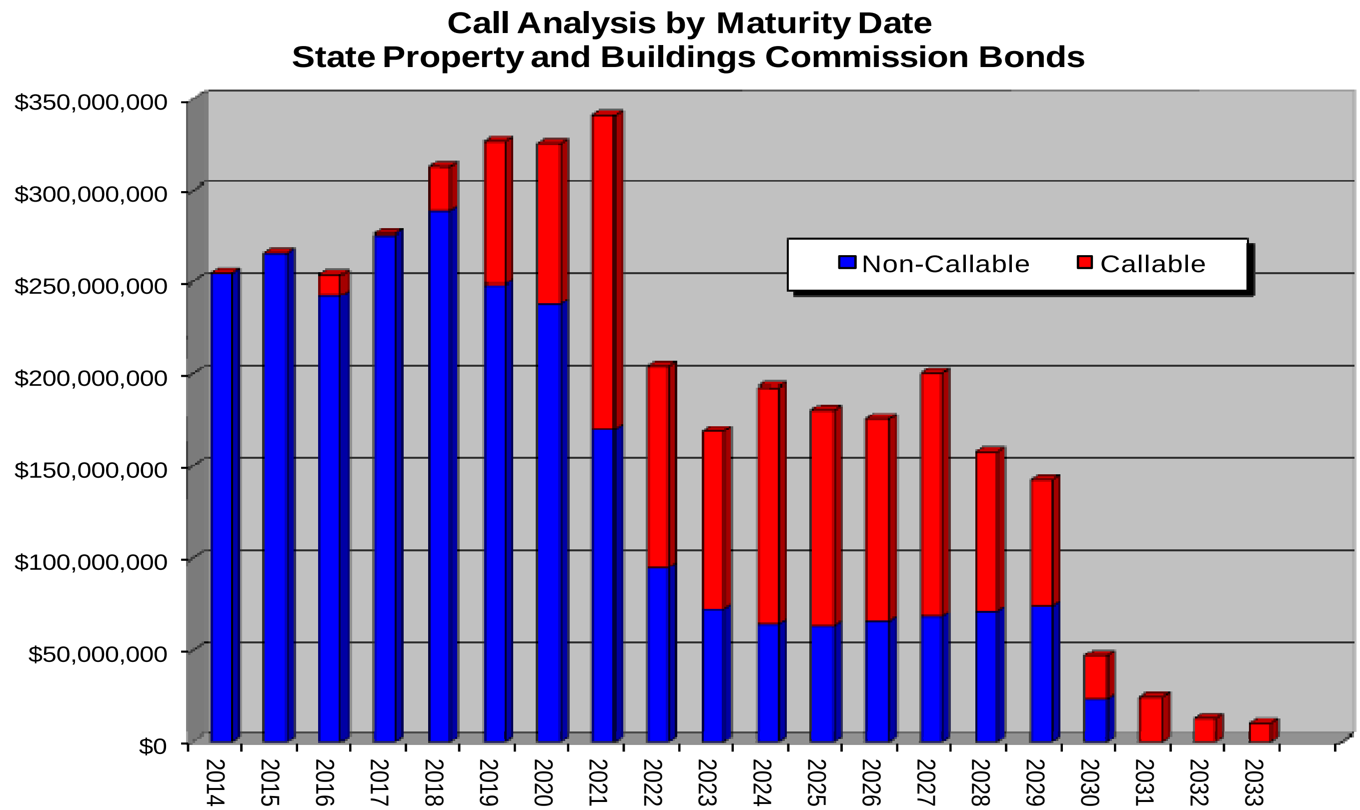
The average and median balances were negative $966.8 million and negative $1.094 billion, respectively. Since the General Fund continued to have a negative available cash balance for the fiscal year to date, there is little, if anything, that can be done from an asset management point of view beyond current actions.

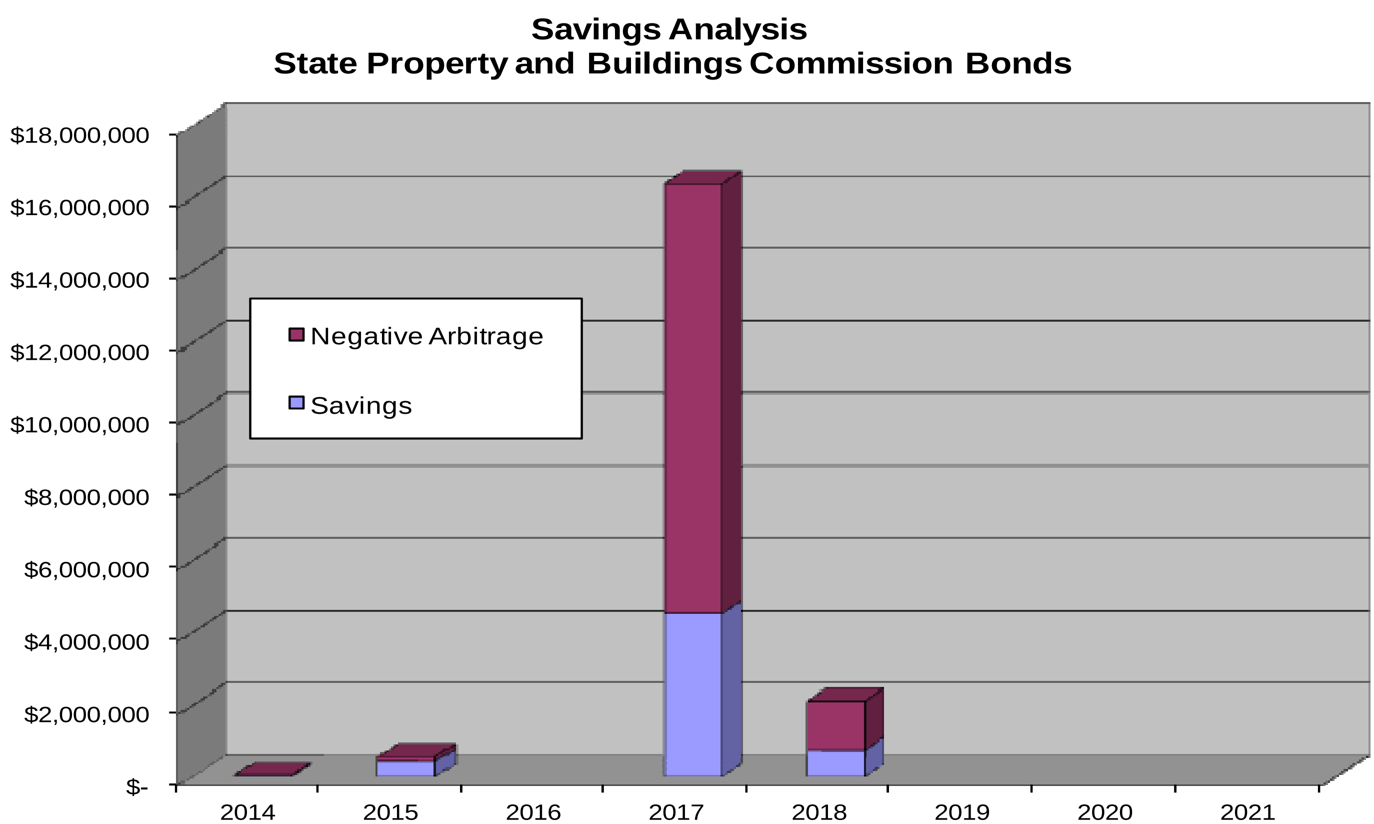
From a liability management perspective, total General Fund debt service, net of credits is expected to be $666.9 million for Fiscal Year 2014. Net interest margin will continue to be negative due to low cash balances versus outstanding fixed rate debt, low level of interest rates, and the callability of the debt portfolio.

**Call Analysis by Call Date**
**State Property and Buildings Commission Bonds**



# DEBT MANAGEMENT



# DEBT MANAGEMENT

## *Road Fund*

The Road Fund average daily cash balance for the first half of Fiscal Year 2014 was $567 million compared to $577 million for the first half of Fiscal Year 2013. The Road Fund cash was invested in the Intermediate Term Investment Pool which had a duration of 1.5 years as of December 31, 2013. The Road Fund earned $0.9 million on a cash basis for the first half of Fiscal Year 2014 versus $2.1 million for the first half of Fiscal Year 2013. The continued relatively low level of investable balances at certain times during the fiscal year limits the investment opportunities.

As of December 31, 2013, the Turnpike Authority of Kentucky (TAK) had $1.539 billion of bonds outstanding with a weighted average coupon of 4.83 percent and an average life of 8.80 years.

Road Fund debt service paid in Fiscal Year 2014 is expected to be $153.3 million, resulting in a net interest margin (investment income earned year-to-date less debt service paid) of negative $152.4 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.

## *TAK 2013 Series A*

On October 2, 2013, TAK closed a $187,625,000 issuance of Economic Development Road Revenue Bonds (Revitalization Projects), the proceeds of which will be used to pay the costs of certain additions and improvements to the Kentucky Economic Development Road System (Revitalization Projects) and to pay for costs of issuance. The bond proceeds represent $200 million of a $400 million authorization by the 2010 Extraordinary Session of the General Assembly. The projects being financed are highway projects approved within the Transportation Cabinet's Six-Year Highway Plan.

The transaction was sold on a negotiated basis on September 12, 2013 with Goldman, Sachs & Co. acting as senior manager and Peck, Shaffer & Williams LLP serving as bond counsel. Stites & Harbison, PLLC was underwriter's counsel.

The 20-year, level debt, tax-exempt financing had an All-In True Interest Cost of 4.14%, an average life of 12.1 years, a 10-year par call, and a final maturity of July 1, 2033. The bonds received ratings of Aa2/AA+/A+ from Moody's, S&P and Fitch, respectively.

## *ALCo 2013 GARVEEs*

In August of 2013, ALCo issued $212,545,000 of Project Notes, 2013 Federal Highway Trust Fund First Series A (GARVEEs). The proceeds of the notes are being used to finance (i) the costs of portions of the project and (ii) the costs of issuing the 2013 Notes. The financing for this project was authorized by House Bill 410 of the 2008 Regular Session of the General Assembly and House Bill 3 of the 2010 Extraordinary Session of the General Assembly.

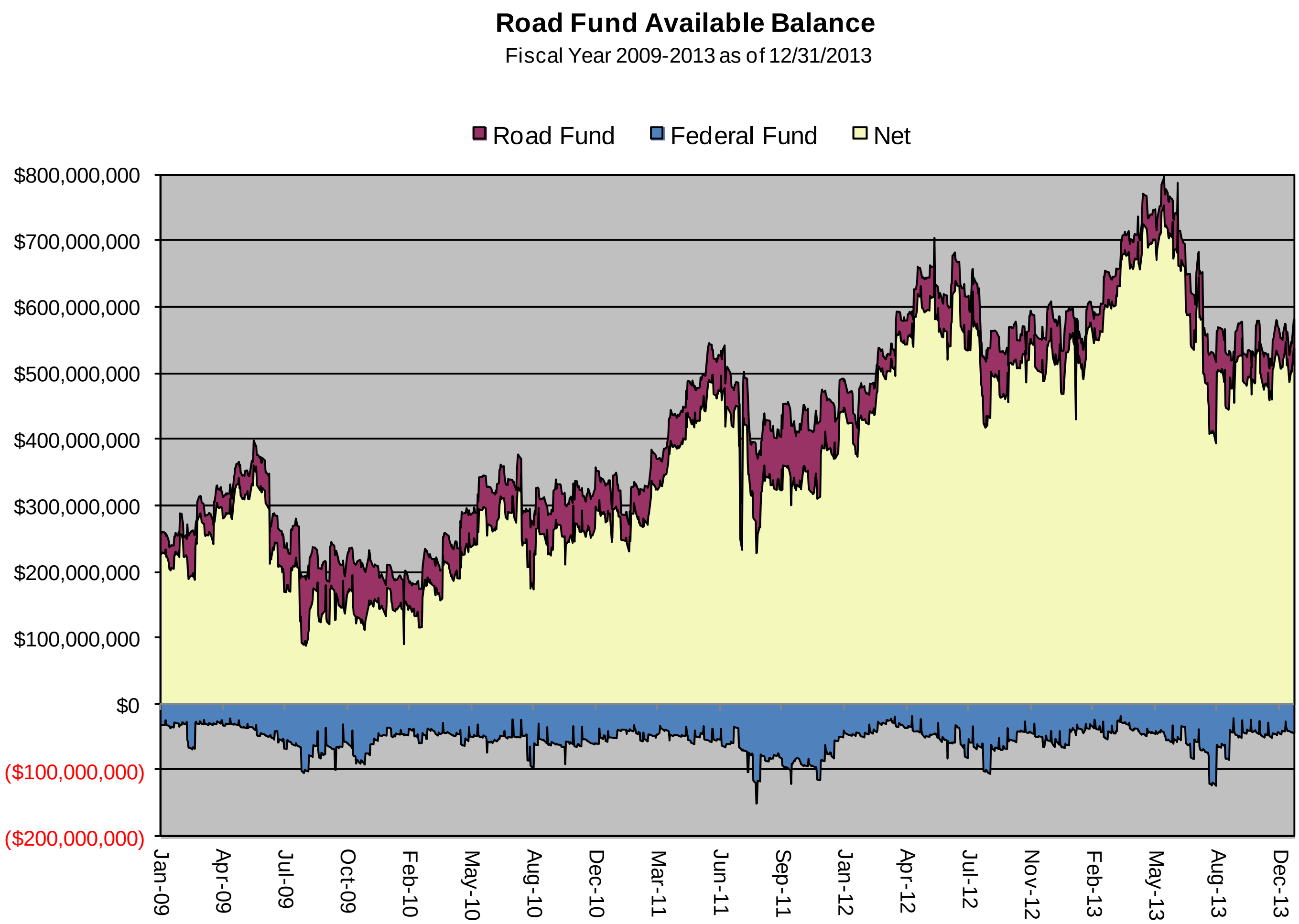
The portion of the project being funded by the 2013 Notes consists of project development activities related to the Kentucky portion of the Louisville-Southern Indiana Ohio River Bridges Project ("LSIORBP"). The major Kentucky components of the LSIORBP are (i) a new downtown bridge just east of the Kennedy Bridge (I-65), including the approaches to this bridge in Kentucky, from the south, and Indiana, from the north and (ii) a rebuild of the Kennedy Interchange where Interstate 64, Interstate 65 and Interstate 71 converge in downtown Louisville. Funding by the 2013 Notes for the Kentucky portion of the LSIORBP includes, but is not limited to, final design, right-of-way acquisition, utility relocation, the implementation of environmental mitigation and related design build construction.

# DEBT MANAGEMENT

The structure of the transaction was essentially a 12-yr wrapped debt financing consisting of serial bonds with maturities beginning in 2017 to help level, or smooth out, the GARVEE debt portfolio.

The bonds received ratings of Aa3/AA/A+ from Moody's, S&P and Fitch, respectively.

The transaction was sold via negotiated sale with Citigroup serving as senior managing underwriter and Kutak Rock LLP as bond counsel. The transaction was sold on schedule, received 59% in individual and professional retail orders and achieved rates with an All-In True Interest Cost of 3.387% with an average life on the bonds of 8.376 years.



# 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 four to 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)* | 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 | 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 December 31, 2013 (negative indicates payment owed by ALCo if terminated) | (757,053) | (7,080,318) | (8,081,751) | (10,341,741) |
| Interest Earnings (not applicable) | | | | |
| Total | not applicable | not applicable | not applicable | not applicable |

## Swap Summary

## As of December 31, 2013

**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**

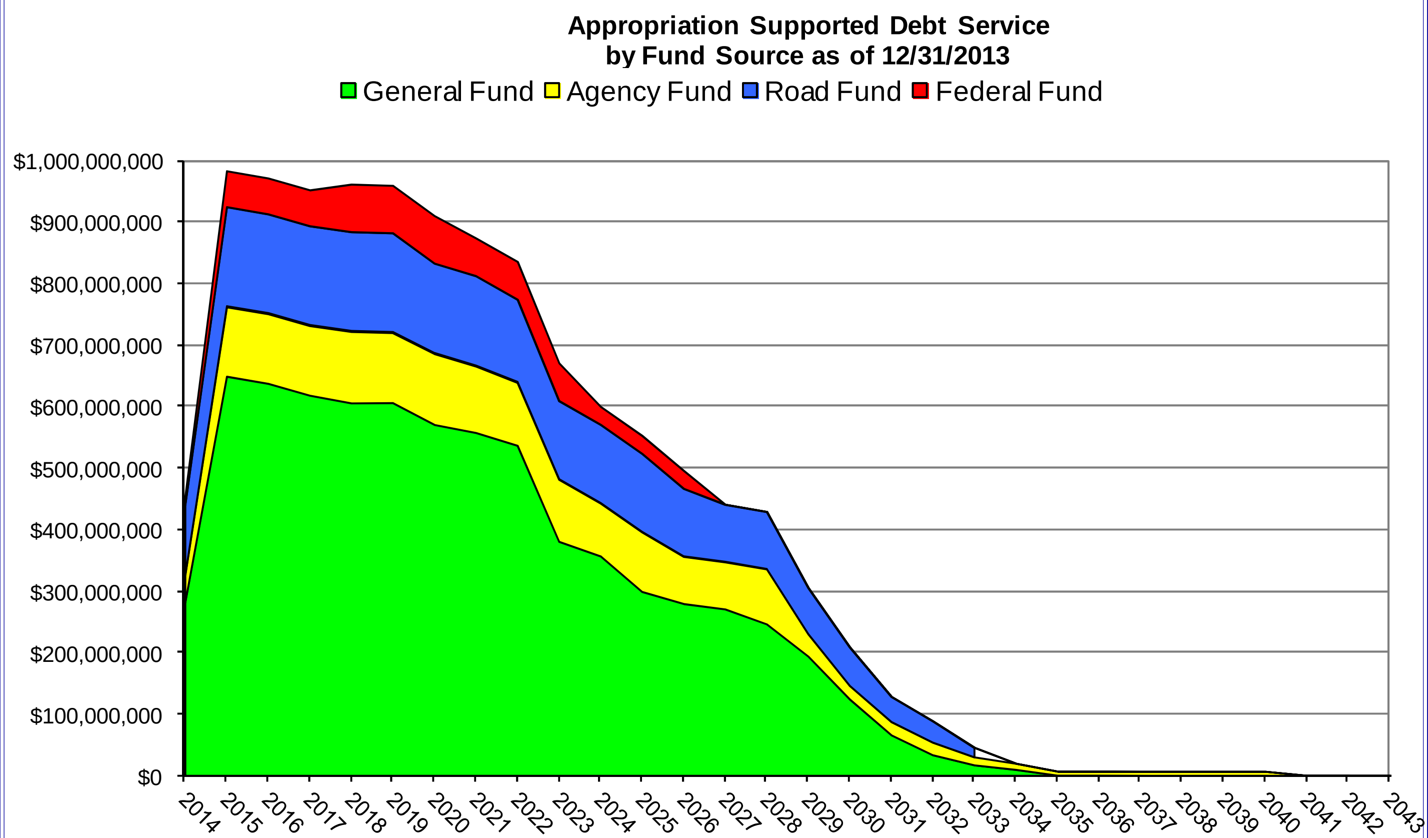
Deutsche Bank (assigned from Citibank on 2/14/2011)

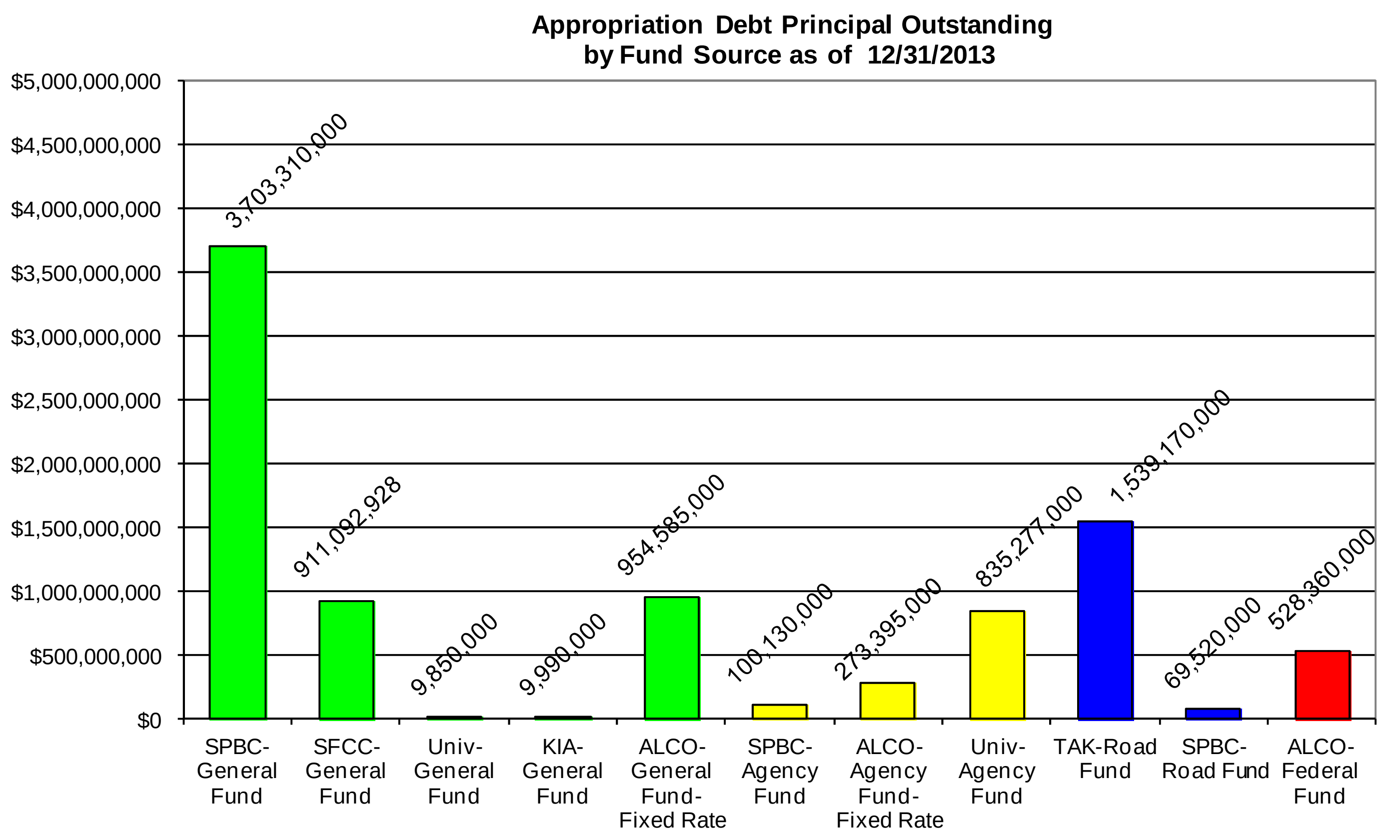
243,080,000

| | Debt: General Fund | Debt: Road Fund | 10 Percent Net Exposures: General Fund | 10 Percent Net Exposures: Road Fund |
|---|---|---|---|---|
| **Bonds Outstanding** | 4,657,895,000 | 1,608,690,000 | 465,789,500 | 160,869,000 |
| **Authorized but Unissued** | 214,169,000 | 223,000,000 | 21,416,900 | 22,300,000 |
| **Total** | 4,872,064,000 | 1,831,690,000 | 487,206,400 | 183,169,000 |

| Investment Pool Balances: Other Funds | Investment Pool Balances: Net Road Fund | 10 Percent Investment Portfolio: Other Funds | 10 Percent Investment Portfolio: Net Road Fund |
|---|---|---|---|
| 2,574,371,868 | 537,387,851 | 257,437,187 | 53,738,785 |

# APPENDIX B


Appropriation Supported Debt Service
by Fund Source as of 12/31/2013
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
2014 2015 2016 2017 2018 2019 2020 2021 2022 2023 2024 2025 2026 2027 2028 2029 2030 2031 2032 2033 2034 2035 2036 2037 2038 2039 2040 2041 2042 2043


Appropriation Debt Principal Outstanding
by Fund Source as of 12/31/2013
$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
3,703,310,000
911,092,928
9,850,000
9,990,000
954,585,000
100,130,000
273,395,000
835,277,000
1,539,170,000
69,520,000
528,360,000
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 12/31/13

| FUND TYPE<br>SERIES TITLE | | AMOUNT<br>ISSUED | DATE OF<br>ISSUE | MATURITY<br>DATE | PRINCIPAL<br>OUTSTANDING |
|---|---|---|---|---|---|
| **General Fund Project & Funding Notes** | | | | | |
| 2005 1st Series | | $81,850,000 | 6/2005 | 5/2025 | $57,480,000 |
| 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 | $306,750,000 |
| 2011 1st Series-KTRS Funding Notes | | $269,815,000 | 3/2011 | 4/2022 | $232,445,000 |
| 2013 1st Series-KTRS Funding Notes | | $153,290,000 | 2/2013 | 4/2023 | $153,290,000 |
| | **FUND TOTAL** | **$1,215,590,000** | | | **$954,585,000** |
| **Agency Fund Project Notes** | | | | | |
| 2005 1st Series | | $11,275,000 | 6/2005 | 6/2025 | $8,215,000 |
| 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** | | | **$273,395,000** |
| **Federal Hwy Trust Fund Project Notes** | | | | | |
| 2005 1st Series | | $139,635,000 | 6/2005 | 9/2017 | $54,455,000 |
| 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 |
| | **FUND TOTAL** | **$719,800,000** | | | **$528,360,000** |
| **ALCo NOTES TOTAL** | | **$2,278,660,000** | | | **$1,756,340,000** |

## 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

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