Semi-Annual Report
of the
Kentucky Asset/Liability Commission

31ST EDITION

Steven L. Beshear

Governor

Commonwealth of Kentucky

Lori H. Flanery

Secretary

Finance and Administration Cabinet

F. Thomas Howard

Executive Director

Office of Financial Management

For the period ending June 30, 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-first semi-annual report pursuant to KRS 56.863 (11) for the period beginning January 1, 2012 through June 30, 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 three straight years of growth but remains well below previous recoveries with average real growth of 2.2% during this time period.
- The unemployment rate, while well below the peak of 10.0% in 2009, has stabilized at 8.2% during the first half of Calendar Year 2012. The growth in nonfarm payrolls, while still positive, has fallen to less than 100,000 per month.
- The Federal Reserve continues to target Federal Funds in the range of 0.00 to 0.25 percent. The Fed is considering additional "quantitative easing" measures to further spur the economy but has shown no action as of June 30, 2012.
- Sovereign credit problems continue in Europe with Spanish banks requiring support and the market yields on both Spain and Italy indicating that further support may be necessary.
- During this period, Moody's Investor Service revised its ratings criteria for banks resulting in numerous downgrades of large banks both domestically and internationally.

On the state level

- General Fund receipts totaled $9,091.0 million for Fiscal Year 2012. General Fund receipts increased 3.8% for Fiscal Year 2012 over the same period in Fiscal Year 2011. Final General Fund receipts for Fiscal Year 2012 were $83.3 million, or 0.9 percent, more than the official revenue estimate which projected 2.8 percent growth.
- Road Fund receipts for Fiscal Year 2012 totaled $1,443.8 million. Fiscal Year 2012 Road Fund receipts increased 7.8% over Fiscal Year 2011. Final Road Fund receipts for Fiscal Year 2012 were $31.3 million, or 2.2 percent, more than the official revenue estimate which projected 5.5 percent growth.
- 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 17).
- Kentucky's seasonally adjusted unemployment rate stood at 8.2% at the end of June 2012, down from 9.6% one year ago.

INVESTMENT MANAGEMENT

MARKET OVERVIEW

During Fiscal Year 2012, the U.S. economy continued to struggle with below trend growth. For the year, growth in real GDP averaged 2.2% but trended lower towards the end of the year as growth fell to only 1.5% annualized in the final quarter. This tepid performance is being driven primarily by limited activity in the housing market and low levels of consumer spending. The month over month change in nominal retail sales had been, while not strong, at least positive since June 2010 until April of 2012. In April, May and June of 2012, retail sales fell by 0.5%, 0.2% and 0.5%, respectively. Because consumer spending accounts for roughly 70% of the overall economy, it is not possible to achieve high GDP growth without growth in retail sales.

On the bright side, at least some portion of this slowdown is attributable to weather and seasonal adjustment factors. Many economic indicators are seasonal in nature. For example, retail sales normally are stronger in December than any other month because of Christmas. The various entities reporting economic statistics routinely adjust the results for these factors.

The U.S. experienced unusually mild weather during January and February of this year. This mild weather front loaded some seasonal spending, including car sales and home improvements, from the second quarter to the first quarter. The normal seasonal adjustments artificially add economic activity to the first calendar quarter and reduce activity in the second quarter. Combining the weather and the seasonal adjustments indicates that at least some of the slowdown in the second quarter, mentioned in the first paragraph, is related to reporting conventions rather than actual experience.

Employment statistics show a similar pattern. The change in nonfarm private payrolls, the net number of people hired by the private sector, hit a six-year high of 277,000 in January of 2012. This growth in new jobs, while still positive, has fallen to only 274,000 during the entire second calendar quarter. This level of net job creation is not enough to offset population growth meaning that the unemployment rate (number of people actively looking for jobs divided by the total workforce) will not experience marked improvement until more hiring commences.

Again, these statistics are affected by the weather and by seasonal adjustments. Generally, the construction industry experiences lay-offs during the first quarter as weather prevents construction projects. The laid-off individuals are then re-hired during the second quarter as the construction on projects resumes. The statistics are adjusted to reflect this experience. During the last six months, the construction industry did not experience as many or typical levels of lay-offs in the first quarter as the weather was mild. In the second quarter, there was no need to re-hire individuals laid-off in the first quarter, as there were not many, and the low levels of construction activity did not require many new workers in the second quarter.

The Federal Reserve has maintained stimulative monetary policy since late 2008. The Federal Funds Rate has remained near zero, while the Fed has initiated two "quantitative easing" programs of purchasing fixed income securities to drive interest rates down and initiated "operation twist" to drive longer term primarily mortgage interest rates down. Although there have been calls for further action due to the second quarter slowdown, the Fed has resisted additional stimulus until it is clear that the slowdown is real as opposed to a statistical anomaly.

Over the next six to twelve months, the economy faces three significant head winds. First, an extensive drought across much of the U.S.'s agricultural lands is pushing the price of corn and soybeans up. If it continues, inflation of food prices will create a drag on consumer spending. Second, the European economy continues to be turbulent because of the sovereign and bank debt problems. This may lead to a reduction in U.S. economic activity as exports to Europe fall. Finally, the U.S. may hit a "fiscal cliff" (Federal Reserve Chairman Ben Bernanke's term) at the end of the year as a variety of tax cuts and spending initiatives expire, and automatic sequestration of further federal spending begins. Some people predict that this may push the U.S. back into recession during 2013. With upcoming elections in November, a political solution may be difficult until the new year.

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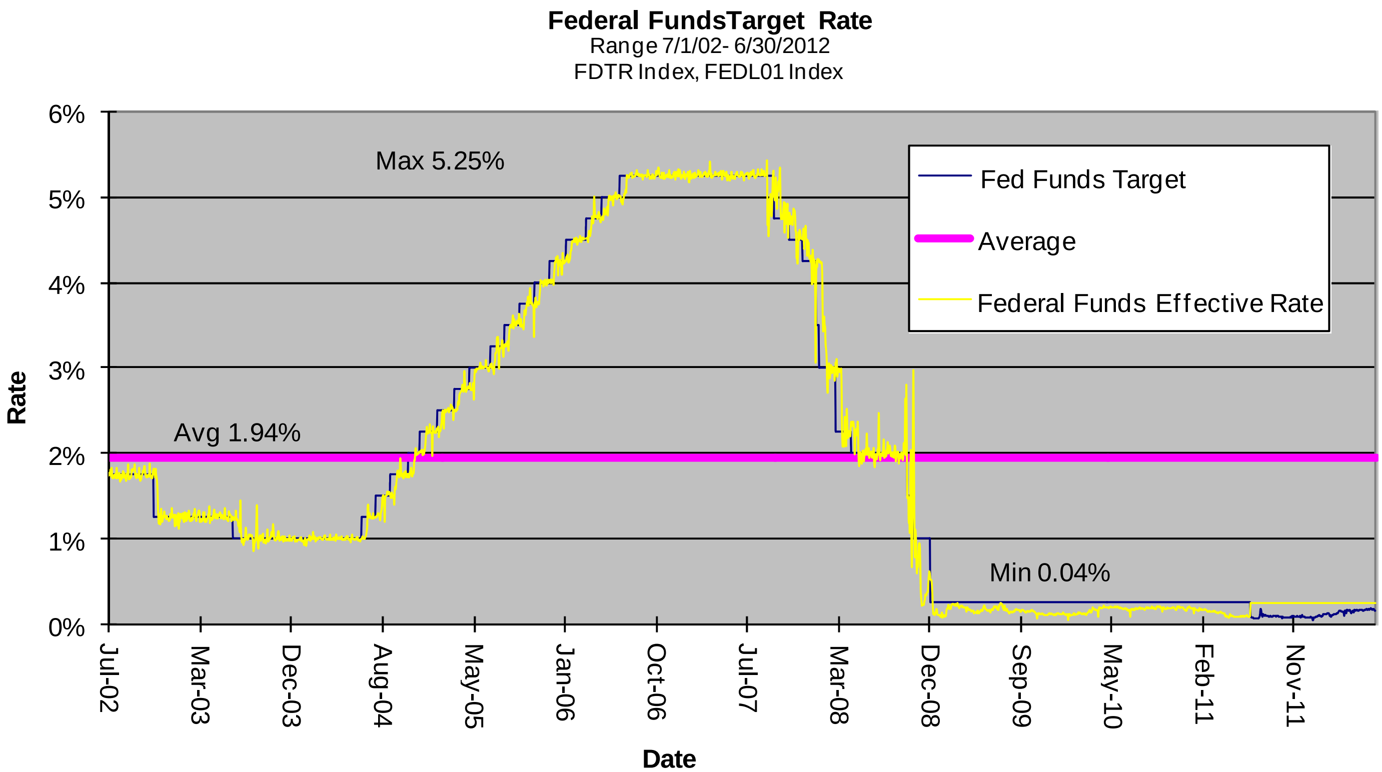
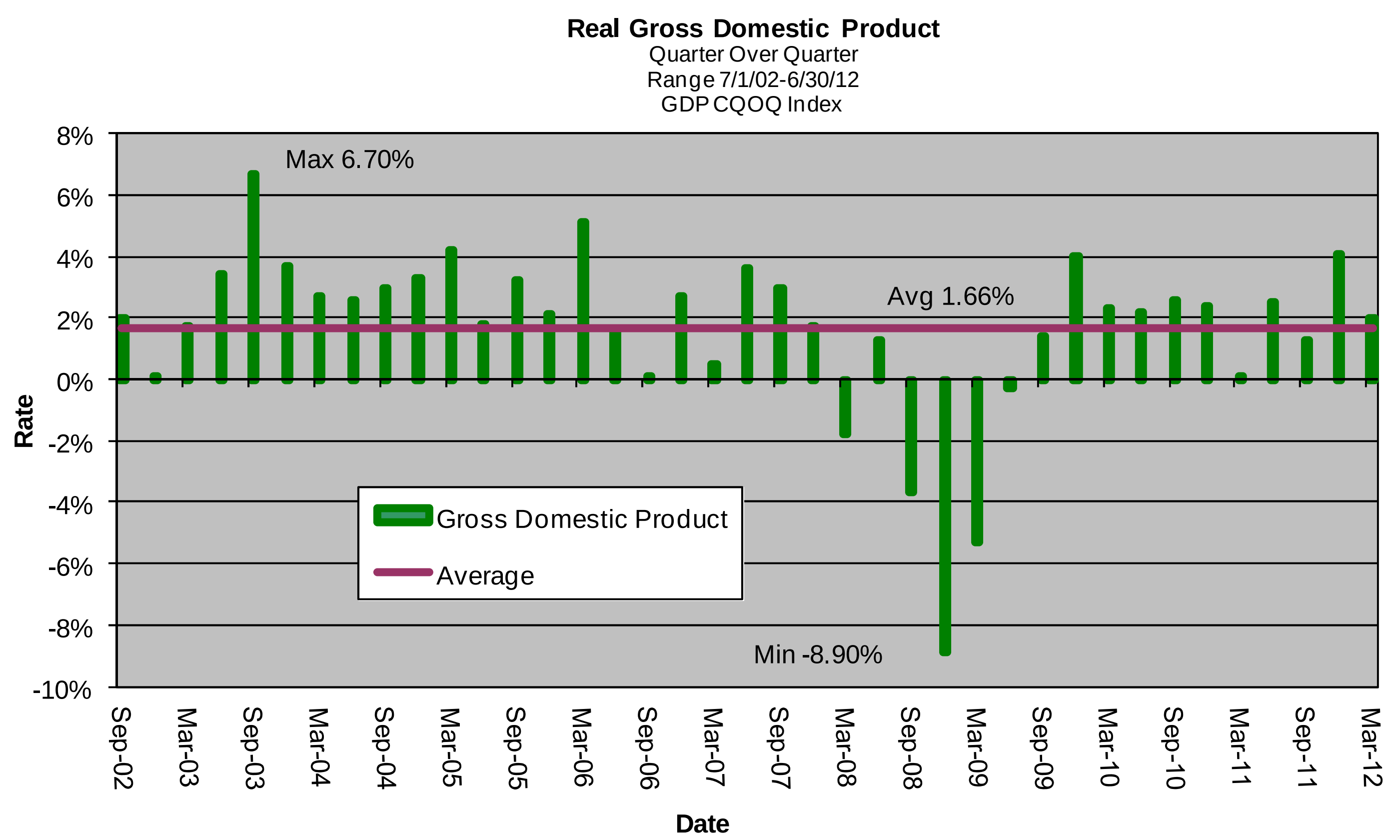
Federal Funds Target Rate & Real Gross Domestic Product





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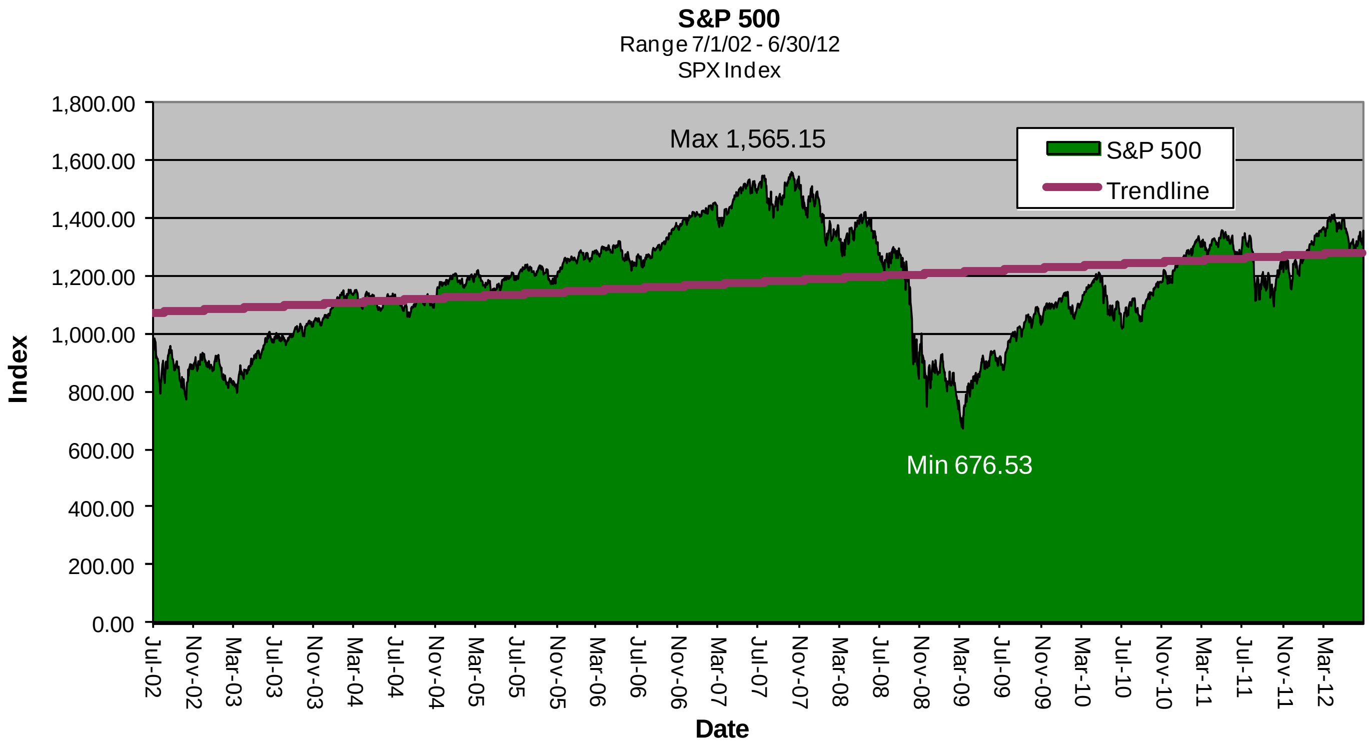
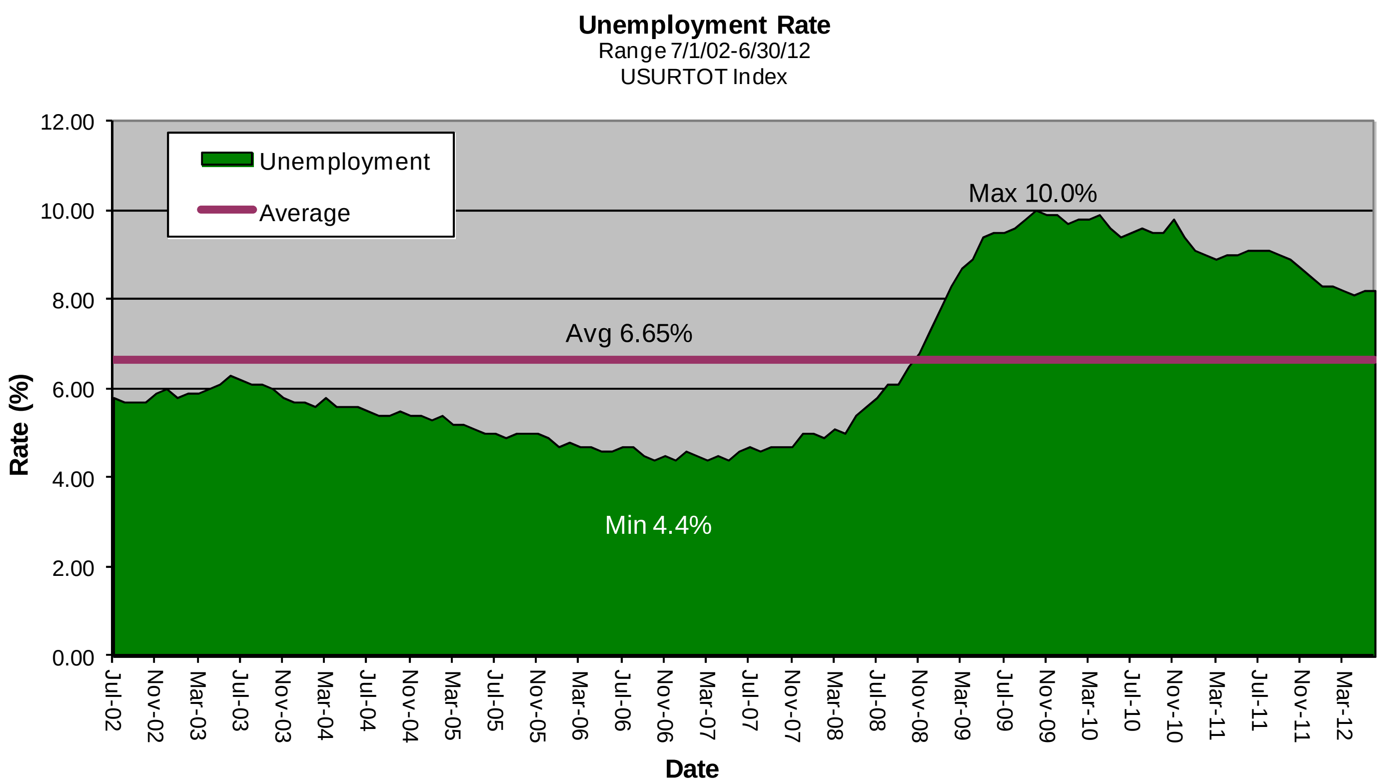
S&P 500 & Unemployment Rate





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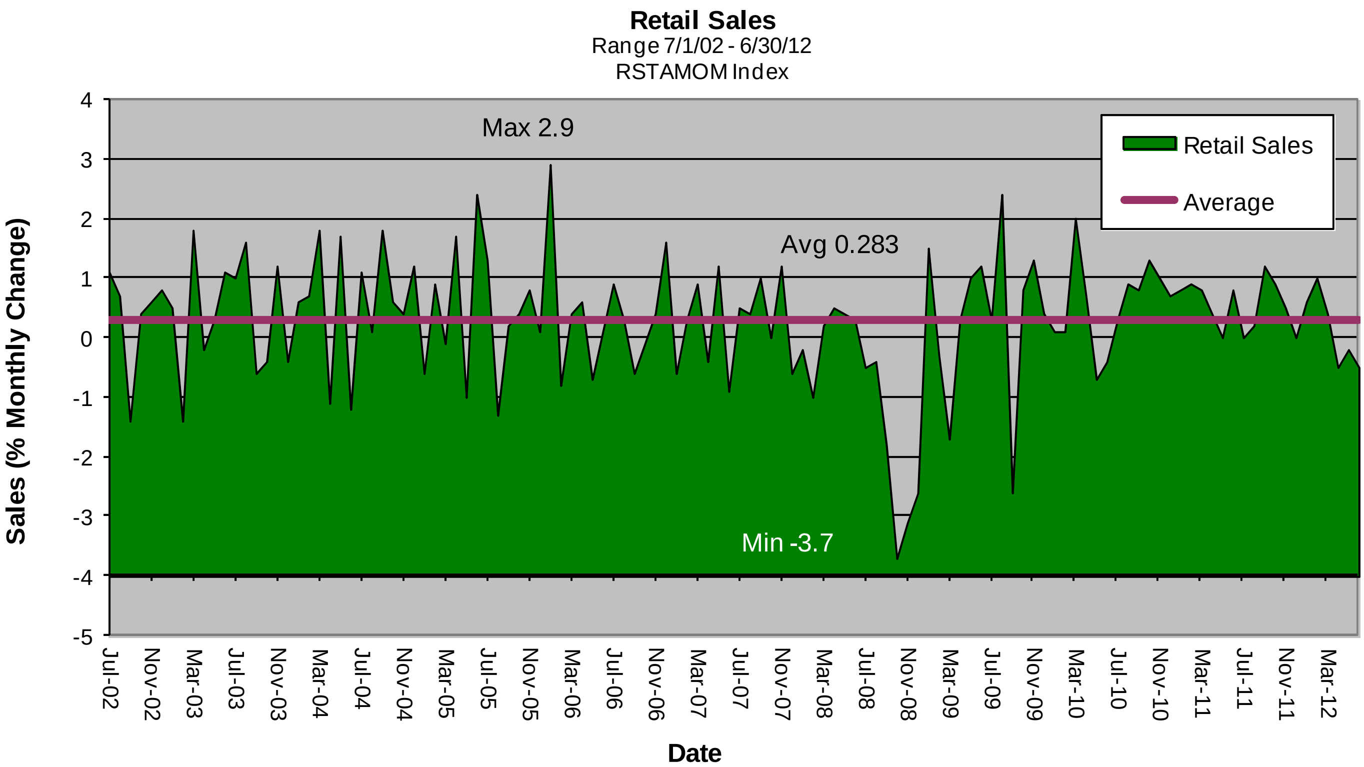
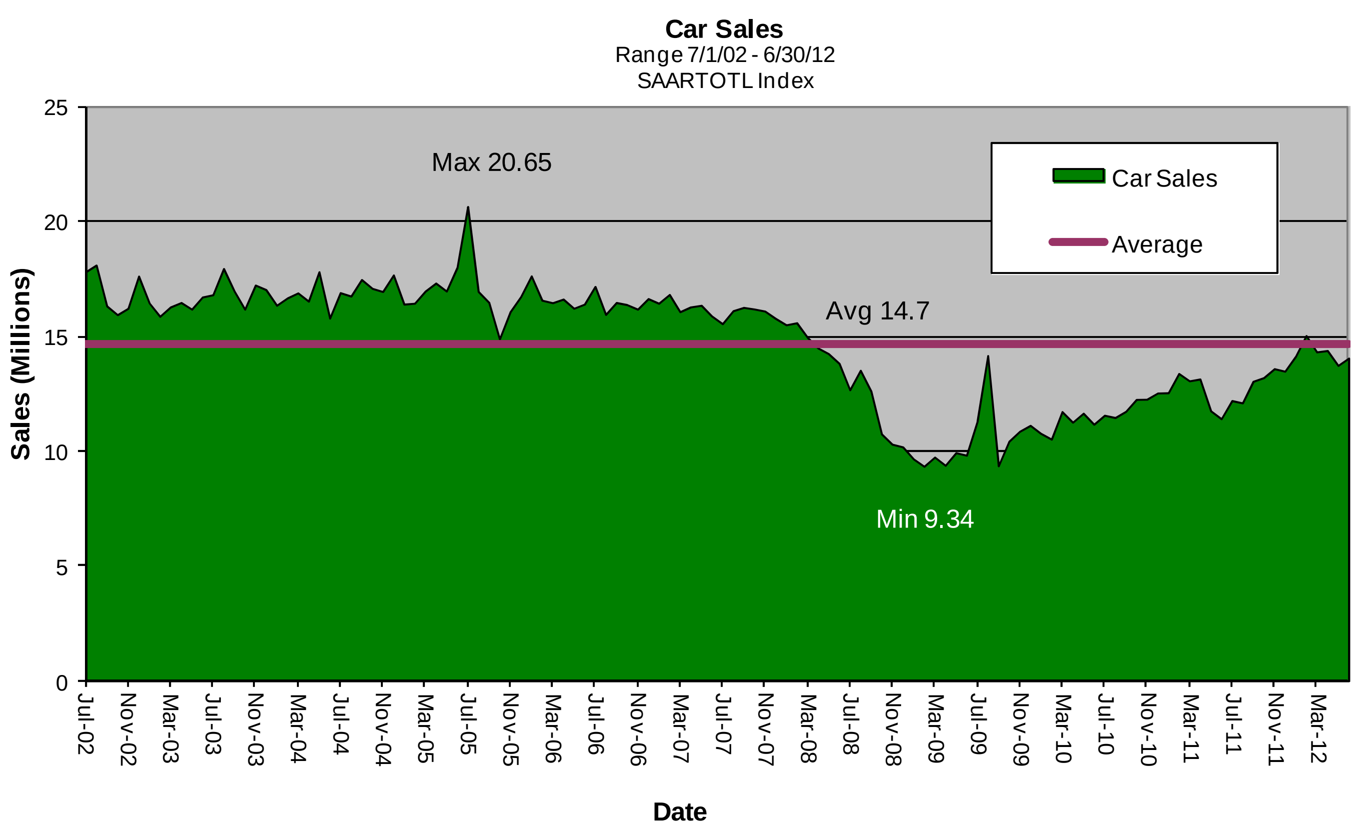
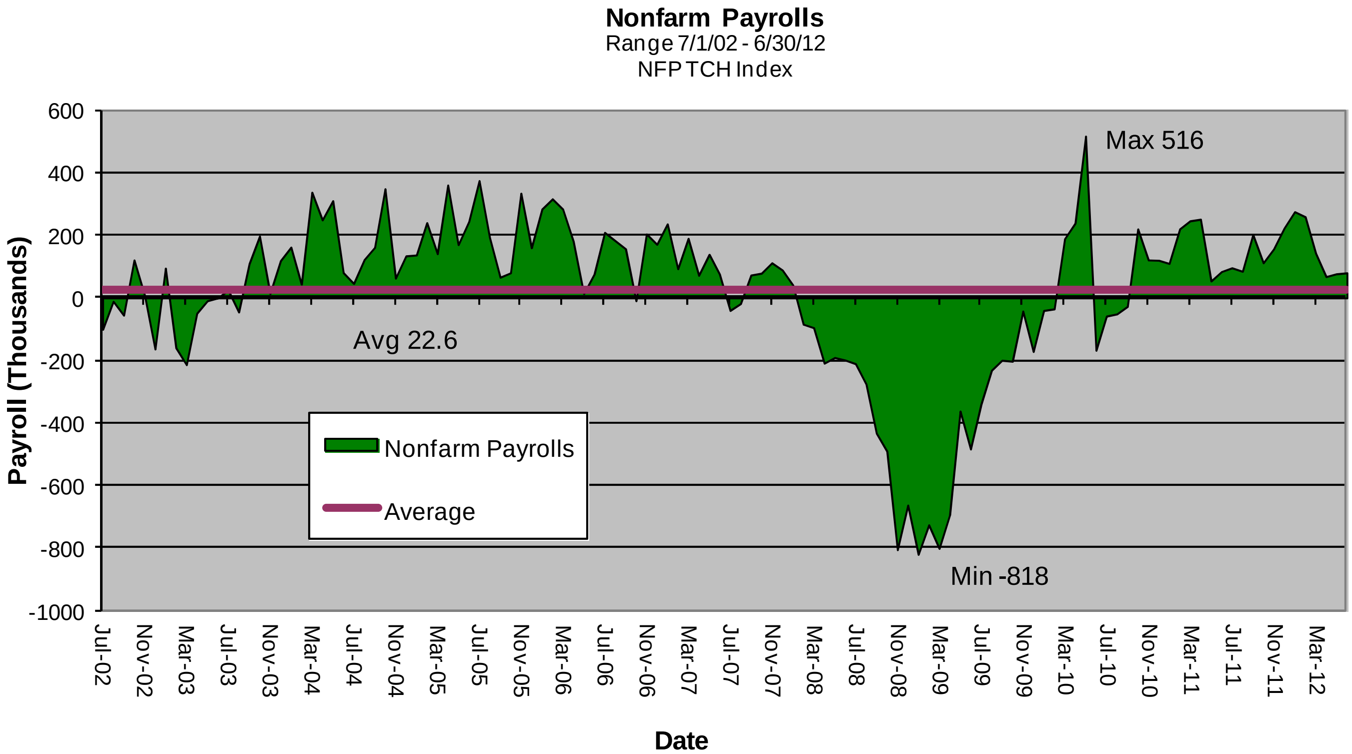
Retail Sales & Car Sales

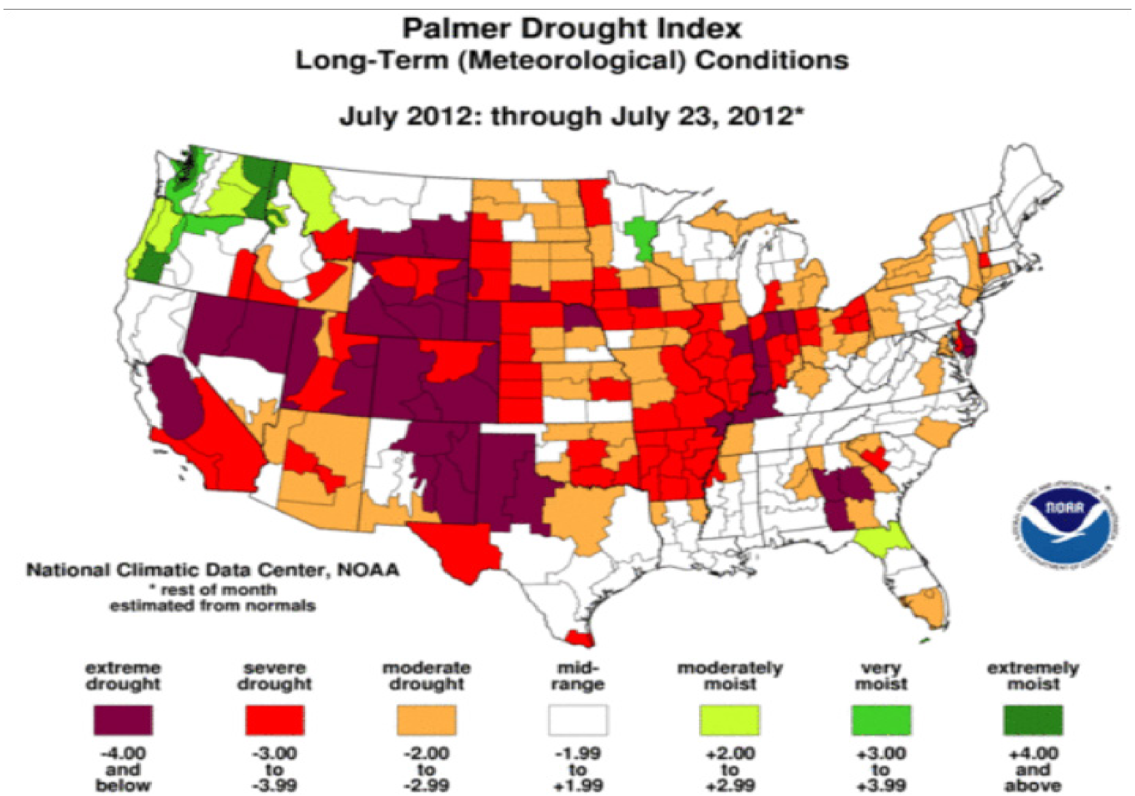




INVESTMENT MANAGEMENT

Nonfarm Payrolls & Palmer Drought Index





INVESTMENT MANAGEMENT

PORTFOLIO MANAGEMENT

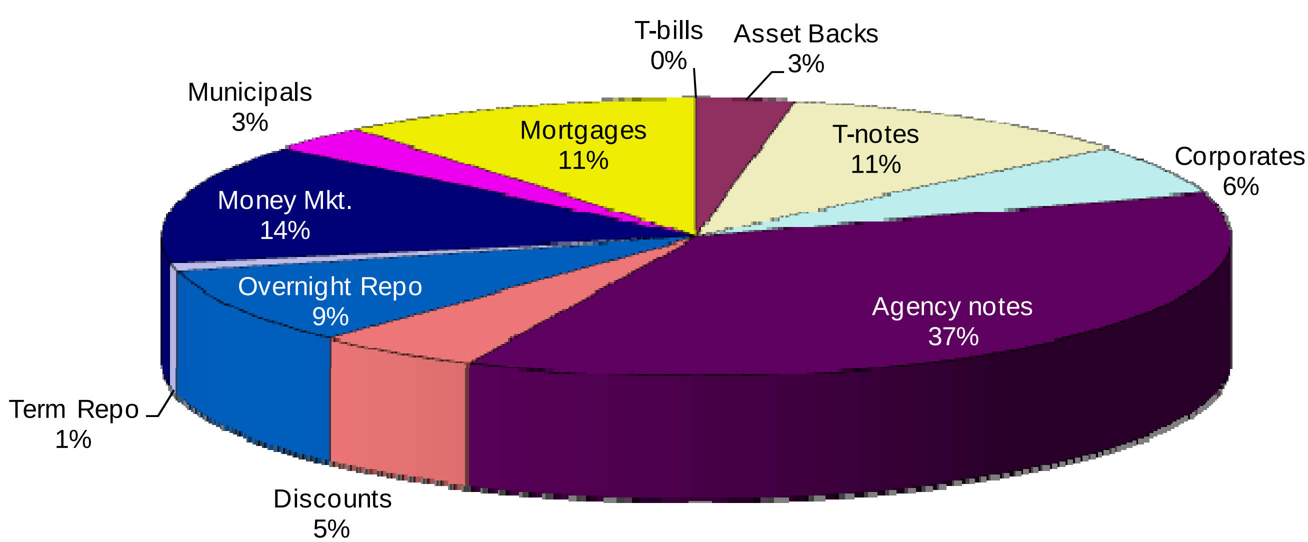
For the twelve months ended June 30, 2012, the Commonwealth's investment portfolio averaged \$3.5 billion. As of June 30, 2012, the portfolio was invested in U. S. Treasury Securities (11 percent), U. S. Agency Securities (42 percent), Mortgage Pass Through Securities (1 percent), Collateralized Mortgage Obligations (10 percent), Repurchase Agreements (10 percent), Municipal Securities (3 percent), Corporate Securities (6 percent), Asset-Backed Securities (3 percent), and Money Market Securities (14 percent). The portfolio had a market yield of 0.76 percent and an effective duration of 0.98 years.

The total portfolio is broken down into three investment pools. The pool balances as of June 30, 2012, were: Short Term Pool - \$147 million, Limited Term Pool - \$833 million, and Intermediate Term Pool - \$2,693 million.

During the first half of Calendar Year 2012, with approval of the State Investment Commission and the Office of the Controller, the Office of Financial Management ("OFM") adopted a full accrual accounting approach for distributing earnings from the pools. As a result, cash earnings are no longer distinct from full mark-to-market earnings since all earnings are distributed regardless of whether the cash earnings have been received. For the twelve months ending June 30, 2012, total investment income was \$19.8 million compared to \$38.6 million for the twelve months ended June 30, 2011. The drop in income during the fiscal year was due to recognition of unrealized losses on legacy assets from past TRAN programs required by the adoption of GASB 31.

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.

Distribution of Investments as of June 30, 2012



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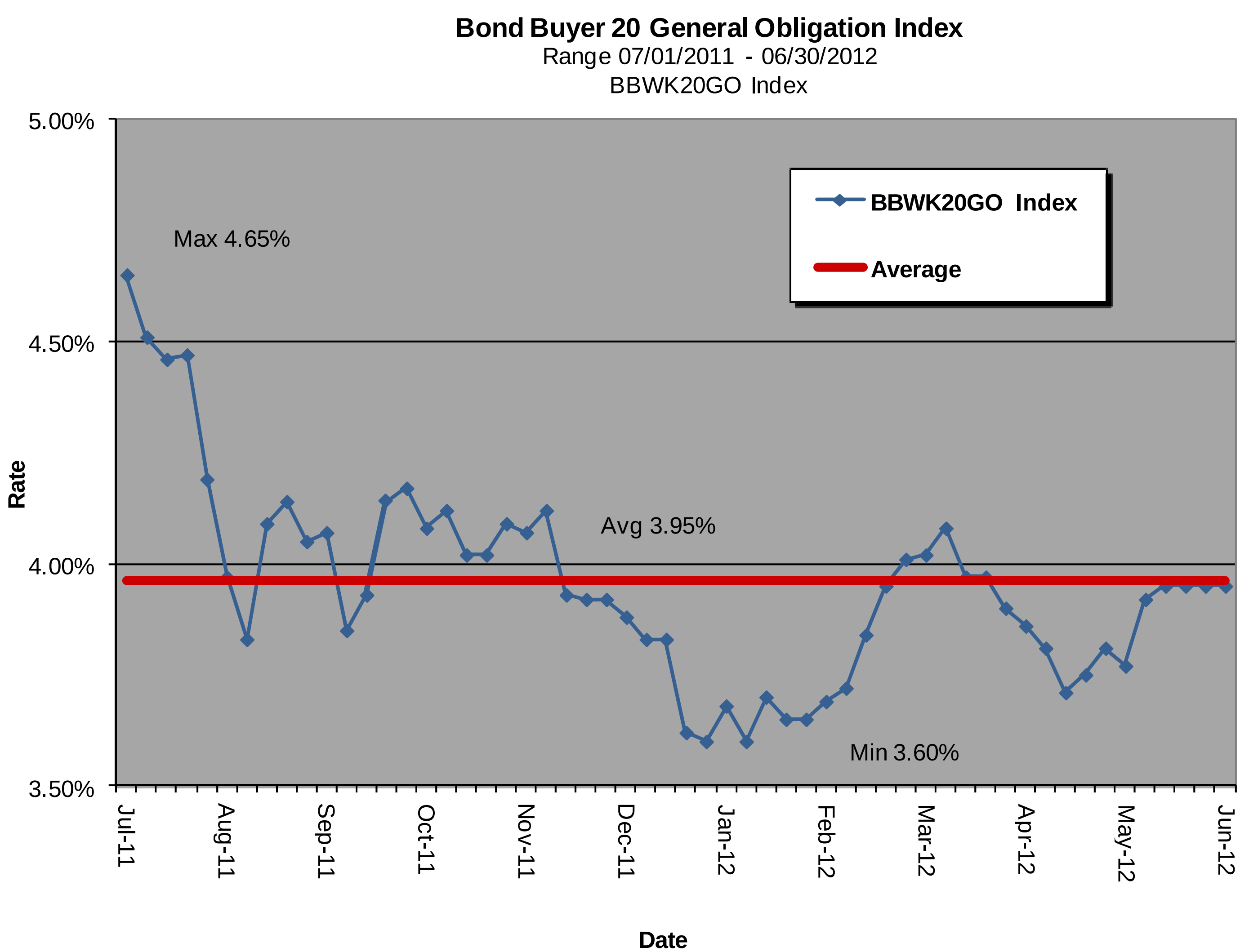
Tax-Exempt Interest Rates and Relationships

The Bond Buyer 20 year General Obligation Index averaged 3.82% for the reporting period and 3.95% for Fiscal Year 2012. The fiscal year high was 4.65% in July 2011 and the fiscal year low was 3.60% in January 2012 with the fiscal year end at 3.96%.

The Securities Industry and Financial Markets Association ("SIFMA") Municipal Swap Index averaged 0.17% for the reporting period and 0.15% for Fiscal Year 2012. The high was 0.26% in April 2012 and the low was 0.06% in January 2012 and it ended the fiscal year at 0.18%. The 30-day USD London Interbank Offered Rate ("LIBOR") averaged 0.25% for the reporting period and 0.24% for Fiscal Year 2012. The fiscal year high was 0.30% in December 2011 and the low was 0.19% in July 2011 and it ended the fiscal year at 0.25%. During the fiscal year, SIFMA traded as high as 95.92% of the 30-day LIBOR in August 2011 and as low as 20.36% in January 2012 with an average of 53.70% for the fiscal year. The fiscal year ended with SIFMA at 53.01% of the 30-day LIBOR.



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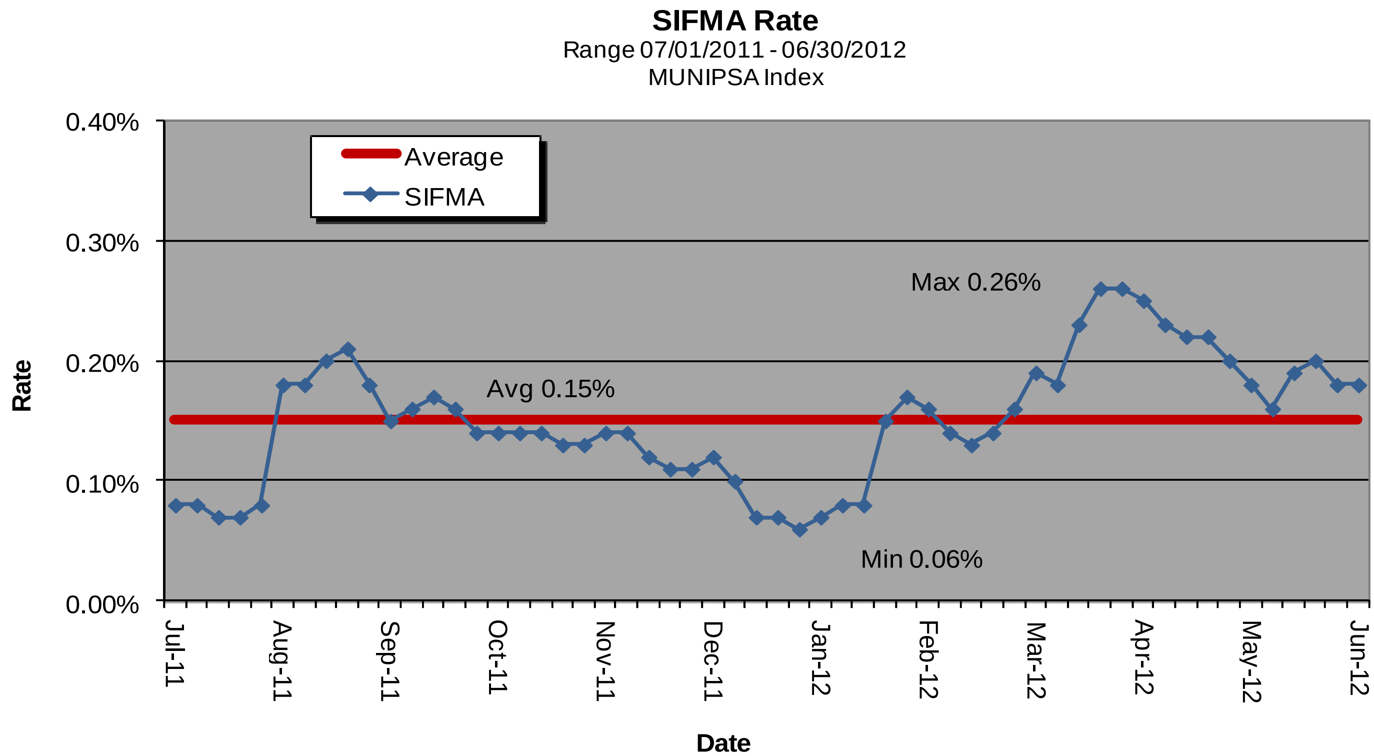
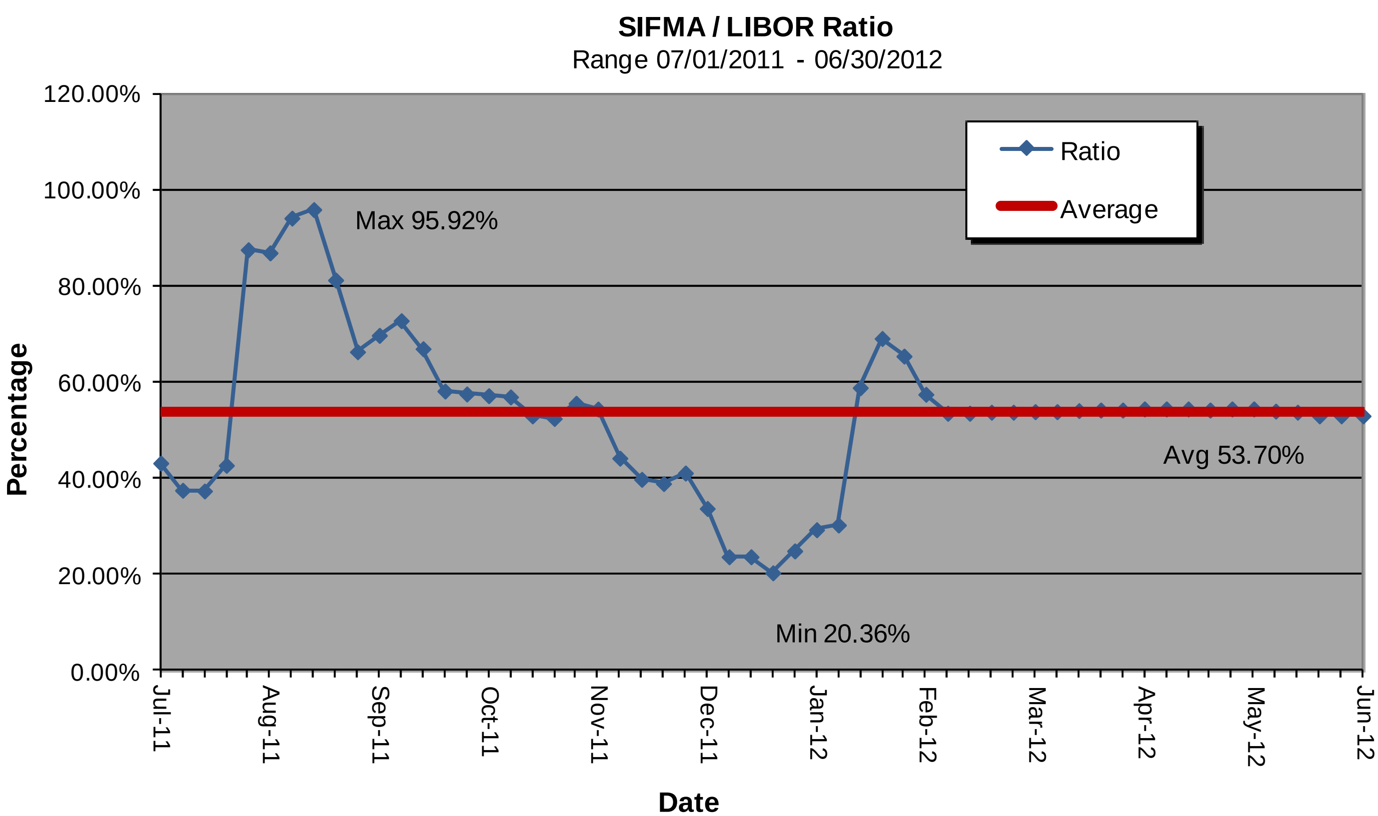
SIFMA and SIFMA/LIBOR Ratio





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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, and $43.5 million is Agency Restricted Fund supported. A portion of the Agency Restricted Fund authorization listed above has been permanently financed. All of the authorized but unissued General Fund supported bond authorized projects are eligible for interim funding through a 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 June 30, 2012, the unissued balances of bond authorizations from the General Assembly prior to and including 2012 were:

General Fund - $470.96 million

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 and terms 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, expenditures, the economy, debt management and pension obligations. Unemployment and the softening in the national and state economies over the past few years as well as ballooning unfunded pension obligations have continued to put pressure on the Commonwealth's credit ratings. However, it is important to note that Standard & Poor's, and most recently Moody's view of the Road Fund, continues to diverge from the traditional appropriation ratings, especially the General Fund.

In February of 2012, Moody's affirmed their "Aa2" rating on the Commonwealth's Road Fund lease supported bonds and revised the rating outlook on the Road Fund bonds from "negative" to "stable". Moody's noted that the rating reflects the available Road Fund resources, which are constitutionally dedicated transportation-related revenues and provide good coverage of debt service as well as the underlying strength of the economy. The Common-

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wealth relies heavily on appropriation-backed financings to fund capital investments increasing the likelihood that appropriations from the Road Fund will continue to be made. They also noted that the Kentucky Transportation Cabinet also has a history of full and timely lease rental payments, successful management of the Road Fund, and legislative support for the highway program. The outlook revision to "stable" from "negative" reflects recent revenue rebounds and the expectation for continued good coverage of debt service. Continued revenue strength as well as continued legislative support for highways and the Transportation Cabinet's effective management will continue to be important rating factors in the future. Moody's has maintained a "negative" rating outlook on the Commonwealth's issuer credit rating as well as its General Fund lease appropriation ratings since April of 2008.

In February of 2012, Fitch Ratings affirmed their "AA-" rating on the Commonwealth's 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, weak pension funding levels, the Commonwealth's above average debt position, and 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, could lead to a future rating downgrade. Fitch Ratings affirmed its "negative" rating outlook on the Commonwealth at the time.

In February of 2012, S&P affirmed its "AA+" rating on the Kentucky Turnpike Authority's Road Fund lease supported bonds. S&P noted that the rating reflected their view of: 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 legal provisions, which include a 2x additional bonds test. S&P noted that the "stable" outlook reflects their expectation that debt service coverage from future road revenues available for debt service will be consistent and that appropriations will continue to be made without interruption, thus preventing the Authority's need to turn to motor fuel taxes.

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)

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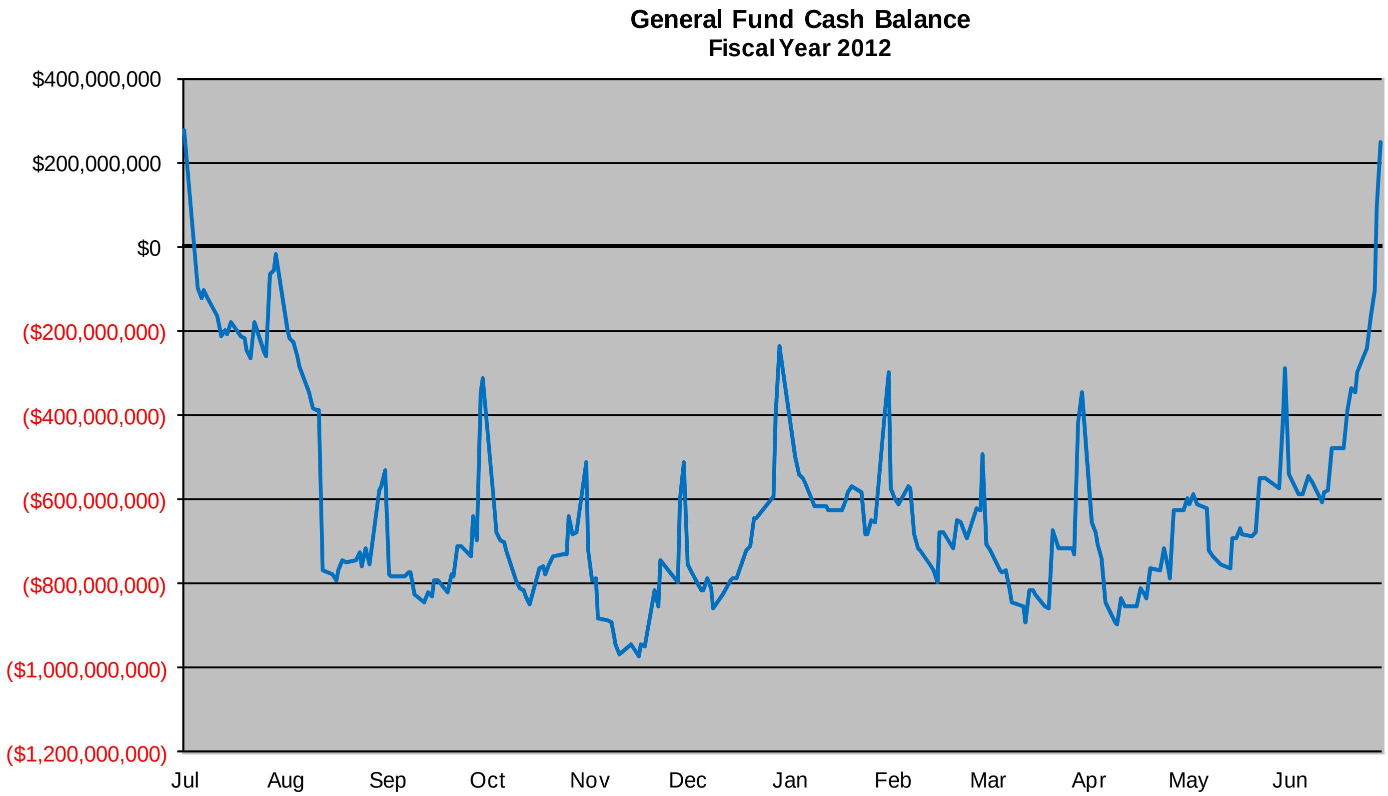

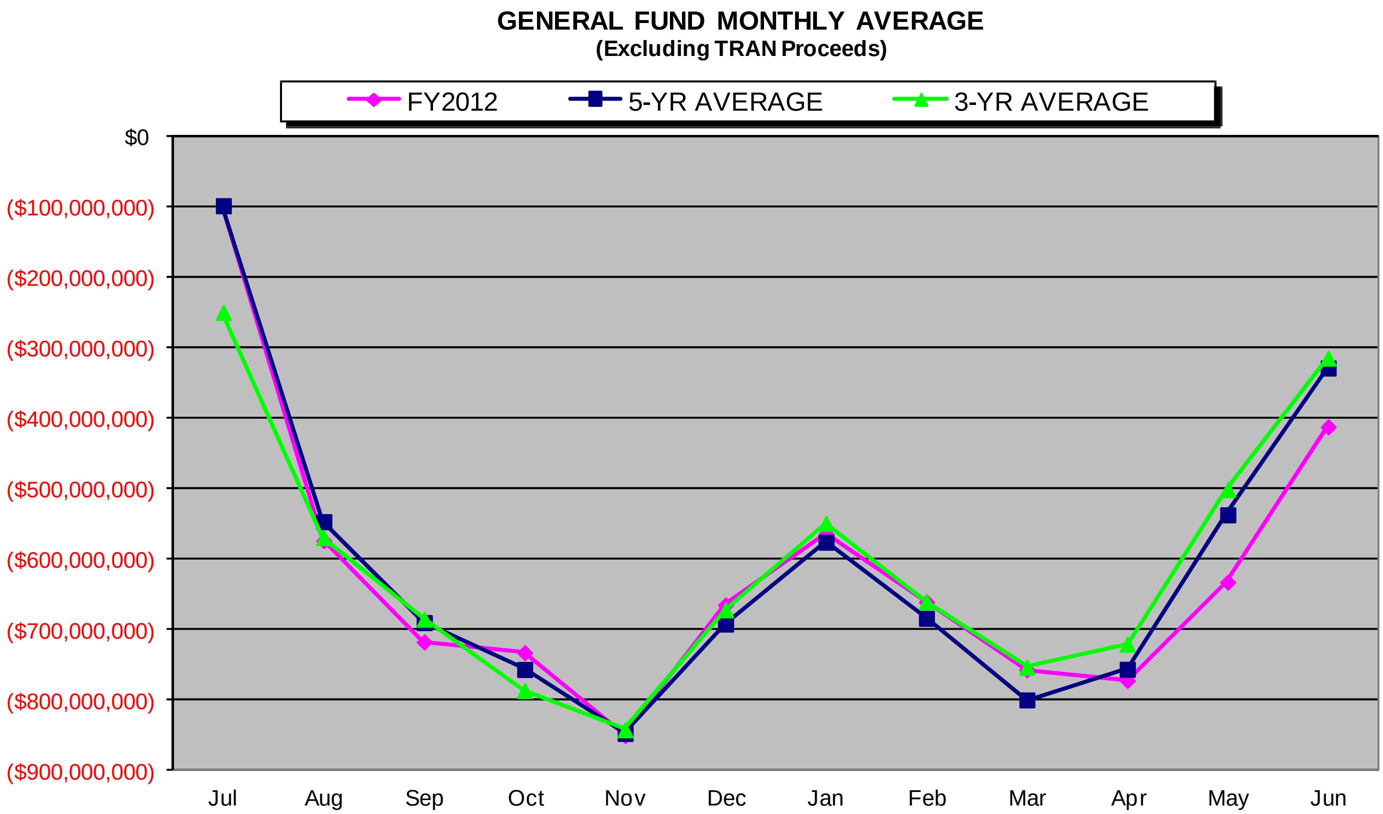

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FINANCIAL AGREEMENTS

As of June 30, 2012, ALCo had four financial agreements outstanding, with a net notional exposure amount of $216.475 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 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 June 30, 2012 are presented in Appendix A.

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ASSET/LIABILITY MODEL

General Fund

The total SPBC debt portfolio as of June 30, 2012 had $4,175 million of bonds outstanding with a weighted average coupon of 5.00 percent and a weighted average life of 7.93 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 $1,251 million callable portion had a weighted average coupon of 5.08 percent.

The SPBC debt structure has 29 percent of principal maturing in 5 years and 66 percent of principal maturing in 10 years. The first ratio is 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 prior debt restructurings.

The General Fund had a high balance of $276 million near the beginning of Fiscal Year 2012 and a low of negative $974 million on November 16, 2011.

The average and median balances were a negative $623 million and a negative $686 million, respectively. Since the General Fund continued to have a negative available cash balance for most of the fiscal year, 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 $430 million for Fiscal Year 2012. 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.

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 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 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 2013.

KIA Series 2012A

House Bill 1 of the 2010 Extraordinary Session of the General Assembly authorized $125 million of Agency Fund supported bonds for the Kentucky Infrastructure Authority ("KIA"). The bonds were to be backed by repayments received by KIA under their Wastewater and Drinking Water State Revolving Fund ("SRF") programs. The authorization provided KIA the continued ability to leverage their SRF programs and to maximize the amount of financial assistance available under the programs.

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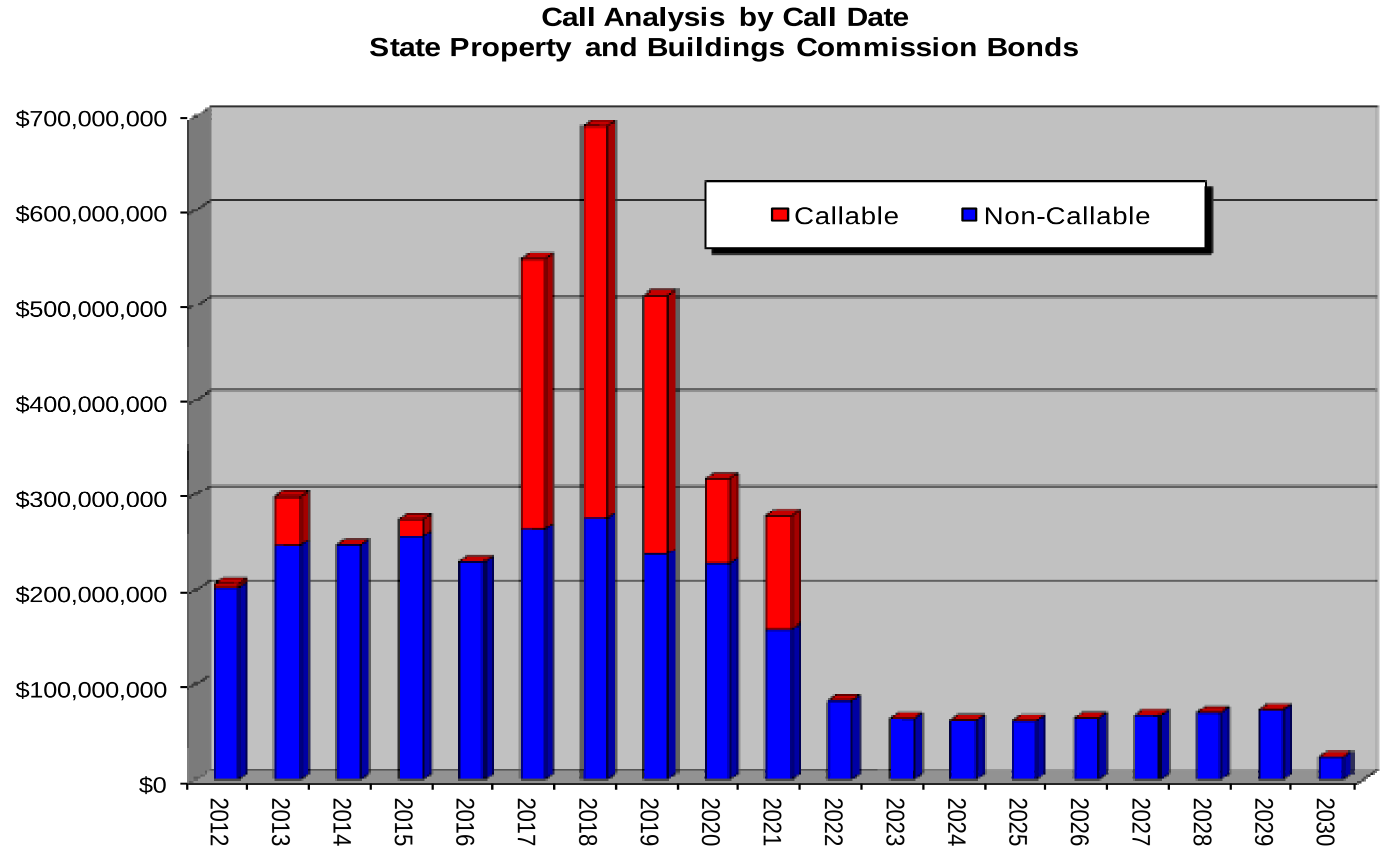

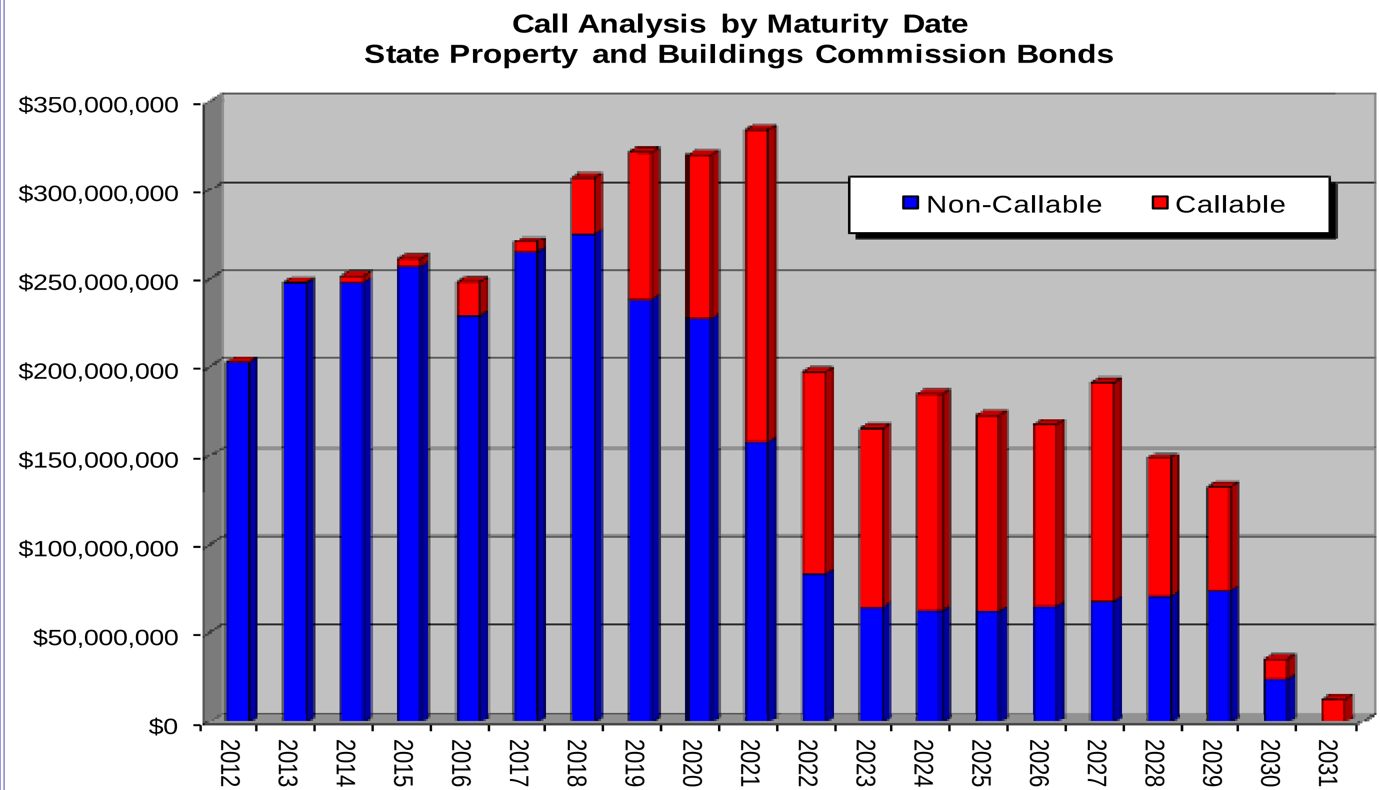

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Under existing contracts, First Southwest served as financial advisor, Morgan Stanley as senior managing underwriter, and Peck Shaffer & Williams LLP as bond counsel for this transaction. Moody's, Standard & Poor's and Fitch assigned ratings for the transaction as Aaa, AAA & AAA, respectively.

The bonds were sold on March 27, 2012, in a par amount of $111,345,000 and provided $125 million of available proceeds for KIA to make loans under the SRF programs ($100 million for the Wastewater program and $25 million for the Drinking Water program). The arbitrage yield on the bonds for the combined issuance was 2.57%, with an All-In True Interest Cost of 3.063% and an average life on the bonds of 10.325 years. The transaction closed on April 19, 2012.

In the extremely low interest rate environment that currently exists, staff regularly monitors potential economic refunding opportunities. Unfortunately, low investment rates also exist in the reinvestment market creating significant negative arbitrage in escrows and reduces the potential for present value savings from economic refundings. OFM's primary goal is to maximize net present value savings after the impact of negative arbitrage in the escrows.

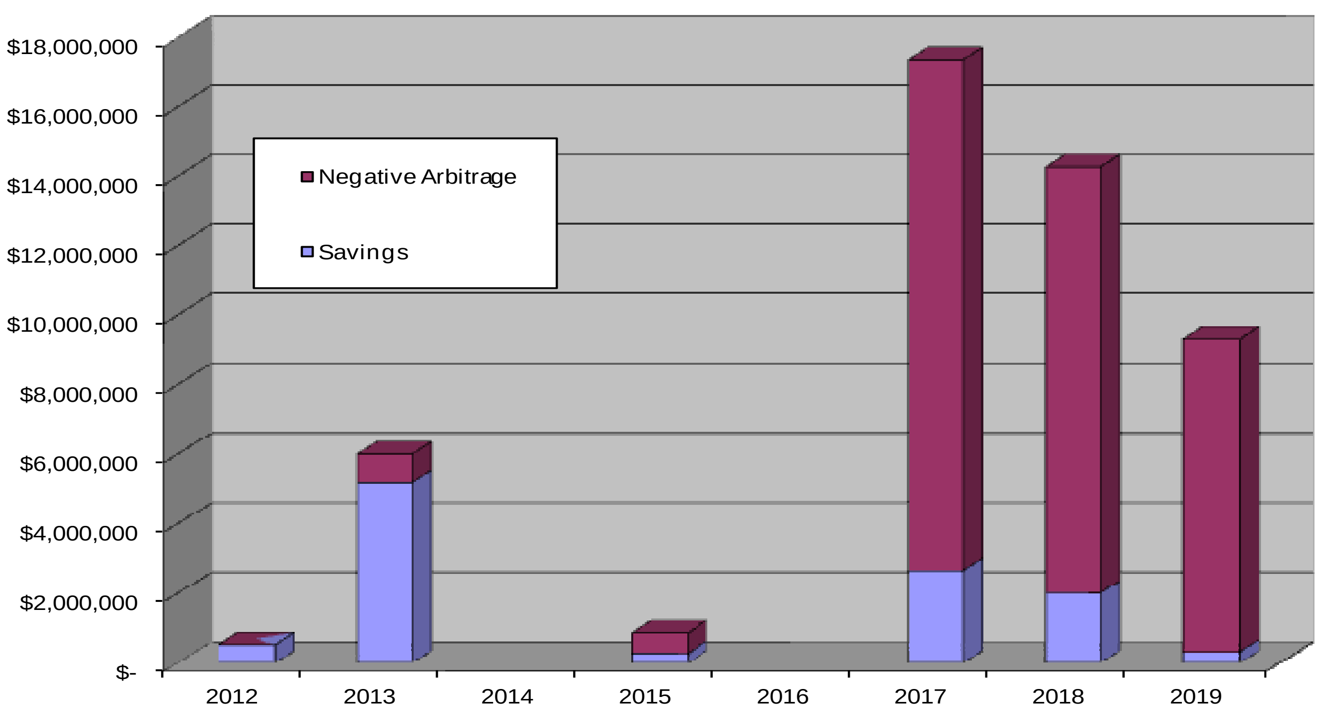
Road Fund

The Road Fund average daily cash balance for Fiscal Year 2012 was $498 million compared to $368 million for Fiscal Year 2011. The Road Fund cash was invested in the Intermediate Term Investment Pool which had a duration of 1.22 years as of June 30, 2012. The Road Fund earned $3.1 million on a cash basis for Fiscal Year 2012 versus $2.0 million for Fiscal Year 2011. The relatively low level of investable balances at certain times during the fiscal year limits the investment opportunities.

As of June 30, 2012, the Turnpike Authority of Kentucky (TAK) had $1,422 million of bonds outstanding with a weighted average coupon of 4.8 percent and average life of 9.9 years.

Road Fund debt service for Fiscal Year 2012 was $112.2 million, resulting in a net interest margin (investment income earned less debt service paid) of negative $109.1 million. The negative amount stems from the level of investable balances and a general low level of interest rates on the invest-

Savings Analysis
State Property and Buildings Commission Bonds



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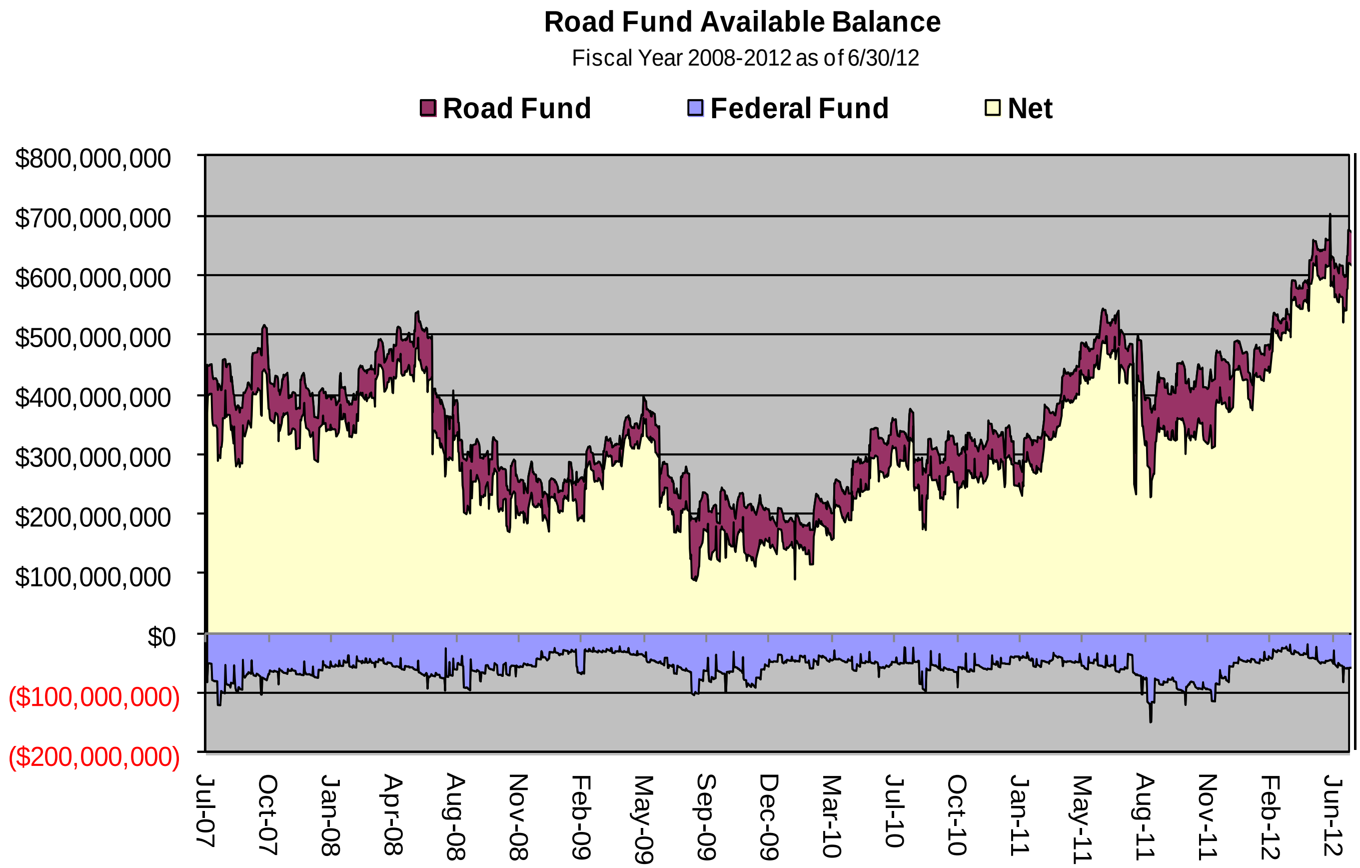


ment side in addition to the negative arbitrage in refunding escrows for callable bonds and limited callability of fixed rate obligations on the liability side.

TAK 2012 Series A

In March of 2012, TAK issued a $218,200,000 financing. The proceeds of the bonds were used to (1) provide $56 million in Economic Development bonds for the Base Realignment and Closure (BRAC) project authorized for Fiscal Year 2012 in the 2010 Extraordinary Session of the General Assembly, (2) provide the remaining balance of $200 million in Economic Development bonds for highway projects authorized in the 2009 Regular Session of the General Assembly, and (3) pay for costs of issuance.

The structure of the transaction was essentially a 20-yr level debt financing with maturities beginning in 2016 to help level, or smooth out, the Road Fund debt portfolio and consisted of one series of bonds, Series A, being tax-exempt new money bonds.

The bonds received ratings of Aa2/AA+/AA- from Moody's, S&P and Fitch, respectively. Moody's changed their outlook on the Road Fund from "negative" to "stable". The transaction was sold via negotiated sale with Goldman Sachs serving as senior managing underwriter and Peck, Shaffer & Williams LLP as bond counsel. The transaction was sold on schedule and achieved cost effective rates with an All-In True Interest Cost of 3.184% with an average life on the bonds of 13.415 years which is, to OFM's knowledge, quite possibly the lowest cost of financing on a lease appropriation 20-year negotiated tax-exempt financing for the Commonwealth to date. Staff continues to monitor select maturities for possible economic refundings, which is heavily influenced by negative arbitrage in the escrows.

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.

At the end of Fiscal Year 2012, the Commonwealth was able to cut (budget reduction) or lapse \$214.4 million of budgeted General Fund debt service and \$17.7 million of budgeted Road Fund debt service. Approximately \$127.3 million of General Fund debt service was restructured for Fiscal Year 2012 through SPBC 100.

Over the past two to three years, the high cost and terms 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

as of 6/30/2012

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	15,015,000	62,785,000	67,740,000	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, 2012 (negative indicates payment owed by ALCo if terminated)	(1,354,270)	(12,401,830)	(12,534,617)	(18,177,755)
Interest Earnings (not applicable)				
Total	not applicable	not applicable	not applicable	not applicable

Swap Summary As of June 30, 2012	Total Notional Amount Executed		Net Exposure Notional Amount	
	General Fund	Road Fund	General Fund	Road Fund
	243,080,000	0	216,475,000	0

Total Notional Amount Executed by Counter Party

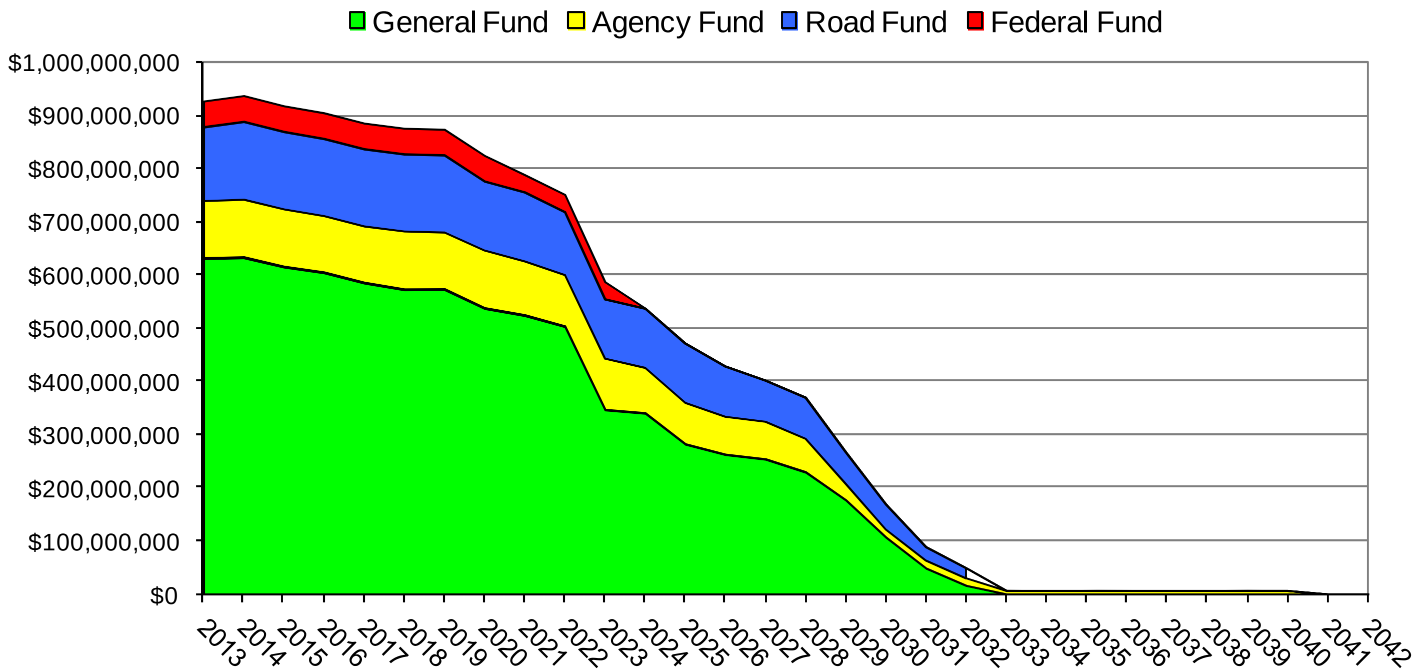
Deutsche Bank (assigned from Citibank on 2/14/2011)
243,080,000

	Debt		10 Percent Net Exposures	
	General Fund	Road Fund	General Fund	Road Fund
Bonds Outstanding	4,899,085,000	1,503,885,000	489,908,500	150,388,500
Authorized but Unissued	470,959,840	423,000,000	47,095,984	42,300,000
Total	5,370,044,840	1,926,885,000	537,004,484	192,688,500

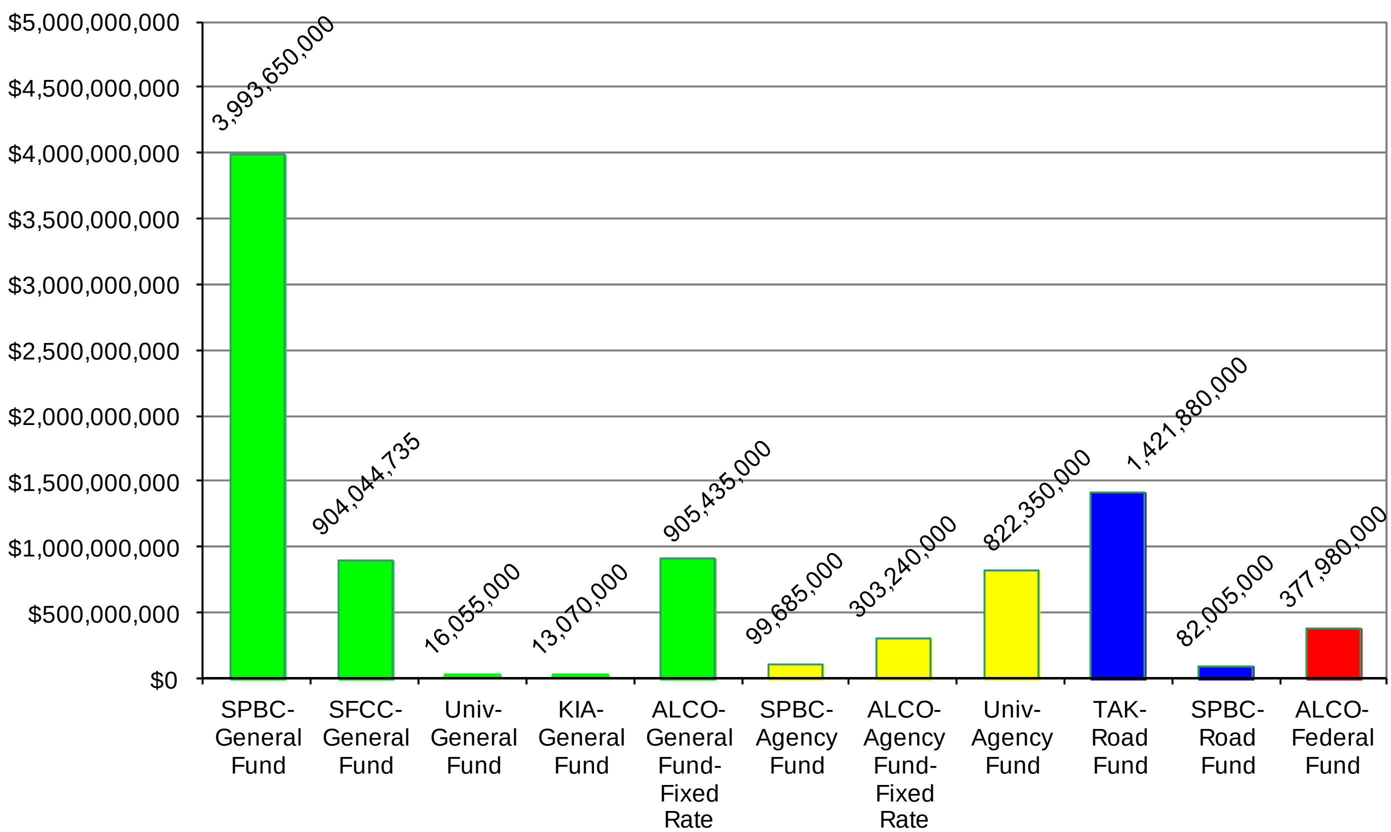
	Investment Pool Balances		10 Percent Investment Portfolio	
	Other Funds	Net Road Fund	Other Funds	Net Road Fund
	3,052,182,965	620,701,141	305,218,297	62,070,114

APPENDIX B

Appropriation Supported Debt Service by Fund Source as of 6/30/2012



Appropriation Debt Principal Outstanding by Fund Source as of 6/30/2012



APPENDIX C

COMMONWEALTH OF KENTUCKY
ASSET/LIABILITY COMMISSION
SCHEDULE OF NOTES OUTSTANDING
AS OF 6/30/2012

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	$8,365,000
2005 1st Series	$81,850,000	6/2005	5/2025	$60,935,000
2007 A, B Series	$243,080,000	5/2007	11/2027	$216,475,000
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
FUND TOTAL	**$1,233,560,000**			**$905,435,000**
Agency Fund Project Notes				
2005 1st Series	$11,275,000	6/2005	6/2025	$8,710,000
2005 Series A-UK Gen Recpts	$107,540,000	11/2005	10/2025	$93,885,000
2006 Series A-UK Gen Recpts	$66,305,000	10/2006	10/2022	$52,835,000
2007 Series A-UK Gen Recpts	$77,905,000	11/2007	10/2027	$72,295,000
2007 Series B-UK Gen Recpts	$80,245,000	11/2007	10/2027	$75,515,000
FUND TOTAL	**$343,270,000**			**$303,240,000**
Federal Hwy Trust Fund Project Notes				
2005 1st Series	$139,635,000	6/2005	9/2017	$77,960,000
2007 1st Series	$277,910,000	9/2007	9/2019	$210,310,000
2010 1st Series	$89,710,000	3/2010	9/2022	$89,710,000
FUND TOTAL	**$507,255,000**			**$377,980,000**
ALCo NOTES TOTAL	**$2,084,085,000**			**$1,586,655,000**

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

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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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Creating Financial Value for the Commonwealth