KENTUCKY ASSET/LIABILITY COMMISSION

SEMI-ANNUAL REPORT

For the Period Ending June 30, 2003

This is the Kentucky Asset/Liability Commission's ("ALCo") thirteenth semi-annual report pursuant to KRS 56.863(11) for the period beginning January 1, 2003 through June 30, 2003. In complying with the Governor's cost cutting measures and in conjunction with the very narrow readership and high production cost of this report, The Office of Financial Management ("OFM") will only distribute a limited number of black and white copies to the ALCo Board members, State Investment Commission and to the Legislative Research Commission. This report may be viewed in color on the OFM web site at http://ofm.state.ky.us.

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KEY THEMES

On the national level:

- Global unrest abounds.
- State governments wrestle with prospects of significant tax increases and/or service reductions.
- Federal Reserve cuts the borrowing rate to banks by 25 basis points to 1.0 percent.
- The Dow Jones Industrial Average gains 932 points or approximately 11.5 percent to 8,985.44.

On the state level:

- A budget is enacted with substantial new capital investment.
- Ratings for appropriation supported debt are upheld.
- Tax-exempt market ratios make the issuance of a TRAN uncertain.

Investment Management

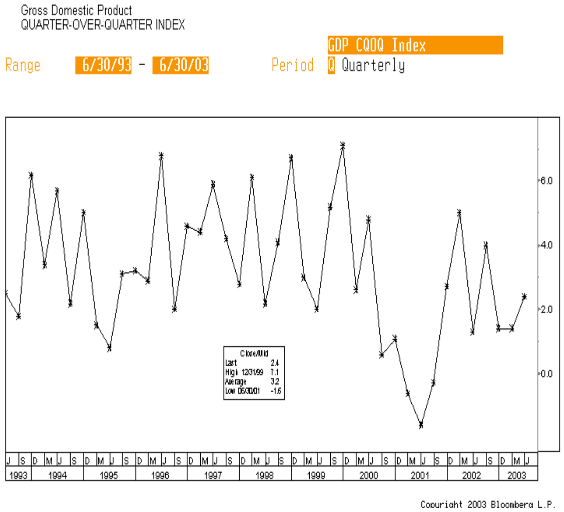
Market Overview. The second half of fiscal year 2003 was an interesting time for the bond markets and the economy in general. The economy entered this period in the middle of a "jobless recovery" which subsequently weakened due in part to the war in Iraq. Following the "end of major military actions," the financial markets began to focus on the May 6, 2003 Federal Open Market Committee's ("FOMC") statement and concern about "an unwelcome substantial fall in inflation" or deflation. As a result, the bond markets rallied throughout most of this period hitting what appears to be a cyclical low and historic low in interest rates on June 13, 2003.

Real Gross National Product (GNP) grew by 1.4 percent annualized during the first quarter of the calendar year and 3.6 percent during the second quarter. While the economy is clearly growing in total, the number of jobs has fallen by 295,000. This increase in output with fewer workers has been possible due to remarkable growth in productivity. Productivity grew at over 5.5 percent during calendar year 2002 and reached the high level of 7.2 percent during the second quarter of 2003. At the same time, inflation has remained subdued with the Consumer Price Index ("CPI") at 2.1 percent year over year as of June 2003 and the Gross Domestic Product ("GDP") Price Deflator dropping to 0.9 percent during the second quarter of 2003.

This low and by some measures, declining level of inflation prompted Federal Reserve Board Chairman Greenspan, along with the FOMC, to express concern about the possibilities of Japan type deflation. The FOMC dropped the Fed Funds target rate to 1.0 percent at the June 25, 2003 meeting. FOMC members, through official statements and during public testimony and speeches, have stated that they examined the use of "nontraditional means" of applying monetary policy. The financial markets have interpreted this to mean that the Fed is prepared to begin buying longer dated Treasury securities rather than simply targeting the Fed Funds rate.

The prospect of the Fed buying Treasuries prompted a substantial rally in the bond markets. The ten-year Treasury fell from a high of 4.18 percent in January to a low of 3.11 percent on June 30. The average during the time period was 3.75 percent compared to 4.59 percent during 2002. In a similar manner, the two-year Treasury fell from a high of 1.86 percent in January to a low of 1.08 percent on June 13. The average during the time period was 1.51 percent compared to 2.60 percent during 2002.

The considerable drop in interest rates also helped the mortgage market immensely. The Federal Home Loan Mortgage Corporation (Freddie Mac or FHLMC) survey rate (a survey of the average rate being offered for 30-year fixed mortgages) reached an all-time low of 5.21 percent during the middle of June. Very attractive mortgage rates have generated enormous levels of refinancings and home sales. To understand the significance, at one point in June, 96 percent of all mortgages in this nation were refinancing candidates. This activity has pumped in excess of $60 billion a month into consumers' hands. It has also supported the strongest sector of the economy, housing. Existing home sales are running at over 5.75 million annualized and new home sales are running at nearly 1.2 million annualized (a record pace). In addition, the refinancing boom has helped support consumer spending, with retail sales growing 5.0 percent year-over-year as of June, in the face of a weak job market.


Gross Domestic Product
QUARTER-OVER-QUARTER INDEX
GDP CQOQ Index
Range 6/30/93 - 6/30/03 Period Q Quarterly
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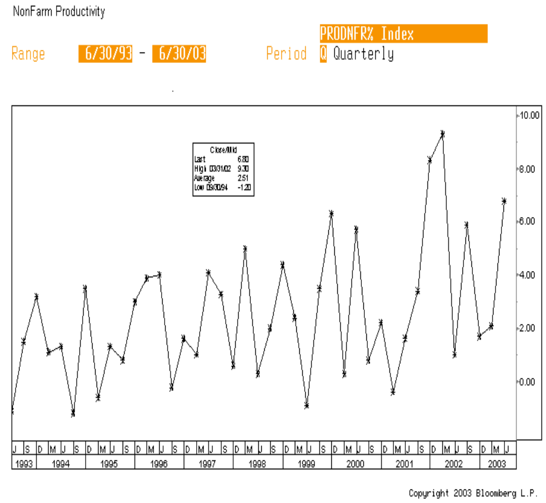
NonFarm Productivity
PRODNFR% Index
Range 6/30/93 - 6/30/03 Period Q Quarterly
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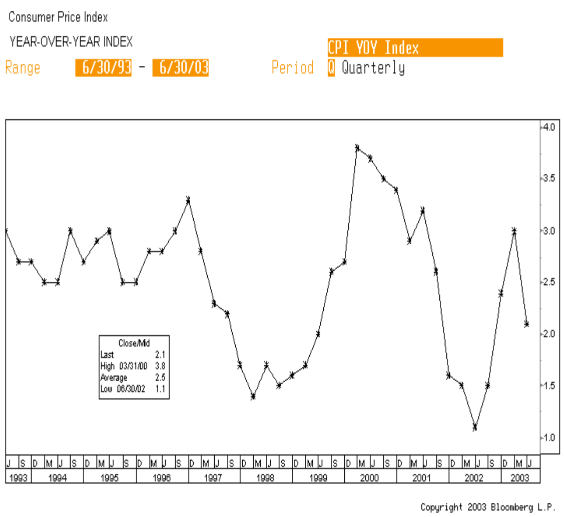
Consumer Price Index
YEAR-OVER-YEAR INDEX
CPI YOY Index
Range 6/30/93 - 6/30/03 Period Q Quarterly
Close/Mid
Last 2.1
High 03/31/00 3.8
Average 2.5
Low 06/30/02 1.1
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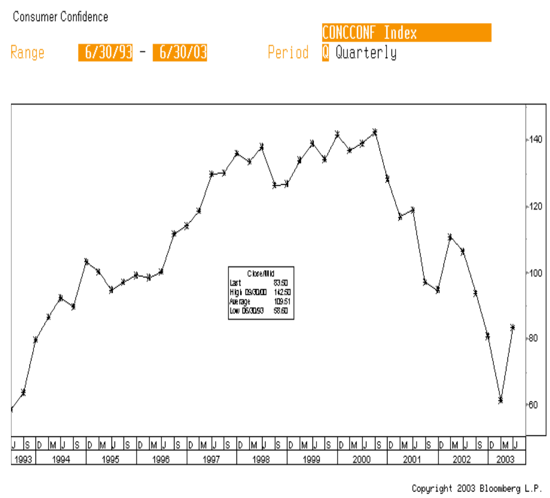
Consumer Confidence
CONCCONF Index
Range 6/30/93 - 6/30/03 Period Q Quarterly
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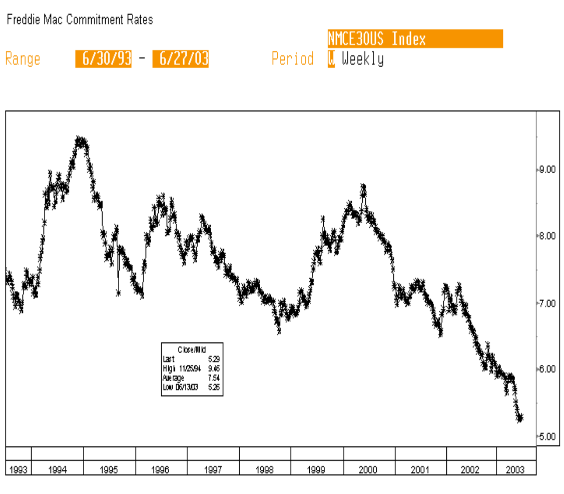
Freddie Mac Commitment Rates
NMCE30US Index
Range 6/30/93 - 6/27/03 Period W Weekly
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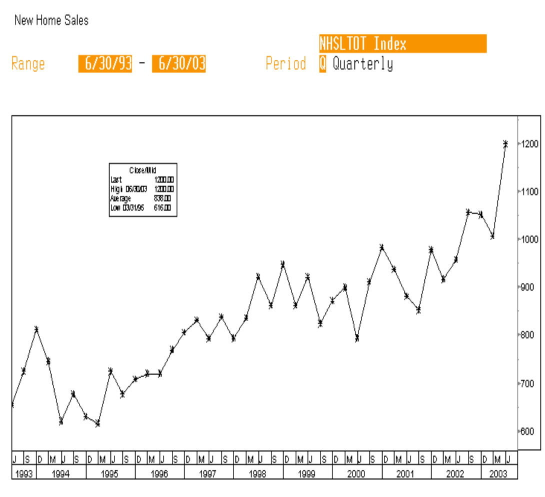
New Home Sales
NHSLTOT Index
Range 6/30/93 - 6/30/03 Period Q Quarterly
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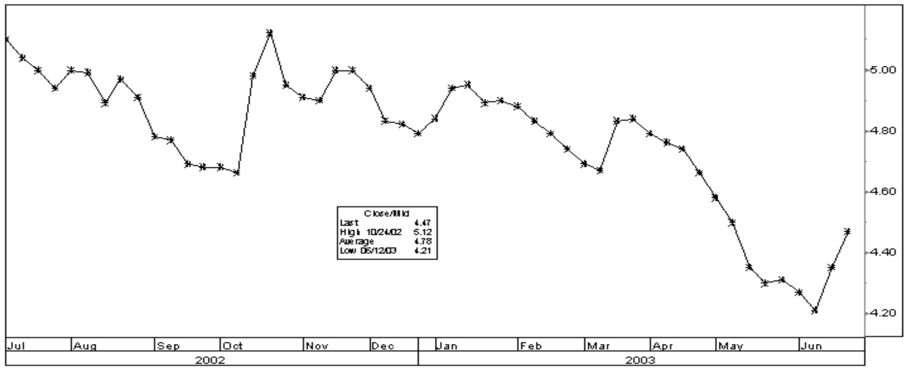
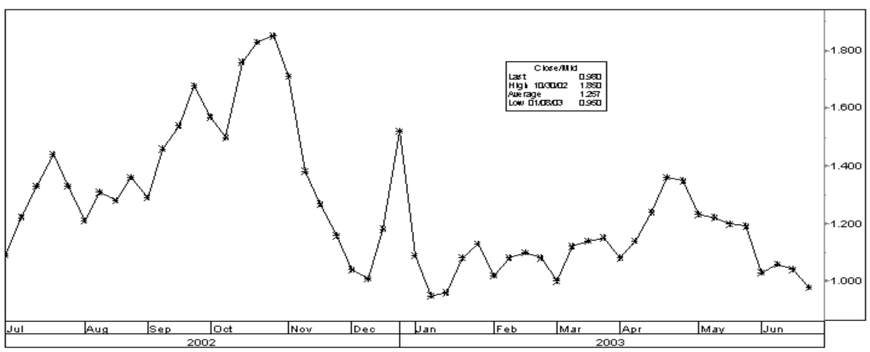
Bond Buyer 20-year General Obligation Index

Range 6/30/02 - 6/26/03 Period W Weekly BBWK20GO Index



Bond Market Association "BMA"
Municipal Swap Index

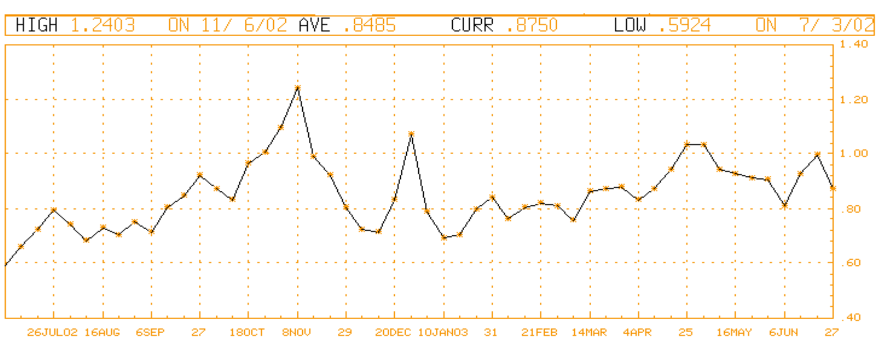
Range 6/30/02 - 6/25/03 Period W Weekly MUNIPSA Index



Bond Market Association "BMA" Municipal Swap Index
as a percent of one month LIBOR

RANGE 7/ 3/02 6/25/03

HIGH 1.2403 ON 11/ 6/02 AVE .8485 CURR .8750 LOW .5924 ON 7/ 3/02



Questions about where the economy goes from here boil down to the employment market. Current projections are that GDP growth will accelerate during the third and fourth quarters of 2003. The recent run up in longer term interest rates, since the mid-June low, has substantially reduced mortgage refinancing incentives. However, current fiscal stimulation (next year's projected budget deficit exceeds $450 billion) and monetary stimulation (Fed Funds at 1.0 percent and the expectation that they will stay there for a "considerable length of time") should continue to strengthen the economy. The question is whether the growth will be fast enough to create jobs, which could then feed into higher levels of consumer spending and provide a sustainable expansion. To date, the evidence is mixed at best.

Tax-Exempt Interest Rates and Relationships. The Bond Buyer 20-year General Obligation Index averaged 4.66 percent for the six-month period and 4.78 percent for the fiscal year. The fiscal year high was 5.12 percent in October 2002 and the low was 4.21 percent in June 2003.

The Bond Market Association ("BMA") Municipal Swap Index averaged 1.12 percent for the reporting period and 1.26 percent for the fiscal year. The fiscal year high was 1.85 percent in October 2002 and the low was 0.95 percent in January 2003. The 30-day USD London Interbank Offered Rate ("LIBOR") averaged 1.30 percent for the period and 1.5 percent for the fiscal year. The fiscal year high was 1.84 percent in July 2002 and the low was 1.02 percent in June 2003.

Ratios of tax-exempt securities versus taxable securities continued at historically high levels. BMA traded as high as 124 percent of 30-day LIBOR in November 2002 while averaging 84.8 percent for the fiscal year. It began the fiscal year at a low of 59 percent in July 2002 and ended with a low of 69 percent in June 2003.

Portfolio Management. For fiscal year 2003, the Commonwealth's investment portfolio averaged $2.9 billion. As of June 30, 2003, the portfolio was invested in US Treasury Securities (19 percent), US Agency Securities (35 percent), Mortgage Pass Through Securities (1 percent), Collateralized Mortgage Obligations (6 percent), Repurchase Agreements (13 percent), Municipal Securities (5 percent), Corporate Securities (8 percent), Asset-Backed Securities (2 percent), and Money Market Securities (11 percent). The portfolio had a current yield of 1.71 percent and an effective duration of 1.55 years.

The total portfolio is broken down into four investment pools. The pool balances as of June 30, 2003, were Short-term - $528 million, Intermediate-term - $1,582 million, Long-term - $209 million, and Bond Proceeds - $410 million.

Total investment income from all investments, on a cash basis, for the fiscal year was $145 million versus $211 million for fiscal year 2002. On a full mark-to-market accrual basis, investment income was $149 million versus $221 million for fiscal year 2002.

During June, an $8.5 million charge was recorded to the General Fund as negative investment income. During the previous several years, the General Fund has had seasonal negative daily cash balances or overdrafts. Any overdraft must be covered by borrowing funds from other state agencies with funds invested in one of the state investment pools. The charge represents accrued interest owed by the General Fund to the various agencies as compensation for the borrowed money. Going forward, any further interest expense will be calculated daily and charged monthly. This charge was not due to a loss on any investments.

During July, approximately $400 million was transferred from the Intermediate-term Investment Pool to the Short-term Investment Pool. This transfer reflected the reassignment of all General Fund accounts and agency accounts whose investment income post to the General Fund in the Short-term Investment Pool. Previously, certain related General Fund accounts with positive balances resided in the Intermediate-term Investment Pool while certain General Fund accounts with occasional negative balances resided in the Short-term Investment Pool. This situation created administrative problems from accruing income between pools. The July transfer resolves these problems.

Subsequently, during July 2003, all assets of the Long-term Investment Pool were transferred to the Intermediate-term Investment Pool. Throughout fiscal year 2003, only certain Transportation Cabinet funds were invested in this pool. Because of the dwindling balance and expectation of further declines, it was decided to reinvest these funds into the shorter duration Intermediate-term Investment Pool.

Debt Management

The only appropriation supported debt issued during the period, other than school bonds and university refundings, was the refunding of certain outstanding State Property and Buildings Commission ("SPBC") bonds by ALCo.

OFM is developing a comprehensive debt plan for newly authorized debt that:

- Provides cash to fund eligible projects in a timely manner consistent with constraints established in House Bill 269.
- Achieves the lowest borrowing cost over the life of the obligation, consistent with risk tolerance.
- Minimizes budgetary complications.
- Evaluates and combines refunding candidates with new money issues for economic savings.
- Maintains existing ratings if possible.

Ratings Update. Kentucky finds itself in difficult times, but no more so than most states. As such, the rating community has not taken any further action since that of last fall. Currently, Kentucky's appropriation supported debt is rated Aa3 by Moody's Investors Service, AA- by Fitch Ratings and A+ by Standard & Poor's. The Moody's rating carries a Negative Outlook. Fitch Ratings does not typically issue an Outlook. Standard & Poor's carries a Stable Outlook.

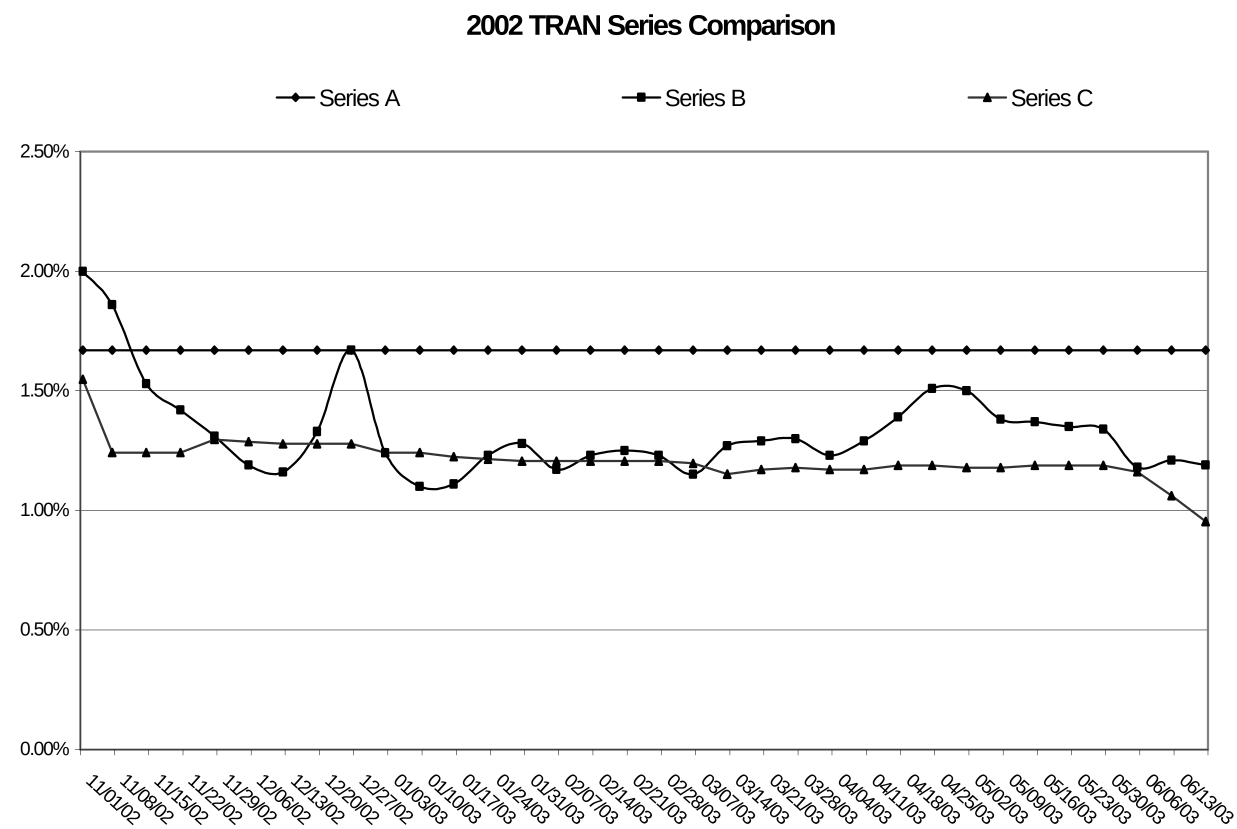
As outlined in the previous report, rating agency concerns continue to focus on a structurally balanced budget, lack of liquidity and further commitment to replenishing the Budget Reserve Trust Fund ("BRTF").

Tax and Revenue Anticipation Notes

2002 TRAN. Due to the lack of a legislatively enacted budget, the TRAN was delayed until November 1, 2002 in order to assess the likelihood of a possible resolution, court actions and to address rating agency concerns. The Commission ultimately issued $500 million of TRANs in three series to mature on June 26, 2003.

- 2002 Series A - $250,000,000 fixed rate notes with a coupon of 2.75 percent to yield 1.67 percent.
- 2002 Series B - $200,000,000 index rate notes equal to 100 percent of the BMA Index plus 0.15 percent adjusted weekly. BMA averaged 1.18 percent for the term and the Note's average rate was 1.33 percent.
- 2002 Series C - $50,000,000 index rate notes equal to 90 percent of 30-day LIBOR. One month LIBOR averaged 1.34 percent for the term of the Notes resulting in an average rate of 1.21 percent.

OFM and ALCo entered into various interest rate swaps with Citigroup and others to both invest and hedge the TRAN proceeds. Investment income from the TRAN proceeds exceeded $5.7 million which narrowly covered the TRAN net interest expense.



Due to the tremendous compression of tax-exempt and taxable interest rates, ie. the cost of borrowing versus the reinvestment yields, and the magnitude of the average daily General Fund balance (negative $511,768,957), the incremental value that the 2002 TRAN was able to provide amounted to only $350,000. This equates to approximately 12 basis points annualized or about one-third less than originally projected.

2003 TRAN. Originally, TRANs were issued at tremendous rate advantages to taxable reinvestment rates, often producing 2 percent excess returns when the General Fund had excess cash and significantly lowering the borrowing cost when the balances were negative. The recent economic downturn has caused revenue growth to drop sharply against ever increasing demands on the expenditure side. The prospects for an improved General Fund cash position in fiscal year 2004 over fiscal year 2003 are not bright unless the US economy were to jump out of the doldrums in a surprising rebound. Additionally, in a current fixed income market environment where tax-exempt notes are trading between 86 percent and 91 percent of one-month LIBOR plus the cost of issuance makes the economic case for issuing a TRAN very narrow especially when the General Fund can rely on internal resources at equally competitive interest rates.

Should the relationship between tax-exempt and taxable ratios decrease to more normal levels, then staff would rapidly pursue a 2003 TRAN. Another consideration is the overall liquidity of the state and the corresponding investment pools. Should those balances deteriorate, then the General Fund would need to seriously consider a TRAN to fund those immediate needs. However, it should be noted that in that circumstance it is highly likely that we could not achieve the highest short-term ratings required to be money fund eligible and, as a result, the cost of borrowing would increase commensurate with second tier credit spreads at the time of issuance. The current estimate would be 30-50 basis points depending upon the circumstances.

Project Notes. General Fund Project Notes, 2002 Series A in the amount of $12,775,000 were delivered on June 26, 2002 to fund the remaining Economic Development Bond Pool projects authorized by HB 507. The Notes which mature on November 1, 2003 have been refinanced by the SPBC 77 bonds delivered on August 20, 2003. The Agency Fund Project Notes, 2002 Series A also mature on November 1, 2003. These Notes in the amount of $6,360,000 funded the University of Kentucky's Center for Rural Health located in Hazard, Kentucky. It is expected that SPBC 80 bonds to be sold in October 2003 will permanently finance that project.

ALCo Project Refunding Notes, 2003 General Fund Series A in the amount of $171,260,000, were sold on June 11, 2003 (two days before the low in interest rates) for delivery on July 17, 2003. The Notes refunded all of the remaining SPBC 55 Bonds, except the 2003, 2007 and 2008 maturities which are not callable, and all of the outstanding ALCo Project Notes, 1999 General Fund First Series.

ALCo entered into an interest rate hedge with UBS Financial Services on December 12, 2002 to lock in the savings on approximately two-thirds of the transaction. (See Financial Agreements.) Present value savings for the refunding of SPBC 55 bonds were $5.1 million and the present value savings for the ALCo Note refunding was $.8 million. Combined, the present value savings to the General Fund were $5.9 million or 3.42 percent of refunded par.

Additionally, the 2001 General Fund Project Notes, a fixed rate series originally issued as seven-year notes to fund equipment acquisition for higher education and other state agencies, remain outstanding.

Outstanding ALCo Notes as of June 30, 2003*

1999 General Fund First Series	0	* $22,695,000 refunded
2001 General Fund First Series	$ 27,865,000	Final maturity February 1, 2008
2002 General Fund First Series	$ 12,775,000	Matures November 1, 2003
2003 General Fund Series	$171,260,000	*Sold June 11, 2003 with delivery on July 17, 2003
Total General Fund Series	$211,900,000	
2002 Agency Fund Series	$ 6,360,000	Matures November 1, 2003
Total All Series	$218,260,00	

Financial Agreements

As of June 30, 2003 ALCo had four financial agreements outstanding, but a net notional amount exposure of zero. These transactions are detailed in the table on page 10. During the period, the SPBC 55 transaction was terminated simultaneously with the sale of the ALCo Project Refunding Notes, 2003 General Fund Series. The transaction related to the Turnpike Authority of Kentucky ("TAK") Toll Road 1986 Series A Bonds was partially terminated reflecting federal funds applied to the redemption of bonds and removal of tolls from two toll roads. Additionally, a transaction entered into to hedge a portion of the 2002 TRAN transaction matured on the due date of the Notes.

Of the continuing outstanding financial agreement transactions, the first item is a total return swap related to the $56,485,000 July 1, 2009 maturity of the TAK Resource Recovery 1985 Series A Bonds, which bears interest at six percent. Staff worked for approximately 18 months to develop this transaction with Morgan Stanley ("MS") and finally executed the trade in April 2001. The 1985A Bonds could not be economically refunded, despite a very low interest rate environment, due to the enormous transferred proceeds penalty associated with the Debt Service Reserve Fund ("DSRF") which is earning approximately 10 percent. MS, bond counsel and the Commonwealth developed a structure whereby the bonds would be called, but not redeemed. Once called, the bonds were sold to MS. ALCo then entered into a total rate of return swap, whereby MS pays ALCo six percent (the coupon on the bonds) and ALCo pays to MS BMA (short-term tax-exempt municipal index) plus a spread (currently 58 basis points) to cover expenses. This transaction provided the synthetic variable rate exposure to offset the asset sensitivity in the balance sheet, i.e. sensitivity to declining interest rates. During the first few weeks of the trade, ALCo booked $147,727 in earnings on the first payment date of July 1, 2001. Rates continued to steadily decline, putting the trade in a very favorable position. Shortly after the events of September 11, 2001, interest rates tumbled dramatically and on September 27, 2001, staff entered into an offsetting trade, locking in a guaranteed spread of 213 basis points. The reversal rate (rate ALCo agrees to pay MS) was 3.87 percent versus the original fixed receiver rate of 6.00 percent from MS. ALCo has received over $2 million under the terms of the agreement since inception. The expected total benefit from this transaction to maturity is $7.46 million.

Since the two transactions offset each other for a net notional amount of zero, ALCo collects the difference between the two payments and deposits the proceeds into a swap account held for the benefit of the Road Fund. This account also secures future payments to MS under the agreement, if necessary. ALCo is obligated under the agreement to accumulate a minimum balance of $3 million in the swap account. Once cumulative deposits have achieved that level, funds may be available to offset future debt service payments. Since the bonds are still outstanding and the TAK retains the right to call the bonds at face value (par), the termination value of the swap is essentially the present value of the fixed expenses (13 basis points). In the event that short-term tax-exempt rates rise above the coupon on the bonds, the transaction would be terminated and the bonds would be resold to the marketplace. If the value of the bonds in the market are below par, then ALCo would make a payment from the swap account to MS equal to the difference between the then market value and par. Alternatively, the Road Fund could purchase the bonds as an investment at par. The Road Fund and the TAK get the best of both worlds with this transaction in that they retain the highly valuable DSRF earning ten percent and lower the cost of borrowing as long as interest rates stay low. In the event that interest rates rise dramatically, then the investment portfolio of the Road Fund will earn significantly more than projected so long as the Road Fund maintains an investable balance equal to or greater than the notional amount of the transaction.

ALCo also entered into an identical transaction with MS for the 5.50 percent bonds due July 1, 2007 of the TAK Toll Road 1986 Series A Bonds with a par amount of $50,920,000. The Toll Road DSRF earns a bit less than the Resource Recovery 1985A bonds and the coupon on the outstanding bonds is also less, but the mechanics are the same.

On July 24, 2001 MS agreed to enter into a total return swap whereby MS would pay ALCo beginning on January 3, 2002, 5.50 percent in exchange for BMA plus 45 basis points (to cover expenses) The trade could not be executed until December 7, 2001, after the call notice for the bonds had been issued. ALCo agreed to pay MS 4.15 percent in exchange for BMA plus 45 basis points, locking in a guaranteed spread of 135 basis points as long as BMA plus 45 basis points remains below the coupon of the bonds of 5.50 percent.

During fiscal year 2003, the Federal Highway Administration awarded the state Transportation Cabinet approximately $13 million, the estimated remaining principal amount of the Toll Road Bonds related to the Toll Roads known as the Daniel Boone Parkway and the Louie B. Nunn Cumberland Parkway. The award was granted with the understanding that the tolls would no longer be collected and the toll booths removed on these two roads. On July 1, 2003, the Total Return and Fixed Swap transactions were adjusted due to the $12,195, 000 partial redemption of the 2007 term maturity of the Toll Road 1986 Series A Bonds. The $50,920,000 original notional amount was reduced to $38,725,000, with no obligation due from either party with respect to the unwound notional amount as the partial termination occurred on an interest payment date. A swap termination payment on the fixed portion in the amount of $705,000 was paid to MS. The revised present value savings level, factoring in all expenses, is approximately $1.6 million. The net notional amount exposure remains at zero and the market value is par as in the previously described transaction. ALCo has received $689,547 to date.

SWAP SUMMARY

	TAK RR 85 A Total Return	TAK RR 85 A Fixed	TAK TR 86 A Total Return[1]	TAK TR 86 A Fixed[1]	SPBC 55 current refunding[2]	ALCo 2002 TRAN[3]
Fund Source	Road Fund	Road Fund	Road Fund	Road Fund	General Fund	General Fund
Hedge	Net Interest Margin	Total Return	Net Interest Margin	Total Return	Refunding	Variable Notes
Counter-Party	Morgan Stanley	Morgan Stanley	Morgan Stanley	Morgan Stanley	UBS Financial	Citigroup
Counter-Party Ratings*	Aa3/AA-/AA	Aa3/AA-/AA	Aa3/AA-/AA	Aa3/AA-/AA	Aa2/AA+/AAA	Aa1/AA-/AA+
Termination Trigger	BBB-/Baa3	BBB-/Baa3	BBB-/Baa3	BBB-/Baa3	BBB-/Baa3	BBB-/Baa3
Swap Type	Variable Pay	Fixed Pay	Variable Pay	Fixed Pay	Fixed Pay	Variable Pay
Benchmark	BMA	BMA	BMA	BMA	LIBOR	BMA
Reset	Weekly	Weekly	Weekly	Weekly	Semiannual	weekly
Notional Amount	56,485,000	56,485,000	50,920,000	50,920,000	113,185,000	200,000,000
Amortize (yes/no)	no	no	yes	yes	yes	no
Execution Date	4/23/2001	9/20/2001	7/24/2001	7/24/2001	12/12/2002	10/17/2002
Start Date	5/24/2001	9/27/2001	1/3/2002	1/3/2002	8/1/2003	11/1/2002
End Date	*see confirmation*	7/1/2009	7/1/2007	7/1/2007	8/1/2013	6/26/2003
Fixed Rate pay-(rec)	(6.000%)	3.870%	(5.50%)	4.150%	3.215%	1 mo LIBOR-0.17%
Day Count	30/360	30/360	30/360	30/360	30/360	237/365
Payment Dates	Jan. 1 & July 1	Jan. 1 & July 1	Jan. 1 & July 1	Jan. 1 & July 1	Feb. 1 & Aug. 1	at termination
Security Provisions	Road Fund Inv.	Road Fund Inv.	Road Fund Inv.	Road Fund Inv.	GF Debt Service	General Fund
Current Market Valuation June 30, 2003	0.00	0.00	0.00	0.00	(5,889,111.00)	0.00
Interest Earnings						
Cumulative Prior Periods	147,727	1,504,327	0.00	455,716	0.00	0.00
Current Period - 6/30/2003	0.00	439,407	0.00	233,831	0.00	-65,814.57
Total	147,727	1,943,733	0.00	689,547	0.00	-65,814.57

* *Moody's, S&P, Fitch*

[1] *Partial Unwind of $12,195,000 on July 1, 2003 leaving $38,725,000 notional amount.*

[2] *Terminated on July 17, 2003 with $5,889,111 payment as priced on June 11, 2003.*

[3] *Terminated on June 26, 2003 with $65,814.57 payment at TRAN maturity.*

Total Notional Amount Executed

	General Fund	Road Fund		UBS Financial	Morgan Stanley	Citigroup
Fund Source Total	313,185,000	214,810,000	Counter Party	113,185,000	214,810,000	200,000,000

Net Exposure Notional Amount

	General Fund[2]	Road Fund		UBS Financial[2]	Morgan Stanley	Citigroup
Fund Source	113,185,000	0	Counter Party	113,185,000	0	0

10 Percent Net Exposure

Debt Outstanding	General Fund	Road Fund		General Fund	Road Fund
June 30, 2003	1,960,979,490	870,179,002	10 Percent	196,097,949	87,017,900

10 Percent Investment Portfolio

Investment Pool Balance	Other Funds	Net Road Fund		Other Funds	Net Road Fund
June 30, 2003	2,439,177,591	289,930,496	10 Percent	243,917,759	28,993,050

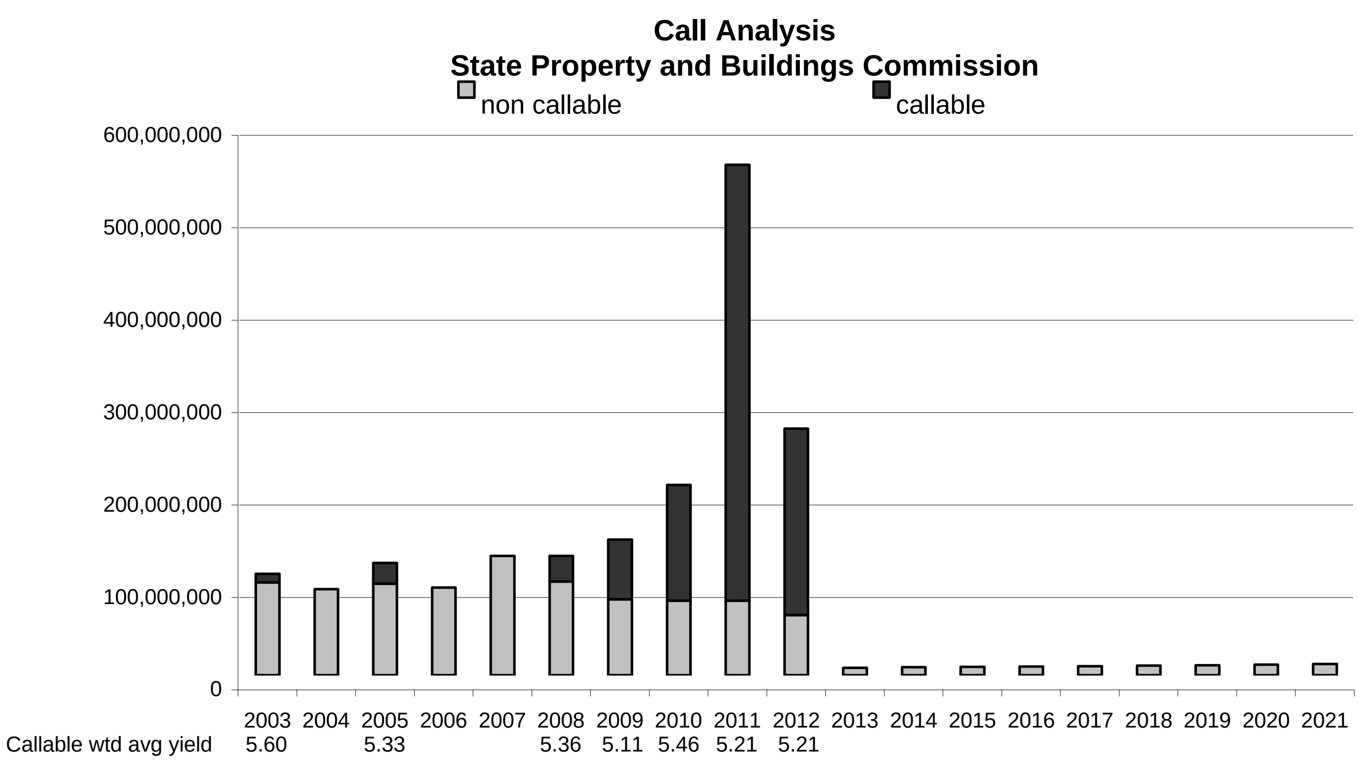
*UBS downgraded to AA+ on September 11, 2003.

Due to the success of similar transactions, it was determined that ALCo would enter into a cash settled hedge to attempt to preserve savings for a potential refunding of SPBC 55. Cash settled interest rate swaps unwind (at bond pricing) with a cash settlement at the time the corresponding bonds or notes closes.

ALCo entered into the trade with UBS Financial (UBS") on December 12, 2002 to be effective August 1, 2003, for a notional amount of $113,185,000 to be amortized through August 1, 2013. UBS agreed to pay a floating rate of 78.75 percent of LIBOR in exchange for a fixed payment from ALCo of 3.215 percent. When executed, the present value savings for this portion of the transaction were projected to be $4,773,114. The swap transaction was terminated on June 11, 2003, the same day that the bonds were priced. The actual present value savings attributable to the hedged portion of the transaction were $4,698,817. This is very close to the original projection and staff is satisfied that the hedged performed as designed. The slight under performance was attributable to a continuation of the abnormally high ration of BMA as a percentage of LIBOR.

Asset/Liability Model

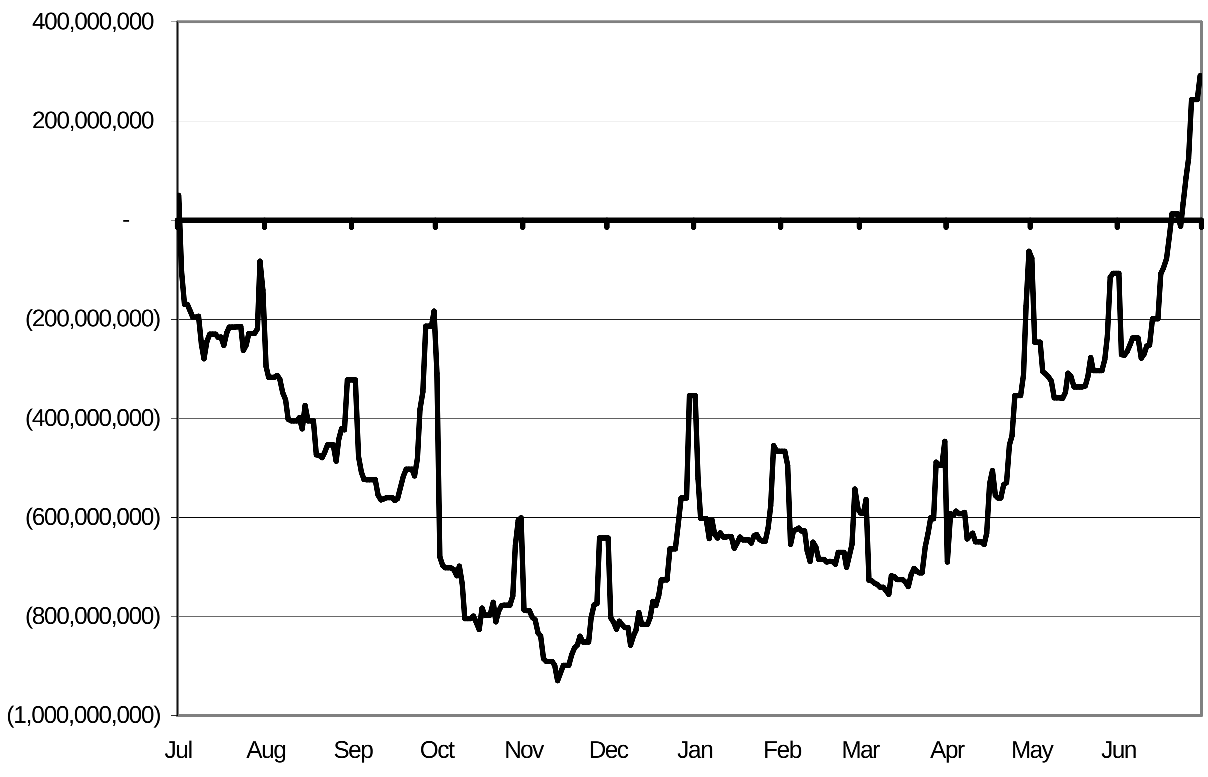
General Fund. The SPBC debt portfolio as of June 30, 2003, had $2,051 million of bonds outstanding with a weighted average coupon of 5.16 percent, modified duration of 5.16 years, and a yield at market of 3.25 percent. The market yield increased by 19 basis points from the prior reporting period while modified duration decreased by .13 years reflecting maturing debt. The callable portion was $923 million and had an average coupon of 5.32 percent. Due to the low average coupon and negative arbitrage in the advance refunding environment, there is no economically feasible refunding candidate. The 2003 callable bonds mature within one year and have no significant savings once costs are considered.



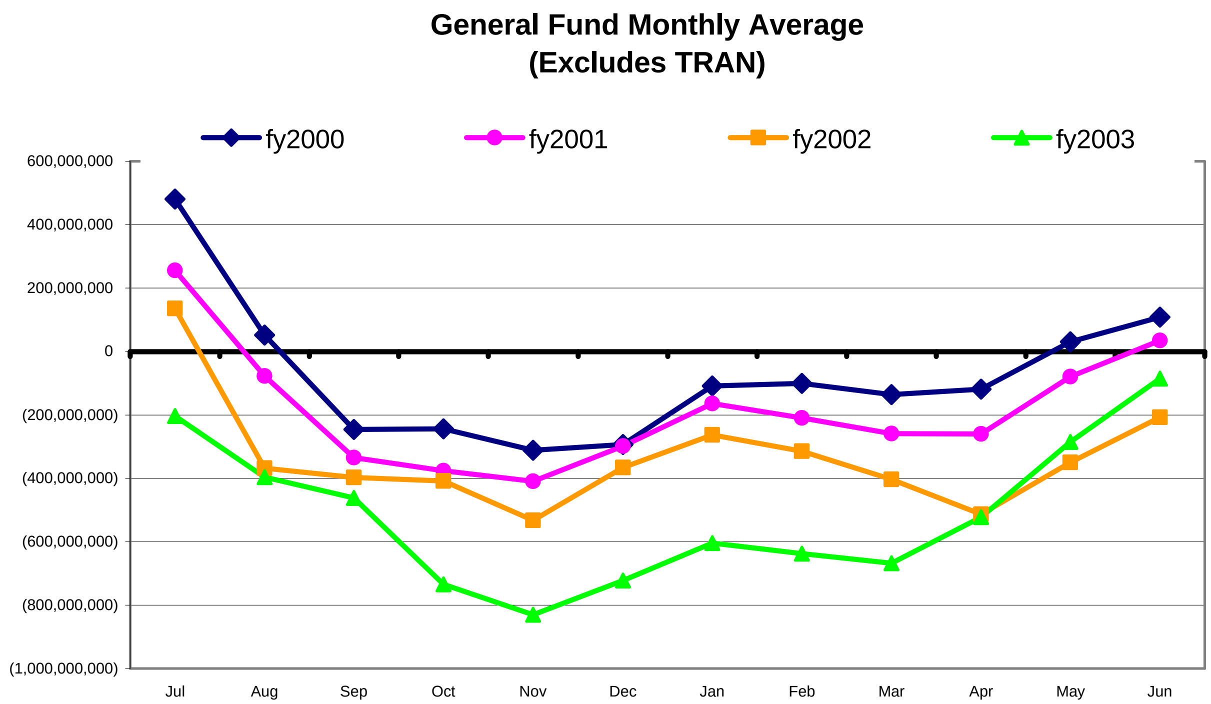
The General Fund had a high balance of $292 million on June 30, 2003, and a low of negative $930 million on November 13, 2002. The average and median balances were a negative $512 million and a negative $560 million, respectively. Since the General Fund continued to have a negative average cash balance for most of the period there is little, if anything, that can be done from an asset management viewpoint beyond current actions. The 2002 TRAN proceeds added economic benefit in that it reduced the amount of borrowing from other sources but could not fully offset the negative balances of the General Fund. The BRTF, which became a statutory account in 1995, was drawn upon to balance the fiscal 2001 and 2002 budgets and currently has a zero balance.

From a liability management perspective, total General Fund debt service, net of reserve fund credits, was $388.7 million for the fiscal year. No General Fund investment income was distributed this fiscal year as the General Fund experienced net interest expense of $8.5 million as a result of significant interfund borrowing.

General Fund Available Balance
Fiscal Year 2003
(Excludes TRAN)



The structural change to the Short-term Investment Pool will keep borrowing costs as low as possible and provide additional needed liquidity. In addition to the continued development of our own software, staff is evaluating the possible use of a proprietary model developed by a major Wall Street bank for their own application. Net Interest Margin will continue to be negative due to compressed yield ratios, overall level of interest rates and optionality of the debt portfolio.

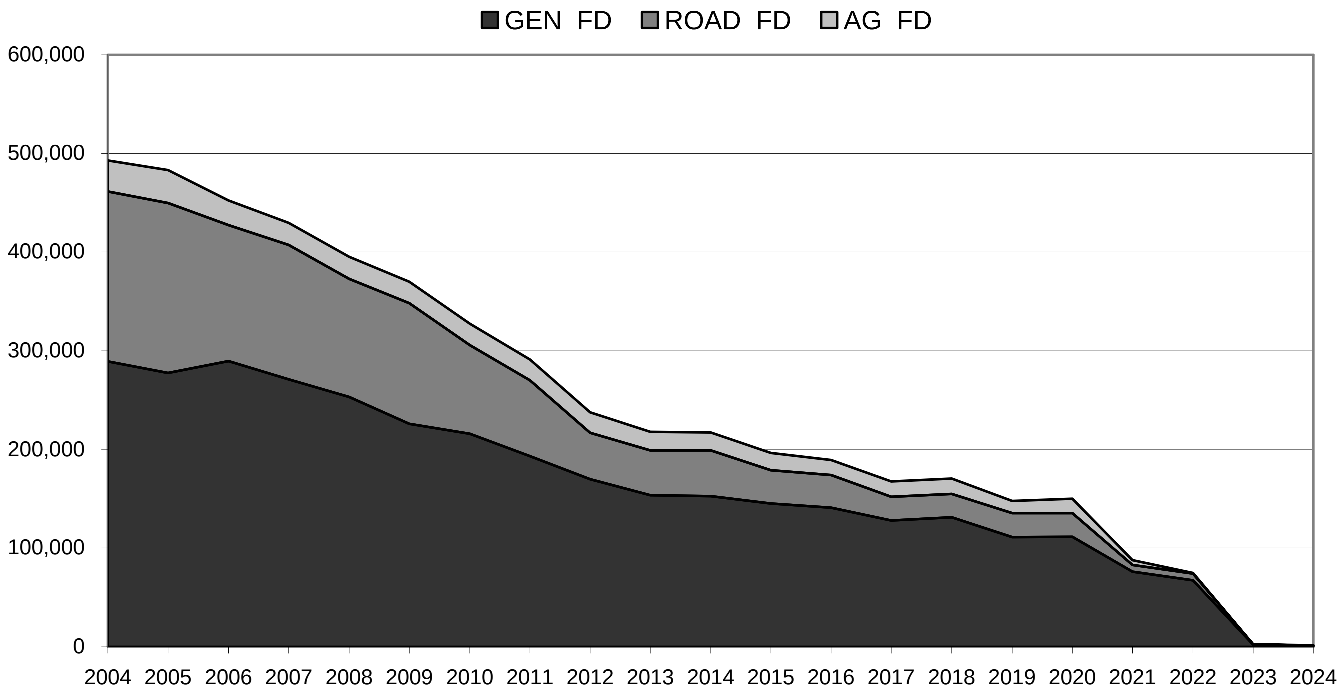


Road Fund. The Road Fund average daily cash balance for fiscal year 2003 was $428 million. Of that average amount, $228 million was invested in the Intermediate-term Investment Pool and $200 million in the Long-term Investment Pool. The duration of the respective pools was 1.89 years and 2.96 years as of June 30, 2003. The Road Fund earned $29 million on a cash basis versus the revised budget amount of $23 million for the fiscal year. Declining balances have resulted in a collapse of the Long-term Intermediate Pool in July 2003.

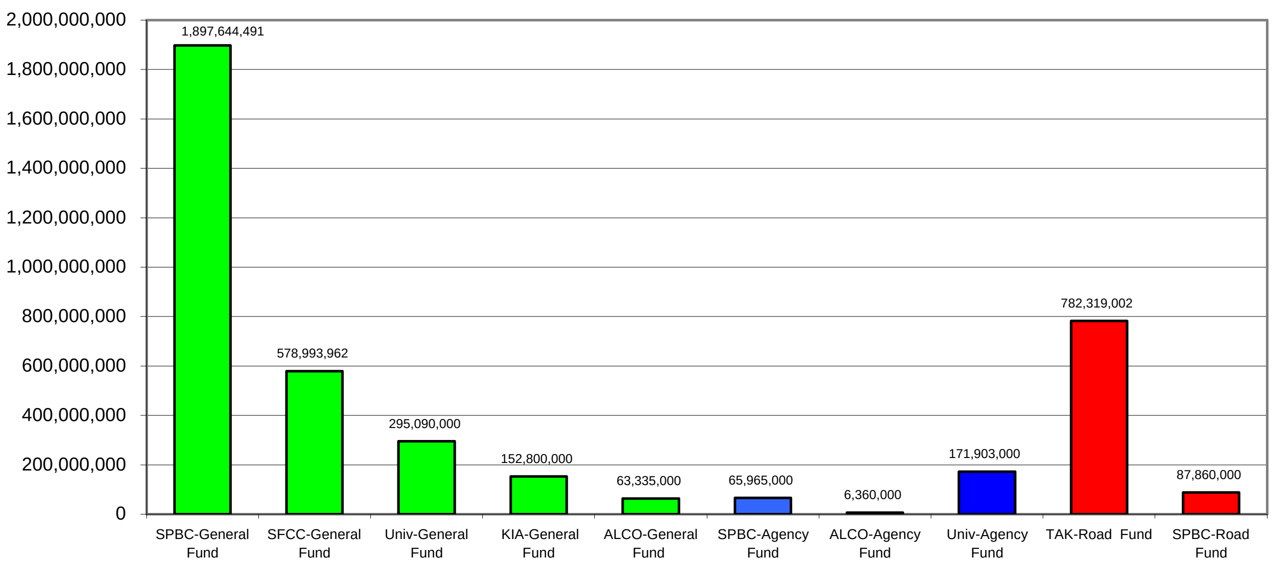
As of June 30, 2003, TAK has $782 million of bonds outstanding with a weighted average coupon of 5.20 percent, modified duration of 4.16 years, and yield at market of 2.89 percent. Selected maturities of the Resource Recover 1985A and Toll Road 1986 A bonds with the most economical value, were previously synthetically refunded with financial agreements as identified previously.

Road Fund debt service paid, net of reserve fund credits, during fiscal year 2003, was $175.8 million resulting in a net interest margin (investment income earned less debt service paid) of negative $146.7 million. The negative amount stems from a general decrease in interest rates on the investment side and fixed rate obligations on the liability side. As the Road Fund has experienced in recent years, this trend can reverse itself very quickly when interest rates rise.

Appropriation Supported Debt Service by Fund Source as of 06/30/03* (000)



Appropriation Debt Principal Outstanding by Fund Source As of 6/30/03*



*Includes $22,695,000 of ALCo 1999 General Fund Notes and $150,810,000 SPBC 55 bonds that were refunded by June 11, 2003 sale, with July 17, 2003 delivery, and TAK $12,915,000 Toll Road 1986 Series principal defeased on June 5, 2003 (FHWA grant) but not called until July 1, 2003.

SUMMARY

ALCo's approach to managing the Commonwealth's interest-sensitive assets and interest-sensitive liabilities continues to produce excellence results.

- **Investments**. Incremental returns derived from new investment asset classes are $4.9 million for fiscal year 2003 and $26.9 million since inception.

- **Cash Management**. Cash management improved dramatically with the implementation of the General Fund TRAN program producing $3.2 million in fiscal year 1998, $4.7 million in fiscal year 1999 and $7.3 million in fiscal year 2000. Economic benefit for fiscal year 2001 was $6.5 million, fiscal year 2002 was $4.3 million and $.3 million in fiscal year 2003 for a cumulative benefit of $26.3 million.

- **Debt Management**. Debt Service savings have contributed an estimated $244 million in value added since inception.

  ⇒ Synthetic advanced refunding of SPBC 40 (Second Series) using a delayed start interest rate swap produced $1.1 million in present value savings.

  ⇒ Synthetic refunding of TAK Resource Recovery 1985 Series A bonds has accumulated $2 million to date of which $439,407 is attributable to the current period.

  ⇒ Synthetic refunding of TAK Toll Road 1986 Series A bonds has provided $689,547 to date of which $233,831 was earned during the current period.

  ⇒ Application of Medium Term Notes structure and financial agreement strategies resulted in present value savings of $6.6 million from SPBC refundings.

  ⇒ Lapsed General Fund debt service for fiscal year 1999 was $10.5 million, fiscal year 2000 was $29 million, fiscal year 2001 was $76.5 million, fiscal year 2002 was $104 million, and fiscal year 2003 was $13.4 million. The total of $233.6 million reflects the savings from actual versus budgeted debt service.

- **Total value added since inception is approximately $297 million**.