Semi-Annual Report of the Kentucky Asset/Liability Commission

23RD EDITION

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Commonwealth of Kentucky

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For the period ending June 30, 2008

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This report may be viewed at:

http://finance.ky.gov/ourcabinet/caboff/OOC/ofm/debt/AlcoSemiAnnualRpt.htm

INTRODUCTION

This is the Kentucky Asset/Liability Commission's ("ALCo") twenty third semi-annual report pursuant to KRS 56.863 (11) for the period beginning January 1, 2008 through June 30, 2008. 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 begins to slow.
- U.S. average home prices dramatically decline 20 percent due to the sub-prime market deterioration.
- War in the Middle East continues.
- The Dow Jones Industrial Average finishes the fiscal year at 11,347 down 2,019 points from December 2007.
- Federal Funds rate decreases to 2.00 percent after four cuts during the period.
- Monoline insurers downgraded by credit rating agencies, with only two retaining AAA status.
- The Federal Reserve Bank brokers a buyout of Bear Stearns by JP Morgan in order to avert a major market collapse.
- UBS discontinues its Public Finance operations.

On the State level

- Continued implementation of the two largest bond authorizations in the history of the Commonwealth from the 2005 and 2006 General Assemblies.
- Fiscal year 2008 General Fund revenues increased 1.1 percent over fiscal year 2007.
- The 2008 General Assembly adopted HB 406 which authorized an additional $650 million General Fund supported bonds, an additional $135 million Road Fund supported bonds, an additional $643 million Agency Fund supported bonds and an additional $231 million bonds to be supported from the Federal Highway Trust Fund.

INVESTMENT MANAGEMENT

MARKET OVERVIEW

The past year has seen the unwinding of a bubble in the housing market and a massive de-leveraging of the financial system. The painful results have been widespread. To understand this experience, it is necessary to examine how the situation was created.

The Federal government, through acts of Congress, created two Government Sponsored Entities (GSE's), Freddie Mac and Fannie Mae in 1970 and 1938, respectively. The two GSE's were charged with providing liquidity to the mortgage market and were granted implied credit support from the government through small lines of credit at the US Treasury. (There are other GSE's, but these are the two dedicated to supporting the mortgage market) The two GSE's provided the liquidity support by purchasing any mortgage which meets their underwriting standards. They then "pooled" groups of similar mortgages and sold securities backed by those mortgages. This is known as securitization. It created a market for mortgage-backed securities by eliminating the need for investors to underwrite individual loans because Fannie and Freddie already had, and the two GSE's guaranteed the credit of the pool.

Over the last 10 to 15 years, numerous Wall Street firms and banks copied that model. Nearly any asset could be "pooled" with securities issued which are backed by the pooled assets. The credit risk of the underlying assets was concentrated into certain subordinate bonds which allowed the creation of high quality, AAA-rated tranches which were sold widely into the market. Because these pools were structured as independent entities, the banks which created the assets (mortgages, home equity lines, credit cards, auto loans, etc.) no longer held the credit risk.

The next step in the process was the use of leverage to purchase the securities. Numerous market participants began borrowing in the repo and commercial paper market by using the securitized mortgages as collateral for the loans. Much of this activity was in the unregulated "shadow banking" system including hedge funds and Special Investment Vehicles (SIVs) which are off-balance sheet bank creations.

This demand and ability to off-load the credit risk spawned enormous growth in the mortgage market. Houses are most often purchased based on the monthly payment, not the price. As the market expanded, new types of loans were created which reduced the payments, such as Option ARMs. This creative funding artificially boosted demand for houses and lead to dramatic price increases. Because the credit risk of the individual loans was passed on to other investors, underwriting standards dropped to the point of almost non-existence.

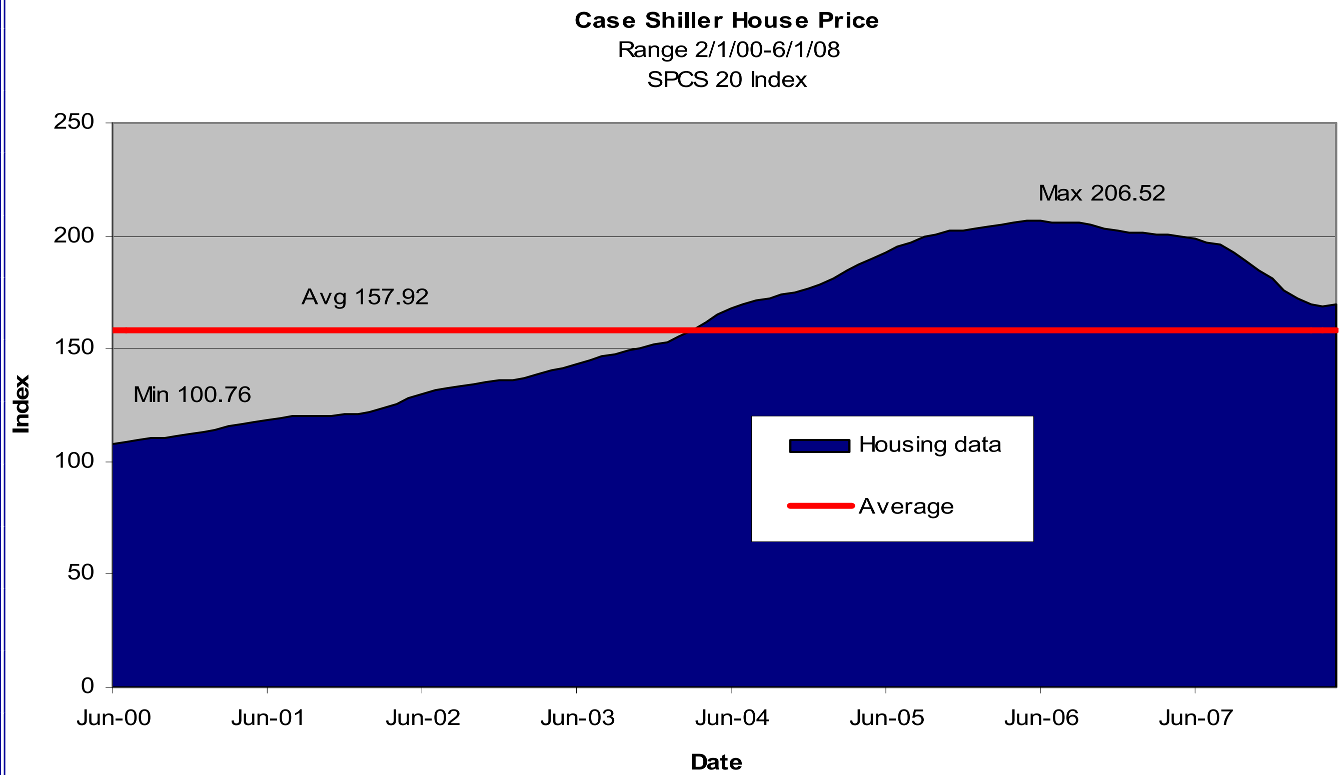
This bubble burst last year as rising delinquencies and foreclosures began to impair some of the securitized pools. Prices began to drop. At that point, the leverage in the market began to multiply the effect of the price declines. As prices fell, leveraged holders received margin calls forcing them to liquidate positions. This led to further price drops causing more margin calls. This de-leveraging has devastated the markets.

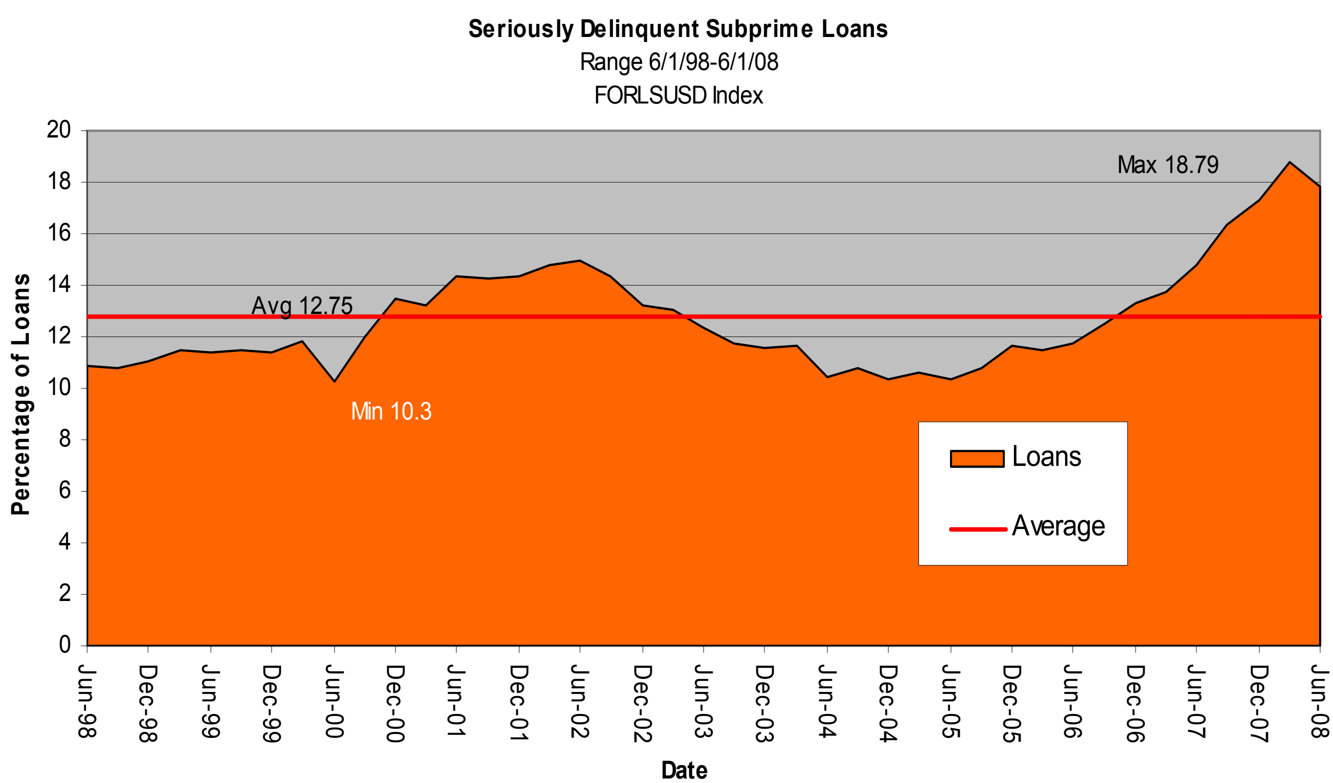
To date, Wall Street firms and large banks have been hit with losses of nearly $500 billion. Countrywide, previously the nation's largest mortgage originator, was purchased by Bank of America. Bear Stearns collapsed leading to a rescue by JP Morgan with unprecedented funding from the Federal Reserve. IndyMac Bank failed and was taken over be the FDIC in the third largest bank failure in US history. A mortgage bailout bill passed the US Congress authorizing the Treasury to loan money to, or take an equity stake in the GSE's if needed. The previous implied support is now explicit.

Where do things go from here? It appears that the bottom of the housing market has not been reached. Delinquencies and foreclosures continue to increase while prices of homes continue to fall. As this bleeds into the financial markets, security prices continue to fall leaving the banking system in weaker condition. This restricts the availability of credit which hurts consumer spending, which further weakens the housing market. At some point, a bottom will be reached, but we are not there yet.

INVESTMENT MANAGEMENT

Housing Prices & Delinquent Loans

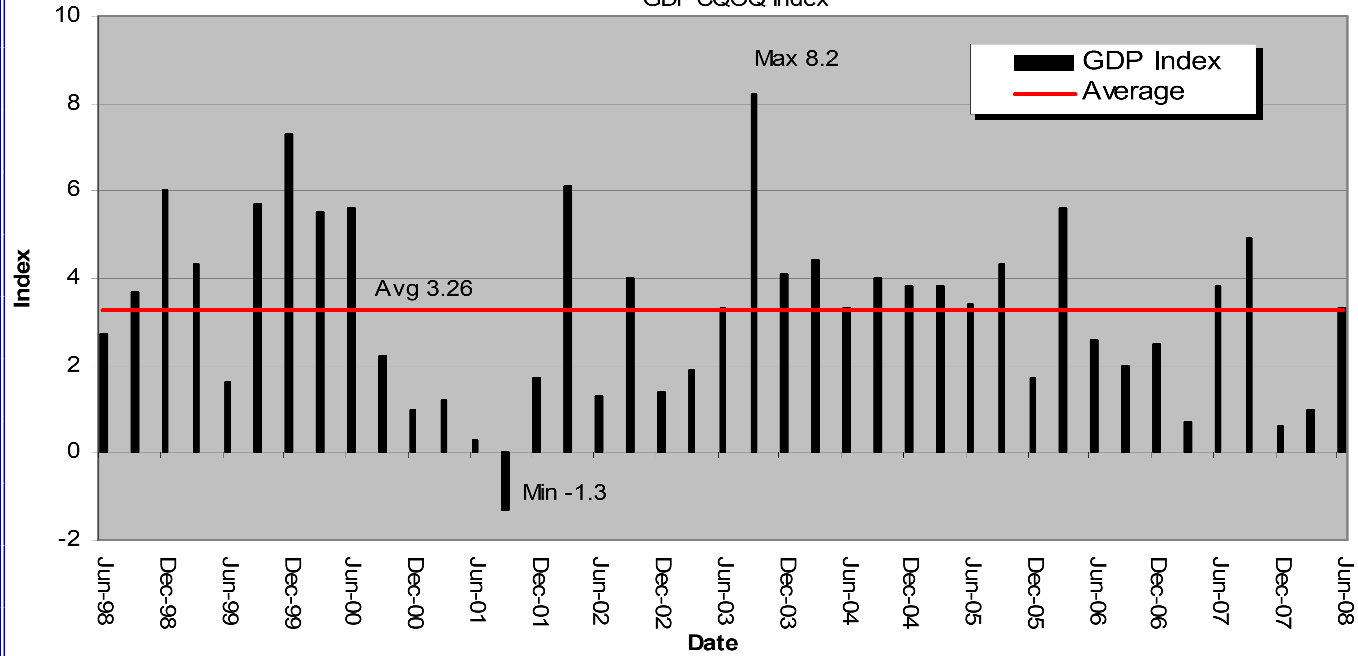




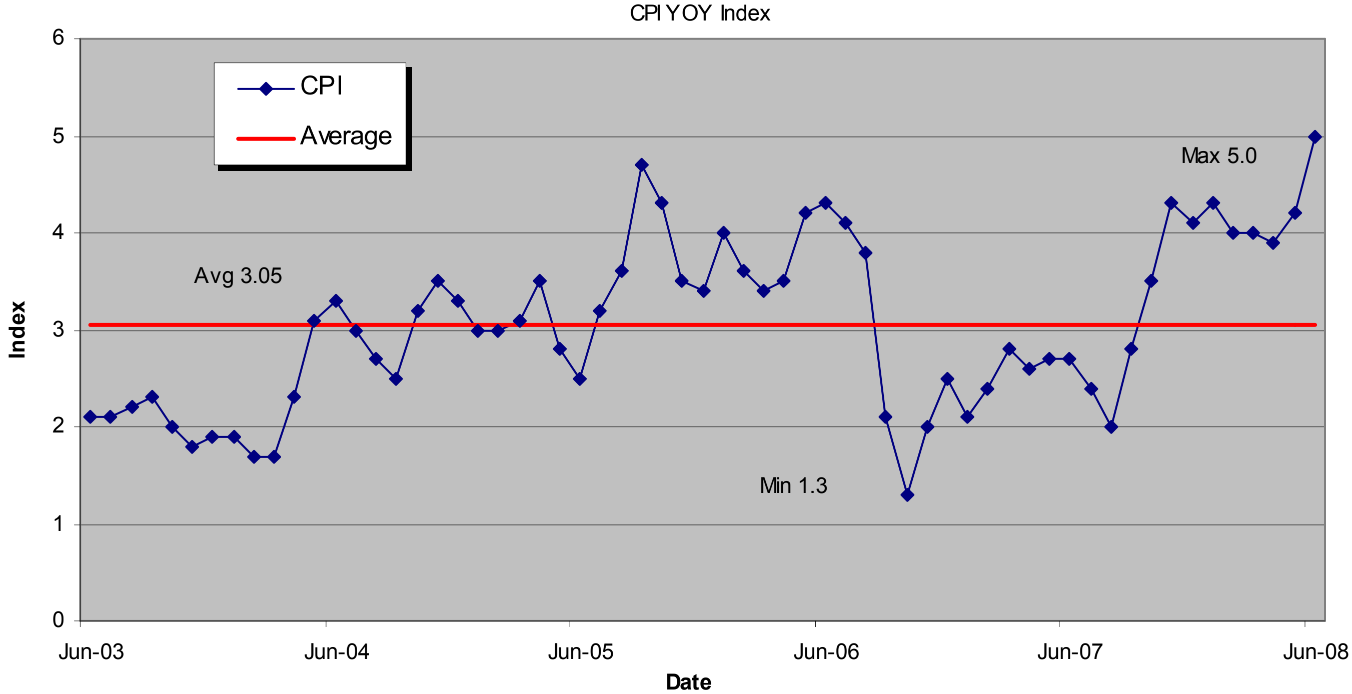
INVESTMENT MANAGEMENT

Gross Domestic Product & Consumer Price Index

Real Gross Domestic Product
Quarter Over Quarter
Range 6/30/98-6/30/08
GDP CQOQ Index



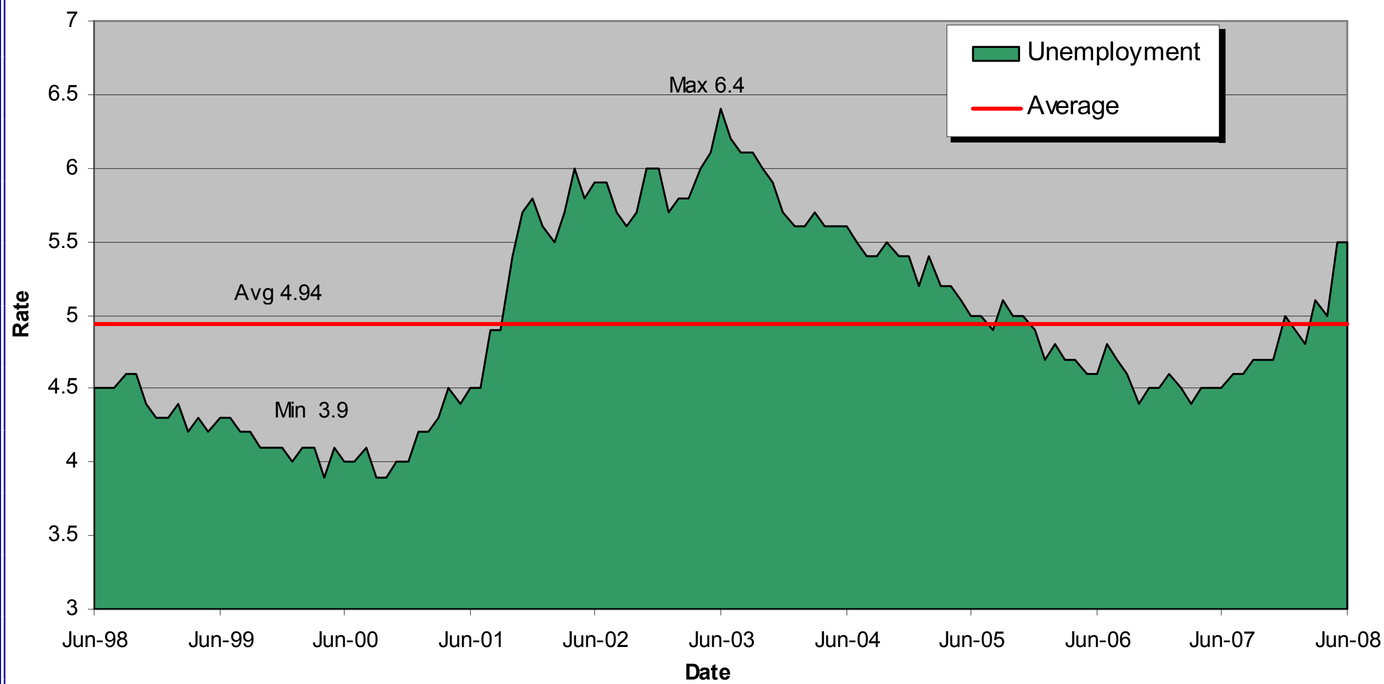
Consumer Price Index
Year over Year
Range 6/30/03-06/30/08
CPI YOY Index



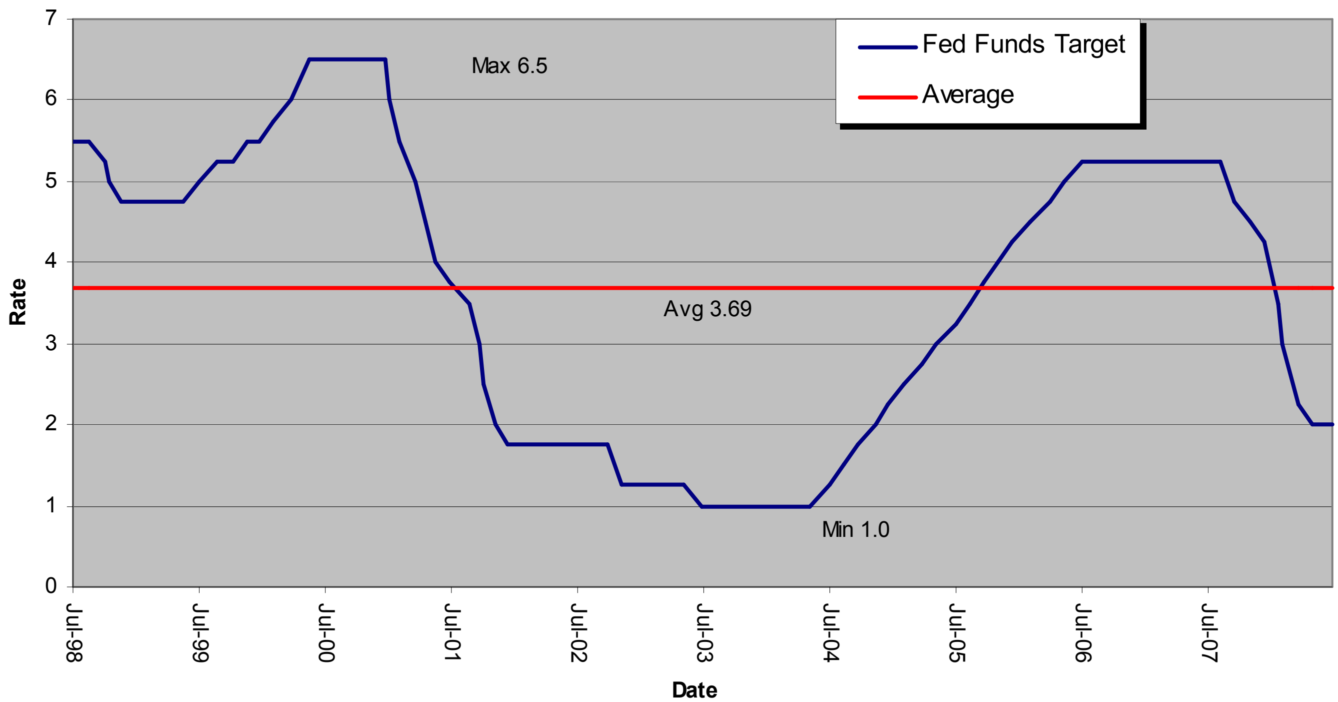
INVESTMENT MANAGEMENT

Unemployment & Federal Funds Target Rate

Unemployment Rate
Range 6/30/98-6/30/08
USURTOT Index



Federal Funds Target Rate
Range 7/01/98-6/25/08
FDTR Index



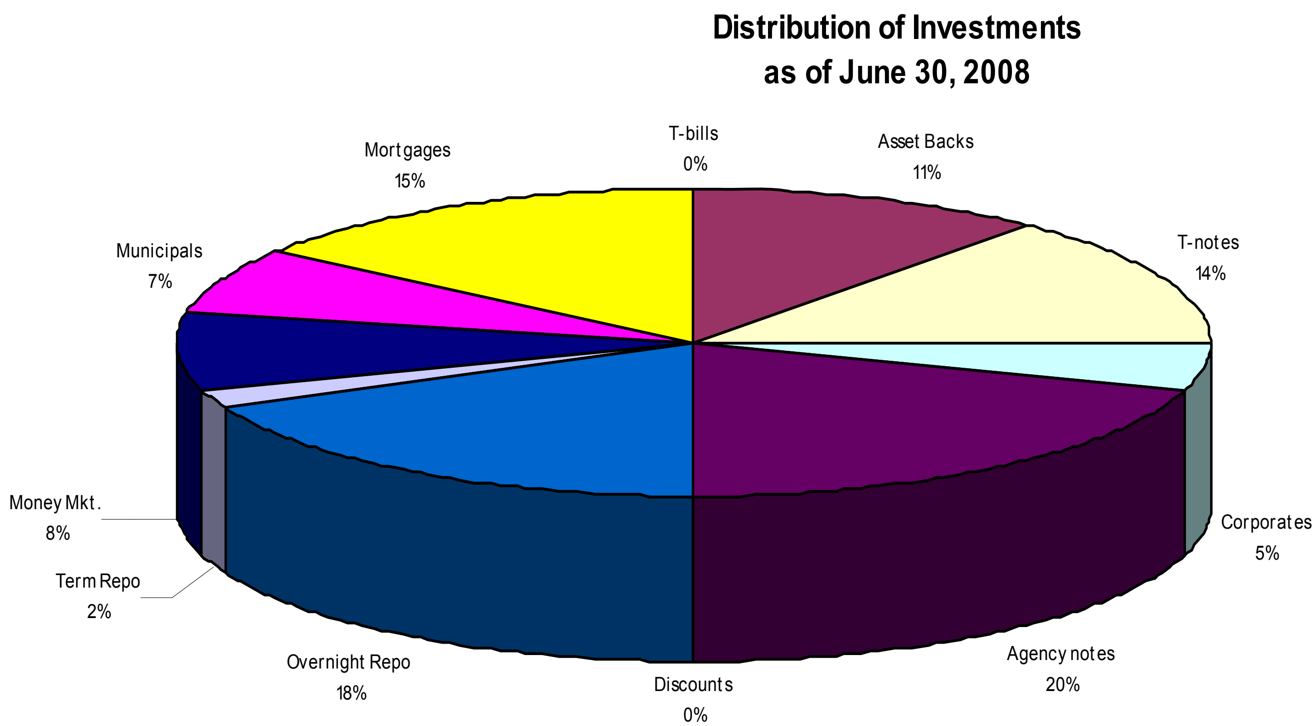
INVESTMENT MANAGEMENT

PORTFOLIO MANAGEMENT

For the year ended June 30, 2008, the Commonwealth's investment portfolio averaged $3.9 billion. As of June 30, 2008, the portfolio was invested in U. S. Treasury Securities (14 percent), U. S. Agency Securities (20 percent), Mortgage Pass Through Securities (2 percent), Collateralized Mortgage Obligations (13 percent), Repurchase Agreements (20 percent), Municipal Securities (7 percent), Corporate Securities (5 percent), Asset-Backed Securities (11 percent), and Money Market Securities (8 percent). The portfolio had a market yield of 4.26 percent and an effective duration of .91 years.

The total portfolio is broken down into five investment pools. The pool balances as of June 30, 2008, were: Short Term Pool: $1,562 million, Intermediate Term Pool: $1,588 million, Bond Proceeds Pool: $315 million, TRAN Pool: $362 million, and UK Hospital Pool: $121 million.

Total investment income from all investments, on a cash basis, for the year ended June 30, 2008, was $190.3 million versus $256.2 million for the year ended June 30, 2007. On a full mark-to-market basis, investment income was $198.9 million for the year ended June 30, 2008, versus $221.8 million for the year ended June 30, 2007. These totals are down due to the lower interest rate environment during fiscal year 2008.

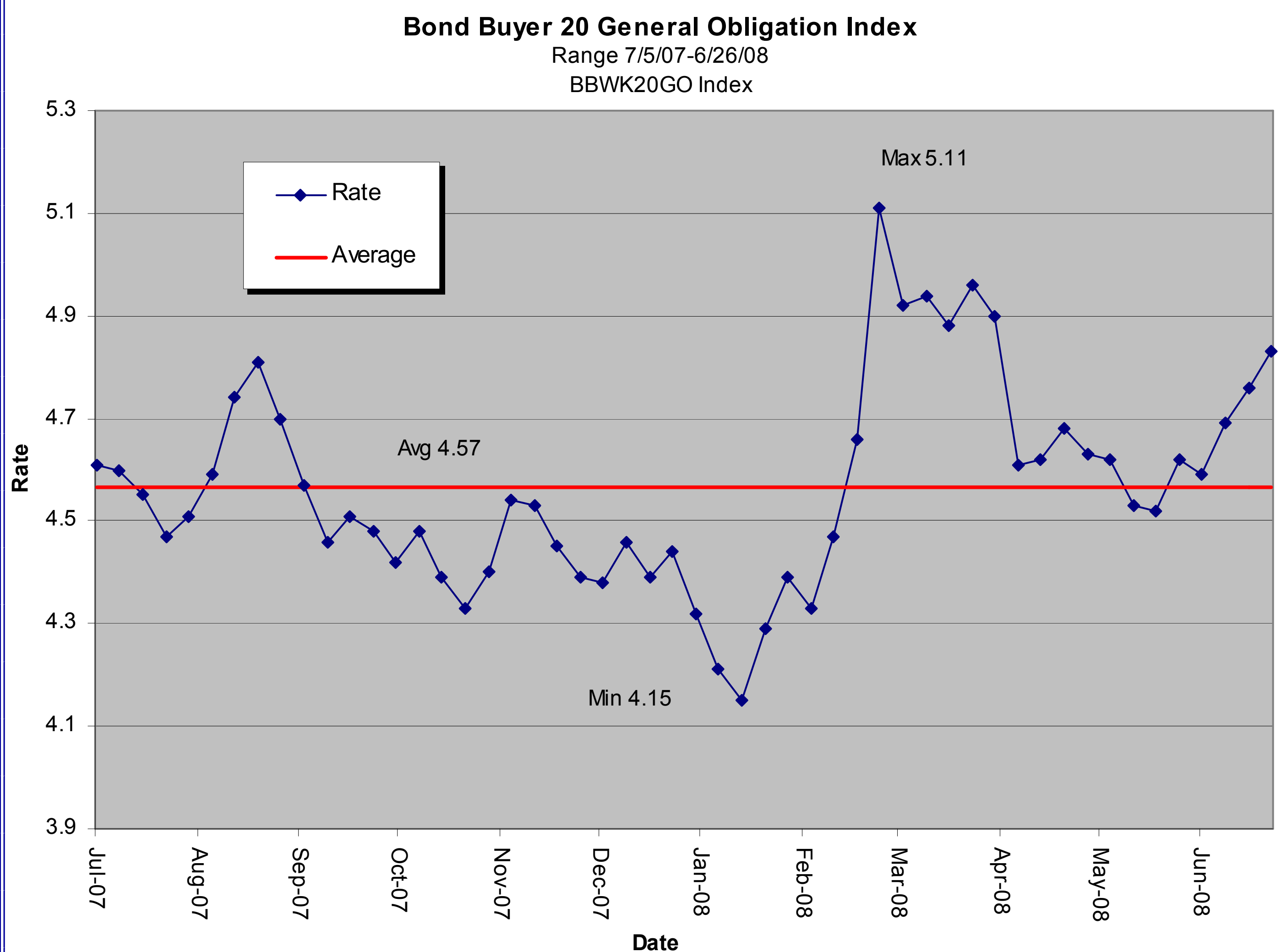


INVESTMENT MANAGEMENT

Tax-exempt Interest Rates and Relationships

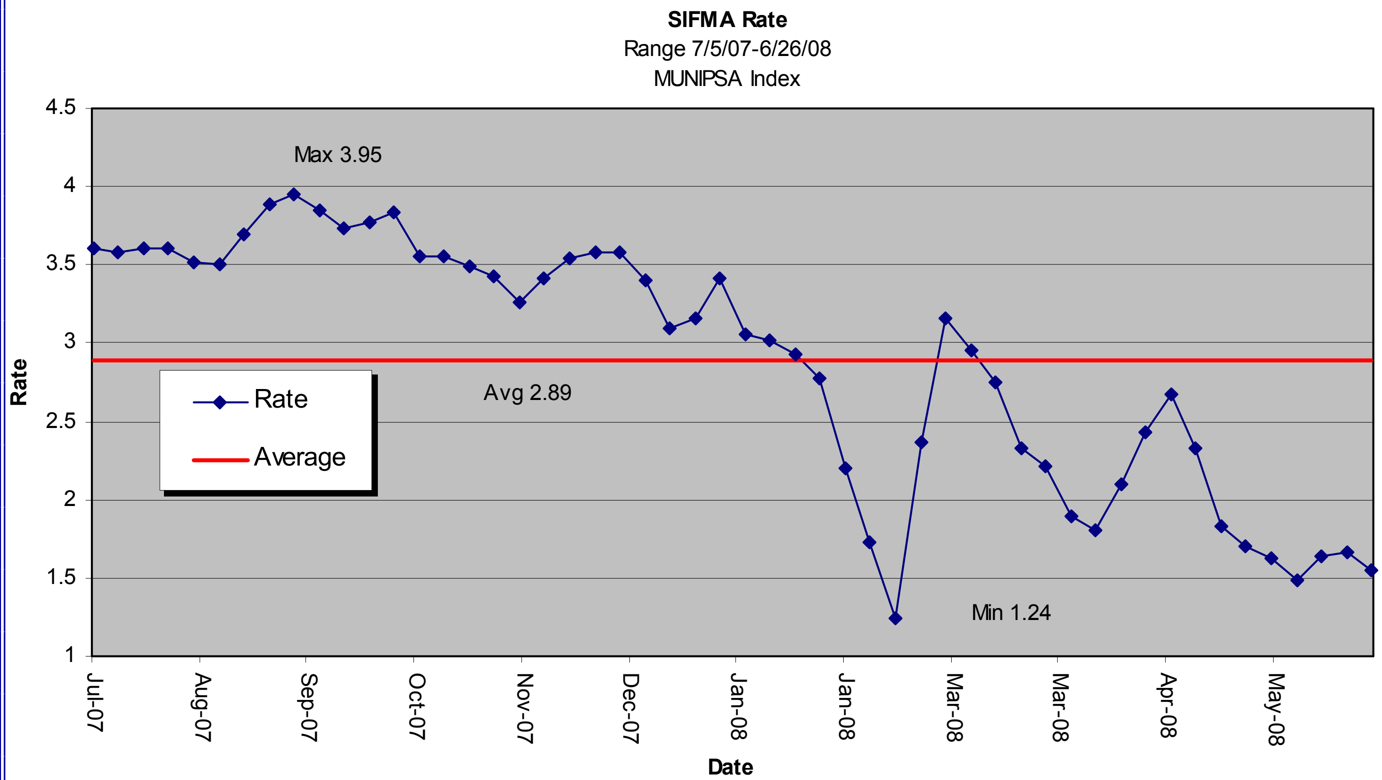
The Bond Buyer 20 year General Obligation Index averaged 4.62 percent for the six-month reporting period and 4.57 percent for fiscal year 2008. The fiscal year high was 5.11 percent in February 2008 and the low was 4.15 percent in January 2008.

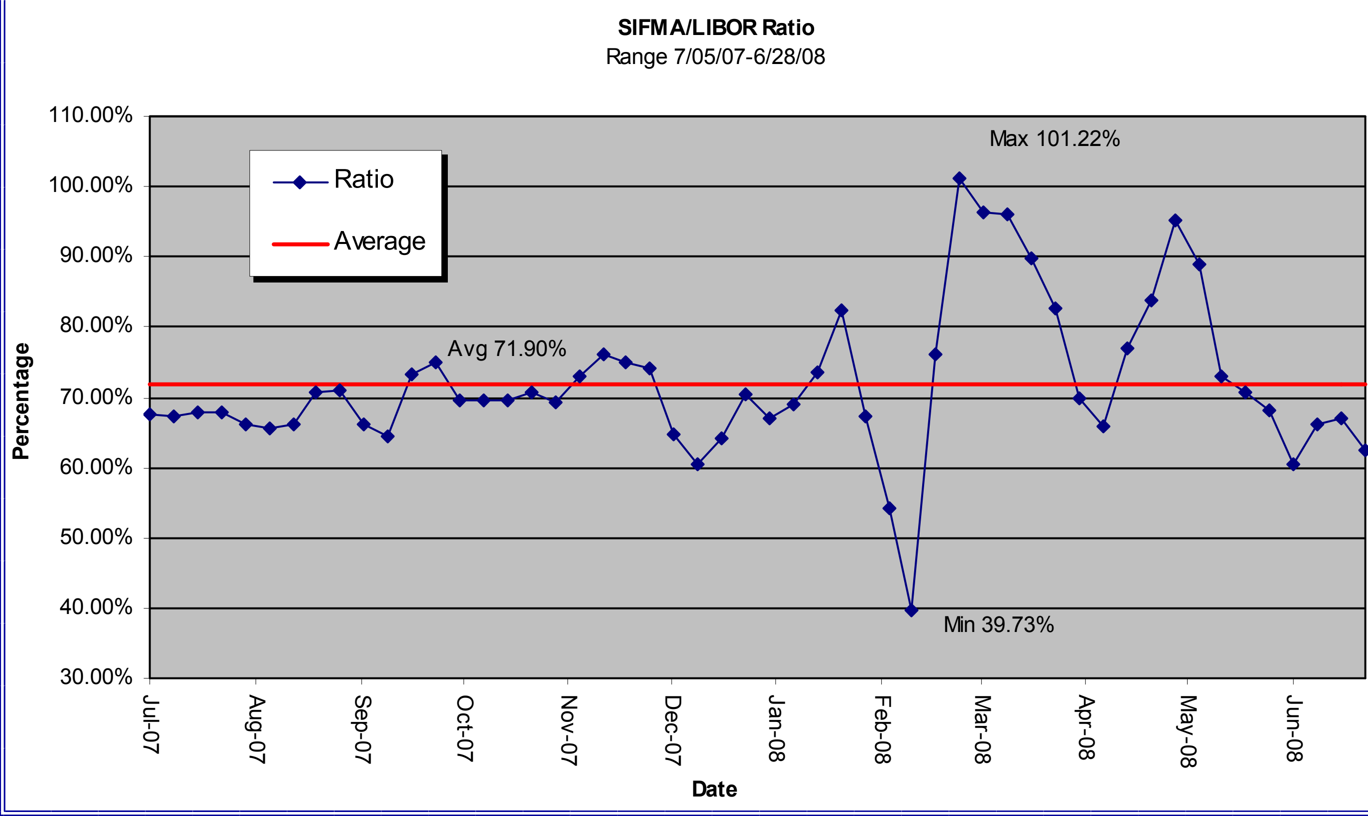
The Securities Industry and Financial Markets Association (SIFMA) Municipal Swap Index averaged 2.21 percent for the reporting period and 2.89 percent for the fiscal year. The fiscal year high was 3.95 percent in August 2007 and the low was 1.24 percent in February 2008. The 30-day USD London Interbank Offered Rate ("LIBOR") averaged 2.94 percent for the reporting period and 4.05 percent for the fiscal year. The fiscal year high was 5.82 percent in September 2007 and the low was 2.38 percent in May 2008. During the fiscal year, SIFMA traded as high as 101 percent of 30-day LIBOR in February 2008 and as low as 40 percent during the same month. The SIFMA as a percent of LIBOR averaged 71 percent for the fiscal year and ended the fiscal year at 64 percent.



INVESTMENT MANAGEMENT

SIFMA and SIFMA/LIBOR Ratio





DEBT MANAGEMENT

The 2005 Kentucky General Assembly enacted a State Budget for the biennium ending June 30, 2006, which authorized $2.056 billion of bond funded capital projects. The General Fund authorization was $1,204 million; the Road Fund authorization was $450 million; Agency Funds were authorized at $251.7 million; and $150 million was authorized to be supported by the Federal Highway Trust Funds (FHTF). Bonds have been issued to permanently finance the Road Fund, Agency Fund and FHTF authorizations.

The 2006 Kentucky General Assembly adopted a State Budget for the biennium ending June 30, 2008, which authorized an additional $2.3 billion of bond funded capital projects. The General Fund authorization was $1,392.9 million; the Road Fund authorization was $350 million; Agency Funds were authorized at $267.5 million; and the FHTF authorization was $290 million. Bonds have been issued to permanently finance the Agency Fund authorization, while ALCo issued project notes in September 2007 to permanently finance the FHTF authorization and provide interim financing for the Road Fund authorization.

In the 2007 2nd Special Session, the Kentucky General Assembly authorized $100 million of General Fund supported Energy Bonds.

A significant portion of the General Fund bond projects from the above authorizations have been permanently financed. Interim note financing is available through ALCo for the remaining projects. The timing of permanent financing is uncertain and dependent upon expenditure needs.

The 2008 Kentucky General Assembly enacted a State Budget for the biennium ending June 30, 2010, which authorized an additional $1.739 billion of bond funded capital projects. The General Fund authorization was $650.3 million; the Road Fund authorization was $135 million; Agency Funds were authorized at $643.2 million; the FHTF authorization was $231 million; and there were $80 million of other authorizations.

Ratings Update

The rating agencies continually monitor the Commonwealth's performance in areas such as revenue, the economy and debt management. The recent softening in the economy has put pressure on the Commonwealth's credit ratings at Moody's & Fitch.

In April 2008, Moody's Investors Service revised from "stable" to "negative" , the outlook on the Commonwealth's "Aa2" issuer credit rating and State Property and Buildings Commission (SPBC) rating of "Aa3", citing ongoing economic and financial weakening, leading to revenue underperformance and sizable budget deficits. Moody's also cited a draw-down of ending and reserve balances, and a strong reliance on one-time resources to balance the biennial budget for FY 2009-10. Based on a history of active financial management, Moody's expects that the Commonwealth will work towards stabilizing its fiscal condition and return to structural budget balance in the near-term.

Also in April 2008, Fitch Ratings, for similar reasons, revised its outlook from "stable" to "negative" on its "AA-" rating for SPBC.

In January 2007, S&P revised its outlook from "stable" to "positive", for Kentucky's "AA-" issuer credit rating and its "A+" rating for SPBC, based on the Commonwealth's positive economic and revenue growth, steadily replenishing reserves, and the expectation that the Commonwealth will devise a long-term plan addressing rising pension and healthcare liabilities. S&P has maintained these ratings and outlook through the first half of 2008.

Under the traditional rating scales, the credit rating agencies have historically rated many state and municipal credits lower than corporate debt with similar default rates. However, recently Moody's, S&P and Fitch came under pressure to overhaul their decades-old rating scales as municipal bond insurers lost their AAA ratings after expanding coverage into subprime-related debt. On June 12, 2008,

DEBT MANAGEMENT

Moody's Investor Service announced it would review its public finance rating criteria to make U.S. municipal bonds comparable with corporate debt. Subsequently in August 2008, Moody's stated it will begin upgrading U.S. state and municipal bonds in October 2008 in an effort to make public finance ratings directly comparable with corporate and other credit ratings. Moody's, under pressure from Congress, expects to complete the revisions involving more than 70,000 credits before April 2009. Standard & Poor's has been using a global rating scale since 2000, and has upgraded about half the 12,000 municipal credits it rates since that time. Recently, S&P stated that it will accelerate an upgrade of municipal bonds as part of a broader ratings review. They did not provide a timetable. In July 2008, Fitch stated they would likely be upgrading municipal credits as well.

Tax and Revenue Anticipation Notes (TRAN)

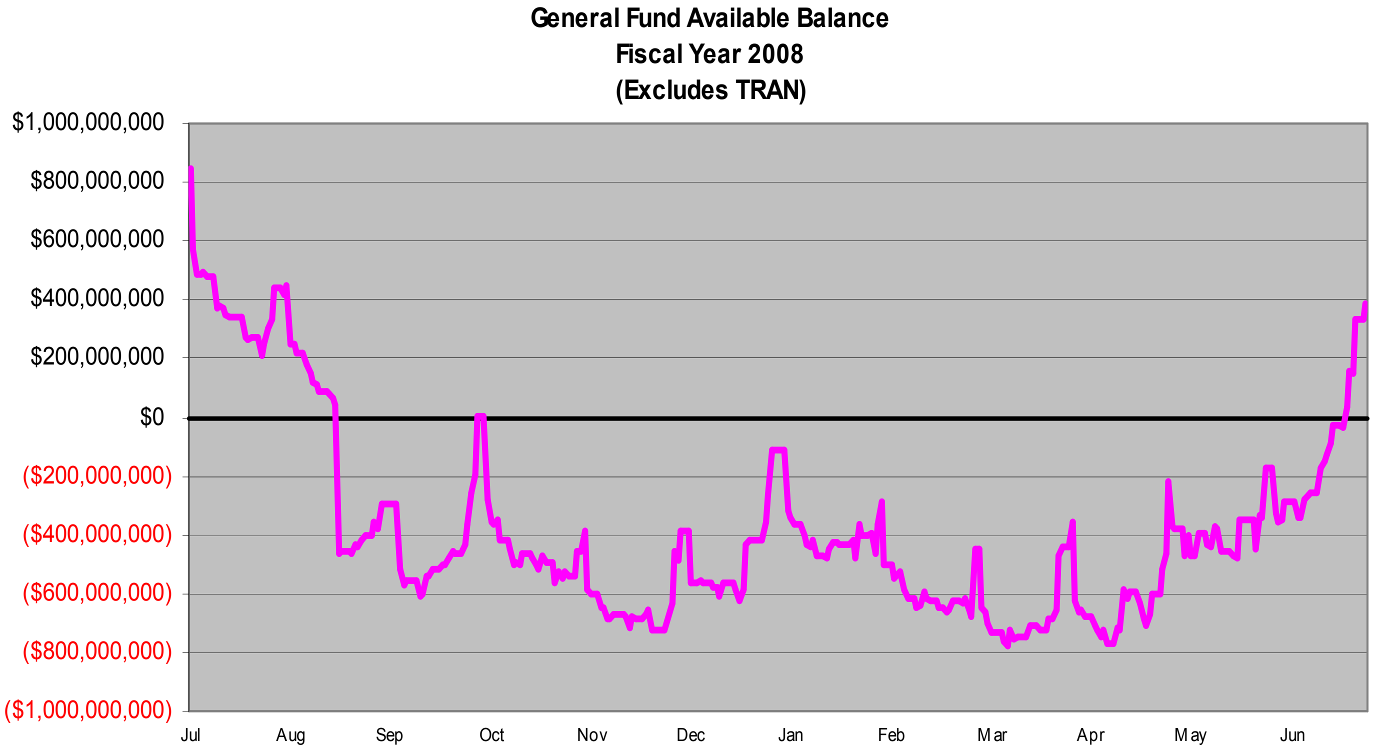
2008 TRAN - Originally, TRANs were issued at tremendous rate advantages to taxable reinvestment rates, often producing 2 percent excess returns when the General Fund had excess cash and significantly lowering the borrowing cost when the balances were negative. ALCo authorized the 2008 (FY 2009) TRAN program in an amount not to exceed $600 million. On July 1, 2008, $400 million was delivered to mature on June 25, 2009. The 2008 Series A TRANs were sold by Citigroup Global Markets, Inc. on June 16, 2008. The fixed rate notes carry a coupon of 3.00 percent to yield 1.78 percent. The net benefit to the General Fund for the fiscal year is expected to be approximately $5.9 million.

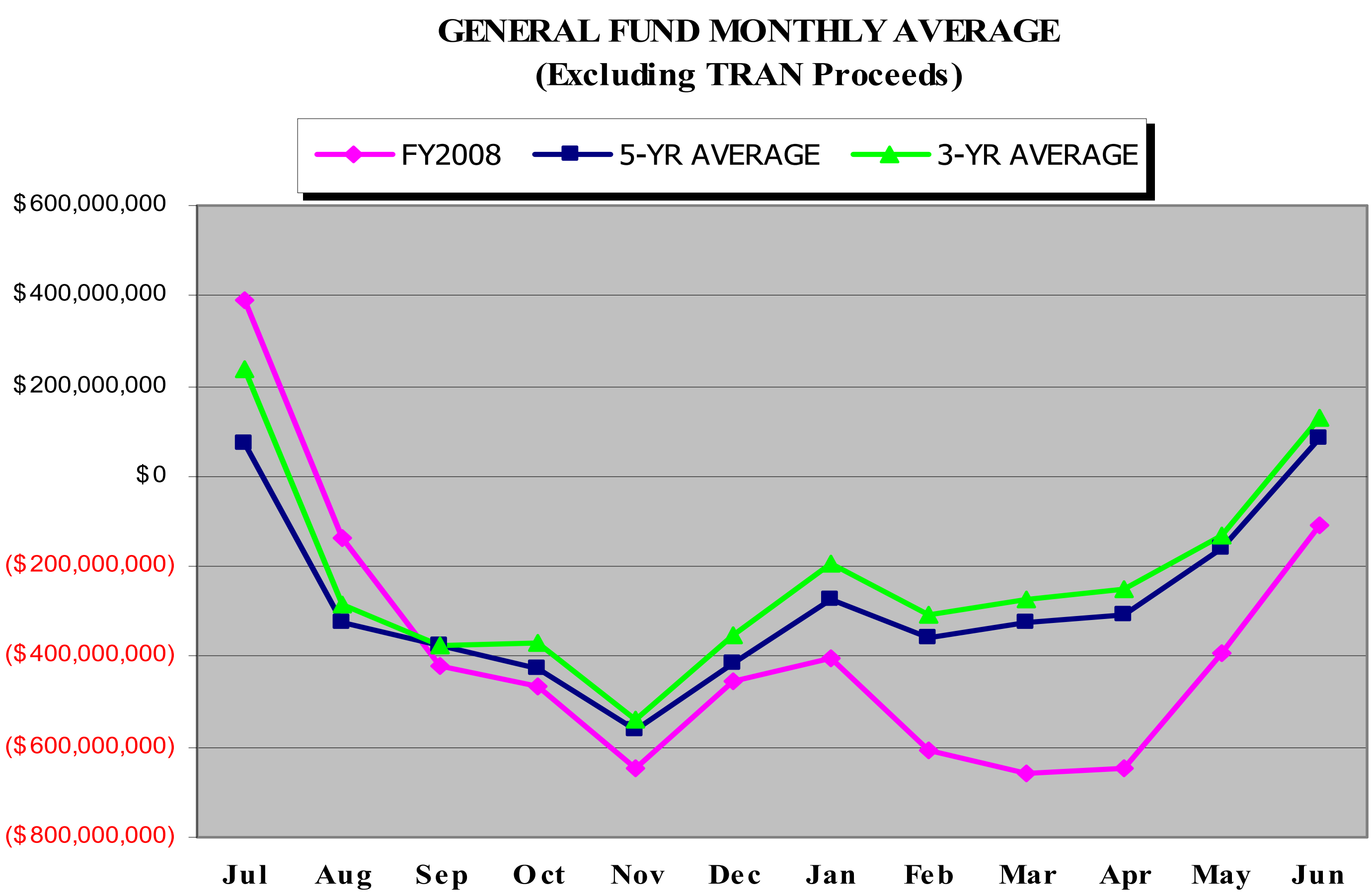
ALCo entered into an Interest Rate Swap with UBS to partially hedge the 2008 TRAN. The Commonwealth will receive a 3.387 percent fixed rate on $400 million notional amount (1.61 percent above cost of funds) while paying 1 month LIBOR. The swap maturity date matches the life of the TRAN.

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	5.9	Estimated

($ in millions)

DEBT MANAGEMENT





DEBT MANAGEMENT

FINANCIAL AGREEMENTS

As of June 30, 2008, ALCo had eight financial agreements outstanding, with a net notional exposure amount of $787.5 million. There was one additional financial agreement executed during the period and one financial agreement terminated during the period. The terms of all outstanding transactions are detailed in Appendix A.

General Fund – Forward Hedge (1)

In August 2007, to protect against continued volatility in interest rates, ALCo competitively bid and subsequently entered into a $150 million interest rate swap transaction with a single counterparty (UBS) to hedge the future issuance of approximately $300 million of permanent tax-exempt bonds for General Fund authorized but unissued projects. The 2009 forward-starting swap agreement features a mandatory early termination date of November 2, 2009. The hedge allows for a portion of the fiscal year 2009 and fiscal year 2010 debt service to be appropriated at a lower rate than the budgeted template rate of 5.85 percent. This results in annual savings (reduction in appropriation) to the General Fund.

The ALCo forward-starting swap hedges roughly one fifth of the currently authorized but unissued General Fund supported debt. ALCo may look to further hedge additional portions of the Commonwealth's remaining authorized but unissued General Fund supported debt, but current dislocation between bonds & swaps make this unlikely.

The previously outstanding 2008 forward-starting swap was terminated as part of SPBC Project 89, which closed in May 2008.

General Fund – 2008 TRAN Hedge (1)

On June 16, 2008, ALCo competitively bid and subsequently entered into a $400 million interest rate swap transaction with a single counterparty (UBS) to partially hedge the newly issued 2008 TRAN. The Commonwealth will receive a fixed rate of 3.387 percent on a notional amount of $400 million (1.61 percent above cost of funds) while paying one month LIBOR. ALCo's variable rate exposure from the swap is offset by certain investments in the Commonwealth's investment pool which are indexed to one month LIBOR. The swap maturity date matches the life of the 2008 TRAN.

General Fund – Floating Rate Note Hedges (4)

In May, 2007, ALCo issued $243.08 million of Floating Rate Notes (FRNs) to permanently finance $100 million of General Fund 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 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.

Road Fund (2)

Of the outstanding Road Fund financial agreements, the first item is a Total Return swap related to the $56,485,000 July 1, 2009 maturity of the Turnpike Authority of Kentucky (TAK) Resource Recovery 1985 Series A Bonds, which bears interest at 6 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 6 percent (the coupon on the bonds) and ALCo pays to MS, SIFMA plus a spread (originally 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. 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 percent from MS. ALCo has received $6.5 million under the terms of the agreements since inception. The expected total benefit from this transaction to maturity is $7.5 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 achieve that level, excess funds are available to offset debt service payments. In June 2007, approximately $2.6 million in excess funds were transferred from the swap account to the Road Fund and subsequently used to pay debt service.

Since the bonds are still outstanding and 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 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 is 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 10 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.

For tax purposes, the Total Return Swap must terminate prior to the final maturity of the bonds. The original end date for the Total Return Swap was July 1, 2007. In late June 2007, ALCo renewed the Total Return Swap with MS through January 1, 2009 at a reduced spread to SIFMA of 37 basis points. At the end of this term, depending up market conditions at the time, the fixed receiver swap may be terminated.

ASSET/LIABILITY MODEL

General Fund

The total SPBC debt portfolio as of June 30, 2008 had $2,569 million of bonds outstanding with a weighted average coupon of 4.98 percent, modified duration of 5.37 years, and a yield at market of 3.55 percent. The market yield decreased 28 basis points from the prior reporting period while modified duration decreased by 0.11 years. The average coupon reflects investor preference for callable premium bonds in the current market at a yield lower than par or discount coupon bonds. The $778 million callable portion had a weighted average coupon of 4.95 percent. There is $25 million callable in calendar year 2008, consisting mainly of unrefunded SPBC Project 57 and Project 60 bonds.

The SPBC General Fund debt structure has 30 percent of principal maturing in 5 years and 64 percent of principal maturing in 10 years. The Commission has continued taking steps to rebalance the portfolio to bring these percentages in line with policy goals and the rating agencies' proposed targets of 27-30 percent due in 5 years and 55-60 percent maturing within 10 years.

The General Fund had a high balance of $848 million on July 1, 2007 and a low of negative $776 million on March 11, 2008. The average and median balances were a negative $376 million and a negative $457 million, respectfully. 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 reserve fund credits is expected to be $448 million for fiscal year 2008. 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 Project Notes, 2005 General Fund Second Series.

Late in 2005, the remaining $640 million General Fund supported bond projects authorized by the 2005 General Assembly, but not yet permanently financed, were placed under an ALCo interim plan of finance. The 2005 General Fund Second Series Note program provides a funding mechanism that allows state agencies and universities to move forward with their capital projects prior to their need for permanent financing. In 2006, the Commission adopted resolutions to place the $1,243 million General Fund supported bond projects, authorized by the 2006 General Assembly, under the same ALCo interim financing plan. The maximum authorized amount of notes outstanding under the program was increased from $750,000,000 to $950,000,000. The projects were placed under the program because they are not expected, at this time, to meet the IRS spend-down requirements of a traditional bond issue.

An initial tax-exempt tranche of $100,000,000, in two Series, was delivered on November 2, 2005. JP Morgan and UBS each provided remarketing services for the two separate $50 million Note Series, both issued in the commercial paper rate mode. The Note Series are each supported by a standby note purchase agreement provided by Dexia Credit Local, a leading European bank based in France, acting through its New York branch.

A second tax-exempt tranche of $100,000,000, in two Series, was delivered on January 25, 2007. The two separate $50 million Note Series again were issued in the commercial paper mode and serviced by JP Morgan, UBS and Dexia.

In February 2007, SPBC issued its Revenue and Revenue Refunding Bonds, Project 87, which currently refunded the first $100,000,000 tranche of ALCo 2005 General Fund Second Series Notes, a $5 million project previously funded with ALCo Agency Fund Notes and select maturities of SPBC 57. SPBC 87 permanently financed a total of $278,441,000 of General Fund supported bond projects authorized by the 2005 and 2006 General Assemblies.

A third tranche of $100,000,000 was issued, in two Series, and delivered on June 26, 2007. This tranche of tax-exempt notes, similar to the first two, was issued in commercial paper mode, remarketed by JP Morgan and UBS and supported by Dexia.

In October 2007, the Commission adopted a resolution to place the $100 million General Fund supported Energy Bonds, authorized by the 2007 2nd Special Session of the Kentucky General Assembly, under the same ALCo interim financing plan. At that time, the Commission also increased the maximum authorized amount of notes outstanding under the program from $950,000,000 to $1,400,000,000 in order to assure coverage of all remaining authorized but unissued General Fund supported debt.

In November 2007, SPBC issued its Revenue Bonds, Project 88, which currently refunded the second $100,000,000 tranche of ALCo 2005 General Fund Second Series Notes. SPBC 88 permanently financed a total of $277,821,000 of General Fund supported bond projects authorized by the 2005 and 2006 General Assemblies.

A fourth tranche of $100,000,000 was issued, in two Series, and delivered on March 5, 2008. This tranche of tax-exempt notes, similar to the first three, was issued in commercial paper mode, remarketed by JP Morgan and UBS and supported by Dexia.

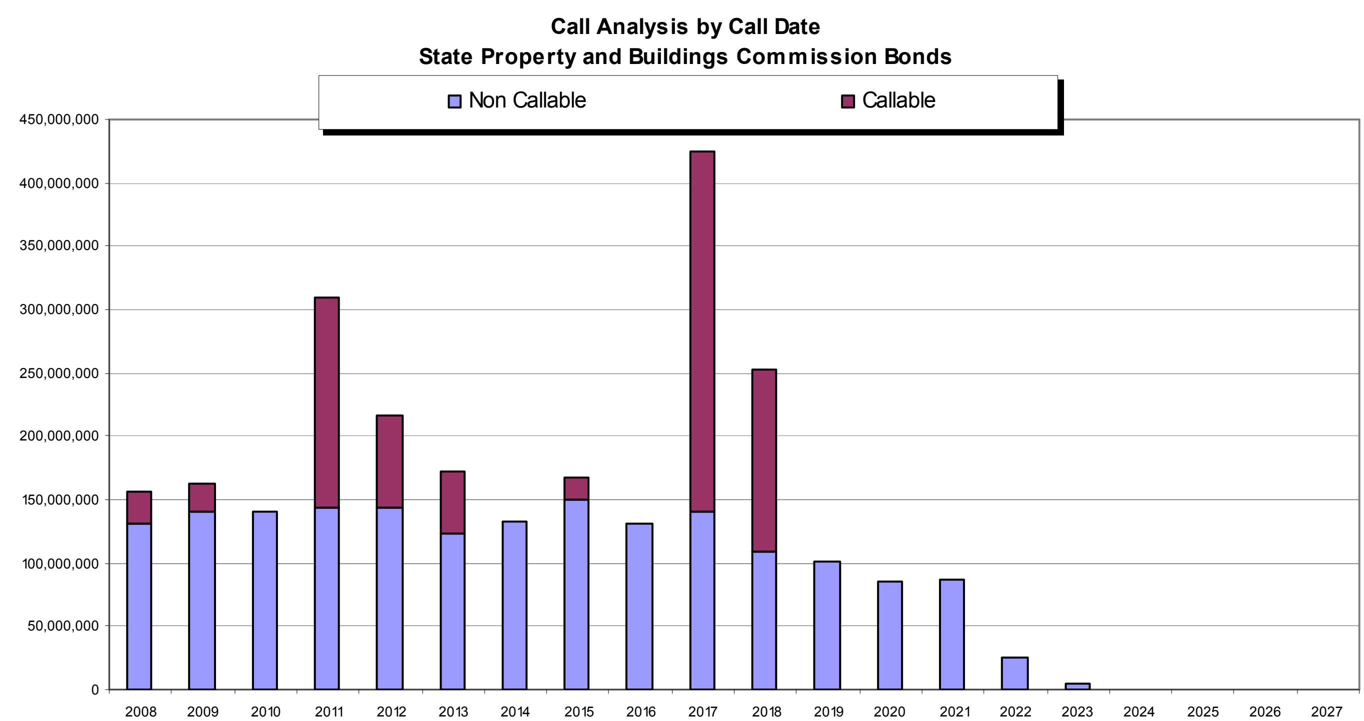
In May 2008, UBS announced their intention to exit the municipal finance business. In order to prevent any disruptions in the program and to assure the continued successful remarketing of the ALCo 2005 General Fund Second Series notes, the Commission, with the consent of the liquidity provider (Dexia) and the trustee (Bank of New York Mellon), quickly acted to transfer remarketing agent services on the series A-2 notes from UBS to JP Morgan. The transfer of duties became effective on June 15, 2008.

Remarketing information and the cost of capital to date is provided in Appendix C. As of June 30, 2008, $200 million of notes were outstanding and the bond projects remaining under the interim financing program had expended $140 million. OFM will continue to monitor project expenditures and direct the issuance of notes as needed to meet current capital needs.

To date, the commercial paper note program has enjoyed an exceptionally low liquidity facility fee of 0.075 percent and has provided a very attractive level of financing at remarketing rates consistently well below the current budgeted template rate of 5.85 percent.

SPBC 89

In May of 2008, SPBC issued $205,080,000 Revenue Bonds, Project 89, which provided permanent financing for $204,962,000 of General Fund bond-supported projects authorized by the 2005 and 2006 General Assemblies. See Appendix D, "Project List." SPBC 89 was structured to rebalance a portion of the Commonwealth's General Fund debt portfolio in order to bring its principal amortization schedule closer in line with policy goals and rating agency guidelines.



DEBT MANAGEMENT

With the delivery of SPBC 89, the forward starting swap that featured a mandatory early termination date of November 2008 was terminated with a payment of $8,567,000 from bond proceeds. This $150 million notional hedge was originally executed in August 2007 to provide budgetary stability in a volatile interest rate environment.

The SPBC 89 transaction also initially included the tender of all or a portion of the outstanding Kentucky Asset/Liability Commission Floating Rate Project Notes ("FRNs"). An opportunity existed for the Commonwealth to buy back all or a portion of the FRNs at a significant discount and replace them with traditional fixed rate bonds. However, there were a number of tax law issues that limited the flexibility of the tender and the prices that could be offered. Ultimately, the tender was unsuccessful.

The bonds were sold via negotiated sale with Citigroup as managing underwriter and Kutak Rock serving as bond counsel. The bonds were insured by FSA (for maturities after 2010) and sold well in an extremely volatile market with an All-In TIC of 4.88%.

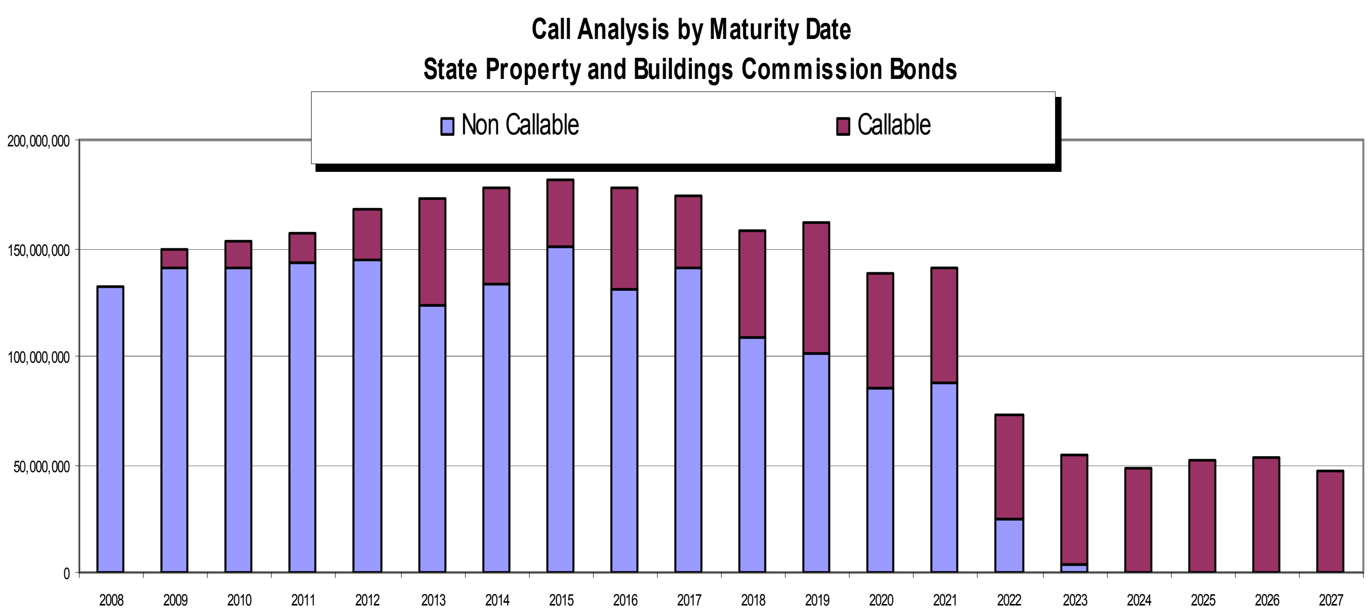
ALCo Project Notes, 2005 General Fund First Series.

Project proceeds of $81,850,000 ALCo 2005 General Fund First Series delivered on June 8, 2005 to provide for the financing of the Phase II Tobacco Settlement Payments were returned to the state in late 2005. The proceeds have been yield restricted and applied to General Fund supported bond projects, specifically the infrastructure for economic development fund for tobacco counties. As of June 30, 2008, $60 million of the proceeds had been expended on projects.

Road Fund

In September 2007, ALCo implemented the 2007 Road Fund First Series Project Note Program and issued $150 million of the $350 million of Road Fund Supported Economic Development Bonds authorized by the 2006 General Assembly. The interim financing program provides for notes not to exceed $350 million to be issued in anticipation of permanent financing by TAK. The notes are secured by a standby note purchase agreement provided by Dexia under the same terms as the General Fund Series. JP Morgan provides remarketing for the notes, which are in commercial paper mode.

On March 5, 2008 an additional $50 million in notes were issued bringing the total amount of notes out-



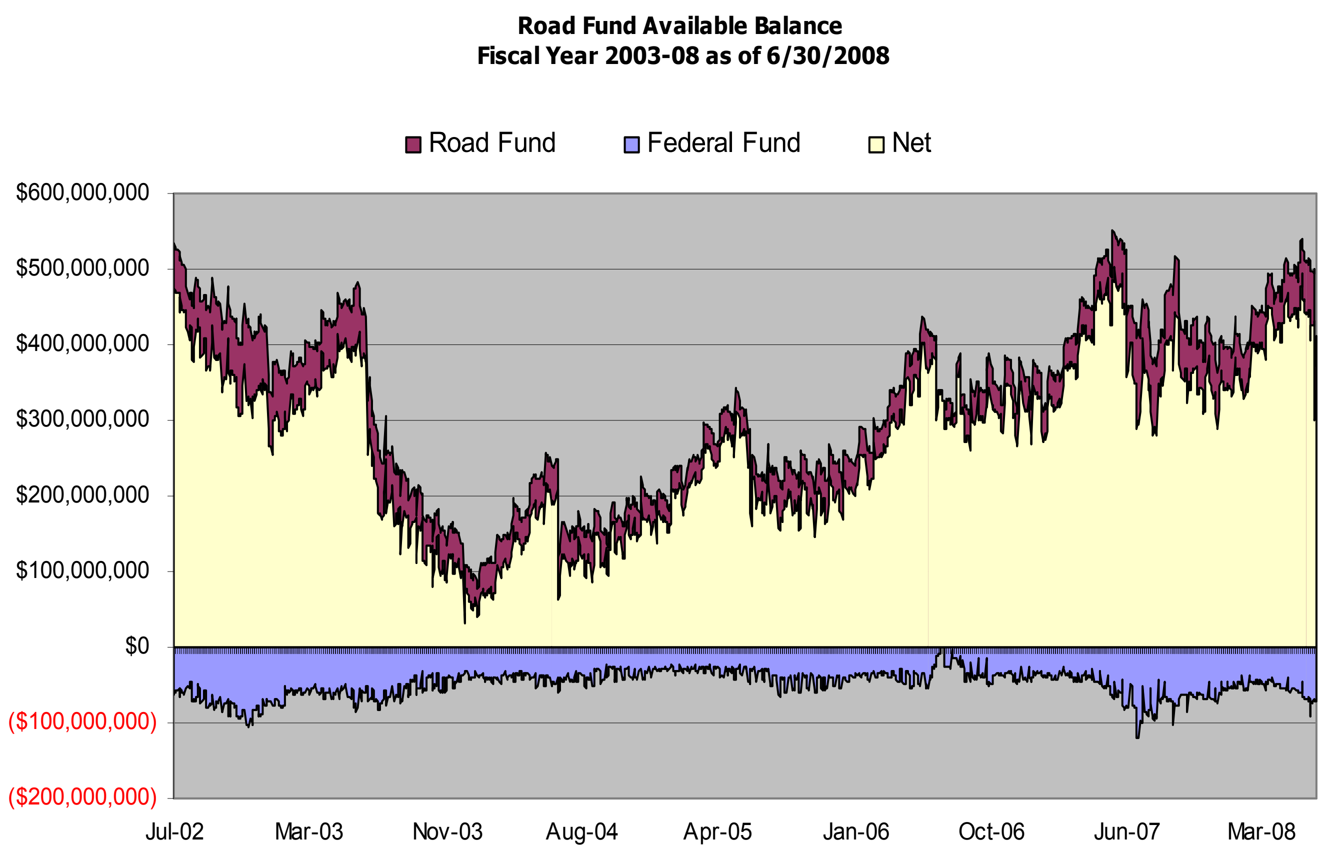
DEBT MANAGEMENT

standing under the program to $200 million. Permanent financing will be provided by future TAK debt issuances. Appendix C provides cost of capital to date.

The Road Fund average daily cash balance for fiscal year 2008 was $440 million compared to $392 million for fiscal year 2007. The Road Fund cash was invested in the Intermediate Term Investment Pool which had a duration of 1.61 years as of June 30, 2008. The Road Fund earned $18.3 million on a cash basis for fiscal year 2008 versus $14.7 million for fiscal year 2007. The continued relatively low level of investable balances and the large debt authorization limits the opportunity to implement new asset liability management strategies at this time.

As of June 30, 2008, TAK had $769 million of bonds outstanding with a weighted average coupon of 4.47 percent, modified duration of 5.13 years, and yield at market of 3.54 percent. Selected maturities of the Resource Recovery 1985A with the most economical value are associated with the financial agreements identified previously.

Road Fund debt service paid , net of reserve fund credits for fiscal year 2008 was $158 million, resulting in a net interest margin (investment income earned less debt service paid) of negative $140 million. The negative amount stems form 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 obligation on the liability side. While cash balances have improved, they are not sufficient to offset interest expenses.



DEBT MANAGEMENT

SUMMARY

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

Since its inception, ALCo has been instrumental in adding additional investment asset classes to the Commonwealth's investment portfolio, adding millions of dollars of incremental returns on investment income. ALCo has also continued to manage General Fund intra-year cash flow deficits through its TRAN program. ALCo has issued a General Fund TRAN each fiscal year since 1998 (with the exception of FY04), 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 hundreds of millions of dollars each year in budgetary savings through debt service lapses. At the end of fiscal year 2008, the Commonwealth was able to lapse $93 million of budgeted General Fund debt service and $27 million of budgeted Road Fund debt service.

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 products.

APPENDIX

APPENDIX A

ALCo Financial Agreements	SPBC Nov. 2009 Hedge	ALCo 2008 TRAN Hedge	TAK RR 85A Total Return	TAK RR 85A Fixed
Fund Source	General Fund	General Fund	Road Fund	Road Fund
Hedge	Net Interest Margin	2008 TRAN Notes	Net Interest Margin	Total Return
Counter-Party	UBS	UBS	Morgan Stanley	Morgan Stanley
Counter-Party Ratings *(Moody's/S&P/Fitch)*	Aa2/AA-/AA-	Aa2/AA-/AA-	A1/A+/AA-	A1/A+/AA-
Termination Trigger	A3/A-	A3/A-	BBB-/Baa3	BBB-/Baa3
Swap Type	Fixed Pay	Variable Pay	Variable Pay	Fixed Pay
Benchmark	SIFMA	1M LIBOR	SIFMA	SIFMA
Reset	Weekly	Monthly	Weekly	Weekly
Notional Amount	150,000,000	400,000,000	56,485,000	56,485,000
Amortize (yes/no)	yes	no	no	no
Execution Date	8/2/2007	6/16/2008	4/23/2001	9/20/2001
Start Date	11/2/2009	7/1/2008	5/24/2001	9/27/2001
Mandatory Early Termination	11/2/2009			
Cash Settlement Payment Date	11/16/2009	6/25/2009		
End Date	11/1/2029	6/25/2009	1/1/2009	7/1/2009
Fixed Rate pay-(rec)	4.276%	(3.387%)	(6.000%)	3.870%
Day Count	30/360	30/360	30/360	30/360
Payment Dates	May 1 & Nov 1	25th of each Month	Jan. 1 & July 1	Jan. 1 & July 1
Security Provisions	General Fund Bonds	General Fund Revenues	Road Fund Investment	Road Fund Investment
Current Market Valuation June 30, 2008 (negative indicated payment by ALCo)	(5,745,064)	1,718,999	0	0
Interest Earnings				
Cumulative Prior Periods			147,727	5,864,803
Current Period - 06/30/2008			0.00	498,431
TOTAL	not applicable	not applicable	147,727	6,363,234

Swap Summary
As of June 30, 2008

Total Notional Amount Executed		Net Exposure Notional Amount	
General Fund	Road Fund	General Fund	Road Fund
793,080,000	112,970,000	787,535,000	0

Total Notional Amount Executed by Counter Party

Morgan Stanley	Citibank	UBS
112,970,000	243,080,000	550,000,000

	Debt		10 Percent Net Exposures	
	General Fund	Road Fund	General Fund	Road Fund
Bonds Outstanding	2,757,730,000	805,386,344	275,773,000	80,538,634
Authorized but Unissued	1,676,252,000	485,000,000	167,625,200	48,500,000
Total	4,433,982,000	1,290,386,344	443,398,200	129,038,634

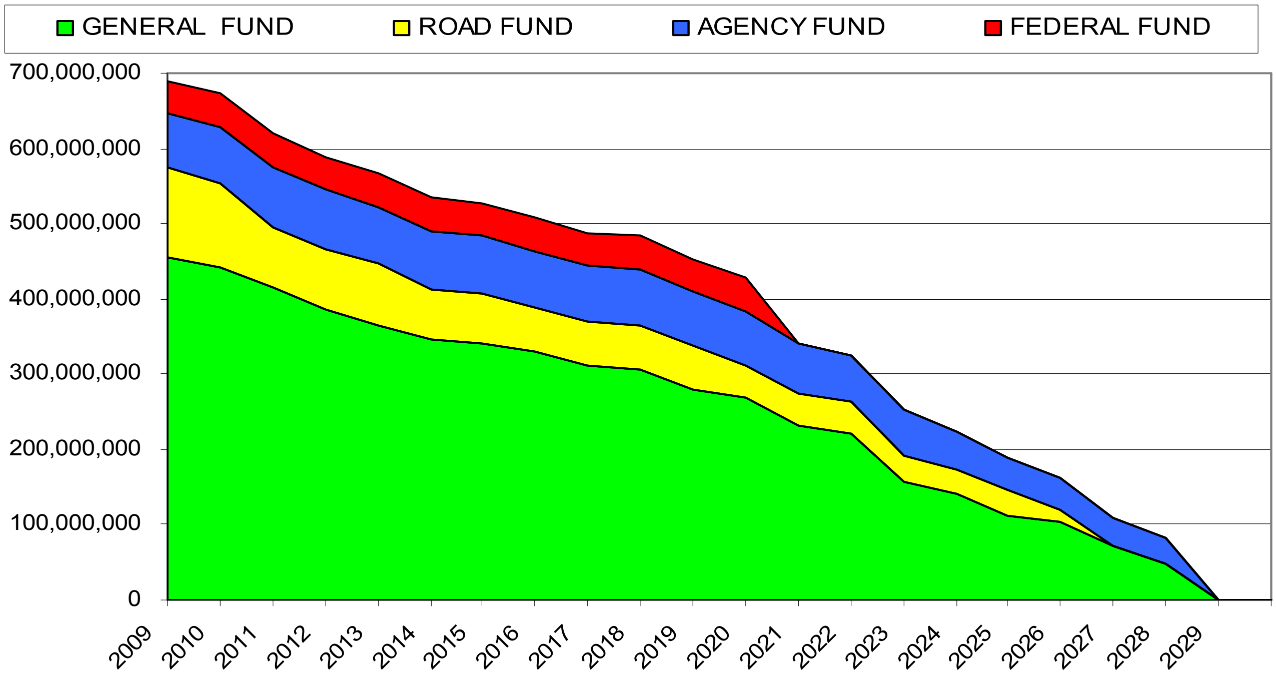
Investment Pool Balances		10 Percent Investment Portfolio	
Other Funds	Net Road Fund	Other Funds	Net Road Fund
3,641,731,551	339,697,243	364,173,155	33,969,724

APPENDIX A

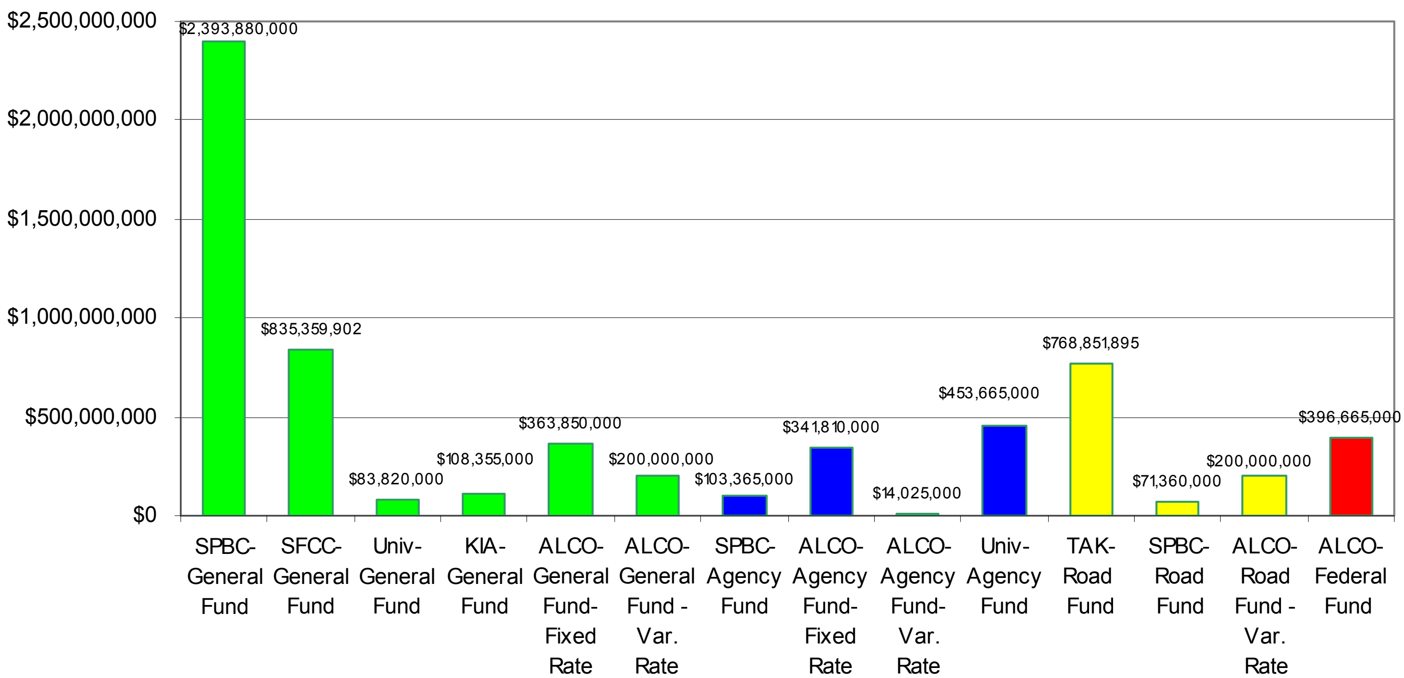
ALCo Financial Agreements	ALCo FRN Series A Hedge	ALCo FRN Series A Hedge	ALCo FRN Series B Hedge	ALCo FRN Series B Hedge
Fund Source	General Fund	General Fund	General Fund	General Fund
Hedge	2017 FRN	2027 FRN	2021 FRN	2025 FRN
Counter-Party	Citibank	Citibank	Citibank	Citibank
Counter-Party Ratings *(Moody's / S&P / Fitch)*	Aa1/AA/AA-	Aa1/AA/AA-	Aa1/AA/AA-	Aa1/AA/AA-
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	23,260,000	73,065,000	70,275,000	70,935,000
Amortize (yes/no)	yes	yes	yes	yes
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
Mandatory Early Termination				
Cash Settlement Payment Date				
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, 2008 (negative indicates payment owed by ALCo if terminated)	(646,726)	(2,718,313)	(3,178,938)	(2,690,473)
Interest Earnings (not applicable)				
Total	not applicable	not applicable	not applicable	not applicable

APPENDIX B

Appropriation Supported Debt Service
by Fund Source
as of 6/30/08
(Fixed Rate Only)



Appropriation Debt Principal Outstanding
by Fund Source as of 6/30/08
(Variable Rate Debt = Bond Anticipation Notes)



APPENDIX C

COMMONWEALTH OF KENTUCKY
ASSET/LIABILITY COMMISSION

SCHEDULE OF NOTES OUTSTANDING
AS OF 6/30/2008

FUND TYPE SERIES TITLE	AMOUNT ISSUED	DATE OF ISSUE	MATURITY DATE	PRINCIPAL OUTSTANDING
General Fund Project Notes				
2003 Series A	$171,260,000	7/2003	7/2013	$52,985,000
2005 1st Series	$81,850,000	6/2005	5/2025	$73,330,000
2005 2nd Series	$400,000,000	11/2005	11/2025	$200,000,000
2007 A, B Series	$243,080,000	5/2007	11/2027	$237,535,000
FUND TOTAL	**$390,560,000**			**$563,850,000**
Agency Fund Project Notes				
2005 1st Series	$11,275,000	6/2005	6/2025	$10,490,000
2005 2nd Series	$47,055,000	12/2005	4/2006	$14,025,000
2005 Series A-UK Gen Recpts	$107,540,000	11/2005	11/2025	$107,540,000
2006 Series A-UK Gen Recpts	$66,305,000	10/2006	6/2028	$65,630,000
2007 Series A-UK Gen Recpts	$77,905,000	11/2007	10/2027	$77,905,000
2007 Series B-UK Gen Recpts	$80,245,000	11/2007	10/2027	$80,245,000
FUND TOTAL	**$390,325,000**			**$355,835,000**
Road Fund Project Notes				
2007 First Series	$200,000,000	9/2007	6/2028	$200,000,000
Federal Hwy Trust Fund Project Notes				
2005 1st Series	$139,635,000	6/2005	9/2017	$118,755,000
2007 1st Series	$277,910,000	9/2007	9/2019	$277,910,000
FUND TOTAL	**$139,635,000**			**$396,665,000**
PROJECT NOTES TOTAL	**$1,120,520,000**			**$1,516,350,000**
TRAN 2008	$400,000,000	6/2008	6/2009	$400,000,000
TRAN TOTAL	**$400,000,000**			**$400,000,000**

APPENDIX C

Kentucky Asset/Liability Commission
Variable Rate Debt
Weighted Average Yields - Cost of Capital Since Implementation

	2005 General Fund Second commercial paper			2007 Road Fund First commercial paper	2005 Agency Fund Second (1) SIFMA + 0.45% weekly reset
	Series A-1	**Series A-2**	**Total**		**Series A-5**
Program Size		*Not to exceed $1,400 million*		*Not to exceed $350 million*	*Not to exceed $250 million*
Amount Issued	$200,000,000	$200,000,000	**$400,000,000**	**$200,000,000**	$14,025,000
Amount Outstanding	$100,000,000	$100,000,000	**$200,000,000**	**$200,000,000**	$14,025,000
Initial Date of Issue	2-Nov-05	2-Nov-05		25-Sep-07	27-Nov-07
Agency	- - -	Various	- - -	Transportation	KRA
Project Amount Authorized	- - -	$1,131,671,000	- - -	$350,000,000	$33,200,000

June 30, 2008

	Series A-1	Series A-2	Total	2007 Road Fund First	Series A-5
SIFMA	3.255%	3.255%		2.65%	2.397%
Average Notes Outstanding	$73,841,401	$72,848,198	**$146,689,598**	**$170,967,742**	$14,025,000
Inception Weighted Yields	3.108%	3.211%	**3.159%**	**2.515%**	2.847%
Cost of Issuance					0.109%
Remarketing Fee	0.050%	0.050%	**0.050%**	**0.050%**	-
Liquidity Facility Fee	0.075%	0.075%	**0.075%**	**0.075%**	-
Average Cost of Funds	**3.233%**	**3.336%**	**3.284%**	**2.640%**	**2.956%**

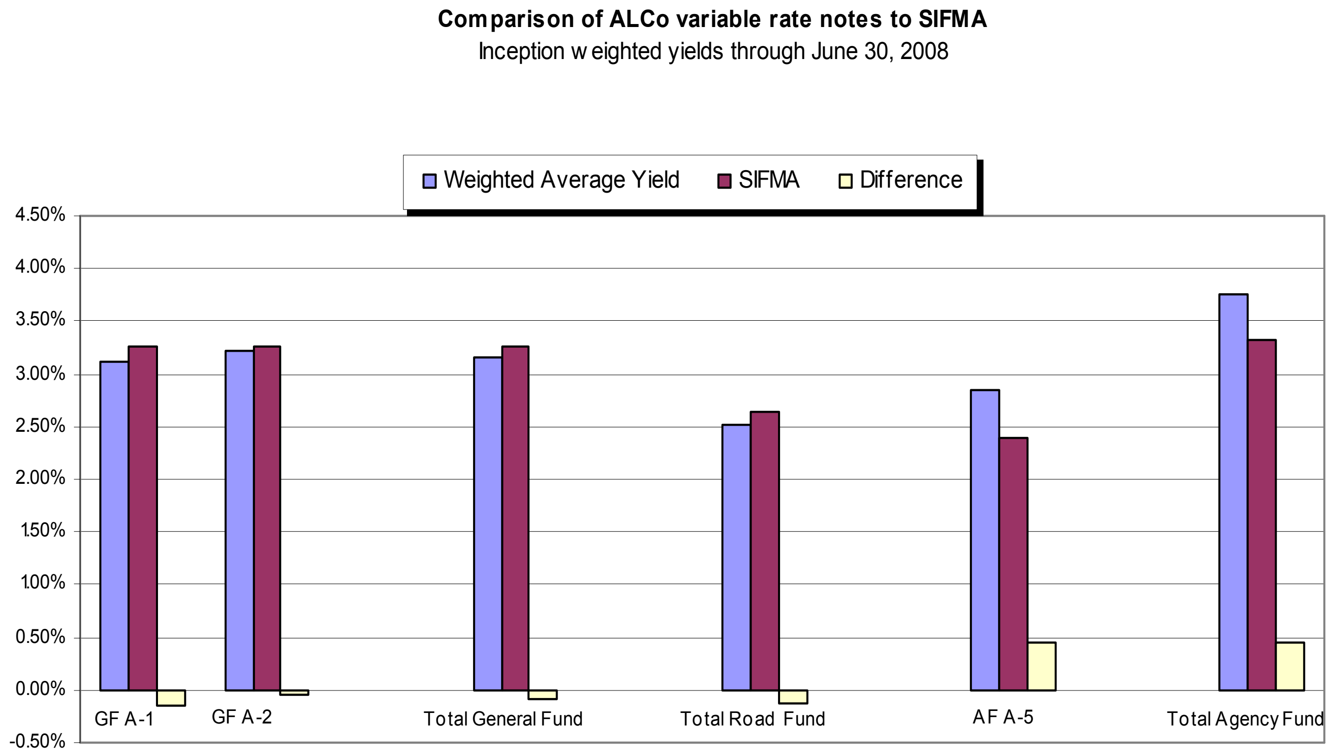
June 30, 2007

	Series A-1	Series A-2	Total
SIFMA	3.472%	3.472%	
Average Notes Outstanding	$60,247,934	$58,736,529	**$118,984,463**
Inception Weighted Yields	3.589%	3.374%	**3.483%**
Cost of Issuance			
Remarketing Fee	0.050%	0.050%	**0.050%**
Liquidity Facility Fee	0.075%	0.075%	**0.075%**
Average Cost of Funds	**3.714%**	**3.499%**	**3.608%**

Notes Not Yet Outstanding

(1) Agency Fund 2005 Second Series
Trustee fee of $6,000 distributed evenly to each series
Fees allocated as percentage of Total Authorized Amount for each respective project
Totals for the Agency Fund series include previously redeemed tranches save Amount Issued, Outstanding and Authorized

APPENDIX C



Comparison of ALCo variable rate notes to SIFMA
Inception w eighted yields through June 30, 2008
Weighted Average Yield
SIFMA
Difference
4.50%
4.00%
3.50%
3.00%
2.50%
2.00%
1.50%
1.00%
0.50%
0.00%
-0.50%
GF A-1
GF A-2
Total General Fund
Total Road Fund
AF A-5
Total Agency Fund

APPENDIX D

PROJECT LIST

General Fund supported Bonds Authorized by the General Assembly permanently financed within the reporting period.

State Property and Buildings Commission Revenue Bonds, Project No. 89

Agency	Project Title	Amount [1]
Tourism, Arts and Heritage Cabinet		
	Department for Public Health - Health Departments Infrastructure Pool	$60,000,000
Council on Postsecondary Education		
	University of Kentucky Biological/Pharmaceutical Complex	40,000,000
Cabinet for Economic Development		
	Economic Development Bond Pool - Purchase Area Regional Industrial Authority (PARIA)	2,500,000
	Innovation and Commercialization for a Knowledge-Based Economy Bond Pool - Aspen Compressor LLC / Pulaski County	500,000
Cabinet for Health and Family Services		
	Department for Public Health - Health Departments Infrastructure Pool	10,000,000
Education Cabinet		
	Department of Education- Kentucky Education Network	8,900,000
	Department of Education- Mercer County Technical Center	4,000,000
	Department of Education- Student Information System	10,000,000
Finance and Administration Cabinet		
	Department of Revenue - Develop Streamlined Sales Tax Simplification System	14,062,000
	Facilities and Support Services – Statewide Repair, Maintenance, and Replacement	10,000,000
Department for Local Development		
	Governor's Office for Local Development - Community Development Fund Projects	45,000,000 [2]
TOTAL		$204,962,000

[1] Excludes allocable costs of issuance.

[2] Less than full Authorization.

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Creating Financial Value for the Commonwealth