Semi-Annual Report of the Kentucky Asset/Liability Commission

27TH EDITION

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Commonwealth of Kentucky

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Secretary

Finance and Administration Cabinet

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Executive Director

Office of Financial Management

For the period ending June 30, 2010

This report may be viewed at:

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

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INTRODUCTION

This is the Kentucky Asset/Liability Commission's ("ALCo") twenty-seventh semi-annual report pursuant to KRS 56.863 (11) for the period beginning January 1, 2010, through June 30, 2010. 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

- While the National Bureau of Economic Research has not officially declared an end to the recession, the economy is experiencing positive, but slowing growth.
- Even with the support of the first time home buyers tax credit, the sales of new and existing homes seems to be slowing. The expiration of the tax credit will lead to further declines.
- The Federal Reserve continues to target Federal Funds in the range of 0.00 to 0.25 percent. They are allowing limited quantitative tightening as their balance sheet declines in size due to security maturities which are not being replaced.
- Most of the stimulus programs initiated by the federal government have ended during the last six months.
- The credit worthiness of the weaker European Union countries has been called into question as Greece required support from the European Central Bank.

On the state level

- Fiscal Year 2010 General Fund receipts totaled \$8,225.1 million, a decrease of 2.4% compared to Fiscal Year 2009. However, receipts were \$27.2 million or 0.3% higher than the revised official estimate.
- Fiscal Year 2010 Road Fund receipts totaled \$1,206.6 million, an increase of 1.2% over Fiscal Year 2009. Receipts exceeded the revised official estimate by \$7.5 million or 0.6%.
- The official revenue forecast for the General Fund for Fiscal Year 2011, as modified by the 2010 General Assembly, is \$8,570.9 million.
- The official revenue forecast for the Road Fund for Fiscal Year 2011, as modified by the 2010 General Assembly, is \$1,265.8 million.
- The 2010 Extraordinary (Special) Session of the General Assembly delivered House Bill 1 (Executive Branch Budget other than Transportation Cabinet) & House Bill 3 (Kentucky Transportation Cabinet Budget) to the Governor on May 28, 2010 which, together, authorize \$1.980.2 billion in bond financing to support the various capital initiatives of the Commonwealth.

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MARKET OVERVIEW

While the overall economy has registered a full year of growth since the depths of financial crisis induced recession, the rate of growth has slowed significantly over the past six months and appears poised to slow even further increasing the risk of a double dip recession. During the fourth quarter of 2009, real GDP grew at 5.0% on an annualized basis. That growth has fallen to 2.4% during the second quarter of 2010. Much of the slowdown appears to have occurred during May and June, the final two months of the quarter.

Historically, the housing market has had a counter-cyclical influence on the economy. During times of weakness, the Federal Reserve will implement a stimulative monetary policy by lowering the Federal Funds rate. The Fed reduced the Funds rate to 0.25% on December 16, 2008, and have held it there ever since. When the Fed drives short term rates lower, longer term rates generally follow. As long term mortgage rates fall, refinancing activity picks up providing a boost to consumer spending and helping to push the economy back towards growth.

The Fed move has pushed 30 year fixed mortgage rates to historically low levels. However, refinancing activity has not spiked this year even though almost all outstanding mortgages are eligible for refinancing. The median sales price for an existing home sale has dropped from a high of over $230,000 in 2006 to only $183,500 in June of 2010. The price of houses has dropped so much that most mortgages are larger than the value of the house. These are simply not refinanceable.

In past recoveries, stimulative monetary policy has led to an increase in personal spending. Although spending has bounced well above the lows in 2009, May and June of 2010 have shown a significant downturn. A major driver is continued high levels of unemployment. While the unemployment rate has fallen from a high of 10.5%, it remains at 9.5% in June 2010. Additionally, this measure somewhat understates the true level of unemployment. To calculate this, the Labor Department divides the number of people actively looking for jobs by the total workforce. Non-government job creation has averaged 93,000 per month for the first half of the calendar year and averaged less than 50,000 in May and June. The U.S. requires growth of about 300,000 to keep up with population growth. The unemployment rate is not higher because numerous people are becoming discouraged and have stopped looking for jobs.

The leading economic indicators index is a composite of a number of other economic statistics. These statistics have some ability to project the direction of the overall economy. In June, the index turned negative. While this is an extremely volatile index, it seems to be pointing towards a further slowdown. This compliments some of the other indications mentioned earlier that indicate a slowing economy. While nothing is yet pointing towards a "double dip" recession, this possibility seems increasingly likely.

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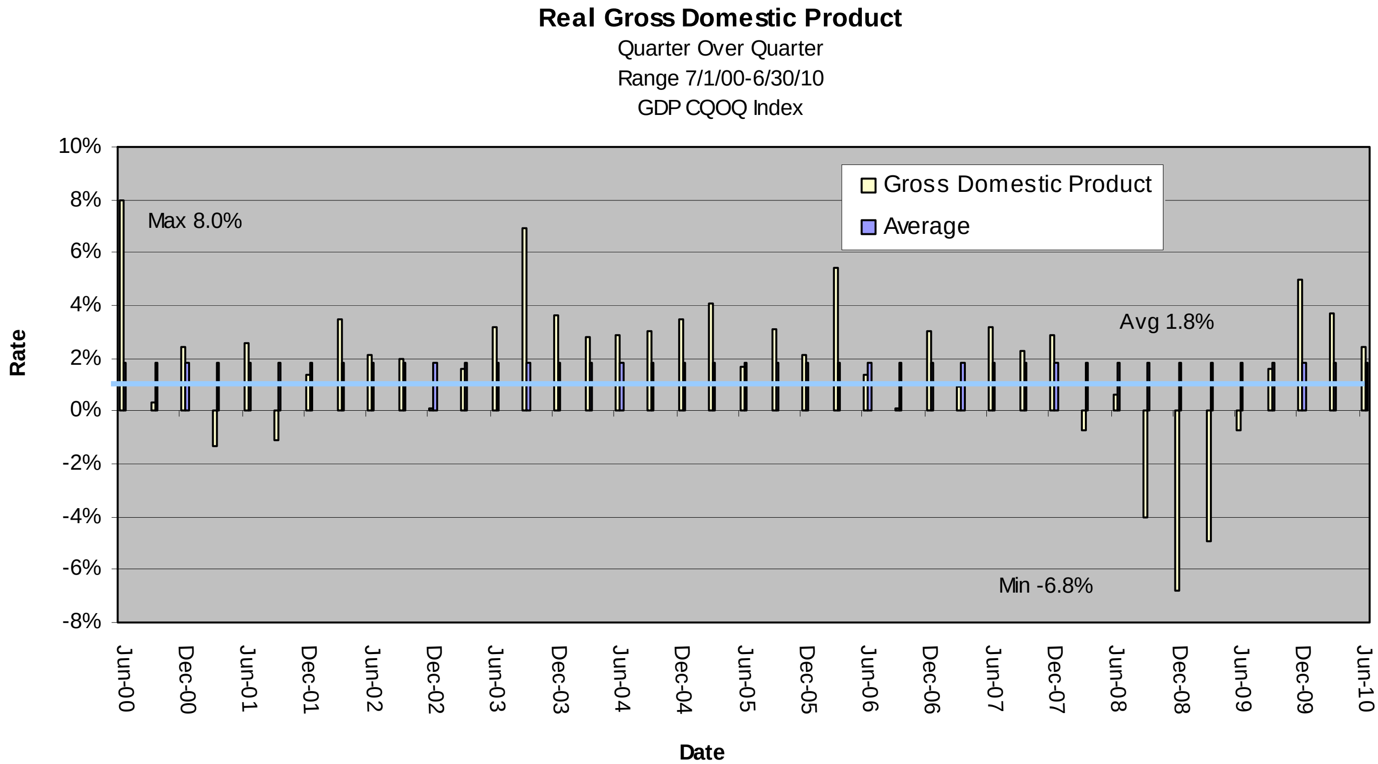
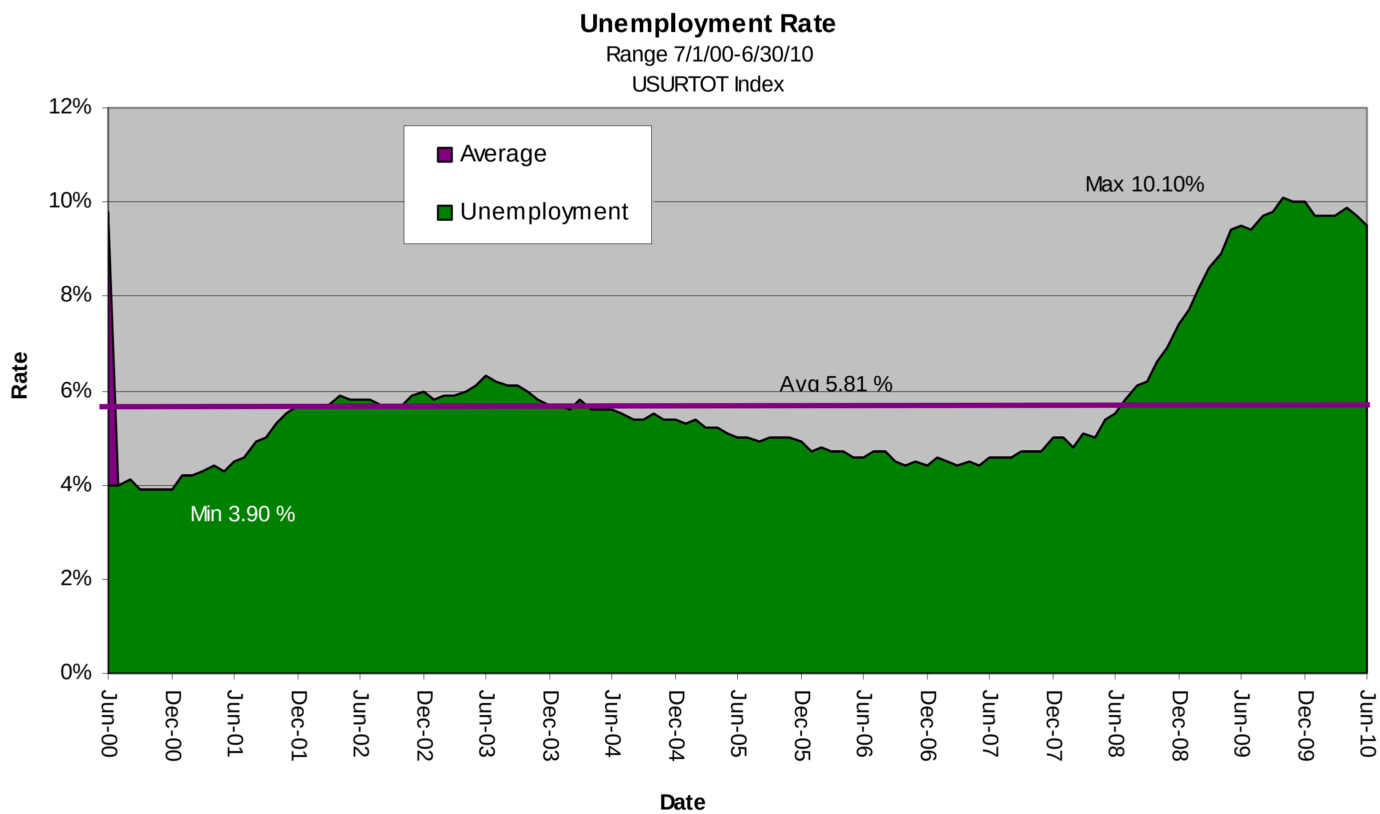
Real Gross Domestic Product & Unemployment





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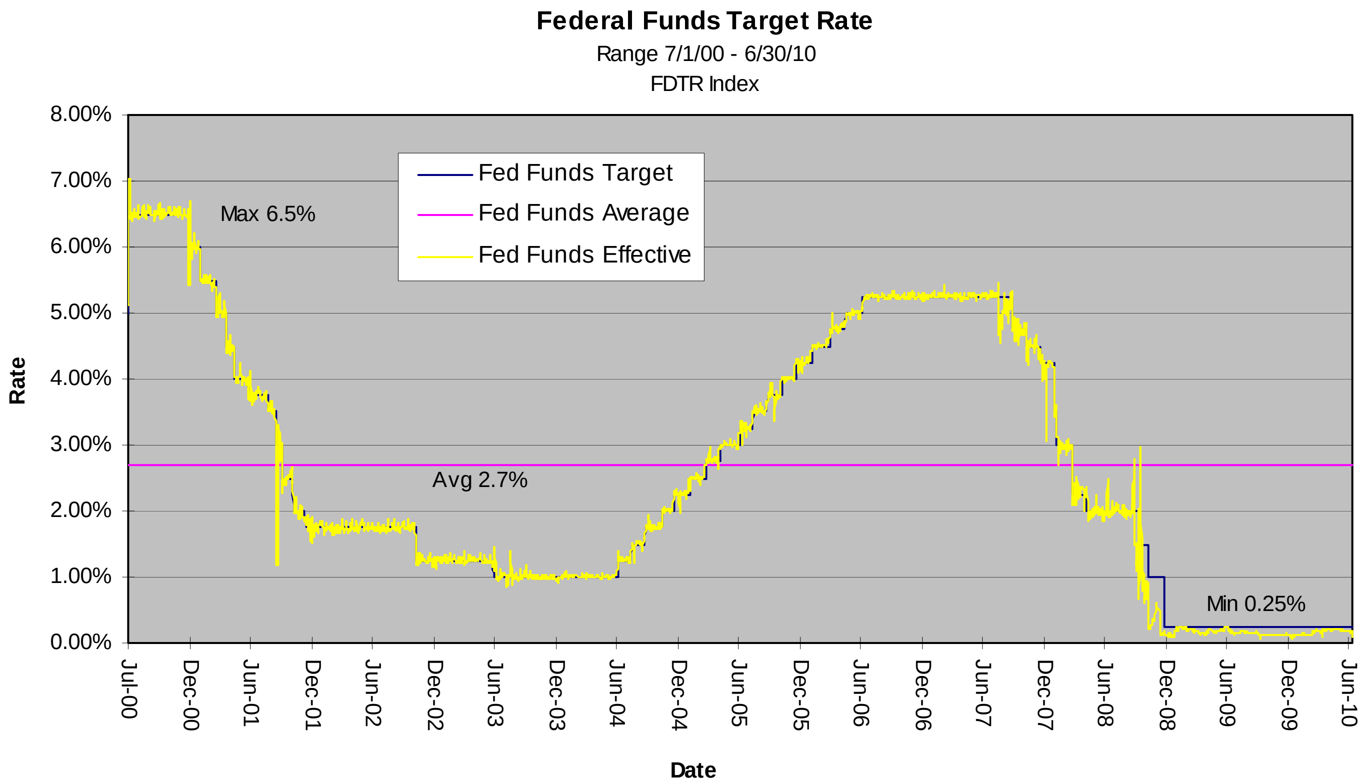
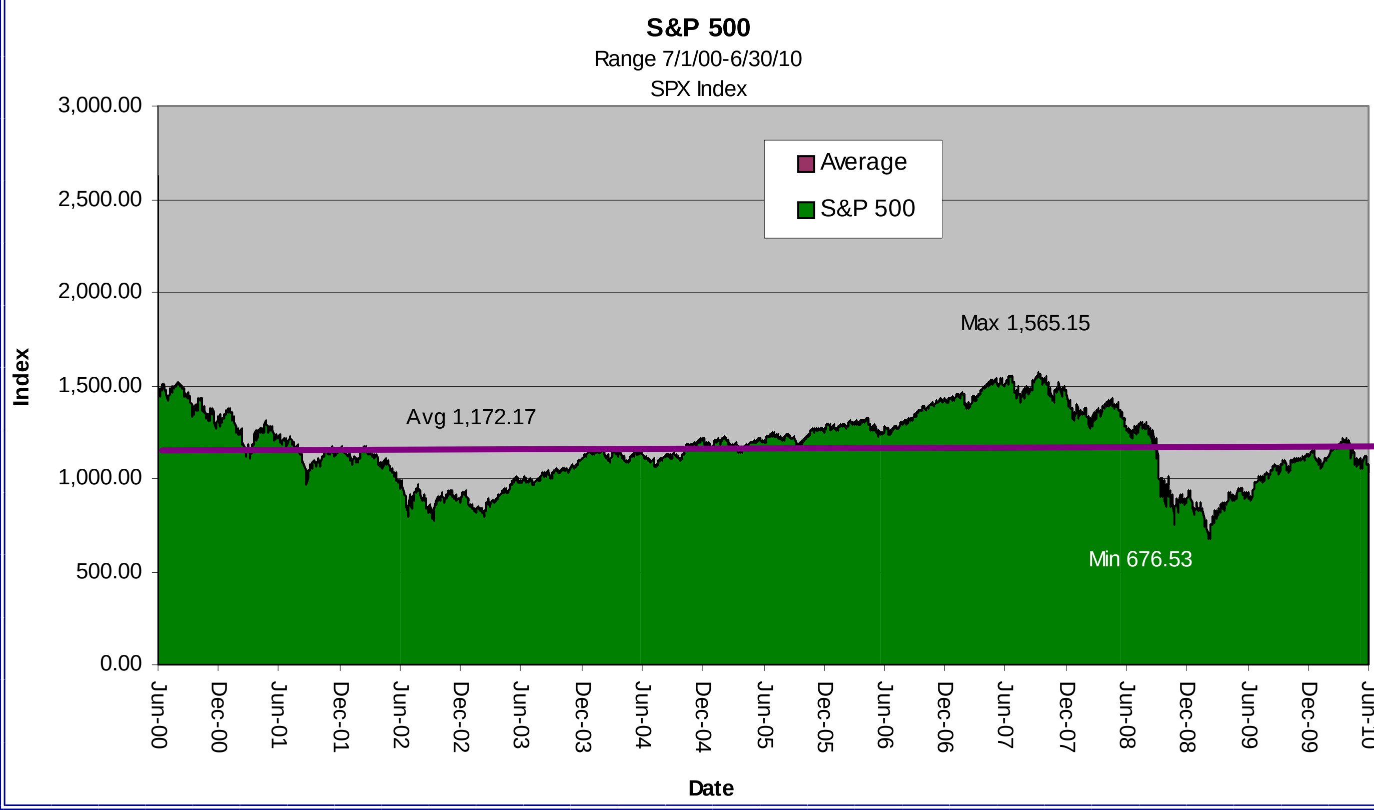
Federal Funds Target Rate & S&P 500





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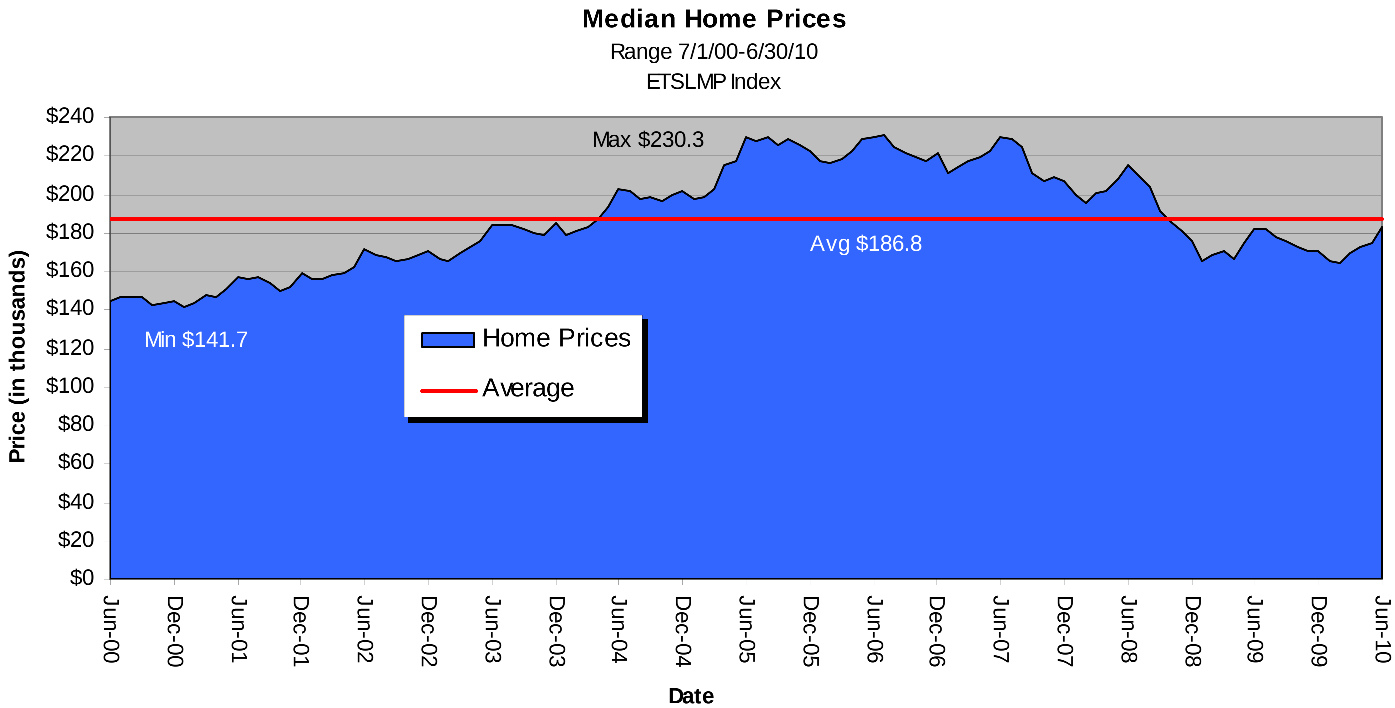
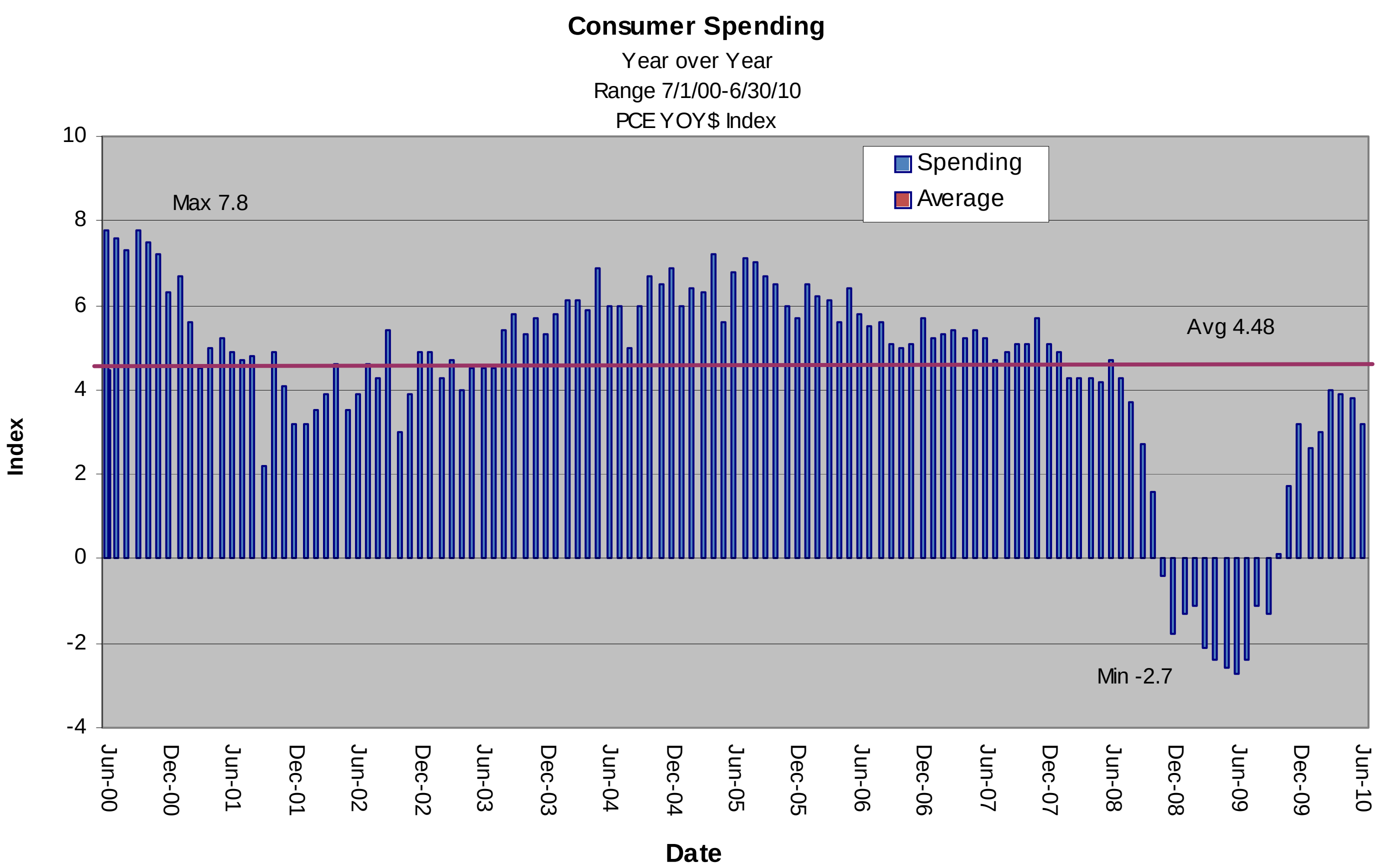
Median Home Price & Consumer Spending





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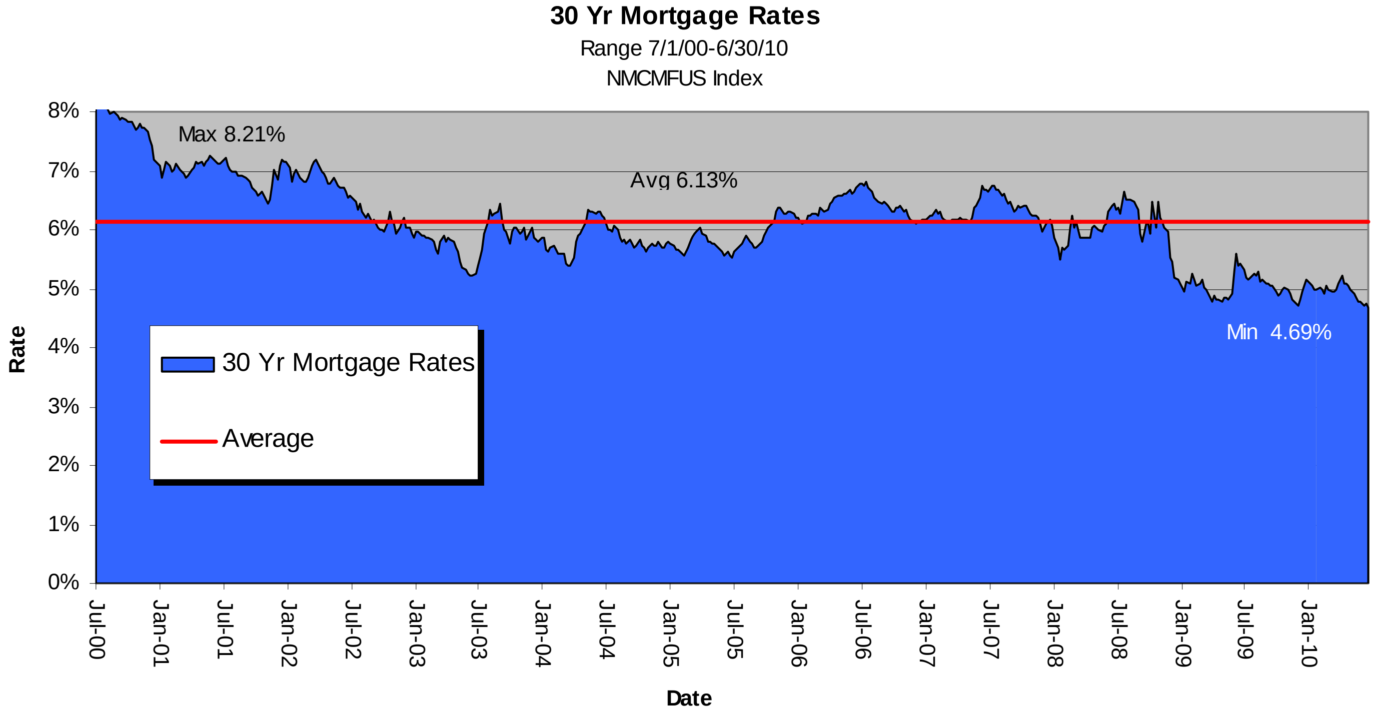
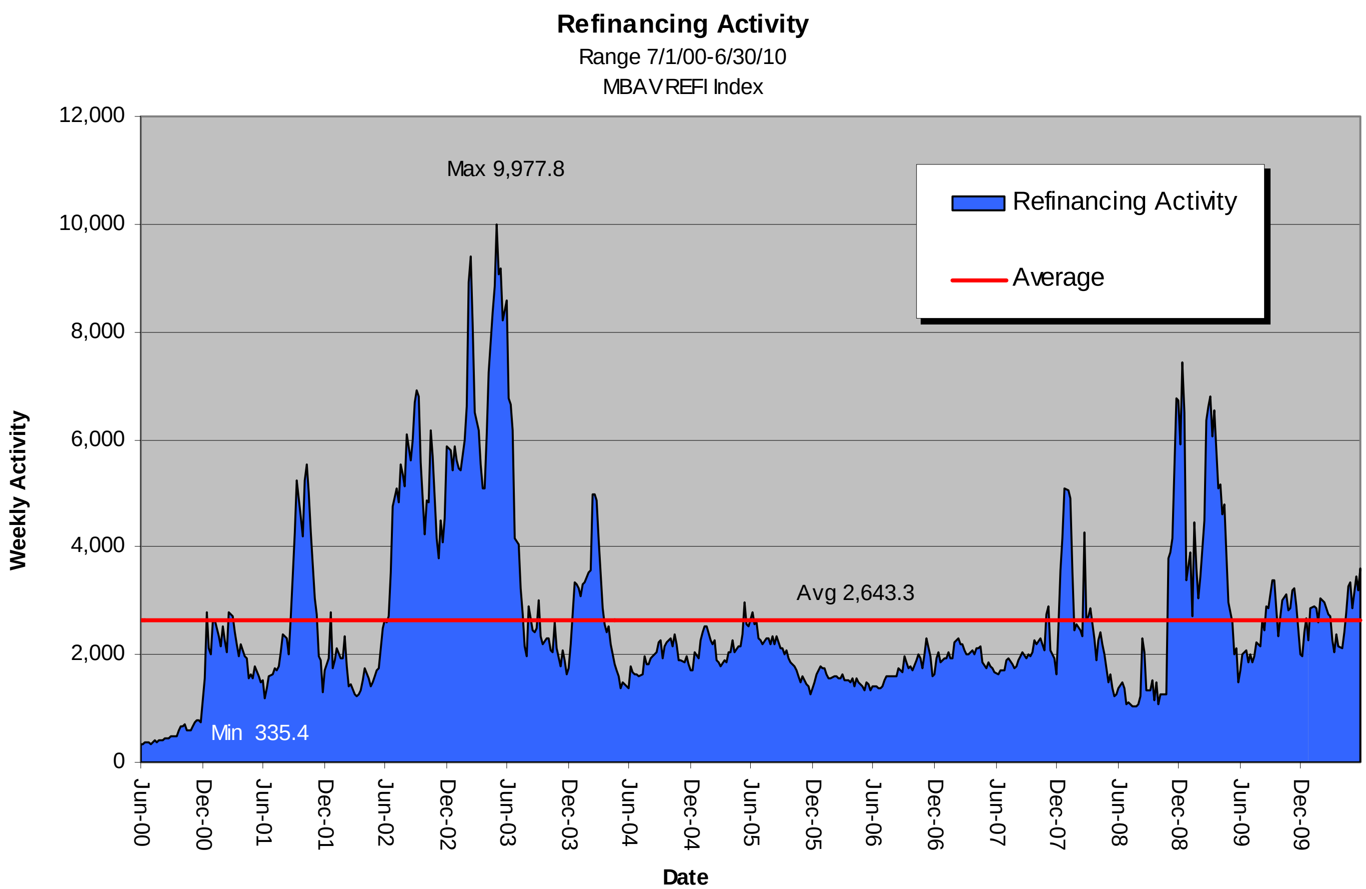
30 Year Mortgage Rates & Refinancing Activity





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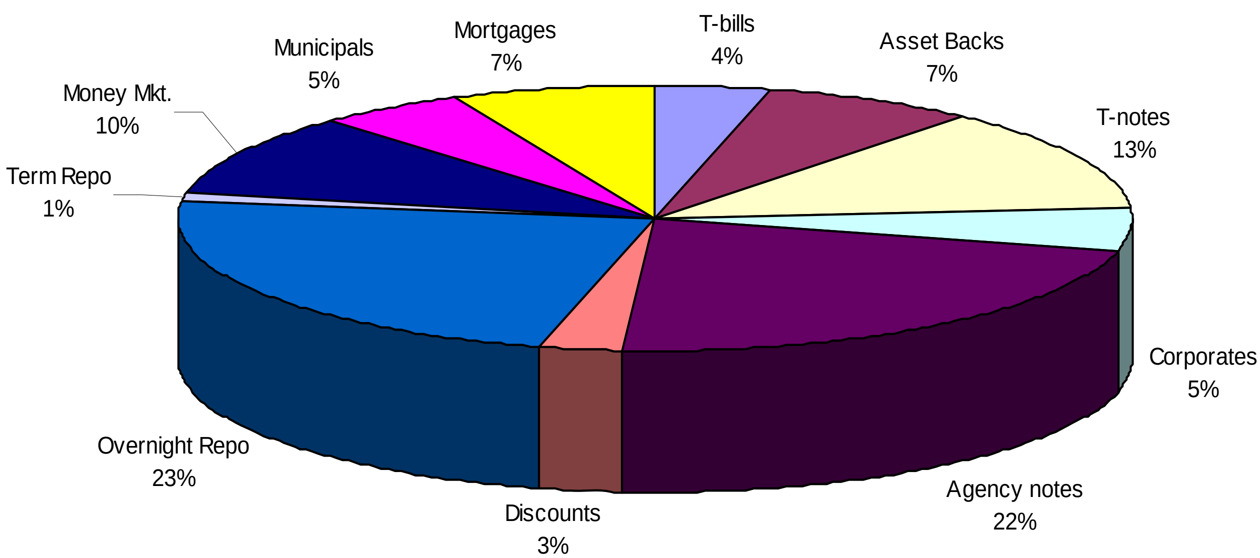
PORTFOLIO MANAGEMENT

For the year ended June 30, 2010, the Commonwealth's investment portfolio averaged $2.7 billion. As of June 30, 2010, the portfolio was invested in U.S. Treasury Securities (17 percent), U. S. Agency Securities (25 percent), Mortgage Pass Through Securities (1 percent), Collateralized Mortgage Obligations (6 percent), Repurchase Agreements (24 percent), Municipal Securities (5 percent), Corporate Securities (5 percent), Asset-Backed Securities (7 percent), and Money Market Securities (10 percent). The portfolio had a market yield of 0.69 percent and an effective duration of .60 years.

The total portfolio is broken down into three investment pools. The pool balances as of June 30, 2010, were: Short Term Pool - $1,196 million, Intermediate Term Pool - $1,851 million, and Bond Proceeds Pool - $390 million.

Total investment income from all investments, on a cash basis, for the year ended June 30, 2010, was $52.7 million versus $107.6 million for the year ended June 30, 2009. On a full mark-to-market basis, investment income was $54.7 million for the year ended June 30, 2010, versus $106.2 for the year ended June 30, 2009. The reduction in both measures of income was due in part to a 20% reduction in balances to be invested with the rest due to the substantial decline in market interest rates.

Distribution of Investments for June
as of 6/30/2010



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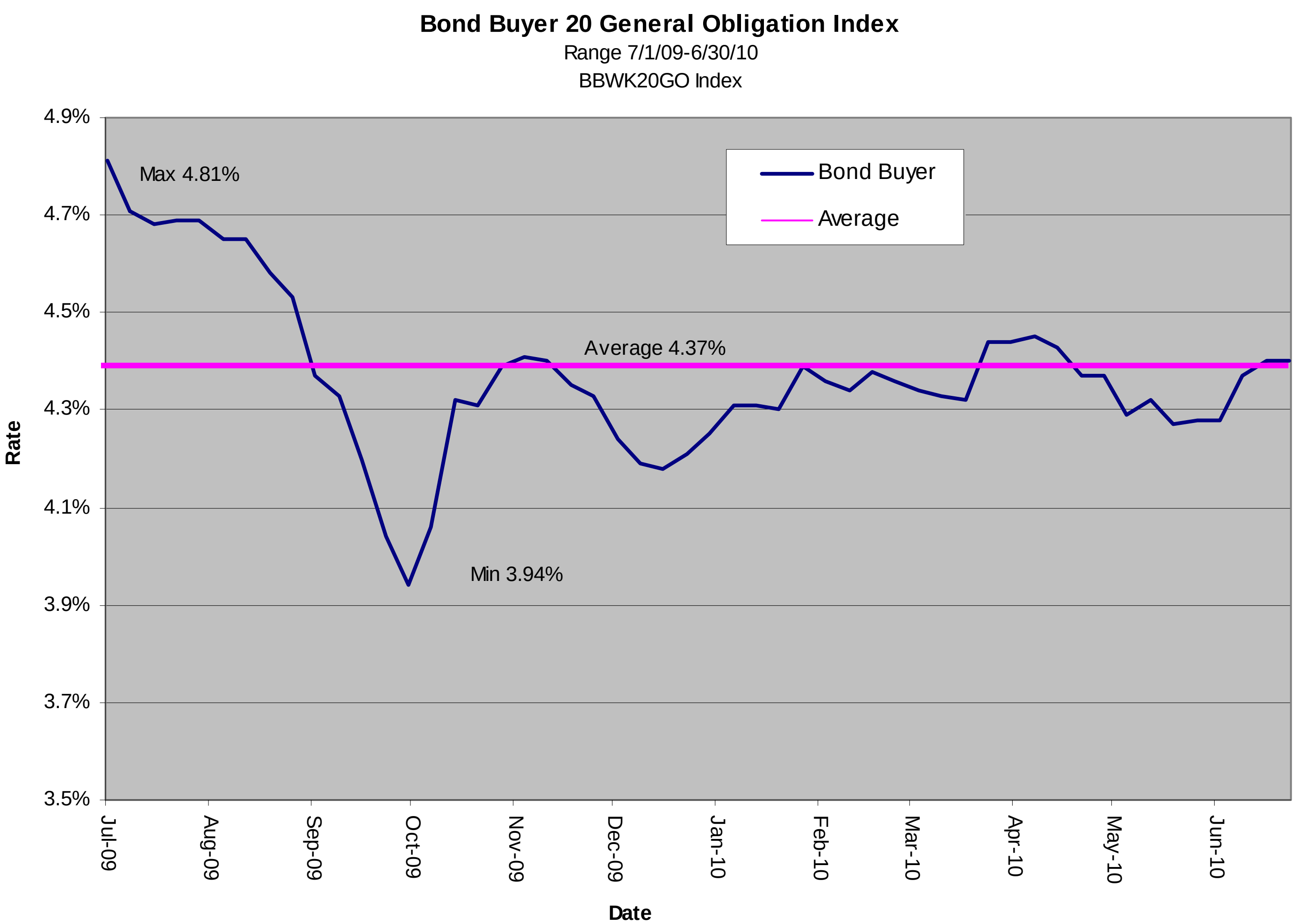
Tax-Exempt Interest Rates and Relationships

The Bond Buyer 20 year General Obligation Index averaged 4.35% for the reporting period and 4.37% for Fiscal Year 2010. The fiscal year high was 4.81% in July 2009 and the low was 3.94% in October 2009 with the fiscal year end at 4.40%.

The Securities Industry and Financial Markets Association (SIFMA) Municipal Swap Index averaged 0.25% for the reporting period and 0.28% for Fiscal Year 2010. The high was 0.43% in August 2009 and the low was 0.15% in January 2010 and ended the fiscal year at 0.25%. The 30-day USD London Interbank Offered Rate ("LIBOR") averaged 0.27% for the reporting period and 0.26% for Fiscal Year 2010. The fiscal year high was 0.35% in May 2010 and the low was 0.23% in February 2010 and ended the fiscal year at 0.35%. During the fiscal year, SIFMA traded as high as 162.43% of 30-day LIBOR in September 2009 and as low as 64.34% in January 2010 with an average of 106.31% for the fiscal year. The fiscal year ended with SIFMA at 71.75% of 30-day LIBOR.



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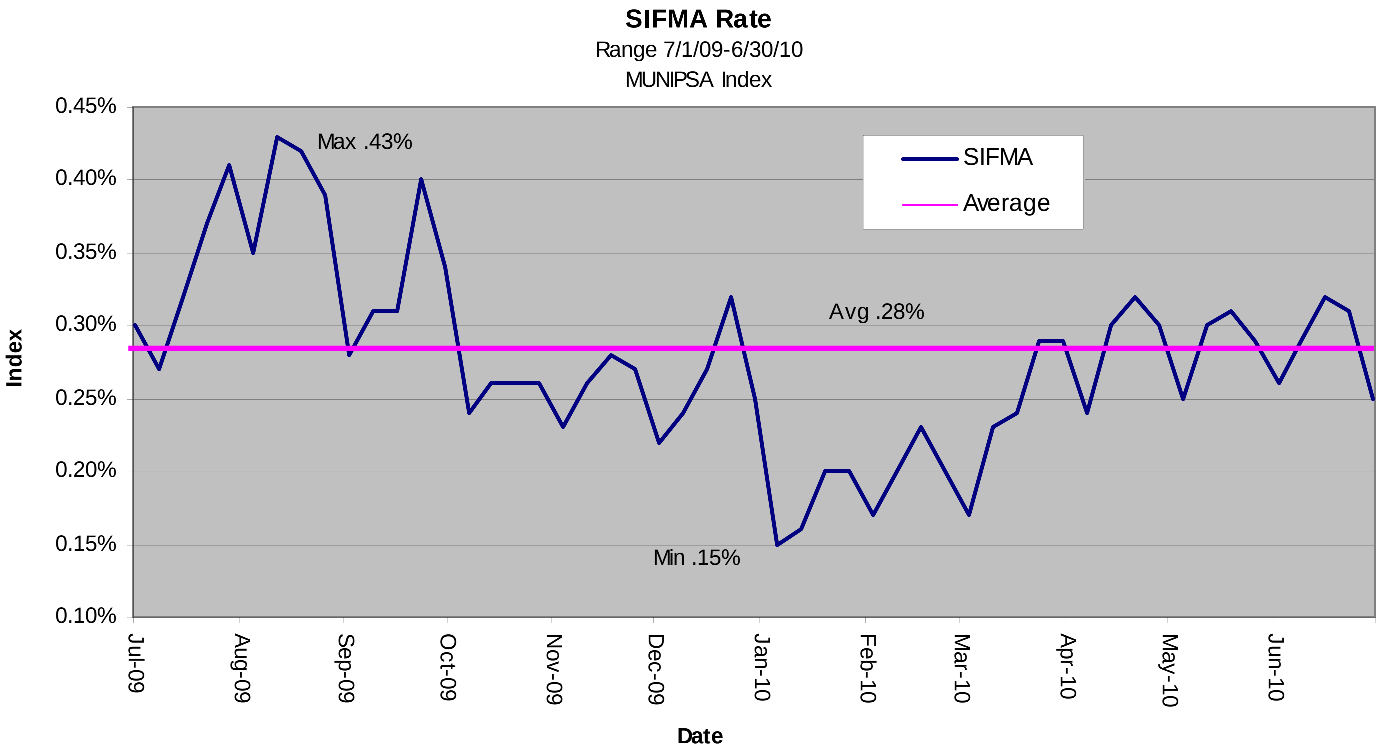
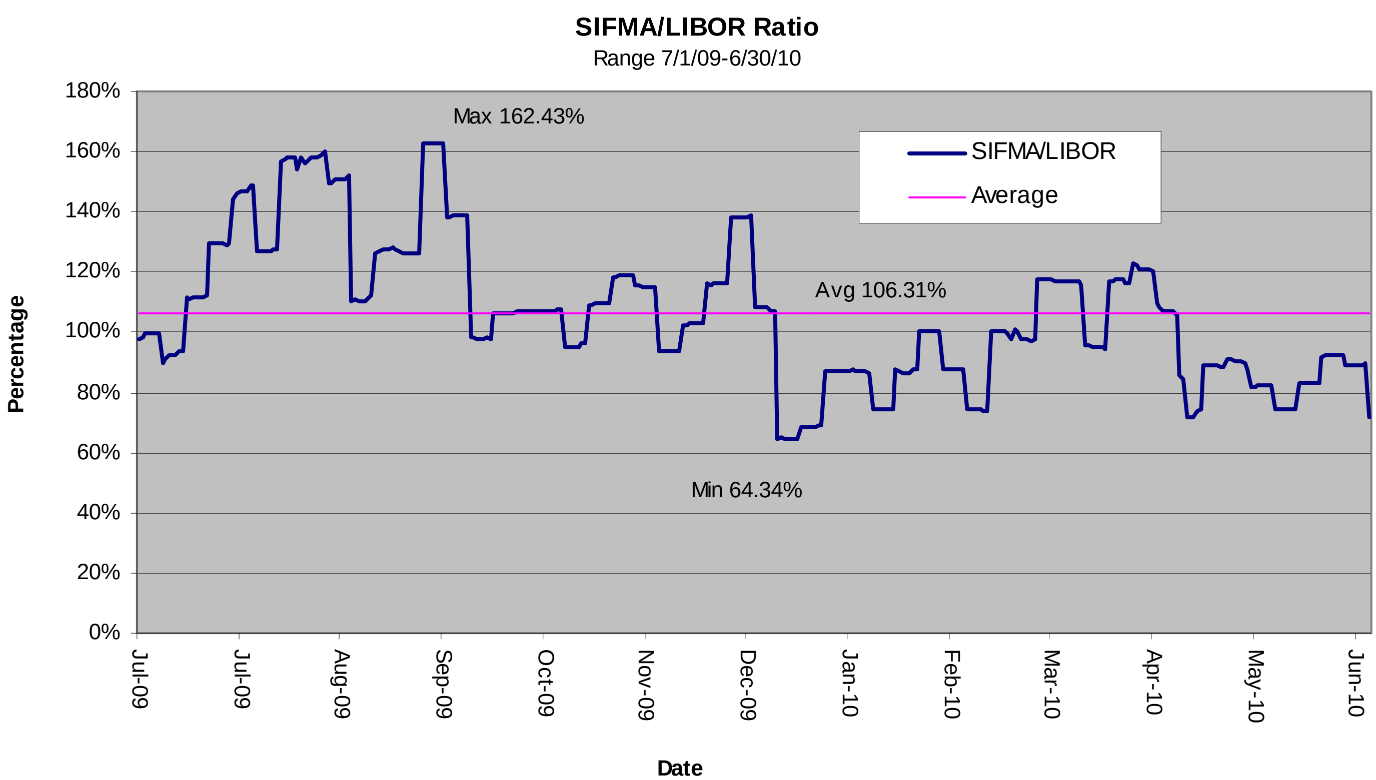
SIFMA and SIFMA/LIBOR Ratio





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The 2005 Kentucky General Assembly adopted 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 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 Road Fund, Agency Fund and FHTF authorizations.

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

The 2008 Kentucky General Assembly adopted 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. Bonds have been issued to permanently finance the Road Fund and Agency Fund authorizations and a portion of the FHTF authorization.

The 2009 Kentucky General Assembly authorized $7 million of additional General Fund supported bonds and an additional $400 million of Economic Development Road Revenue Bonds to be supported from the Road Fund. Bonds have been issued to finance half of the 2009 Road Fund authorization to date.

In the 2009 Special Session, the Kentucky General Assembly authorized $100 million of Agency Fund supported bonds to provide additional financing for the University of Kentucky hospital. These bonds were issued in November 2009.

The 2010 Special 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 is General Fund supported, $522.5 million is supported by Road Fund appropriations, $515.3 million is Agency Restricted Fund supported and $435 million is 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.

To date, a significant portion of the General Fund bond projects from the above authorizations have been permanently financed. Interim note financing through ALCo is not currently available due to increased funding costs related to credit facilities for this type of program. The Commonwealth plans to provide financing for the balance of the existing authorizations through permanent fixed rate bonds. However, ALCo will continue to analyze potential interim financing options to provide construction financing for future debt authorizations of the General Assembly.

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 continued to put pressure on the Commonwealth's credit ratings.

In June 2010, Fitch Ratings downgraded the Commonwealth's General Fund and Road Fund lease

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supported bonds from "AA" to "AA-". The downgrade reflected their view of "the Commonwealth's reduced operating flexibility as reserves have been depleted, budget targets that may be difficult to meet particularly as Federal Fiscal Stimulus Funds expire, and a continuing reliance on non-recurring budget items, including debt restructuring and issuance for operating purposes." They also noted that "the Commonwealth's debt levels are at the higher end of the moderate range and are rising due to significant recent debt authorizations and issuance", and that "funding for the Commonwealth's pension systems is a credit concern, although enacted pension reform should moderate future expense." They stated that the key rating driver moving forward will be the Commonwealth's ability to return to balanced financial operations and the restoration of depleted reserves. Fitch Ratings also revised its outlook from "negative" to "stable".

In June 2010, Moody's Investors Service affirmed its "Aa1" issuer credit rating and "Aa2" rating on the Commonwealth's General Fund and Road Fund lease supported bonds. Moody's stated that "the Commonwealth's economic and financial weakening has led to sizable budget deficits, which the Commonwealth has dealt with largely through the use of one-time resources, including a drawdown of reserve balances and borrowing for budget relief. Kentucky faces ongoing budget pressure over the biennium as it seeks to stabilize its finances. The Commonwealth has a history of active financial management that has enabled it to address fiscal instability in the past. In the near-term, the Commonwealth's ability to maintain fiscal stability by meeting planned expenditure, revenue, and debt targets over the next fiscal year without additional reliance on one-time resources is a key credit consideration. As the economic recovery takes hold, it will be important for the Commonwealth to wean itself of non-recurring budgetary solutions and to rebuild reserves to maintain financial flexibility." Moody's has maintained a "negative" outlook on the Commonwealth's issuer credit rating as well as its General and Road Fund lease appropriation ratings since April of 2008.

In June 2009, S&P revised its outlook from "positive" to "stable" for Kentucky's "AA-" issuer credit rating and its "A+" rating for General Fund lease appropriation bonds issued by the State Property and Buildings Commission (SPBC), based on the impact of a challenging revenue climate on the Commonwealth's budget and reserves. S&P also observed that the pressure on revenues is hindering meaningful progress in reducing the Commonwealth's unfunded liabilities for retiree pensions and health care. The "stable" outlook does however recognize the Commonwealth's demonstrated willingness to make budget cuts and enhance revenues in order to balance its budget. S&P affirmed its ratings and outlook for the Commonwealth and SPBC in June 2010.

The Fitch Ratings downgrade and Moody's rating affirmation each come on the heels of the recent rating "recalibrations" done by both agencies in April 2010. These recalibrations each moved the Commonwealth's ratings to a Global Rating Scale used to rate sovereign, sub-sovereign, financial institution, project finance, structured finance and corporate obligations. The recalibrations are intended to enhance the comparability of ratings across the universe of rated issuers of bonds by now including municipal obligations. The primary driver for the recalibrations is the market's increasing desire for rating comparability between municipal and non-municipal sectors given the growing number of "cross-over" investors active in both tax-exempt and taxable markets, including Build America Bonds. Historically, municipal ratings have been calibrated on a separate rating scale that emphasized the ordinal ranking of credit risk within the municipal sector only while also considering distance to distress. Now, under the recalibrated ratings, each rating agency will now maintain a single global scale rating system for municipal issuers (S&P has maintained that its ratings are already on a single scale) and will no longer assign municipal scale ratings to municipal obligations.

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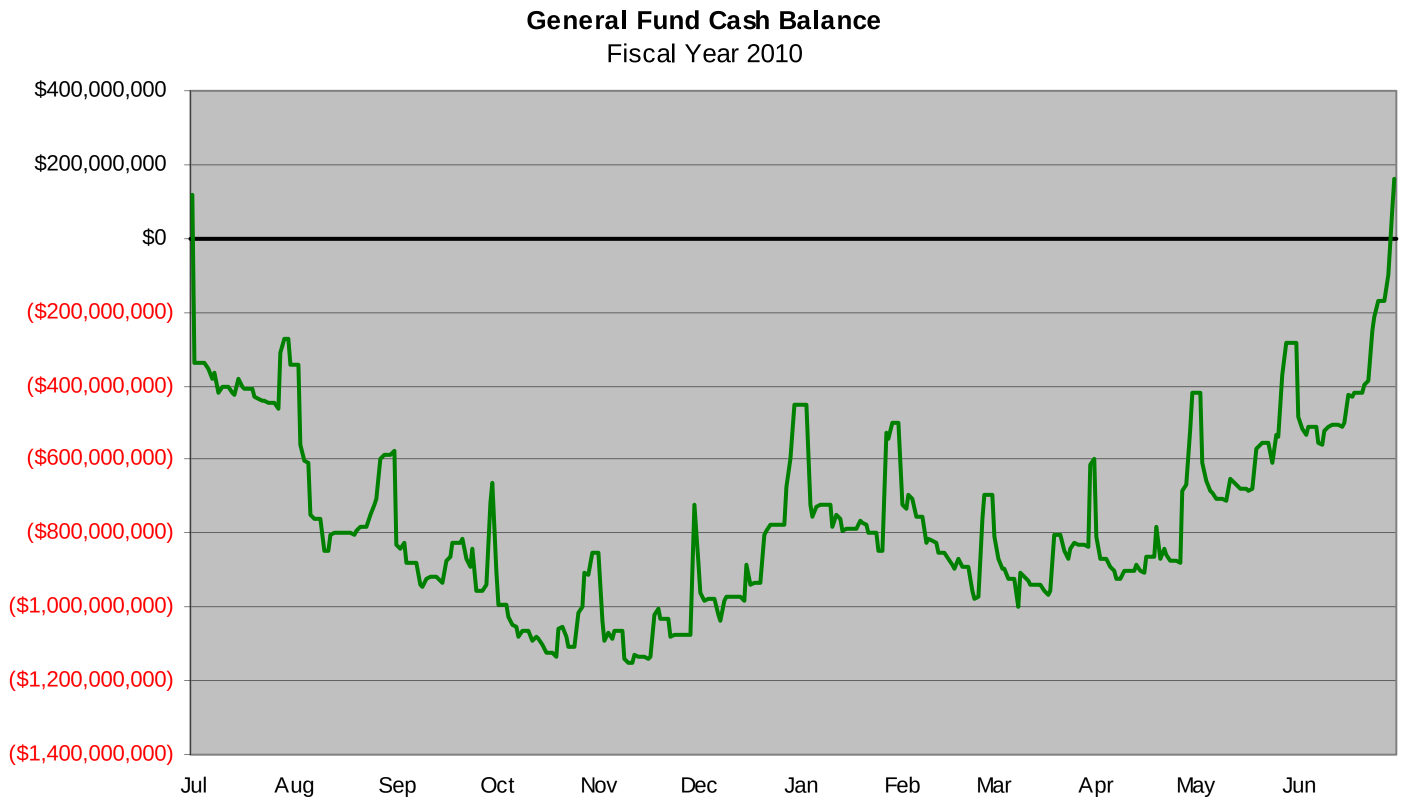

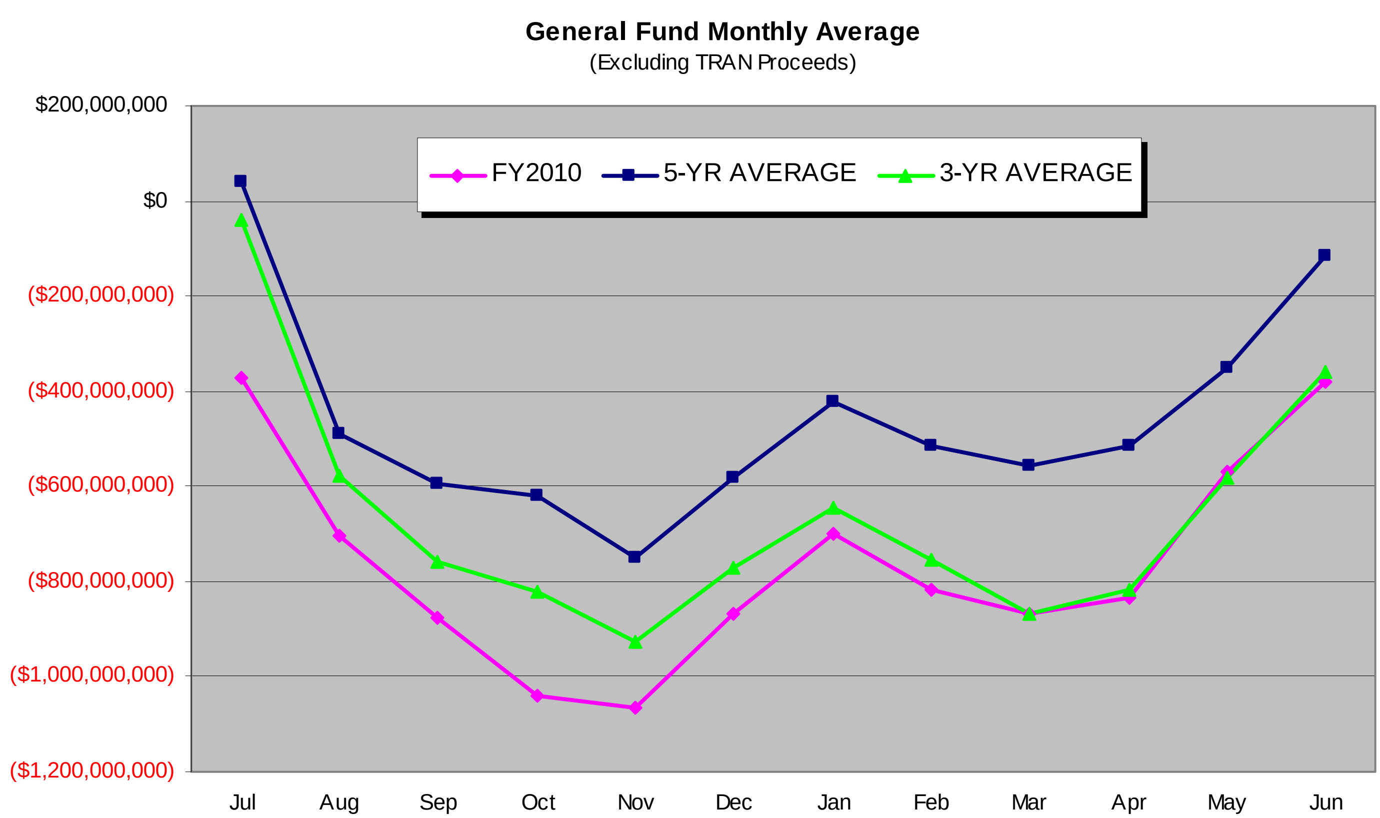

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Tax and Revenue Anticipation Notes (TRAN)

No General Fund TRAN was issued for Fiscal Year 2011. As in Fiscal Year 2010, 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

($ in millions)

FINANCIAL AGREEMENTS

As of June 30, 2010, ALCo had four financial agreements outstanding, with a net notional exposure amount of $227.42 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, both the Notes and interest rate swaps were insured by FGIC, which maintained an Aaa/AAA credit rating at the time from Moody's and S&P. Under the terms of the interest rate swaps, the counterparty (Citibank) may optionally terminate the agreements if the insurer's claims paying rating falls 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 below investment grade 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. As of the reporting date, National is rated Baa1/A, and so long as National maintains the "A" level rating from S&P no action will be required. ALCo has been in ongoing communications with the counterparty to stay apprised of any new developments and has been analyzing potential solutions in the event of a further downgrade and possible early termination on the swaps.

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ASSET/LIABILITY MODEL

General Fund

The total SPBC debt portfolio as of June 30, 2010 had $3,823 million of bonds outstanding with a weighted average coupon of 5.06 percent, modified duration of 4.94 years, and a yield at market of 2.19 percent. The market yield decreased 31 basis points from the prior reporting period while modified duration decreased by 0.02 years. The average coupon reflects the influence of the taxable Build America Bond program, 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 $1,310 million callable portion had a weighted average coupon of 5.13 percent.

The SPBC General Fund debt structure has 27 percent of principal maturing in 5 years and 63 percent of principal maturing in 10 years. These ratios are approximately in line with 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 $169 million at the end of Fiscal Year 2010 and a low of negative $1,151 million on November 10, 2009.

The average and median balances were a negative $757 million and a negative $802 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 $288 million for Fiscal Year 2010. 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 First Series.

Project proceeds of $87,000,000 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, 2010, $85.6 million of the proceeds had been expended on projects.

ALCo Funding Notes

On April 26, 2010, Governor Beshear signed House Bill 531, which amended certain sections of KRS Chapter 56 to modify the definition of Kentucky Asset/Liability Commission Funding Notes to include notes issued by ALCo for the purpose of financing or refinancing obligations owed under KRS 161.550(2) or 161.553(2) to the Kentucky Teachers' Retirement System ("KTRS"). This authorization, together with certain authorizations in House Bill 1 (the Executive Branch Biennial Budget Bill), permits the Commission to issue Funding Notes in an amount not to exceed $875 million to refinance loans previously made from the KTRS Pension Fund to the KTRS Medical Insurance Fund for stabilization funding in previous fiscal years. Subsequent to the reporting period, the first issue of Funding Notes was sold in mid-August 2010 in the amount of $467.555 million and will result in approximately $87.8 million in cashflow savings for the General Fund over the next ten fiscal years versus the prior obligations.

SPBC 98

In late June of 2010, SPBC sold $153,965,000 Revenue and Revenue Refunding Bonds, Project No. 98 and closed on the transaction on July 13, 2010. The transaction included proceeds to (1) provide additional funding of $22.9 million for the Kentucky Human Resource Information System (KHRIS) project authorized in House Bill 1 of the 2010 Special Session of the General Assembly, (2) refinance certain General Fund Notes issued by the Commission and certain General Fund Bonds issued by the SPBC to provide budgetary relief for Fiscal Year 2011 in the amount of approximately $143 million (principal and interest), and (3) pay costs of

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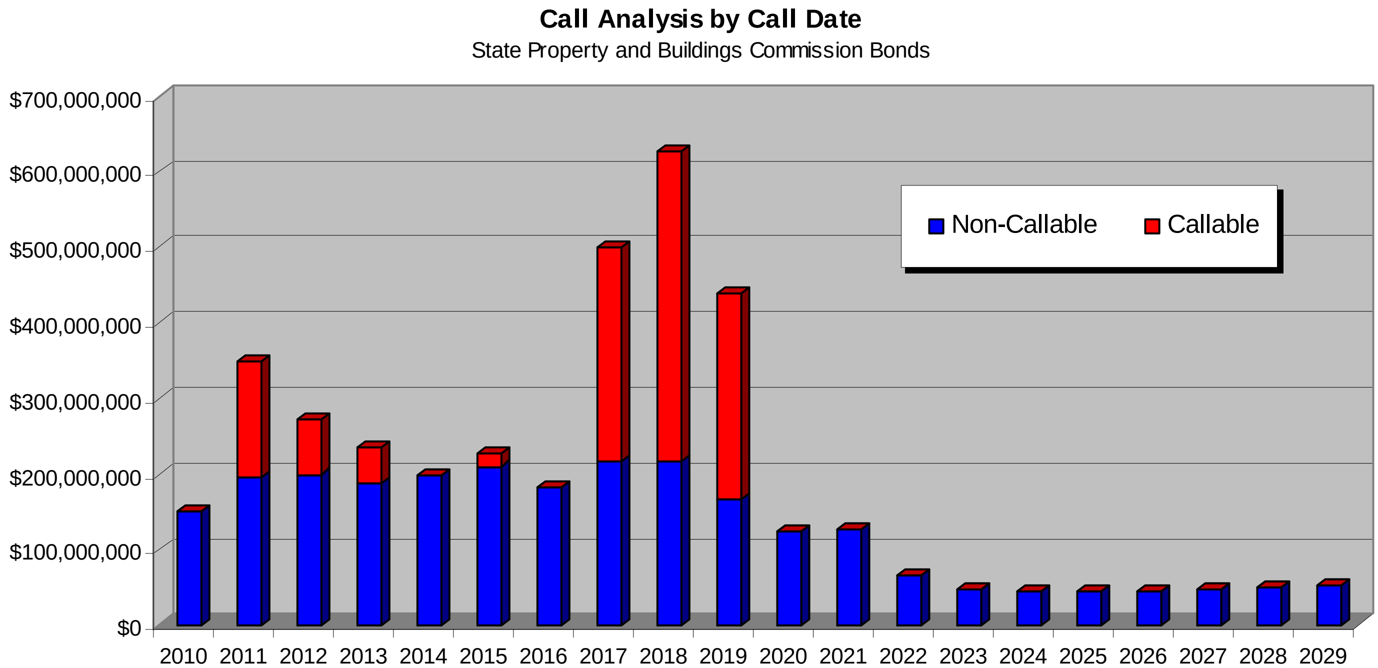
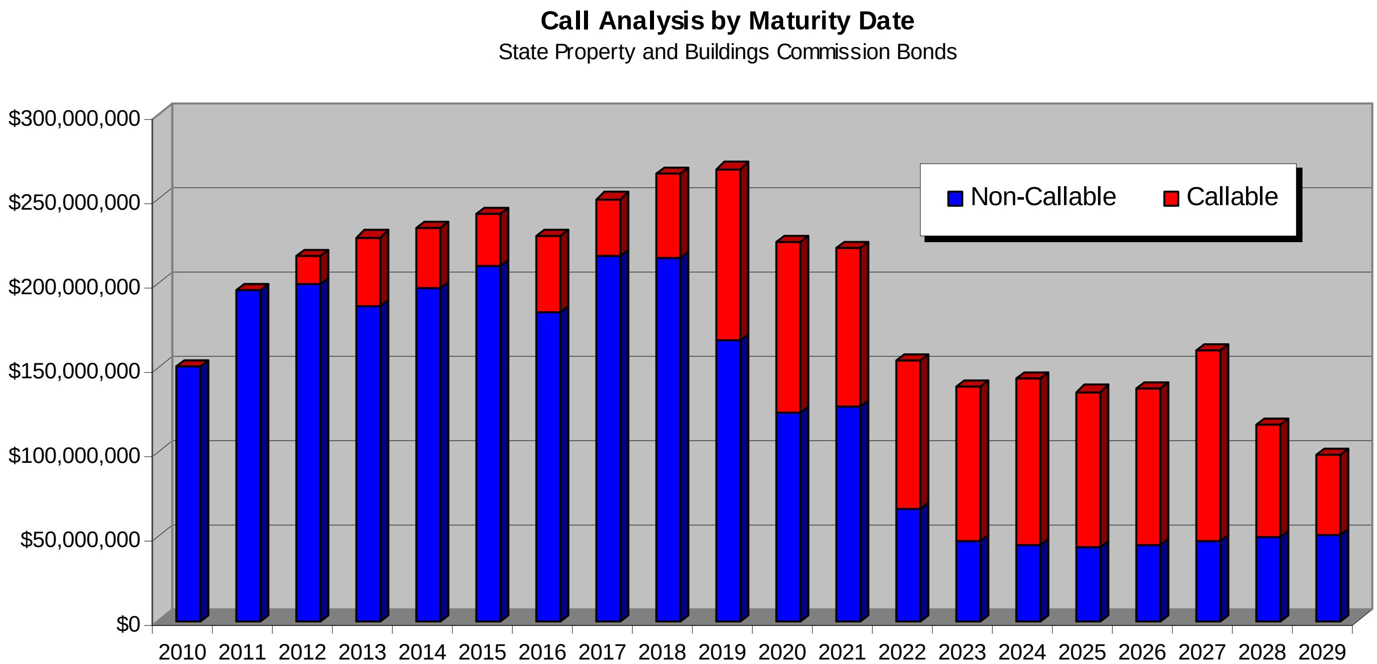
issuing the bonds.

The bonds were sold on a tax-exempt basis and received ratings of Aa2/A+/AA- from Moody's, S&P and Fitch, respectively. S&P and Fitch assigned a stable outlook, while Moody's maintains a negative outlook for the Commonwealth. The bonds were sold via negotiated sale with Citigroup serving as senior managing underwriter and Peck, Shaffer & Williams LLP as bond counsel. Even though the General Fund budget for the Commonwealth was not enacted until late May 2010 and Fitch recently





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downgraded the Commonwealth's General Fund lease appropriation credit from "AA" to "AA-", the transaction was sold on schedule and achieved very attractive rates with a TIC of 3.7213% and an average life on the bonds of 9.873 years.

Road Fund

The Road Fund average daily cash balance for Fiscal Year 2010 was $236 million compared to $305 million for Fiscal Year 2009. The Road Fund cash was invested in the Intermediate Term Investment Pool which had a duration of 0.87 years as of June 30, 2010. The Road Fund earned $3.6 million on a cash basis for Fiscal Year 2010 versus $10.4 million for Fiscal Year 2009. 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.

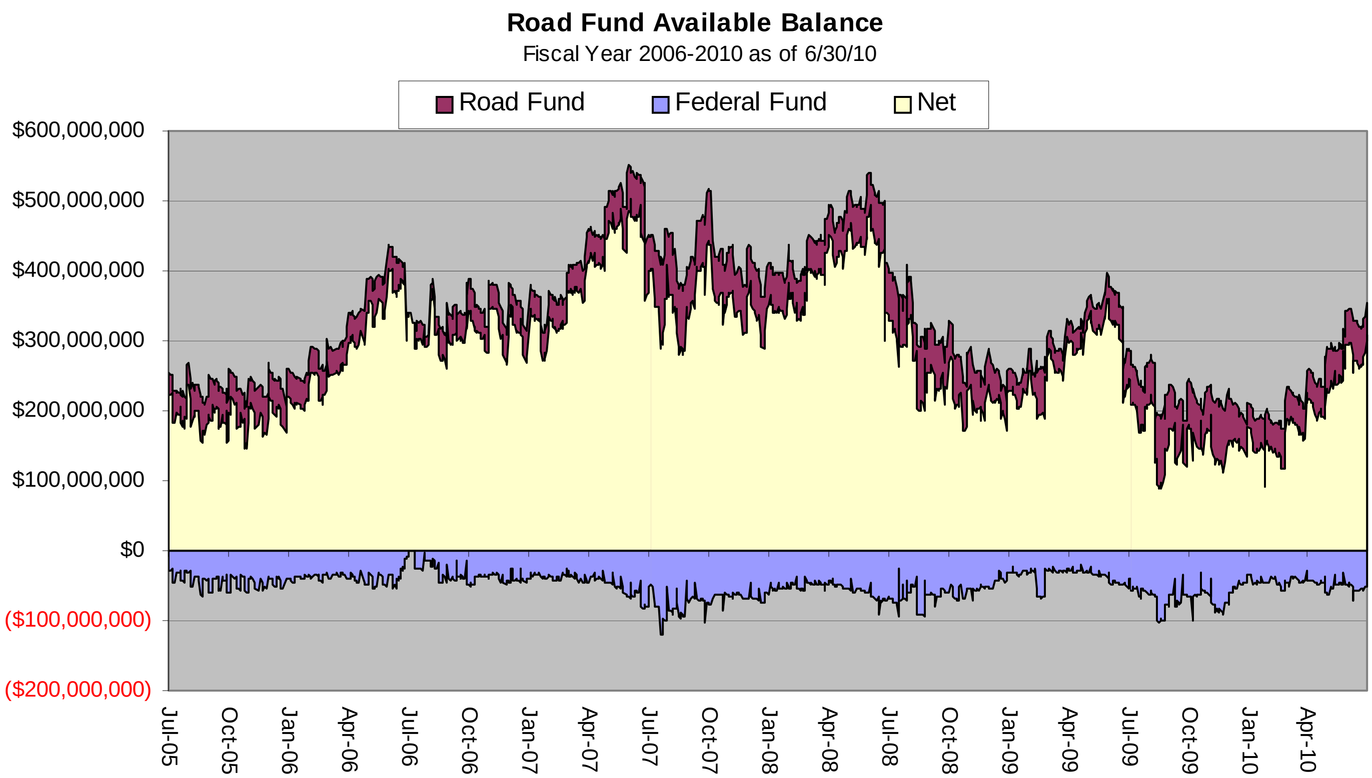
As of June 30, 2010, the Turnpike Authority of Kentucky (TAK) had $1,253 million of bonds outstanding with a weighted average coupon of 4.79 percent, modified duration of 5.43 years, and yield at market of 2.32 percent.

Road Fund debt service paid, net of reserve fund credits for Fiscal Year 2010 was $40.6 million, resulting in a net interest margin (investment income earned less debt service paid) of negative $37 million. The negative amount stems from the level of investable balances and a general low level of interest rates on the investment side in addition to the limited callability of fixed rate obligation on the liability side.

2010 GARVEE

In February of 2010, ALCo issued $89,710,000 Kentucky Asset/Liability Commission Project Notes, 2010 Federal Highway Trust Fund First Series A. The proceeds of the bonds were used to: (1) finance various expenditures related to the Louisville Southern-Indiana Ohio River Bridges Project ("LSIORBP") authorized by House Bill 410 of the General Assembly of the Commonwealth of Kentucky, 2008 Regular Session; and (2) pay for costs of issuance.

The Notes were issued on a tax-exempt basis and received ratings of "AA-," "Aa3" and "AA," from Fitch, Moody's and Standard & Poor's, respectively.



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The transaction was sold on a negotiated basis with Citigroup Global Markets, Inc. acting as senior managing underwriter. Kutak Rock served as bond counsel. The sale proved to be successful and the bonds were sold with an All-in TIC of 3.65% and an average life of 11.5 years.

TAK 2010 Series A and B

In June of 2010, TAK issued a $340,900,000 financing which consisted of $153,260,000 Economic Development Road Revenue and Revenue Refunding Bonds (Revitalization Projects), 2010 Series A and $187,640,000 Economic Development Road Revenue Bonds (Revitalization Projects), 2010 Series B (Federally Taxable – Build America Bonds – Direct Payment to the Authority). The proceeds of the bonds were used to (1) provide $50 million in Economic Development Bonds for the Base Realignment and Closure (BRAC) project authorized in the 2008 Regular Session of the General Assembly, (2) provide $200 million in Economic Development Bonds for certain projects from the Transportation Cabinet's six year highway plan, which comprises half of the Road Fund bond authorization from the 2009 Regular Session of the General Assembly, (3) provide approximately $81 million in debt restructuring for budgetary relief in Fiscal Year 2010, and (4) pay for costs of issuance.

The structure of the transaction was essentially a 20-yr level debt financing with maturities beginning in 2013 and consisting of two series of bonds, Series A being tax-exempt refunding and new money bonds and Series B issued as Build America Bonds (BABs), sold on a taxable basis with a 35% federal subsidy on the interest portion of the debt service. BABs were created under the American Recovery and Reinvestment Act of 2009, and this financing was the first issuance of BABs for the Road Fund in the Commonwealth. This transaction was structured to issue over half of the bonds as BABs with tax-exempt bonds issued in the early maturities to appeal to retail and traditional tax-exempt investors. The Kentucky Transportation Cabinet is obligated to pay the gross interest amount on the bonds and plans to request appropriations in future years for the full amount of debt service due on the BABs and use each federal subsidy payment held at the trustee to net fund the next debt service payment. This will allow Transportation to lapse any excess unused debt service appropriations at the end of the fiscal year as is normal practice for Authorized but Unissued (ABUI) capital projects. This approach provides assurance to the rating agencies and investors that there would be no risk of default on a debt service payment in the unlikely event that the federal government did not make their reimbursement in a timely manner or discontinued future reimbursements.

The bonds received ratings of Aa2/AA+/AA- from Moody's, S&P and Fitch, respectively. 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, received retail orders of $36 million and achieved the lowest cost of funds for a 20-year TAK financing in memory, with an All-In TIC of 3.471% and an average life on the bonds of 11.724 years. All despite a late enacted biennial Road Fund budget for the Commonwealth and Fitch's one notch downgrade of the Road Fund lease appropriation credit from "AA" to "AA-".

Agency Fund

SPBC 97

In July 2010, SPBC issued $3,430,000 Taxable Agency Fund Revenue Bonds, Project 97 on behalf of the Kentucky Department of Military Affairs ("DMA") for the construction of a hangar at Bluegrass Station in Lexington. The project, which was authorized in House Bill 302 of the 2010 Regular Session of the General Assembly, is the third financing secured by agency revenues generated by Bluegrass Station. Similar to the previous two transactions, one issued by ALCo in 2005 and one issued by SPBC in 2008, the financing was required to be sold on a taxable basis due to the primarily Federal and private sector tenants at Bluegrass Station both working at the facility and paying the majority of the lease revenue generated there (private use and private payment).

Originally, bond counsel for the SPBC 92 bonds had questions about whether parity bonds could be is-

DEBT MANAGEMENT

sued for Bluegrass Station based on the original ALCo indenture. After careful consideration though, it was determined that parity bonds could be issued by SPBC with the exception that any SPBC 97 and SPBC 92 bondholder remedies under an event of default would be subordinate to the original ALCo noteholder rights which cede control to the bond insurer.

Morgan Keegan & Company, Inc. served as senior managing underwriter on the SPBC 97 financing. Similar to the 2005 ALCo transaction and SPBC 92 transaction, it was believed that the pledged revenues from Bluegrass Station alone, and being subject to legislative appropriation, would likely not be enough to achieve an A level rating from any of the rating agencies. It would again be necessary to have a Moral Obligation pledge of the Commonwealth to pay debt service on the SPBC 97 bonds if revenues from the DMA were insufficient to meet debt service requirements. However, in an effort to mitigate the credit risks to the Commonwealth's General Fund, OFM determined that a 1.2x additional bonds test was an appropriate policy to apply to Bluegrass Station (though not included in the bond documents) and looked to DMA to provide reasonable future expenditure and revenue estimates achieving this level, including reasonable estimates for ongoing capital maintenance. DMA was able to provide final estimates sufficient to meet this policy.

Ultimately, due to the limited revenue history, required rent revenue increases, and the associated appropriation risk, all three rating agencies based their ratings primarily on the Moral Obligation pledge. The bonds were assigned ratings of Aa3/A+/A+ from Moody's, S&P and Fitch, respectively.

The bonds were sold in July 2010 as taxable serial bonds. The 15-year financing was completed on schedule and achieved reasonable rates for the DMA with an All-In TIC of 4.89% with an average life on the bonds of 8.57 years.

KIA Series 2010A

House Bill 406 of the 2008 Regular Session authorized $230 million of Agency 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. This authorization provided KIA the ability to leverage their SRF programs for the first time and to maximize the amount of financial assistance available under the programs.

In January of 2009, KIA procured First Southwest as program advisor to begin the process and implementation of the leveraged SRF programs. In July of 2009, Morgan Stanley was procured as senior managing underwriter and Peck, Shaffer & Williams LLP as bond counsel to KIA. Over the next several months, a new bond indenture was created for the leveraged SRF programs and a great deal of cashflow analysis was undertaken in order to structure the proposed bond offering in a manner that would provide solid debt service coverage ratios and stand up to stringent stress tests applied by rating agencies.

In mid-March 2010, KIA gave detailed presentations to the rating agencies on the new leveraged SRF programs and proposed bond structure. The programs were well received by all three rating agencies. Impressed by strong coverage ratios (in excess of the 110% required by the indenture) and the quality of the leveraged Assistance Agreement credits, KIA secured Aaa, AAA, & AAA ratings from Moody's, Standard & Poor's and Fitch, respectively.

The bonds were sold on March 22, 2010, in a par amount of $208,430,000 and provided $230 million of available proceeds for KIA to make loans under the SRF programs ($200 million for the Wastewater program and $30 million for the Drinking Water program). The arbitrage yield on the bonds for the combined issuance was a very strong 3.15% and KIA successfully delivered the bonds and closed the issuance on April 15, 2010.

DEBT MANAGEMENT

SUMMARY

ALCo's approach to managing the Commonwealth's interest-sensitive assets and interest- sensitive liabilities has provided tremendous flexibility and savings in financing the Commonwealth's capital construction program.

Since its inception, ALCo has been instrumental in adding incremental returns on investment income to the Commonwealth's investment portfolio. ALCo has continued to manage General Fund intra-year cash flow 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.

During Fiscal Year 2010, the Commonwealth was able to cut (budget reduction) or lapse $287 million of budgeted General Fund debt service and $129 million of budgeted Road Fund debt service. Approximately $161 million of the General Fund debt service lapse resulted from debt restructuring completed through the SPBC 90, SPBC 93 and SPBC 95 transactions. Approximately $81 million of the Road Fund debt service lapse resulted from the debt restructuring completed through the TAK 2010 Series A transaction.

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. However, the continuing high cost of acquiring credit/liquidity support for short-term borrowing programs when compared to the low cost of long-term financing currently available through the Build America Bond program will likely limit the Commonwealth's use of any commercial paper or other short-term construction financing programs in the near future.

APPENDIX

APPENDIX A

ALCo Financial Agreements	ALCo FRN Series A Hedge	ALCo FRN Series A Hedge	ALCo FRN Series B Hedge	ALCo FRN Series B Hedge
Fund Source	General Fund	General Fund	General Fund	General Fund
Hedge	2017 FRN	2027 FRN	2021 FRN	2025 FRN
Counter Party	Citibank	Citibank	Citibank	Citibank
Counter-Party Ratings *(Moody's / S&P / Fitch)*	A1/A+/A+	A1/A+/A+	A1/A+/A+	A1/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	19,295,000	68,135,000	69,055,000	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	11/2/2025
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, 2010 (negative indicates payment owed by ALCo if terminated)	(1,645,399)	(8,942,279)	(9,280,667)	(11,456,077)
Interest Earnings (not applicable)				
Total	not applicable	not applicable	not applicable	not applicable

Swap Summary
As of June 30, 2010

	Total Notional Amount Executed		Net Exposure Notional Amount	
	General Fund	Road Fund	General Fund	Road Fund
	243,080,000	0	227,420,000	0

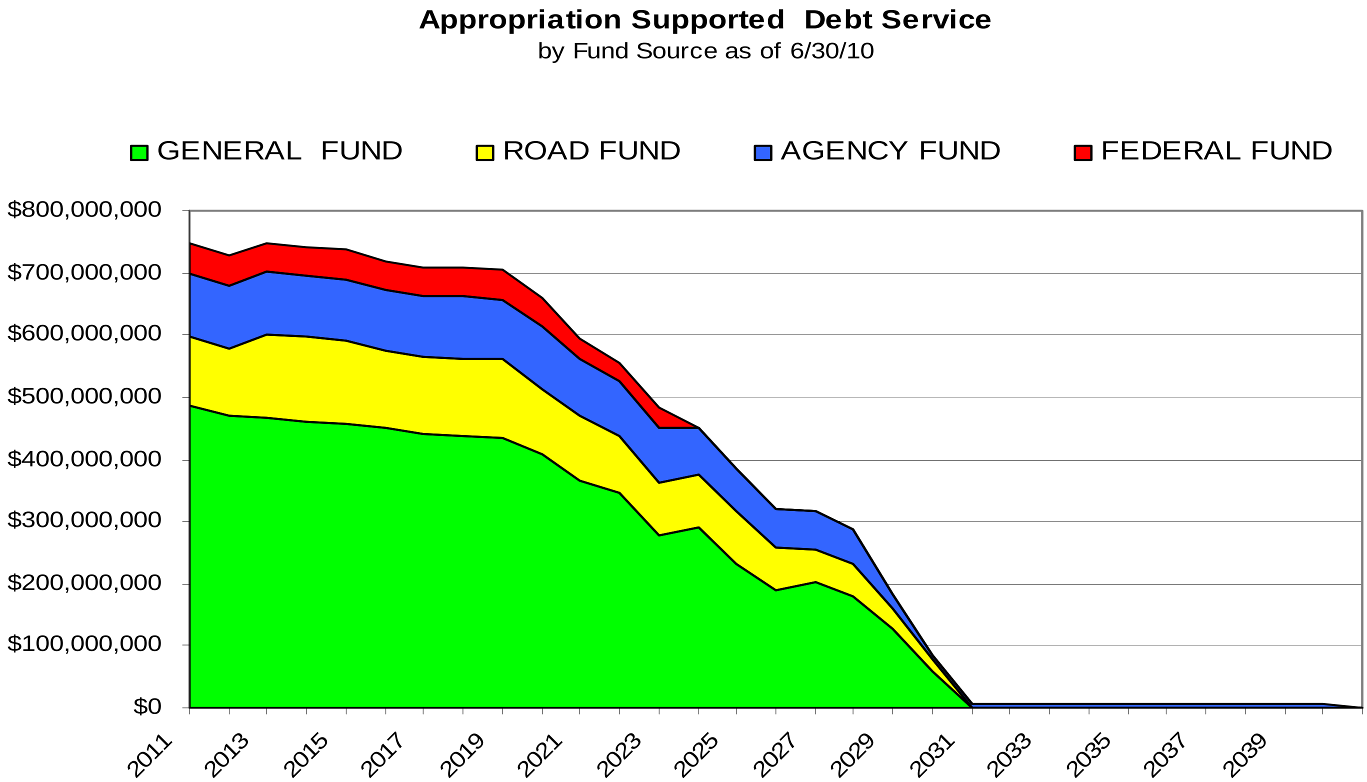
Total Notional Amount Executed by Counter Party

Citibank
243,080,000

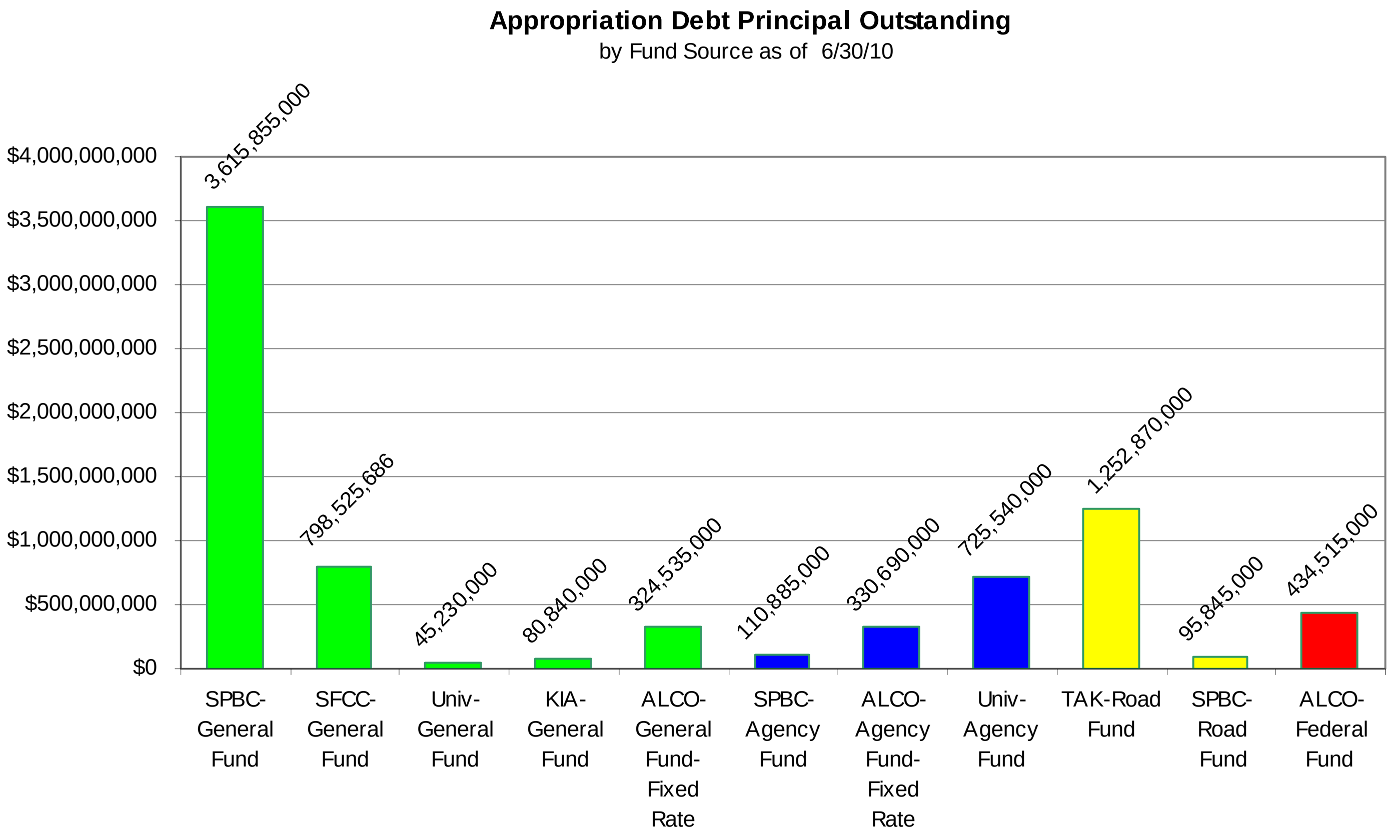
	Debt		10 Percent Net Exposures	
	General Fund	Road Fund	General Fund	Road Fund
Bonds Outstanding	3,940,390,000	1,348,715,000	394,039,000	134,871,500
Authorized but Unissued	728,174,475	772,500,000	72,817,448	72,250,000
Total	4,668,564,475	2,071,215,000	466,856,448	207,121,500

Investment Pool Balances		10 Percent Investment Portfolio	
Other Funds	Net Road Fund	Other Funds	Net Road Fund
3,128,393,092	307,675,799	312,839,309	30,767,580

APPENDIX B



Appropriation Supported Debt Service
by Fund Source as of 6/30/10
GENERAL FUND
ROAD FUND
AGENCY FUND
FEDERAL FUND
$800,000,000
$700,000,000
$600,000,000
$500,000,000
$400,000,000
$300,000,000
$200,000,000
$100,000,000
$0
2011
2013
2015
2017
2019
2021
2023
2025
2027
2029
2031
2033
2035
2037
2039



Appropriation Debt Principal Outstanding
by Fund Source as of 6/30/10
$4,000,000,000
$3,500,000,000
$3,000,000,000
$2,500,000,000
$2,000,000,000
$1,500,000,000
$1,000,000,000
$500,000,000
$0
3,615,855,000
798,525,686
45,230,000
80,840,000
324,535,000
110,885,000
330,690,000
725,540,000
1,252,870,000
95,845,000
434,515,000
SPBC-General Fund
SFCC-General Fund
Univ-General Fund
KIA-General Fund
ALCO-General Fund-Fixed Rate
SPBC-Agency Fund
ALCO-Agency Fund-Fixed Rate
Univ-Agency Fund
TAK-Road Fund
SPBC-Road Fund
ALCO-Federal Fund

APPENDIX C

COMMONWEALTH OF KENTUCKY

ASSET/LIABILITY COMMISSION

SCHEDULE OF NOTES OUTSTANDING

AS OF 6/30/10

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	$29,720,000
2005 1st Series	$81,850,000	6/2005	5/2025	$67,395,000
2007 A, B Series	$243,080,000	5/2007	11/2027	$227,420,000
FUND TOTAL	**$496,190,000**			**$324,535,000**
Agency Fund Project Notes				
2005 1st Series	$11,275,000	6/2005	6/2025	$9,640,000
2005 Series A-UK Gen Recpts	$107,540,000	11/2005	10/2025	$103,145,000
2006 Series A-UK Gen Recpts	$66,305,000	10/2006	10/2022	$59,755,000
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	**$343,270,000**			**$330,690,000**
Federal Hwy Trust Fund Project Notes				
2005 1st Series	$139,635,000	6/2005	9/2017	$99,345,000
2007 1st Series	$277,910,000	9/2007	9/2019	$245,460,000
2010 1st Series	$89,710,000	3/2010	9/2022	89,710,000
FUND TOTAL	**$507,255,000**			**$434,515,000**
PROJECT NOTES TOTAL	**$1,346,715,000**			**$1,089,740,000**

APPENDIX D

General Fund Bond Supported Projects Fully or Partially Financed Within the Reporting Period

PROJECT DESCRIPTION	AGENCY	Authorization Balance	SPBC 90 Allocations	SPBC 93 Allocations	SPBC 95 Allocations	Remaining Balance
Infrastructure for Economic Development Fund for Coal-Producing Counties	KIA	13,000,000 (1)	0	3,619,725	1,809,803	7,570,472
Infrastructure for Economic Development Fund for Tobacco Counties	KIA	7,500,000 (1)	0	0	0	7,500,000
Business Refund Off-Set System	Revenue	1,750,000	68,509	0	0	1,681,491
Construct Business Technology Center - Phase II	EKU	32,850,000	2,417,191	8,398,053	5,305,764	16,728,992
Expand & Upgrade Livestock Disease Diagnostic Center	UK	8,500,000	3,434,797	4,375,611	0	689,592
Renovate Science Campus, Phase II	WKU	33,000,000 (1)	18,365,160	9,829,473	3,032,995	1,772,372
LCC Classroom/Lab Building	KCTCS	31,741,000	1,581,104	551,135	88,265	29,520,496
Replace Records and Secure Evidence Facility	State Police	6,075,000	360,132	3,266,942	516,634	1,931,292
Innovation and Commercialization for a Knowledge-Based Economy Bond Pool	Economic Development	4,500,000 (1)	0	3,250,000	500,000	750,000
Economic Development Bond Pool	Economic Development	8,488,000 (1)	1,300,000	250,000	0	6,938,000
Child Support Enforcement (KASES II)	CHFS	2,040,000	225,389	124,428	38,216	1,651,967
Upgrade KASPER System DPH	Public Health	5,000,000	2,932,498	560,718	142,125	1,364,659
Upgrade HVAC Pipes & Electric - Glasgow	MHMR	117,790	117,790	0	0	0
KHRIS	Personnel	25,000,000	14,816,309	5,009,334	1,354,167	3,820,190
Kentucky Agriculture Finance Corporation - Loan Pool	GOAP	2,000,000 (1)	0	0	0	2,000,000
Plan and Design Glasgow State Nursing Facility	MHMR	2,000,000	0	0	0	2,000,000 ***
Subtotal - 2005 General Assembly		**183,561,790**	**45,618,879**	**39,235,419**	**12,787,969**	**85,919,523**
Western Kentucky Veteran's Center-Alzheimer's/General Care Unit	Veteran's Affairs	1,757,000	0	42,165	0	1,714,835
Public Safety Commission - Infrastructure -KEWS	COT	13,000,000 (1)	0	0	5,366,352	7,633,648
Infrastructure for Economic Development Fund for Non-Coal Producing Counties	KIA	112,500,000 (1)	46,736,384	24,283,951	4,912,786	36,566,879
Infrastructure for Economic Development Fund for Coal Producing Counties	KIA	75,000,000 (1)	28,512,130	13,915,541	5,274,267	27,298,062
Community Development Fund Projects	Local Development	28,958,000 (1)	8,341,063	6,469,303	2,951,132	11,196,502
Warren County Fiscal Court Transpark Rail Spur	Local Development	4,500,000	3,877,299	165,008	75,614	382,079
Implement Comprehensive Tax System - Phase I	Revenue	23,250,000 (1)	0	2,182,667	706,181	20,361,152
Construct Science Building	EKU	54,108,000 (1)	1,900,714	7,494,027	4,098,480	40,614,779
Construct Manchester Postsecondary Education Center	EKU	3,500,000 (1)	1,087,037	1,577,563	118,480	716,920
Renovate Hathaway Hall Phase II	KSU	4,920,000 (1)	4,181,393	565,175	5,000	168,432
Space Science Center - Completion	Morehead State	3,400,000 (1)	993,467	1,834,897	72,153	499,483
Construct Center for Health Education and Research	Morehead State	23,000,000 (1)	4,238,848	11,054,810	2,772,515	4,933,827
Construct New Science Complex - Phase III	Murray State	15,000,000 (1)	0	14,106,679	126,055	767,266

(Continued next page)

APPENDIX D

General Fund Bond Supported Projects Fully or Partially Financed Within the Reporting Period

PROJECT DESCRIPTION	AGENCY	Authorization Balance	SPBC 90 Allocations	SPBC 93 Allocations	SPBC 95 Allocations	Remaining Balance
Construct Center for Informatics	NKU	35,500,000	66,625	4,934,118	3,356,561	27,142,696
Construct Biological/Pharmaceutical Complex Phase II	UK	79,892,000 (1)	28,218,634	46,277,417	5,395,949	0
Construct HSC Research Facility IV	UL	69,680,000 (1)	57,767,730	11,869,369	0	42,901
Replace College of Education Building – Tate Page Hall	WKU	35,000,000	3,702,627	3,855,351	5,830,434	21,611,588
Construct Advanced Manufacturing Tech Center – Gateway CTC	KCTCS	28,000,000	9,179,491	8,808,701	1,251,447	8,760,361
Construct Emerging Technology Center West Kentucky CTC	KCTCS	16,518,000	5,834,103	7,225,156	3,021,776	436,965
Construct Allied Health/Tech Ed Building – Laurel	KCTCS	14,015,000	5,973,734	4,170,289	2,144,324	1,726,653
Construct Administration Building Phase I Maysville CC	KCTCS	5,008,000	1,069,520	3,179,340	393,826	365,314
Construct Science/Allied Health Building – Jefferson CTC	KCTCS	25,557,000	6,293,126	12,682,004	3,519,825	3,062,045
Construct Central Reg. PSE Center Phase II Elizabethtown CTC	KCTCS	20,000,000	4,272,080	9,848,679	2,946,725	2,932,516
Advanced Manufacturing Center – Design – Bluegrass CTC	KCTCS	1,500,000	1,169,591	5,813	0	324,596
Springfield Community and Technical College	KCTCS	14,500,000	4,121,943	6,349,362	1,032,854	2,995,841
McCreary Center – Somerset CC	KCTCS	6,500,000	996,544	3,108,827	1,359,273	1,035,356
Construct Tech Dr Campus Ashland CTC – Phase III	KCTCS	17,600,000 (1)	624,786	10,822,324	2,316,416	3,836,474
Letcher County Central Vocational Center	Education	2,000,000	194,803	0	0	1,805,197
Replace Master Control & Production Infrastructure	KET	15,707,000	6,815,596	6,888,841	1,288,854	713,709
New Economy High-Tech Construction/Investment Pool	Economic Development	20,000,000	0	3,407,500	200,000	16,392,500
Economic Development Bond Pool	Economic Development	17,500,000	0	0	0	17,500,000
Construct New Indoor Arena	Horse Park	36,500,000	26,420,652	8,527,322	567,417	984,609
Safeguarding Children at Risk - TWIST Rewrite II	CHFS	3,134,000 (1)	0	0	0	3,134,000
Oakwood – Replace Chillers Heating & Cooling Lines	MHMR	2,131,000	141,709	204,337	294,175	1,490,779
Home of the Innocents – Phase II Children's Village	Comm. Based Services	8,250,000 (1)	8,250,000	0	0	0
Capital Plaza Complex – Renovation – Design	Facilities Management	4,942,000	435,900	0	0	4,506,100
Subtotal – 2006 General Assembly		**842,327,000**	**271,417,529**	**235,856,536**	**61,398,871**	**273,654,064**
Energy Bonds	Economic Development	100,000,000	0	0	0	100,000,000
Subtotal – 2007 (2nd Special Session) General Assembly		**100,000,000**	**0**	**0**	**0**	**100,000,000**

(Continued next page)

APPENDIX D

General Fund Bond Supported Projects Fully or Partially Financed Within the Reporting Period

PROJECT DESCRIPTION	AGENCY	Authorization Balance	SPBC 90 Allocations	SPBC 93 Allocations	SPBC 95 Allocations	Remaining Balance
Economic Development Bonds	Economic Development	50,000,000	0	0	7,022,670	42,977,330
Operations and Support Services-Student Data Management System-Phase II	Department of Education	4,000,000 (1)	0	0	3,263,777	736,223
FFA Leadership Training Center Renovation	Department of Education	2,000,000	0	0	2,000,000	0
Kentucky Heritage Land Conservation	Natural Resources	17,000,000 (1)	0	0	3,013,011	13,986,989
State-Owned Dam Repair	Natural Resources	2,000,000	0	0	2,000,000	0
Petroleum Storage Tank Environmental Assurance Fund	Environmental Protection	25,000,000	0	0	22,174,600	2,825,400
Maintenance Pool 2008-2010	Facilities and Support Services	6,000,000	0	0	0	6,000,000
Public Safety Communications	COT	18,000,000 (1)	0	0	0	18,000,000
Fourth State Veterans Nursing Home	Department of Veteran's Affairs	10,500,000	0	0	0	10,500,000
Kentucky Agriculture Heritage Center	GOAP	10,000,000	0	0	0	10,000,000
Animal Shelters	Department of Agriculture	3,000,000	0	0	0	3,000,000
Infrastructure for Economic Development	KIA	75,000,000	0	16,426,634	11,113,267	47,460,099
Infrastructure for Economic Development	KIA	150,000,000	0	0	40,000,000	110,000,000
Wastewater Projects - Fund A - State Match	KIA	4,000,000	0	0	0	4,000,000
Drinking Water Projects - Fund F - State Match	KIA	4,000,000	0	0	0	4,000,000
Flood Control Matching Funds	Department for Local Government	2,200,000 (1)	0	0	0	2,200,000
Maintenance Pool 2008-2010	CHFS-Gen Admin and Prog Supp	3,000,000	0	0	0	3,000,000
Brooklawn Child and Family Services	CHFS-Comm Based Services	2,000,000	0	0	2,000,000	0
Construct Hazelwood Intermediate Care Facility	CHFS-MHMR	10,000,000	0	0	0	10,000,000
Maintenance Pool 2008-2010	Justice-Adult Correctional Insts.	4,000,000	0	0	0	4,000,000
Kentucky River Locks and Dams Maintenance	KRA	17,500,000	0	3,735,832	817,311	12,946,857
Replace Power Plant Pollution Control System	Morehead State	5,700,000	4,247,631	898,744	353,129	200,496
Expand and Upgrade Livestock Disease	UK	20,000,000 (1)	0	0	20,000,000	0
Renovate 4H Camps	UK	2,000,000	0	0	2,000,000	0
Capital Renewal and Maintenance Pool	Council on Postsecondary Ed	13,927,000	0	12,666,211	0	1,260,789

(Continued next page)

APPENDIX D

General Fund Bond Supported Projects Fully or Partially Financed Within the Reporting Period

PROJECT DESCRIPTION	AGENCY	Authorization Balance	SPBC 90 Allocations	SPBC 93 Allocations	SPBC 95 Allocations	Remaining Balance
Research Challenge Trust Fund	Council on Postsecondary Ed	57,500,000	0	0	26,267,000	31,233,000
Regional University Excellence Trust Fund	Council on Postsecondary Ed	10,000,000	0	0	3,608,000	6,392,000
LCC Classroom/Lab Building - Additional for Eastern State Hospital Site	KCTCS	4,000,000 (1)	0	0	0	4,000,000
Wetland Restoration	Transportation	10,000,000	0	0	10,000,000	0
Maintenance Pool 2008-2010	Tourism - Parks	4,000,000	0	0	0	4,000,000
Upgrade HVAC Systems	Tourism - State Fair Board	2,000,000	0	18,700	55,395	1,925,905
Major Maintenance Renovation Pool	Tourism- KY Center for the Arts	8,954,000	0	0	0	8,954,000
Subtotal – 2008 General Assembly		**557,281,000**	**4,247,631**	**33,746,121**	**155,688,160**	**363,599,088**
Kentucky Human Resource Information System (KHRIS) - Additional	Personnel	22,900,000	0	0	0	22,900,000 **
Subtotal – 2010 (Special Session) General Assembly		**22,900,000**	**0**	**0**	**0**	**22,900,000** **
TOTAL – All Financed Projects		**1,706,069,790**	**321,284,039**	**308,838,076**	**229,875,000**	**846,072,675**

(1) Less than full Authorization

*** SPBC 96 closed on November 17, 2009 and bond proceeds of $364,000,000 are available for projects but have not been permanently allo-cated.**

**** SPBC 98 closed on July 13, 2010 and bond proceeds of $22,900,000 are available for the KHRIS project.**

***** Reallocated in 2009 Special Session.**

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Creating Financial Value for the Commonwealth