

NOTES TO THE FINANCIAL STATEMENTS

NOTE 7: LONG-TERM LIABILITIES

A. Changes in Long-Term Liabilities

Primary Government. Long-term liability activity for the year ended June 30, 2005, was as follows (dollars in thousands):

	Balance July 1, 2004 (as restated)	Increases	Decreases	Balance June 30, 2005	Amounts Due Within One Year
Governmental activities:					
Bonds and similar debt payable:					
General obligation bonds	\$ 4,982,860	\$ 1,981,165	\$ (1,265,490)	\$ 5,698,535	\$ 329,720
Lease-purchase revenue bonds	218,405	53,640	(7,000)	265,045	10,000
Certificates of participation	301,165	188,385	(14,380)	475,170	21,110
Less deferred amounts:					
For issuance discounts	(1,724)	—	549	(1,175)	—
On refunding	(57,940)	(72,738)	11,025	(119,653)	—
Add issuance premium	158,776	209,324	(29,096)	339,004	—
Total bonds and similar debt payable	5,601,542	2,359,776	(1,304,392)	6,656,926	360,830
Notes payable	25,008	12,686	(3,687)	34,007	6,488
Capital leases payable	304	212	(186)	330	149
Arbitrage rebate payable	43	—	(43)	—	—
Compensated absences	317,975	206,606	(197,397)	327,184	34,127
Net pension obligation	2,186	14,219	(14,361)	2,044	—
Workers' compensation	6,195	262	(957)	5,500	1,075
Deferred death benefit payable	270	130	—	400	195
Cost settlement payable	7,500	—	(2,500)	5,000	2,500
Governmental activity long-term liabilities	<u>\$ 5,961,023</u>	<u>\$ 2,593,891</u>	<u>\$ (1,523,523)</u>	<u>\$ 7,031,391</u>	<u>\$ 405,364</u>
Business-type activities:					
Bonds payable:					
Revenue bonds	\$ 9,325	\$ —	\$ (255)	\$ 9,070	\$ 270
Total bonds payable	9,325	—	(255)	9,070	270
Notes payable	—	1,661	(92)	1,569	112
Compensated absences	2,786	1,983	(2,277)	2,492	190
Business-type activity long-term liabilities	<u>\$ 12,111</u>	<u>\$ 3,644</u>	<u>\$ (2,624)</u>	<u>\$ 13,131</u>	<u>\$ 572</u>

For governmental activities, the compensated absences, net pension obligation, workers' compensation, and cost settlement liabilities are generally liquidated by the General Fund. Arbitrage rebate payable is generally liquidated by other governmental funds. A portion of compensated absences is also liquidated by the Highway Fund. Internal service funds predominantly serve the governmental funds. Accordingly, long-term liabilities for them are included as part of the above totals for governmental activities. At year-end, \$3.329 million of internal service funds compensated absences are included in the above amounts.

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Component Units (University of North Carolina System, North Carolina Housing Finance Agency, and the State Education Assistance Authority). Long-term liability activity for the year ended June 30, 2005, was as follows (dollars in thousands):

	Balance July 1, 2004	Increases	Decreases	Balance June 30, 2005	Amounts Due Within One Year
University of North Carolina System:					
Bonds payable:					
Revenue bonds	\$ 1,635,504	\$ 290,631	\$ (191,252)	\$ 1,734,883	\$ 160,613
Certificates of participation	—	31,545	(360)	31,185	1,395
Less deferred amounts:					
For issuance discounts	(56,504)	—	4,005	(52,499)	—
On refunding	(22,810)	(3,488)	1,208	(25,090)	—
Add issuance premium	14,687	11,411	(1,055)	25,043	—
Total bonds payable	<u>1,570,877</u>	<u>330,099</u>	<u>(187,454)</u>	<u>1,713,522</u>	<u>162,008</u>
Notes payable	43,713	49,695	(23,668)	69,740	2,638
Capital leases payable	16,736	19,122	(2,423)	33,435	2,430
Arbitrage rebate payable	3,729	66	—	3,795	—
Annuity and life income payable	9,414	1,735	(461)	10,688	910
Compensated absences	230,469	158,563	(155,608)	233,424	17,192
Total long-term liabilities	<u>\$ 1,874,938</u>	<u>\$ 559,280</u>	<u>\$ (369,614)</u>	<u>\$ 2,064,604</u>	<u>\$ 185,178</u>

Long-term liabilities of nongovernmental component units of the University of North Carolina System are excluded from the above amounts. At June 30, 2005, nongovernmental component unit foundations and similarly affiliated organizations of the University of North Carolina System had total long-term liabilities of \$289.171 million, of which \$9.947 million was due within one year and \$279.224 million was due in more than one year.

	Balance July 1, 2004	Increases	Decreases	Balance June 30, 2005	Amounts Due Within One Year
North Carolina Housing Finance Agency:					
Bonds payable:					
Revenue bonds	\$ 1,268,137	\$ 195,000	\$ (151,272)	\$ 1,311,865	\$ 31,035
Less deferred amounts:					
For issuance discounts	(19,809)	(2,212)	2,452	(19,569)	—
On refunding	(168)	—	23	(145)	—
Total bonds payable	<u>1,248,160</u>	<u>192,788</u>	<u>(148,797)</u>	<u>1,292,151</u>	<u>31,035</u>
Arbitrage rebate payable	1,089	113	(905)	297	113
Compensated absences	520	313	(250)	583	30
Total long-term liabilities	<u>\$ 1,249,769</u>	<u>\$ 193,214</u>	<u>\$ (149,952)</u>	<u>\$ 1,293,031</u>	<u>\$ 31,178</u>

	Balance July 1, 2004	Increases	Decreases	Balance June 30, 2005	Amounts Due Within One Year
State Education Assistance Authority:					
Bonds payable:					
Revenue bonds	\$ 1,685,968	\$ 396,650	\$ (161,056)	\$ 1,921,562	\$ 1,000
Total bonds payable	<u>1,685,968</u>	<u>396,650</u>	<u>(161,056)</u>	<u>1,921,562</u>	<u>1,000</u>
Arbitrage rebate payable	2,794	7	—	2,801	—
Compensated absences	195	3	(8)	190	9
Total long-term liabilities	<u>\$ 1,688,957</u>	<u>\$ 396,660</u>	<u>\$ (161,064)</u>	<u>\$ 1,924,553</u>	<u>\$ 1,009</u>

NOTES TO THE FINANCIAL STATEMENTS**B. Bonds, Certificates of Participation, and Notes Payable**

Bonds, certificates of participation, and notes payable at June 30, 2005 were as follows (dollars in thousands):

	<u>Interest Rates</u>	<u>Maturing Through Year</u>	<u>Original Issue Amount</u>	<u>Outstanding Balance</u>
Primary Government:				
<u>Governmental activities:</u>				
General obligation bonds.....	1.06% - 6.90%*	2028	\$ 8,026,384	\$ 5,698,535
Lease-purchase revenue bonds.....	2.00% - 5.25%	2024	272,045	265,045
Certificates of participation.....	2.00% - 5.25%	2025	489,840	475,170
Notes payable.....	2.89% - 10.00%	2009	45,406	34,007
<u>Business-type activities:</u>				
Revenue bonds.....	4.21% - 4.32%*	2025	\$ 9,905	\$ 9,070
Notes payable.....	0.00%	2020	1,681	1,569
Component Units:				
<u>University of North Carolina System</u>				
Revenue bonds.....	2.00% - 10.00%*	2034	\$ 1,898,809	\$ 1,734,883
Certificates of participation.....	3.00% - 5.00%	2035	31,545	31,185
Notes payable.....	2.87% - 9.45%*	2035	83,780	69,740
<u>North Carolina Housing Finance Agency</u>				
Revenue bonds.....	2.00% - 9.03%*	2043	\$ 2,941,066	\$ 1,311,865
<u>State Education Assistance Authority</u>				
Revenue bonds.....	2.41% - 6.35%*	2034	\$ 2,041,900	\$ 1,921,562

* For variable rate debt, interest rates in effect at June 30, 2005 are included. For variable rate debt with interest rate swaps, the synthetic fixed rates are included.

The full faith, credit, and taxing power of the State are pledged for the payment of principal and interest on general obligation bonds. The certificates of participation (COPs) and lease-purchase revenue bonds issued by the N.C. Infrastructure Finance Corporation, a blended component unit of the State, are secured by lease and installment payments made by the State and in the event of default, by a security interest in the leased facilities pursuant to a leasehold deed of trust (as applicable). The COPs issued for repair and renovation projects are not secured by a lien upon or security interest in the projects or in any other property of the State. All payments of the State for the COPs and lease-purchase revenue bonds are subject to appropriation by the General Assembly. Other long-term debts of the State and its component units are payable solely from certain resources of the funds to which they relate.

C. Bonds Authorized but Unissued

The amount of authorized but unissued general obligation bonds of the primary government at June 30, 2005, totaled \$872.8 million as follows: higher education \$703.5 million; and clean water \$169.3 million.

The amount of authorized but unissued debt of the primary government subject to annual appropriation requirements at June 30, 2005 totaled \$656.3 million as follows: repair and renovation \$175 million, universities \$337.1 million, hospital \$49 million, prisons \$52.4 million, youth facilities \$22 million and parks \$20.8 million.

D. Demand Bonds

Included in bonds payable are several variable rate demand bond issues. Demand bonds are securities that contain a "put" feature that allows bondholders to demand payment before the maturity of the debt upon proper notice to the issuer's remarketing or paying agents.

Component Units**University of North Carolina System**

With regards to the following demand bonds, the issuer has not entered into take out agreements, which would convert the demand bonds not successfully remarketed into another form of long-term debt.

The University of North Carolina at Chapel Hill - General Revenue, Series 2001B and 2001C

In 2001 the University issued two series of variable rate demand bonds in the amount of \$54,970,000 (2001B) and \$54,970,000 (2001C) that each have a final maturity date of December 1, 2025. The bonds are subject to mandatory sinking fund redemption on the interest payment date on or immediately preceding each December throughout the term of the bonds. The proceeds of these issuances were used to provide funds to refund in advance of their maturity the following issues: Ambulatory Care Clinic, Series 1990; Athletic Facilities, Series 1998; Carolina Inn, Series 1994; School of Dentistry, Series 1995; Kenan Stadium, Series 1996; and Parking System, Series

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1997C. While bearing interest at a weekly rate, the bonds are subject to purchase on demand with seven days notice and delivery to the University's remarketing agents, Lehman Brothers, Inc (2001B) and UBS Financial Services, Inc. (2001C).

The University renewed its line of credit, in the amount of \$107,460,000, with JP Morgan Chase Bank effective February 2, 2005. Under the line of credit agreement, the University is entitled to draw amounts sufficient to pay the principal, and accrued interest on bonds delivered for purchase.

The University is required to pay a quarterly commitment fee for the line of credit of .13% per annum based on the unused portion of the line of credit commitment. If the University's credit rating for unsecured debt were to drop below Aa3 (or its equivalent) by Moody's Investors Service (Moody's), AA- (or its equivalent) by Standard & Poor's (S&P), or AA- (or its equivalent) by Fitch Ratings (Fitch), the quarterly commitment fee would increase to .18%. If the University's credit rating for unsecured debt were to drop below A3 (or its equivalent) by Moody's, A- (or its equivalent) by S&P, or A- (or its equivalent) by Fitch, the quarterly commitment fee would increase to .28%. Additionally, if the University were to terminate the line of credit prior to February 1, 2006, then the University must pay a termination fee of \$50,000 less any unused commitment fees paid to date.

Under the line of credit agreement, the University has promised to repay loans that represent purchase drawings in equal semi-annual payments after termination of the line of credit. Interest at the rate of Prime plus 1.0% (Prime plus 2.0% after 60 days) is payable quarterly and upon draw repayment. At June 30, 2005, no purchase draws had been made under the line of credit.

The line of credit agreement expires on February 1, 2006. However, between November 3, 2005, and December 3, 2005, the University may request that the Bank extend the expiration date for another year. The Bank shall respond affirmatively or negatively within 30 days after receipt of such request.

North Carolina Central University – Revenue Bonds Series 2003A

In October of 2003, the North Carolina Capital Facilities Finance Agency issued Student Housing Facilities Revenue Demand Bonds (\$21,475,000 Variable Rate Revenue Demand Bonds, Series 2003A) that have a maturity date of October 1, 2034. The issuer, the North Carolina Capital Facilities Finance Agency, loaned the proceeds of the Series 2003 Bonds to the NCCU Real Estate Foundation, Inc. (Foundation). The Foundation used the proceeds to finance the costs of building a student housing facility at North Carolina Central University, to fund a debt service reserve fund for the 2003A Bonds, to pay a portion of the interest on the bonds during construction of the project, and to pay certain costs of issuance of the bonds. The 2003A Bonds are subject to mandatory sinking fund redemption at the principal amount on the interest payment dates or immediately preceding October 1, 2005.

The Student Housing Facilities Revenue Demand Bonds (Series 2003) has an Irrevocable Letter of Credit (LOC) for \$21,819,518. The LOC is to secure the payment of the principal and purchase price of interest on the Series 2003 Bonds. The LOC was issued by Wachovia Bank, N.A. and expires on October 15, 2006. The LOC may be extended by request from the Foundation by delivering a notice of extension to the Trustee with a new expiration date. At June 30, 2005, the LOC rate for the bonds was 1.40% and the total amount drawn on it was \$427,404.

The Foundation paid Wachovia Bank, N.A. a commitment fee of \$109,098 for the letter of credit on the date the bonds were issued. Additionally, the Foundation paid credit facility fees in the amount of \$77,217 during the fiscal year. If the Foundation terminates the letter of credit on or before August 1, 2006, then the Foundation must pay a termination fee of \$25,000. The Bonds are not under a take out agreement; however, in the event of termination 100% of the unpaid principal will be due and payable plus any unpaid and accrued interest.

Under the LOC agreement, the proceeds of each drawing under the LOC to pay the portion of the purchase price of Series 2003 bonds allocable to principal will constitute a tender advance and must be reimbursed as provided in the agreement. The Foundation is required to repay each tender advance to Wachovia Bank, N.A. plus an interest rate of Prime plus 1.0%. The amount of any tender advance made is repaid based on the earliest to occur of the date the credit provider bonds purchased pursuant to such tender advances are remarketed, the close of business on the date that is 180 days after the tender was made and/or the termination date.

The Student Housing Facilities Revenue Demand Bonds (Series 2003) has remarketing fees. The remarketing fee is an upfront charge to reset the interest rates on a weekly basis. The remarketing agent is Wachovia Bank, N.A. for the Series 2003A Bonds. At June 30, 2005, the remarketing fee rate for the bonds was 0.125%.

With regards to the following demand bonds, the issuer has entered into take-out agreements, which would convert the demand bonds not successfully remarketed into another form of long-term debt.

North Carolina State University - Revenue Bonds (Centennial Campus Projects), Series 1999A

On September 22, 1999 the University issued tax-exempt variable rate revenue demand bonds in the amount of \$13,500,000 that have a final maturity date of December 15, 2019. The bonds are subject to mandatory sinking fund redemption that began on December 1, 2000. The University's proceeds of this issuance were used to (i) discharge a portion of a loan from Wachovia Bank, N.A., the proceeds from which were used for the construction and equipping of a building known as the Partners II Building located on the Centennial Campus of N.C. State, (ii) paying the cost of relocating utility easements on the Centennial Campus of N.C. State, and (iii)

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paying the costs incurred in connection with the issuance of the 1999A Bonds.

While bearing interest at a weekly rate, the bonds are subject to purchase on demand with seven days notice and delivery to the paying agent, The Bank of New York. Upon notice from the paying agent, the remarketing agent, Lehman Brothers, Inc., has agreed to exercise its best efforts to remarket the bonds for which a notice of purchase has been received.

Under a Standby Bond Purchase Agreement (Agreement) between the Board of Governors of the University of North Carolina and Wachovia Bank, N.A., a Liquidity Facility has been established for the Trustee (The Bank of New York) to draw amounts sufficient to pay the purchase price and accrued interest on bonds delivered for purchase when remarketing proceeds or other funds are not available. This Agreement requires a commitment fee equal to 0.20% of the available commitment, payable quarterly in arrears, beginning on October 1, 1999 and on each January 1, April 1, July 1, and October 1 thereafter until the expiration date or the termination date of the Agreement.

Under the Agreement, any bonds purchased through the Liquidity Facility become Liquidity Provider Bonds and shall, from the date of such purchase and while they are Liquidity Provider Bonds, bear interest at the Liquidity Provider Rate (the greater of the bank prime commercial lending rate and Federal Funds Rate plus 0.5%). Upon remarketing of Liquidity Provider Bonds and the receipt of the sales price by the Liquidity Provider, such bonds are no longer considered Liquidity Provider Bonds. Payment of the interest on the Liquidity Provider Bonds is due the first business day of each month in which Liquidity Provider Bonds are outstanding. At June 30, 2005, there were no Liquidity Provider Bonds held by the Liquidity Facility. The original Liquidity Facility has been extended and is scheduled to expire on September 15, 2008, unless otherwise extended based on the terms of the agreement.

Upon expiration or termination of the Agreement, the University is required to redeem (purchase) the Liquidity Provider Bonds held by the Liquidity Facility in twenty quarterly installments, beginning the first business day that is at least 180 days following such expiration date or termination date along with accrued interest at the Liquidity Provider Rate. In the event the entire issue of \$13,000,000 of demand bonds was "put" and not resold, the University would be required to pay \$3,028,778 a year for 5 years under this agreement assuming a 6% interest rate.

North Carolina State University - General Revenue Bonds, Series 2003B

On June 20, 2003 the University issued tax-exempt variable rate revenue demand bonds in the amount of \$45,660,000 that have a final maturity date of October 1, 2027. The bonds are subject to mandatory sinking fund redemption that began on October 1, 2004. The University's proceeds of this issuance were used to pay a portion of the costs of certain improvements on the campus of the University, to refund certain debt

previously incurred for that purpose, and to pay the costs incurred in connection with the issuance of the 2003B bonds.

While bearing interest at a weekly rate, the bonds are subject to purchase on demand with seven days notice and delivery to the paying agent, The Bank of New York. Upon notice from the paying agent, the remarketing agent, UBS Financial Services Inc., has agreed to exercise its best efforts to remarket the bonds for which a notice of purchase has been received.

Under a Standby Bond Purchase Agreement (Agreement) between the Board of Governors of the University of North Carolina and Bayerische Landesbank, a Liquidity Facility has been established for the Trustee (The Bank of New York) to draw amounts sufficient to pay the purchase price and accrued interest on bonds delivered for purchase when remarketing proceeds or other funds are not available. This Agreement requires a commitment fee equal to 0.20% of the available commitment, payable quarterly in arrears, beginning on July 1, 2003 and on each October 1, January 1, April 1, and July 1 thereafter until the expiration date or the termination date of the Agreement.

Under the Agreement, any bonds purchased through the Liquidity Facility become Liquidity Provider Bonds and shall, from the date of such purchase and while they are Liquidity Provider Bonds, bear interest at the Liquidity Provider Rate (the greater of the bank prime commercial lending rate and Federal Funds Rate plus 0.5%). Upon remarketing of Liquidity Provider Bonds and the receipt of the sales price by the Liquidity Provider, such bonds are no longer considered Liquidity Provider Bonds. Payment of the interest on the Liquidity Provider Bonds is due the first business day of each month in which Liquidity Provider Bonds are outstanding. At June 30, 2005, there were no Liquidity Provider Bonds held by the Liquidity Facility. The original Liquidity Facility expiration date has been extended and is scheduled to expire on November 30, 2015, unless otherwise extended based on the terms of the Agreement.

Upon expiration or termination of the Agreement, the University is required to redeem (purchase) the Liquidity Provider Bonds held by the Liquidity Facility in twenty quarterly installments, beginning the first business day of January, April, July, or October, whichever first occurs on or following the Purchase Date along with accrued interest at the Liquidity Provider Rate. In the event the entire issue of \$45,365,000 of demand bonds was "put" and not resold, the University would be required to pay \$10,569,271 a year for 5 years under this agreement assuming a 6% interest rate.

University of North Carolina Hospitals - Revenue Bonds, Series 2001A and Series 2001B

On January 31, 2001, the Hospitals issued two series of tax-exempt variable rate demand bonds in the amount of \$55,000,000 (2001A) and \$55,000,000 (2001B) that have a final maturity date of February 15, 2031. The bonds are subject to mandatory sinking fund redemption that began on February

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15, 2002. A portion of the proceeds was used to reimburse the Hospitals for \$75,000,000 spent allowing the UNC Health Care System to acquire controlling interest in Rex Healthcare Inc. The remaining proceeds are being used for the renovation of space vacated after the opening of the North Carolina Women's Hospital, North Carolina Children's Hospital, and associated support services. While initially bearing interest in a daily mode, the mode on these bonds may change to a weekly rate, a unit pricing rate, a term rate or a fixed rate.

While in daily mode, the bonds are subject to purchase on any business day upon demand by telephonic notice of tender to the remarketing agent on the purchase date and delivery to the bond tender agent, Wachovia Bank, N.A. The Hospitals' remarketing agents, Merrill Lynch, Pierce, Fenner & Smith Incorporated (Series 2001A) and Banc of America Securities LLC (Series 2001B) have agreed to exercise their best efforts to remarket bonds for which a notice of purchase has been received. The quarterly remarketing fee is payable in arrears and is equal to either 0.05% or 0.08% of the outstanding principal amount of the bonds assigned to each agent, depending upon their performance in comparison to an established benchmark.

Under separate Standby Bond Purchase Agreements for the Series 2001A and Series 2001B (Agreements) between the Hospitals and Landesbank Hessen-Thüringen Girozentrale, a Liquidity Facility has been established for the tender agent to draw amounts sufficient to pay the purchase price and accrued interest on bonds delivered for purchase when remarketing proceeds or other funds are not available. These Agreements require an adjustable facility fee based on the long-term rating of the bonds, which is calculated as a percentage of the available commitment. Payments are made quarterly in arrears, on the first business day of each July, October, January and April thereafter until the expiration date or the termination date of the Agreements. For the past fiscal year the percentage was 0.22%, but with the new long-term agreement that became effective on July 11, 2005, the percentage will be 0.25% unless the bond ratings change.

Under the Agreements, any bonds purchased through the Liquidity Facility become Bank Bonds and shall, from the date of such purchase and while they are Bank Bonds, bear interest at the Formula Rate (Base Rate equal to the higher of the Prime Rate for such day or the sum of 0.50% plus the Federal Funds Rate) subject to a maximum rate as permitted by law. Upon remarketing of Bank Bonds and the receipt of the sales price by the Liquidity Provider, such bonds are no longer considered Bank Bonds. Payment of the interest on the Bank Bonds is due quarterly (the first business day of January, April, July and October) for each period in which Bank Bonds are outstanding. At June 30, 2005, there were no Bank Bonds held by the Liquidity Facility.

Included in the Agreements is a take out provision, in case the remarketing agent is unable to resell any bonds that are "put" within 90 days of the "put" date. In this situation, the Hospitals is required to redeem the Bank Bonds held by the Liquidity Facility. The agreements allow the Hospitals to

redeem bank bonds in equal quarterly installments, on the first business day of January, April, July and October. The payments will commence with the first business day of any such month that is at least 90 days following the applicable purchase date of the Bank Bond and end no later than the fifth anniversary of such purchase date. If the take out agreement were to be exercised because the entire outstanding \$106,000,000 of demand bonds was "put" and not resold, the Hospitals would be required to pay \$24,848,616 a year for five years under the installment loan agreement assuming a 6.25% prime interest rate.

The current expiration date of the Agreements is December 31, 2015. The Liquidity Provider has the option to terminate its commitment on October 11, 2008, October 11, 2011, or October 11, 2014 by providing adequate notice of its intention. The Hospitals may request additional extensions of at least one year from the previous termination date. Extensions are at the discretion of Liquidity Provider.

University of North Carolina Hospitals - Revenue Refunding Bonds, Series 2003A and Series 2003B

On February 13, 2003, the Hospitals issued two series of tax-exempt variable rate demand bonds in the amount of \$63,770,000 (2003A) and \$34,245,000 (2003B) that have a final maturity date of February 1, 2029. The bonds are subject to mandatory sinking fund redemption that began on February 1, 2004. The proceeds were used to advance refund \$88,325,000 of the Series 1996 Bonds. While initially bearing interest in a weekly mode, the mode on these bonds may change to a daily rate, a unit pricing rate, a term rate or a fixed rate.

While in the weekly mode, the bonds are subject to purchase on demand with seven days notice to the remarketing agent and delivery to the bond tender agent, Wachovia Bank, N.A. The Hospitals' remarketing agents, Banc of America Securities LLC (Series 2003A) and Wachovia Bank, N.A. (Series 2003B) have agreed to exercise their best efforts to remarket bonds for which a notice of purchase has been received. The quarterly remarketing fee is payable in arrears and is equal to 0.08% of the outstanding principal amount of the bonds assigned to the remarketing agent for Series 2003A and is equal to 0.07% of the outstanding principal amount of the bonds assigned to the remarketing agent for Series 2003B.

Under separate Standby Bond Purchase Agreements for the Series 2003A and Series 2003B (Agreements) between the Hospitals and Bank of America, N.A. (Series 2003A) or Wachovia Bank, N.A. (Series 2003B) a Liquidity Facility has been established for the Tender Agent to draw amounts sufficient to pay the purchase price on bonds delivered for purchase when remarketing proceeds or other funds are not available. These Agreements require a facility fee equal to 0.22% for Series 2003A (previously 0.20% under the agreement which expired July 1, 2005) and .22% for Series 2003B of the available commitment, payable quarterly in advance, beginning on February 13, 2003, and on each February 1, May 1, August 1, and November 1 thereafter until the expiration date or the termination date of the Agreements.

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Under the Agreements, any bonds purchased through the Liquidity Facility become Bank Bonds and shall, from the date of such purchase and while they are Bank Bonds, bear interest at the Bank Bond Interest Rate (for Series 2003A, the rate equals the London Interbank Offered Rate (LIBOR) plus 2.50% for the first 90 days and then equals LIBOR plus 4.00%; for Series 2003B, the rate equals Prime Rate for the first 90 days and then equals Prime plus 1.00%) subject to a maximum rate as permitted by law. Upon remarketing of Bank Bonds and the receipt of the sales price by the Liquidity Provider, such bonds are no longer considered Bank Bonds. Payment of the interest on the Bank Bonds is on the first business day of each month for each period in which Bank Bonds are outstanding. At June 30, 2005, there were no Bank Bonds held by the Liquidity Facility.

Included in the Agreements is a take out provision, in case the remarketing agent is unable to resell any bonds that are "put" within 90 days of the "put" date. In this situation, the Hospitals are required to redeem the Bank Bonds held by the Liquidity Facility. The Series 2003A agreement allows the Hospitals to redeem bank bonds in twelve equal quarterly installments beginning on the first February 1, May 1, August 1 or November 1 that occurs at least 90 days following the applicable purchase date of the Bank Bond. If the take out agreement was to be exercised because the entire outstanding \$63,135,000 of demand bonds was "put" and not resold, the Hospitals would be required to pay \$23,638,756 a year for three years under the installment loan agreement assuming a 7.34% interest rate (LIBOR plus 4%). The Series 2003B agreement allows the Hospitals to redeem bank bonds in 36 equal monthly installments, on the first business day of each calendar month after the loan date. Payments commence with the first business day of any such month that is at least 120 days following the applicable purchase date of the Bank Bond. If the take out agreement were to be exercised because the entire outstanding \$33,910,000 of demand bonds was "put" and not resold, the Hospitals would be required to pay \$12,611,076 a year for three years under the installment loan agreement assuming a 7.25% interest rate (Prime plus 1%).

The current expiration date of the Series 2003A Agreement is July 1, 2008 and July 31, 2006 for the Series 2003B Agreement. The Hospitals may request additional extensions, which are approved at the discretion of the Liquidity Provider.

E. Interest Rate and Basis Swaps**Primary Government****Governmental Activities**

Objective. As a means to lower its borrowing costs and increase its savings, when compared to fixed-rate refunding bonds at the time of issuance in December 2002, the State entered into two interest rate swaps in connection with its \$499,870,000 Variable Rate General Obligation Refunding Bonds, Series 2002B-F. The intention of the swap agreements was to effectively change the State's interest rate on the bonds to a synthetic fixed rate of 3.283% (Swap 1) and 3.089% (Swap 2). For comparison, the State sold fixed rate bonds on the same day as the swaps, with the same final maturity, at an interest rate of 4.452%.

In June 2003, the State entered into a third interest rate swap agreement (Swap 3) to lower its borrowing costs and reduce its exposure to variable interest rates in connection with \$355,000,000 Variable Rate Public Improvement Bonds, Series 2002 D, E, F, and G. Effective July 1, 2003, the intention of this third swap agreement was to effectively change the interest rate on the bonds to a synthetic fixed rate of 1.06% (Swap 3) for a period of two years.

In March 2005, the State entered into basis rate swap agreements and related swaptions with three separate counterparties to lower its borrowing costs when compared to fixed rate refunding bonds. The swaption component is disclosed and valued in a separate note (see Note 7F). The bonds associated with basis swaps were as follows (dollars in thousands).

Bonds Associated with Basis Swaps	Principal Amount	Average Coupon	Call Date
Public Improvement, Series 2003A	\$ 171,000	4.89%	3/1/2013
Public Improvement, Series 2003B	169,955	4.87%	4/1/2013
Public Improvement, Series 2004A	335,000	4.86%	3/1/2014
Total	<u>\$ 675,955</u>		

Terms - Swaps 1 and 2. The bonds and the related swap agreements mature on June 1, 2019, (Swap 1) and June 1, 2017, (Swap 2) and the combined swaps' notional amount of \$499,870,000 matches the \$499,870,000 variable-rate bonds. The swaps were entered into at the same time the bonds were issued (December 2002). Starting in fiscal year 2012 the combined notional value of the swaps and the combined principal amount of the associated debt begin to decline. Under the swaps, the State pays the counterparties a fixed payment of 3.283% (Swap 1) and 3.089% (Swap 2) and receives a variable payment computed at 64% of the London Interbank Offered Rate (LIBOR). Conversely, the bonds' variable-rate coupons are closely associated with the Bond Market Association Municipal Swap Index (BMA).

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Terms - Swap 3. This swap began July 1, 2003, with a notional amount of \$355,000,000, which matches the bonds outstanding and ended on July 1, 2005. Under Swap 3, the State paid the counterparty a fixed payment of 1.06% and received a variable payment at the BMA.

Terms - 2005 Basis Swaps. The 2005 basis swap agreements were entered into on March 9, 2005 with an effective date of March 30, 2005. The related bonds have serial maturities with Series 2003A having a final maturity on March 1, 2026; 2003B and 2004A have a final maturity on April 1, 2023 and March 1, 2023 respectively. The basis swap agreements mature on March 1, 2026. The swaps combined notional amount of \$675,955,000 matches the \$675,955,000 fixed rate bonds. Under the terms of the basis rate swap and swaption agreement, the State will pay the BMA to the counterparties and will receive 70% of LIBOR plus a fixed spread of 69 basis points (41 attributable to basis swap and 28 basis points for the swaption).

Fair value. Because interest rates have declined since execution of swaps 1 and 2, the swaps have fair values of negative \$10,867,108 (Swap 1) and negative \$7,412,974 (Swap 2) at June 30, 2005. Swap 3, which ended July 1, 2005, had a positive fair value of \$709,319 at June 30, 2005. The swaps' negative fair value may be countered by a reduction in total interest payments required under a potential refunding. The mark-to-market valuations were established by market quotations from the counterparties, representing estimates of the amounts that would be paid for replacement transactions. The 2005 basis rate swaps had valuations at June 30 of: \$7,386,176 (Counterparty 1), \$4,768,564 (Counterparty 2), and \$3,052,694 (Counterparty 3). The 2005 basis swaps were also valued by the mark-to-market method described above.

Credit risk. As of June 30, 2005, the swaps did not expose the State to credit risk because the swaps had a negative fair value, in aggregate. However, should interest rates change and the aggregate fair value of the swaps become positive, the State would be exposed to credit risk in the amount of the derivatives' aggregate fair value. The current counterparty ratings for each swap are presented in the table below:

<u>Swap Counterparty</u>	Moody's	Standard	Fitch
	<u>Investors Service</u>	<u>& Poor's</u>	<u>Ratings</u>
Swap 1	Aa1	AA	AA-
Swap 2	Aaa	AA+	-
Swap 3	Aa1	AA-	AA+
Basis Swap Counterparty 1	Aa2	AA-	AA-
Basis Swap Counterparty 2	Aa3	A+	AA-
Basis Swap Counterparty 3	Aaa	AAA	-

To mitigate the potential for credit risk, if the counterparty's credit quality falls to a specified rating, the counterparty will be required to collateralize a portion (up to 100%) of the fair value. For Swap 1, if the counterparty's credit quality falls to A1 as determined by Moody's Investors Service (Moody's) or A+ as determined by either Standard & Poor's (S&P) or Fitch Ratings (Fitch) and their exposure exceeds \$5,000,000, then the swap

will be collateralized by the counterparty with cash, U.S. government or agency securities, or other collateral acceptable to the State. For Swap 2, if the credit quality falls to Aa1 (Moody's) or AA+ (S&P) and their exposure exceeds \$10,000,000, then the swap will be collateralized by the counterparty with cash, U.S. government or agency securities, or other collateral acceptable to the State. For Swap 3 (ended on July 1, 2005) if either party's rating had fallen below A3 (Moody's) or A- (S&P), a credit support agreement would have been negotiated that would have specified the amounts and types of collateral to be posted. For the basis swaps, if the counterparty's credit quality is rated lower than Baa1 (Moody's), BBB+ (S&P), or BBB+ (Fitch) by two of the three rating agencies, then the swap will need to be collateralized by the counterparty with cash, U.S. government or agency securities, or other collateral acceptable to the State (Fitch credit ratings only apply to counterparty 1). If the counterparty is required to collateralize a portion of the derivative, then the collateral will be posted with a third party custodian or secured party.

An additional termination event occurs if the counterparty fails to maintain: for Swap 1, at least two ratings of at least Baa1 (Moody's) or BBB+ (S&P and Fitch); for Swap 2, at least one rating of at least Baa3 (Moody's) or BBB- (S&P); Swap 3 ended on July 1, 2005. An additional termination event for the basis swaps occurs if counterparty 1 or 3 has one or more issues of rated, unsecured, unenhanced senior debt or long-term deposits outstanding and none of such issues has at least two ratings of at least Baa2 or higher as determined by Moody's, BBB or higher as determined by S&P or BBB or higher as determined by Fitch. For counterparty 2, an additional termination event occurs if it has one or more issues of rated, unsecured, unenhanced senior debt or long-term deposits outstanding and none of such issues has at least two ratings of Baa2 or higher (Moody's), BBB or higher (S&P) or counterparty 2 fails to have a rating on long-term, unsecured, unenhanced senior debt.

Basis risk and termination risk. Swaps 1 and 2 expose the State to basis risk should the relationship between LIBOR and BMA converge, changing the synthetic rate on the bonds. The effect of this difference in basis is indicated by the difference between the intended synthetic rates of 3.283% (Swap 1) and 3.089% (Swap 2) and the synthetic rates as of June 30, 2005, of 3.387% (Swap 1) and 3.193% (Swap 2). As of June 30, 2005, the average rate on the State's bonds was 2.242%, whereas 64% of LIBOR was 2.138%. The swaps may be terminated by the State with 15 days notice and the counterparties can only terminate the swaps if the State's credit rating falls below Baa1 (Moody's), or BBB+ (S&P or Fitch) for Swap 1, and on Swap 2, below Baa3 (Moody's) or BBB- (S&P or Fitch), or an Event of Default occurs.

Swap 3: This swap exposed the State to basis risk when the actual rate on the State's bonds varied from BMA. At June 30, 2005 there was no basis risk as the State's actual synthetic rate of 1.022% was lower than the intended synthetic rate of 1.06%.

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2005 Basis Swaps: These swaps expose the State to basis risk should the relationship between the two variable indexes BMA and LIBOR converge, which would affect the amount of interest savings realized. The State pays BMA and receives 70% of LIBOR plus 69 basis points (28 basis points relate to swaptions) on the notional amounts by counterparty. As of June 30, 2005, there was no basis risk as the State was paying BMA equal to 2.28% and receiving 3.028% (70% LIBOR (3.34% plus 69 basis points). The basis swaps and swaptions may be optionally terminated by the State with two days notice for counterparties 1 and 2 or with five days notice for counterparty 3. The counterparties can only terminate if the State, at any time during the term of the swap transaction, fails to maintain by at least two rating agencies, ratings of at least Baa2 or higher as determined by Moody's, BBB or higher as determined by S&P or BBB or higher by Fitch (Fitch does not apply to counterparty 2).

Market-access risk/Rollover-risk. Swap 1 and Swap 2 are for the term of the bonds and therefore there is no market-access risk or rollover risk. Swap 3 matured on July 1, 2005, at which time the State was exposed to market-access and rollover risk since the underlying debt returned to variable rate. The 2005 basis rate swaps terminate at approximately the same time as the associated serial bonds mature (March 1, 2026; March 1, 2023; and April 1, 2023) and thus no market-access or rollover risk exists.

Business-type Activities

Objective. In order to protect against the potential of rising interest rates, the Town of Butner, State of North Carolina entered into an interest rate swap in connection with its \$9,905,000 Butner Water and Sewer System Revenue Bond Series 2001. The intention of the swap agreement was to effectively change the State's interest rate on the bonds to a fixed rate of 4.21% (plus remarketing and liquidity fees and any difference between the variable rate received by the State (65% of LIBOR) and the rate paid by the State on the variable rate bonds).

Terms. The swap agreement was with Bank of America, N.A. based on a notional amount of \$9,905,000 to mature on September 1, 2025. The swap's notional amount of \$9,905,000 matches the \$9,905,000 variable-rate bonds. Under the swap, the State pays a fixed payment of 4.21% to Bank of America, N.A. and receives a variable payment of 65% of the LIBOR (LIBOR was 3.34% at June 30, 2005). On the other hand, the bond's variable-rate coupons (2.70% at June 30, 2005) are closely associated with the variable BMA, which was 2.28% as of June 30, 2005.

Fair value. Because interest rates have declined since execution of the swap, the swap has a fair value (the State would have to pay the counterparty if the State terminated the swap) of negative \$700,284 (Bank of America, N.A.) as of June 30, 2005. The swap's negative fair value if terminated may be countered by a reduction in total interest payments required under a new swap creating a lower synthetic fixed rate. Because the coupons on the State's variable-rate bonds adjust to

changing interest rates, the bonds do not have a corresponding fair value increase. The mark-to-market valuations were established by market quotations from the counterparty representing mid-market or average estimates/quotes of the amounts that would be paid for replacement transactions (having the effect of preserving the economic benefit to the party).

Credit risk. As of June 30, 2005, the State was not exposed to credit risk because the swap had a negative fair value. However, should interest rates change and the fair value of the swap becomes positive, the State would be exposed to credit risk in the amount of the derivative's fair value.

Basis risk and termination risk. The Swap exposes the State to basis risk (including effects of any reduction in marginal tax rates) should the relationship between LIBOR and BMA converge, changing the synthetic rate to the State on the bonds. The effect of this difference in basis is indicated by the difference between the intended synthetic rate of 4.21 % and the actual synthetic rate as of June 30, 2005 of 4.739% (2.039 % + 2.70 %) reflecting a Bond Rate/LIBOR relationship of 48.43% compared to 65% of LIBOR the State is receiving (as of June 30). The swap may be terminated by either party if the other party fails to perform under the terms of the contract. If the swap is terminated, the associated variable-rate bonds would no longer carry synthetic interest rates. Also, if at the time of termination the swap has a negative fair value, the Town would be liable to the counterparty for that amount.

Component Units**University of North Carolina System***University of North Carolina at Chapel Hill*

Objective. In order to protect against the risk of interest rate changes, effective October 3, 2000, the University entered into an interest rate swap agreement with Lehman Brothers Special Financing, Inc. (Lehman Brothers) related to \$22,000,000 of The University of North Carolina at Chapel Hill Variable Rate Housing System Revenue Bonds, Series 2000. This series of bonds was refunded in its entirety by the issuance of the University's Variable Rate General Revenue Bonds, Series 2001B (2001B Bonds), and the interest rate swap agreement was amended to reflect the refunding.

Terms. Under this amended agreement, Lehman Brothers pays the University interest on the notional amount based on the BMA on a quarterly basis. On a semiannual basis, the University pays Lehman Brothers interest at the fixed rate of 5.24%. The notional amount of the swap reduces annually in conjunction with the 2001B Bonds; the reductions began in November 2002 and end in November 2025. The swap agreement matures November 1, 2025. As of June 30, 2005, rates were as follows:

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	<u>Terms</u>	<u>Rates</u>
Fixed payment to Lehman	Fixed	5.24%
Variable payment from Lehman	BMA	<u>2.13%</u>
Net interest rate swap payments		3.11%
Variable rate bond coupon payments		<u>2.43%</u>
Synthetic interest rate on bonds		<u>5.54%</u>

Fair value. As of June 30, 2005, the swap had a fair value of negative \$4,604,713. The fair value was developed by Lehman Brothers. Their method calculates the future net settlement payments required by the swap assuming that the current forward rates implied by the yield curve correctly anticipate future spot interest rates. These payments are then discounted using the spot rates implied by the current yield curve for LIBOR due on the date of each future net settlement on the swap.

Credit risk. As of June 30, 2005, the University was not exposed to credit risk because the swap had a negative fair value. However, should interest rates change and the fair value of the swap becomes positive, the University would be exposed to credit risk in the amount of the derivative's positive fair value. Should the swap have a positive fair value of more than \$1,000,000, at that point Lehman would be required to collateralize 103% of their exposure. Lehman Brothers Holdings, guarantor of Lehman Brothers Special Financing, Inc., was rated A1 by Moody's, A by S&P, and A+ by Fitch.

Basis risk. The University receives the BMA from Lehman Brothers and pays a floating rate to its bondholders set by the remarketing agent. The University incurs basis risk when its bonds begin to trade at a yield above the BMA. Basis risk also exists since swap payments are made quarterly while bond payments are made monthly. With the alternative tax structure of the swap, a change in tax law would trigger the swap being converted from a BMA swap to a percentage of LIBOR swap. This would introduce basis risk. If the weekly reset interest rates on the University's bonds are in excess of 65% of LIBOR, the University will experience an increase in debt service above the fixed rate on the swap to the extent that the interest rates on the bonds exceed 65% of LIBOR.

Termination risk. The swap agreement uses the International Swap Dealers Association Master Agreement, which includes standard termination events, such as failure to pay and bankruptcy. Termination could result in the University being required to make an unanticipated termination payment. The swap terminates if the University or Lehman Brothers fails to perform under terms of the contract.

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North Carolina State University

Objective. In order to protect against the potential of rising interest rates, the University entered into three separate pay-fixed, receive-variable interest rate swaps at a cost anticipated to be less than what the University would have paid to issue fixed-rate debt.

Terms, fair values, and credit risk. The University's swap agreements contain scheduled reductions to outstanding notional amounts that are expected to approximately follow scheduled or anticipated reductions in the associated bonds payable category. The terms, fair values, and credit ratings of the outstanding swaps as of June 30, 2005 were as follows (dollars in thousands).

Associated Bond Issue	Notional Amounts	Effective Date	Fixed Rate Paid	Variable Rate Received	Fair Values	Swap Termination Date	Counterparty Credit Rating Moody's/S&P/Fitch
Centennial Campus 1999A	\$ 9,000	10/1/1999	4.574%	67% of LIBOR	\$(1,075)	12/01/2019	A1 / A+ / A+
General Revenue 2003B	24,655	6/20/2003	3.54%	BMA ¹	(572)	10/01/2027	Aa1 / AA / AA-
General Revenue 2003B	20,710	6/20/2003	1.19%	BMA	—	7/1/2005 ²	Aa1 / AA / AA-
Total	<u>\$54,365</u>				<u>\$(1,647)</u>		

¹ Variable rate received is the BMA from June 20, 2003 to July 1, 2006; thereafter, the variable rate received will be 75% of LIBOR.

² Counterparty had the option to extend the swap to July 1, 2007, which was not exercised.

Because rates have declined since the effective dates of the swaps, both the 1999A and 2003B swaps have a negative fair value as of June 30, 2005. The negative fair value may be countered by a reduction in total interest payments required under the variable-rate bonds, creating lower synthetic interest rates. Because the coupons on the University's variable-rate bonds adjust to changing interest rates, the bonds do not have corresponding fair value increases. The fair values are the market values as of June 30, 2005.

As of June 30, 2005, the University was not exposed to credit risk because the swaps had a negative fair value. However, should interest rates change and the fair value of the swaps become positive, the University would be exposed to credit risk in the amount of the derivatives' fair value. The swap agreements require termination should the University's or the counterparty's credit rating fall below either Baa2 as issued by Moody's or BBB as issued by S&P or Fitch. Also, under the terms of the swap agreements, should one party become insolvent or otherwise default on its obligations, provisions permit the nondefaulting party to accelerate and terminate all outstanding transactions. Of the three agreements entered into by the University, two swaps, approximating 83% of the notional amount of the swaps outstanding, are held with one counterparty. All the counterparties are rated A1 or better.

Basis risk. The University is exposed to basis risk on the swaps when the variable payment received is based on an index other than BMA. Should the relationship between LIBOR and BMA move to convergence, the expected cost savings may not be realized. As of June 30, 2005, the BMA rate was 2.28%, whereas 67% of LIBOR was 2.24%.

Termination risk. The University or the counterparty may terminate any of the swaps if the other party fails to perform under the terms of the contract. If any of the swaps are terminated, the associated variable-rate bonds would no longer carry synthetic interest rates. Also, if at the time of termination

the swap has a negative fair value, the University would be liable to the counterparty for that amount.

North Carolina Central University

In October of 2003, the North Carolina Capital Facilities Finance Agency issued Student Housing Facilities Revenue Bonds (\$21,475,000 Variable Rate Revenue Demand Bonds, Series 2003A). The issuer, the North Carolina Capital Facilities Finance Agency, loaned the proceeds of the Series 2003 Bonds to the NCCU Real Estate Foundation, Inc. (Foundation). The Foundation used the proceeds to finance the costs of building a student housing facility at North Carolina Central University, to fund a debt service reserve fund for the 2003A Bonds, to pay a portion of the interest on the bonds during construction of the project, and to pay certain costs of issuance of the bonds.

Objective. As a means to lower its borrowing costs and increase its savings, when compared against fixed-rate refunding bonds at the time of issuance in October 2003, effective March 24, 2004, the Foundation entered into two interest rate swaps with Wachovia Bank, N.A., in connection with its \$21,475,000 Variable Rate Revenue Demand Bonds, Series 2003A. The intention of the swap agreements was to effectively change the interest rate on the bonds to a synthetic fixed rate of 3.515% (Swap 1) and 2.71% (Swap 2).

Terms. The bonds and the related swap agreements mature on October 1, 2024, (Swap 1) and April 1, 2009, (Swap 2) and the combined swaps' notional amount of \$17,180,000 hedges 80% of the \$21,475,000 variable-rate bonds. Starting in fiscal year 2006, the combined notional value of the swaps and the combined principal amount of the associated debt decline. Under the swaps, the Foundation pays Wachovia Bank, N.A. a fixed rate of 3.515% (Swap 1) and 2.71% (Swap 2) and receives a variable rate at 70% and 100% of LIBOR and BMA, respectively. The bonds' variable-rate coupons are closely associated with the BMA.

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Fair value. As of June 30, 2005, Swap 1 had a negative fair value of \$388,718 and Swap 2 had a positive fair value of \$100,927. The positive fair value of Swap 2 may be countered by an increase in total interest payments required under the variable rate bonds, creating a higher synthetic interest rate. Because the coupons on the Foundation's variable-rate bond are adjusted every seven days to changing interest rates, the bonds do not have a corresponding fair value increase. The mark-to-market valuations were established by market quotations from Wachovia Bank, N.A. representing estimates of the amounts that would be paid upon terminating the transactions.

Credit risk. As of June 30, 2005, the Foundation was exposed to credit risk because the swaps had a negative fair value in aggregate. However, should interest rates change and the aggregate fair value of the swaps become positive, the foundation would be exposed to credit risk in the amount of the derivatives' aggregate fair value. Swap 1 and Swap 2's counterparty (Wachovia Bank, N.A.) was rated Aa2 by Moody's, AA- by S&P and AA- by Fitch.

Basis risk and termination risk. Swap 1 exposes the Foundation to basis risk should the relationship between LIBOR and BMA converge, changing the synthetic rate on the bonds. The effect of this difference in basis is indicated by the difference between the intended synthetic rate of 3.515% and the actual rate of 3.465% (Swap 1) at June 30, 2005. As of June 30, 2005, the rate on the Foundation's Bonds was 2.29%, whereas 70% of LIBOR was 2.340%. Swap 2 exposes the Foundation to basis risk should the actual rate on the Foundation's Bond vary from the BMA. The effect of this difference in basis is indicated by the difference between the intended synthetic rate of 2.71% and the actual rate of 3.525% (Swap 2) at June 30, 2005. As of June 30, 2005, the rate on the Foundation's Bonds was 2.29%, whereas the BMA index was 2.28%. Termination could result in the Foundation being required to make an unanticipated termination payment. The swap agreements are terminated if the Foundation or Wachovia Bank, N.A. fails to perform under the terms of the contract.

Market-access risk/Rollover-risk. Swap 1 and Swap 2 expose the Foundation to market-access and rollover risk when the swaps mature on October 1, 2024 and April 1, 2009 respectively. When Swap 1 and Swap 2 mature, the interest rate on the underlying debt will return to a variable rate.

University of North Carolina Hospitals

Objective. In order to protect against the risk of interest rate changes, the Hospitals entered into an interest rate swap contract agreement with Bank of America, N.A. (BOA) on February 13, 2003. The agreement covers the Variable Rate Revenue Refunding Bonds, Series 2003A for \$63,770,000 and Series 2003B for \$34,245,000. The 2003 series of bonds partially refunded Fixed Rate Revenue Bonds, Series 1996.

Terms, fair values, and credit risk. Under this agreement, BOA pays the Hospitals interest on the notional amount based on 67% of the arithmetic mean of the USD-LIBOR-BBA (with a designated maturity of one month) on a monthly basis. Also

on a monthly basis, the Hospitals pay BOA interest at the fixed rate of 3.48%. No cash was paid or received by the Hospitals upon initiation of the agreement. The notional amount of the swap reduces annually; the reductions began in February 2004 and end in February 2029. The swap agreement terminates February 1, 2029. As of June 30, 2005, rates were as follows:

		2003A	2003B
	<u>Terms</u>	<u>Rates</u>	<u>Rates</u>
Fixed payment to BOA	Fixed	3.48%	3.48%
Variable payment from BOA	LIBOR	<u>2.15%</u>	<u>2.15%</u>
Net interest rate swap payments		1.33%	1.33%
Variable rate bond payments		<u>2.30%</u>	<u>2.26%</u>
Synthetic interest rate on bonds		<u>3.63%</u>	<u>3.59%</u>

The swap agreement has a mark-to-market value of negative \$5,753,348 as of June 30, 2005. BOA develops the mark-to-market value. Their method calculates the present value of the future net settlement payments required by the swap assuming that the current forward rates implied by the yield curve correctly anticipate future spot interest rates. These payments are then discounted using the spot rates implied by the current yield curve for LIBOR due on the date of each future net settlement on the swap.

As of June 30, 2005, the Hospitals are not exposed to credit risk since the agreement has a negative market value. In the future, if the interest rates were to change and the market value becomes positive, then the credit risk would be equal to the market value of the swap. BOA's current long-term ratings are AA- by Fitch, Aa1 by Moody's, and AA by S&P. At such time that their ratings fall below A3 for Moody's or below A- for S&P, BOA will be required to collateralize a portion of their exposure (up to 100%). The following instruments can serve as eligible collateral: Cash, U.S. Treasury obligations, U.S. government agency fixed rate fixed maturity securities, U.S. government agency single class mortgage-backed securities, U.S. Treasury STRIPS and other U.S. government agency mortgage-backed securities. Posted collateral received will be entered in one or more accounts with a domestic office of a commercial bank, trust company or financial institution organized under the laws of the United States (or any state or a political subdivision thereof).

Basis risk. The Hospitals receive 67% of 1-month LIBOR-BBA Index from BOA and pays a floating rate to its bondholders set by the remarketing agent. The Hospitals incurred basis risk at June 30, 2005, because its bonds traded at a yield above 67% of 1-month LIBOR-BBA Index. If the relationship of the Hospitals' bonds trade to a percentage of LIBOR greater than 67%, the Hospitals will experience an increase in debt service above the fixed rate on the swap.

Termination risk. The derivative contract uses the International Swap Dealers Association Master Agreement, which includes standard termination events, such as failure to pay and bankruptcy. The Hospitals or the counterparty may terminate the swap if the other party fails to perform under the terms of the contract. If the swap is terminated, the associated variable-rate bonds would no longer carry synthetic interest

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rates. Also, if at the time of termination the swap has a negative fair value, the Hospitals would be liable to the counterparty for

that amount. Termination could result in the Hospitals being required to make an unanticipated termination payment.

North Carolina Housing Finance Agency

Objective. The North Carolina Finance Agency (the Agency) has entered into interest rate swaps in connection with its \$79.3 million variable-rate revenue bonds associated with several series in its 1998 Home Ownership Revenue Bond Resolution as a means to lower its borrowing costs when compared against fixed-rate bonds at the time of issuance. The intention of the swaps was to effectively lower the Agency's interest rate on the long term bonds to a fixed rate.

Terms and fair value. The terms and fair value of the outstanding swaps as of June 30, 2005 were as follows (dollars in thousands).

Series	Counterparty	Notional Amount	Date of Swap	Maturity Date of Swap	Fixed Rate	Fair Values
15	UBS AG	\$19,530	5/8/2003	7/1/2032	3.510%	\$ 642
16	Bank of America, N.A.	19,735	9/16/2003	7/1/2032	3.810%	1,216
17	Bank of America, N.A.	20,000	12/11/2003	7/1/2033	3.725%	1,397
18	Goldman Sachs Mitsui Marine	20,000	4/20/2004	7/1/2035	3.288%	272
		<u>\$79,265</u>				<u>\$3,527</u>

Under all of the swaps, the Agency pays the counterparties a fixed rate and receives a variable payment computed as 63% of LIBOR, plus 30 basis points. The bonds' variable-rate coupons are based on the BMA, which was 2.30% as of June 30, 2005.

In total, the swaps have a positive fair value of \$3,526,426 as of June 30, 2005. Because the aggregate fair value of the swaps is positive, the Agency is exposed to credit risk. Because the coupons on the Agency's variable-rate bonds adjust to changing interest rates, the bonds do not have a corresponding fair value increase. The fair value was estimated using the zero-coupon method. This method calculates the future net settlement payments required by the swap, assuming the current forward rates implied by the yield curve correctly anticipate future spot interest rates. These payments are then discounted using the spot rates implied by the current yield curve for hypothetical zero-coupon bonds due on the date of each future net settlement on the swap.

Basis risk and termination risk. The swaps expose the Agency to basis risk should the relationship between LIBOR and BMA converge, changing the synthetic rate on the bonds. Series 15 swap may be terminated if the counterparty's credit rating falls below A3 as issued by Moody's or A- as issued by Fitch or S&P. For series 16, 17 and 18, collateral thresholds have been established if the counterparty's ratings reach A2 for Moody's or A for S&P. Series 16, 17 and 18 swaps may be terminated if the counterparty's rating falls below Baa as issued by Moody's or BBB as issued by S&P.

F. Swaptions

Objective. As a means of lowering its borrowing costs on the existing bonds in the table below and increasing its savings when compared to fixed rate refunding bonds, the State entered into basis swap and swaption contracts with three different financial institutions. Swaptions give the purchaser the right, but not the obligation, to enter into an interest rate swap on a specified future date. These swaptions and the related basis rate swaps disclosed previously were entered into as an alternative to a synthetic fixed rate refunding. This swaption alternative provides an annuity to the State (69 basis points total – 28 for the swaptions). The swaptions give each counterparty the option to require the State to enter into pay-fixed, receive-variable interest rate swaps at the various call dates. If the swaptions are exercised, the State would then expect to issue variable-rate refunding bonds sufficient to retire the related issue.

Bond Series	Principal or Notional Amount (dollars in thousands)				Call Date / Swaption
	Counterparty 1	Counterparty 2	Counterparty 3	Series Total	Exercise Date
Public Improvement Bonds, Series 2003A	\$ 85,500	\$ 51,300	\$ 34,200	\$ 171,000	3/1/2013
Public Improvement Bonds, Series 2003B	84,977	50,987	33,991	169,955	4/1/2013
Public Improvement Bonds, Series 2004A	167,500	100,500	67,000	335,000	3/1/2014
Total	<u>\$ 337,977</u>	<u>\$ 202,787</u>	<u>\$ 135,191</u>	<u>\$ 675,955</u>	

NOTES TO THE FINANCIAL STATEMENTS

Terms. The swaption agreements were entered into on March 9, 2005 and mature March 1, 2026. The swaption annuity was based on the total notional amount of \$675,955,000 and is tied to the respective bond issues noted above. The counterparties have the right to exercise the swaption agreements 90 days prior to the call date for each series. If exercised, the State will pay the counterparties a fixed rate, and the counterparties will pay the State a variable rate (BMA) based on a declining notional amount that matches the amortization of the associated bonds by series. If the swaptions are exercised, the State intends to issue variable rate bonds in a principal amount to retire the associated bond series.

<u>Counterparty</u>	<u>Based on Respective Notional Amounts</u>			<u>Counterparty Credit Rating Moody's/S&P</u>
	<u>Swaption Annuity Payment Received</u>	<u>Fixed Rate Paid by the State</u>	<u>Variable Rate Received by the State</u>	
Counterparty 1	28 Basis Points	4.80%	BMA	Aa2/AA-
Counterparty 2	28 Basis Points	4.80%	BMA	Aa3/A+
Counterparty 3	28 Basis Points	4.80%	BMA	Aaa/AAA

Fair value. As of June 30, 2005, the swaptions had fair values of negative \$16,720,827 (Counterparty 1), negative \$9,926,784 (Counterparty 2) and negative \$6,334,775 (Counterparty 3), which were estimated using the mark to market method. This method of valuation was established by market quotations from the counterparties representing estimates of the amounts that would be paid for replacement transactions. These values reflect a slight decline in interest rates between March 9, 2005, and June 30, 2005, however, only the State has the option to terminate the swaptions. A replacement transaction would generate net present value savings equal to these fair value amounts.

Market-access risk. A small risk exists that the State, for some unforeseen reason, may be unable to issue the variable rate bonds. If the swaptions are exercised and refunding bonds are not issued, the series 2003 A and B and 2004A bonds would not be refunded, the basis rate swaps would continue, and the State would have to pay a termination payment on the swaptions to the counterparties. Termination values will be based on the net present value difference between BMA and 4.80% fixed rate.

NOTES TO THE FINANCIAL STATEMENTS

G. Debt Service Requirements

The following schedules show the debt service requirements for the primary government (governmental activities and business-type activities) and component units (University of North Carolina System, North Carolina Housing Finance Agency, and the State Education Assistance Authority). The debt service requirements of variable rate debt and net swap payments are based on rates as of June 30, 2005 and assume that current interest rates remain the same for their term. As rates vary, variable-rate bond interest payments and net swap payments will vary.

Annual debt service requirements to maturity for general obligation bonds, certificates of participation, revenue bonds, and notes payable are as follows (dollars in thousands).

Primary Government

Fiscal Year Ending June 30	Governmental Activities						
	General Obligation Bonds			Certificates of Participation		Lease-Purchase Revenue Bonds	
	Principal	Interest	Interest Rate Swaps, Net	Principal	Interest	Principal	Interest
2006	\$ 329,720	\$ 253,321	\$ 4,529	\$ 21,110	\$ 18,990	\$ 10,000	\$ 12,140
2007	325,915	238,013	5,203	21,420	21,648	10,000	11,712
2008	324,515	223,588	5,203	21,760	20,824	10,000	11,374
2009	321,120	208,217	5,203	22,110	19,925	10,000	11,041
2010	321,000	191,391	5,203	22,470	18,963	10,000	10,615
2011-2015	1,615,230	723,845	23,818	119,030	79,058	50,000	46,067
2016-2020	1,586,680	377,159	9,937	133,610	48,469	64,000	33,574
2021-2025	824,855	107,778	—	113,660	15,146	101,045	10,182
2026-2030	49,500	3,218	—	—	—	—	—
Total	\$ 5,698,535	\$ 2,326,530	\$ 59,096	\$ 475,170	\$ 243,023	\$ 265,045	\$ 146,705

Fiscal Year Ending June 30	Governmental Activities		Business-type Activities				
	Notes Payable		Revenue Bonds		Interest Rate	Notes Payable	
	Principal	Interest	Principal	Interest	Swaps, Net	Principal	Interest
2006	\$ 6,488	\$ 569	\$ 270	\$ 239	\$ 134	\$ 112	\$ —
2007	20,755	2,563	280	232	130	112	—
2008	5,010	158	295	224	125	112	—
2009	1,754	31	305	216	121	112	—
2010	—	—	320	207	116	112	—
2011-2015	—	—	1,830	894	500	561	—
2016-2020	—	—	2,275	615	344	448	—
2021-2025	—	—	2,845	267	150	—	—
2026-2030	—	—	650	4	2	—	—
Total	\$ 34,007	\$ 3,321	\$ 9,070	\$ 2,898	\$ 1,622	\$ 1,569	\$ —

NOTES TO THE FINANCIAL STATEMENTS

Component Units

University of North Carolina System							
Fiscal Year Ending June 30	Revenue Bonds			Certificates of Participation		Notes Payable	
	Principal	Interest	Interest Rate	Principal	Interest	Principal	Interest
			Swaps, Net				
2006	\$ 68,595	\$ 67,839	\$ 2,588	\$ 1,395	\$ 540	\$ 2,638	\$ 2,600
2007	72,384	65,545	2,562	1,755	863	34,831	1,565
2008	74,545	62,074	2,536	1,810	1,182	1,039	978
2009	76,870	58,736	2,494	1,870	1,128	775	929
2010	77,545	55,204	2,441	1,930	1,064	465	886
2011-2015	400,380	229,145	11,638	8,920	4,100	492	4,257
2016-2020	383,499	150,523	9,527	2,335	2,957	—	4,235
2021-2025	331,565	79,759	5,936	2,905	2,384	—	4,235
2026-2030	194,440	26,843	1,117	3,640	1,646	—	4,235
2031-2035	55,060	4,432	—	4,625	664	29,500	4,133
Total	<u>\$ 1,734,883</u>	<u>\$ 800,100</u>	<u>\$ 40,839</u>	<u>\$ 31,185</u>	<u>\$ 16,528</u>	<u>\$ 69,740</u>	<u>\$ 28,053</u>

Revenue Bonds					
Fiscal Year Ending June 30	North Carolina Housing Finance Agency			State Education Assistance Authority	
	Principal	Interest	Interest Rate	Principal	Interest
			Swaps, Net		
2006	\$ 31,035	\$ 64,804	\$ 917	\$ 1,000	\$ 60,912
2007	33,240	63,527	897	—	60,912
2008	34,950	62,105	876	—	60,912
2009	36,810	60,631	857	—	60,912
2010	38,715	59,032	839	—	60,912
2011-2015	217,900	260,259	3,933	310,012	281,614
2016-2020	216,780	201,913	3,448	423,900	174,971
2021-2025	216,215	154,242	2,807	—	171,804
2026-2030	326,910	98,189	1,577	270,000	153,324
2031-2035	155,215	17,911	274	916,650	77,533
2036-2040	2,310	856	—	—	—
2041-2045	1,785	177	—	—	—
Total	<u>\$ 1,311,865</u>	<u>\$ 1,043,646</u>	<u>\$ 16,425</u>	<u>\$ 1,921,562</u>	<u>\$ 1,163,806</u>

NOTES TO THE FINANCIAL STATEMENTS**H. Bond Defeasances**

The State and its component units have defeased certain bonds through advance refundings by placing refunding bond proceeds into an irrevocable trust with an escrow agent to provide for all future debt service payments on the defeased bonds. Since these bonds are considered to be defeased, the liabilities for these bonds have been removed from the government-wide statement of net assets.

Primary Government

On September 29, 2004, the State of North Carolina issued \$382,260,000 in General Obligation Refunding Bonds, Series 2004 with an average interest rate of 4.89%. This bond issue was used to advance refund (defease) \$388,425,000 of outstanding bonds as follows: 1995A Clean Water Bonds, with an average interest rate of 5.20%; 1997 Capital Improvement Bonds, with an average interest rate of 5.10%; 1997A Public School Building Bonds, with an average interest rate of 5.19%; 1997A Highway Bonds, with an average interest rate of 4.96%; and 1999A Public Improvement Bonds, with an average interest rate of 5.25%. The State reduced its debt service requirements by \$20,002,711 over the next 11 years and obtained an economic gain of \$14,830,625. At June 30, 2005, the outstanding balances were \$60,000,000 for the defeased 1997 Capital Improvement Bonds, \$159,500,000 for the defeased 1997A Public School Building Bonds, \$99,925,000 for the defeased 1997A Highway Bonds, and \$57,000,000 for the defeased 1999A Public Improvement Bonds.

On January 12, 2005, the State of North Carolina issued \$106,895,000 in General Obligation Refunding Bonds, Series 2005A with an average interest rate of 4.67%. This bond issue was used to advance refund \$108,000,000 of outstanding 2000A Public Improvement Bonds, with an average interest rate of 5.05%. The State reduced its debt service requirements by \$5,982,273 over the next 12 years and obtained an economic gain of \$4,789,787. At June 30, 2005, the outstanding balance was \$108,000,000 for the defeased Public Improvement Bonds, Series 2000A.

On June 29, 2005, the State of North Carolina issued \$470,510,000 in General Obligation Refunding Bonds, Series 2005B with an average interest rate of 5.0%. This bond issue was used to advance refund \$490,500,000 of outstanding Public School Building Bonds (\$262,500,000 of Series 1998A and \$228,000,000 of Series 1999, with an average interest rate of 4.68%). The State reduced its debt service requirements by \$21,012,678 over the next 13 years and obtained an economic gain of \$16,207,380. At June 30, 2005, the outstanding balance was \$262,500,000 for the defeased Public School Building Bonds, Series 1998A and \$228,000,000 for the defeased Public School Building Bonds, Series 1999.

Component Units**University of North Carolina System***North Carolina State University*

On February 10, 2005, the University issued \$81,615,000 in North Carolina State University General Revenue Bonds, Series 2005A with an average interest rate of 4.12%. The refunding component of this bond issue was used to advance refund \$7,090,000 of outstanding North Carolina State University Revenue Bonds (Centennial Campus Projects), Series 1997B, with a combined average interest rate of 5.13%. The University reduced its debt service requirements by \$307,435 over the next 13 years and obtained an economic gain of \$406,928. At June 30, 2005, the outstanding balance was \$7,090,000 for the defeased North Carolina State University Revenue Bonds (Centennial Campus Projects), Series 1997B.

University of North Carolina at Greensboro

On April 14, 2005, the University issued \$22,235,000 in 2005A General Obligation Bonds with an average interest rate of 4.73%. The refunding component of this bond issue was used to advance refund \$24,080,000 of outstanding 1997B Student Facilities Revenue Bonds, 1997C Student Facilities Revenue Bonds, 1997D Housing and Dining Revenue Bonds, and 2000G Housing and Dining Revenue Bonds, with a combined average interest rate of 5.42%. The University reduced its debt service requirements by \$1,295,853 over the next 21 years and obtained an economic gain of \$896,763. At June 30, 2005, the outstanding balances were \$3,130,000 for the defeased 1997B Student Facilities Revenue Bonds, \$10,090,000 for the defeased 1997C Student Facilities Revenue Bonds, \$5,000,000 for the defeased 1997D Housing and Dining Revenue Bonds, and \$5,860,000 for the defeased 2000G Housing and Dining Revenue Bonds.

University of North Carolina at Charlotte

On April 14, 2005, the University issued \$11,855,000 in The University of North Carolina Pooled Revenue Bonds, Series 2005A, with an average interest rate of 5.02%. The refunding component of this bond issue was used to advance refund \$11,925,000 of the remaining portion of the Student Activity Center Revenue Bonds, with a combined average annual interest rate of 5.47%. The University reduced its debt service requirements by \$1,093,890 over the next 16 years and obtained an economic gain of \$790,032.

University of North Carolina at Asheville

On April 1, 2005, the University issued \$7,575,000 in General Revenue Bonds, Series 2005A (part of the UNC Pool Issue) with an average interest rate of 4.88% (part used to refund Series C) and 4.11% (part used to refund Series D). The refunding component of this bond issue was used to advance refund \$5,860,000 of outstanding Series C bonds (average interest rate of 5.14%) and \$1,530,000 of outstanding Series D bonds (average interest rate of 4.82%). For the Series C Bonds,

NOTES TO THE FINANCIAL STATEMENTS

the University reduced its debt service requirements by \$185,831 over the next 19 years and obtained a net economic gain of \$130,792. For the Series D Bonds, the University reduced its debt service requirements by \$27,836 and obtained a net economic gain of \$19,751. At June 30, 2005, the outstanding balance was \$7,390,000 for the defeased UNC Asheville Housing/Dining System Series C and D bonds.

University of North Carolina at Wilmington

On April 14, 2005 the University issued \$12,630,000 in General Revenue Bond Series 2005A with an average interest rate of 4.6%. This bond issue was used to advance refund \$12,630,000 of outstanding Dorm and Dining Hall Series I and the Recreation Bonds 1998, with a combined average interest rate of 4.9%. The University reduced its debt service requirements by \$240,623 over the next 14 years and obtained an economic gain of \$320,225. At June 30, 2005, the outstanding balance was \$550,000 for the defeased Dorm and Dining Hall Series I bonds.

Appalachian State University

On April 20, 2005, the University issued \$50,915,000 in Appalachian State University General Revenue and Refunding Revenue Bonds, Series 2005 with an average interest rate of 4.54%. The refunding component of this bond issue was used to advance refund \$9,540,000 of outstanding Appalachian State University Parking System Revenue Bonds, Series 2000 and \$12,340,000 of Housing and Student Center System Revenue Bonds, Series 2000, with a combined average interest rate of 5.61%. The University reduced its debt service requirements by \$1,254,751 over the next 25 years and obtained an economic gain of \$834,633. At June 30, 2005, the outstanding balances were \$9,540,000 for the defeased Appalachian State University Parking System Revenue Bonds and \$12,340,000 for the defeased Appalachian State Housing and Student Center System Revenue Bonds, Series 2000.

University of North Carolina Hospitals

On May 25, 2005, the Hospitals issued \$30,540,000 in University of North Carolina Hospitals Revenue Refunding Bonds, Series 2005A with an average interest rate of 4.97%. This bond issue was used to advance refund \$31,090,000 of outstanding University of North Carolina Hospitals Revenue Bonds, Series 1996, with a combined average interest rate of 5.29%. The Hospitals reduced its debt service requirements by \$1,871,194 over the next 10 years and obtained an economic gain of \$1,167,053. At June 30, 2005, the outstanding balance was \$31,090,000 for the defeased University of North Carolina Hospitals Revenue Bonds, Series 1996 bonds.

Prior Year Defeasances

During prior years, the State and certain component units defeased certain general obligation and other bonds. For those defeasances involving advance refundings, the proceeds and any securities purchased with the proceeds were placed in an irrevocable trust with an escrow agent in an amount sufficient to provide for all future debt service payments on the refunded bonds. Accordingly, the trust account assets and the liability for the defeased bonds are not included in the government-wide statement of net assets. At June 30, 2005, the outstanding balance of prior year defeased bonds was \$435.9 million for the primary government and \$128.3 million for component units.

I. Bond Redemptions

The bond series resolutions for the North Carolina Housing Finance Agency provide for various methods of redemption. Bonds are redeemed at par from prepayments of mortgage loans securing the issues, from unexpended bond proceeds of the issues, or from funds released via the related decreases in the respective debt service reserve requirements. In addition, various bond issues are redeemable at the option of the Agency with premiums ranging up to 2% for up to twelve years after the date of issue.