MANAGEMENT'S DISCUSSION AND ANALYSIS (MD&A)

The following is a narrative overview and analysis of the State of North Carolina's (the State) financial performance for the fiscal year ended June 30, 2006. Please read it in conjunction with the transmittal letter at the front of this report and with the State's financial statements, which follow this section.

Financial Highlights

Government-wide Financial Statements:

— The State's total net assets increased by $2.78 billion or 10.7% as a result of this year's operations. Net assets of governmental activities increased by $2.46 billion, or 9.9% due, in part, to higher than expected growth in tax revenues. Net assets of business-type activities increased by $319 million, or 29.2% due to the strong financial results of the Unemployment Compensation Fund. At year-end, net assets of governmental activities and business-type activities totaled $27.43 billion and $1.41 billion, respectively.

— Component units reported net assets of $13.19 billion, an increase of $1.08 billion or 8.9% from the previous year. About half of the increase ($509 million) is due to the net increase in capital assets, net of related debt for the University of North Carolina System and community colleges. The capital asset additions were financed in part by state debt proceeds.

Fund Financial Statements:

— The fund balance of the General Fund more than doubled from $953.51 million at June 30, 2005 (as restated) to $1.93 billion at June 30, 2006. The increase is explained primarily by higher than expected growth in individual income, corporate income, and sales and use taxes. In fiscal year 2006, the State changed its methodology for reporting individual income taxes, which increased beginning fund balance by $1.04 billion.

— The fund balance of the Highway Fund increased from $383.3 million at June 30, 2005 to $568.79 million at June 30, 2006, an increase of 48.4%. The fund balance growth was attributable to increases in driver's license, vehicle registration and other fees and to increases in gasoline tax collections.

— The fund balance of the Highway Trust Fund decreased substantially from negative $15.36 million at June 30, 2005 to a negative $135 million at June 30, 2006. Higher construction inflation and non-appropriated spending for the Governor's "Moving Ahead" program and other legislative initiatives contributed to the larger fund deficit.

— The net assets of the Unemployment Compensation Fund almost doubled from $258.46 million at June 30, 2005 to $507.48 million at June 30, 2006. The significant increase is explained by the State's lower unemployment rate and by a 20% surcharge on unemployment contributions.

— The N.C. Education Lottery (Lottery) began selling instant game tickets in March 2006 and Powerball tickets in May 2006. As required by statute, the Lottery's net profit of $64.59 million was transferred to the Education Lottery Fund (nonmajor special revenue fund).

Capital Assets:

— The State's investment in capital assets (net of accumulated depreciation) was $29.21 billion, an increase of 5.9% from the previous fiscal year-end.

— This year's major capital asset additions were for highway construction ($1.4 billion), highway land improvements ($479 million) and the construction of correctional facilities ($34 million). Also, construction was completed on two 1,000 bed close custody prisons.

Long-term Debt:

— The State had long-term debt (bonds and similar debt payable) outstanding of $6.52 billion, an increase of less than 1% from the previous fiscal year-end. The long-term debt balance includes $709.1 million of special obligation (non-voted) debt issued for governmental activities.

— The State maintained its AAA bond rating with Standard and Poor's and Fitch. In August 2002, Moody's downgraded the State's credit rating for general obligation debt from "AAA" to "Aa1", representing the first time since 1960 that North Carolina had less than a "AAA" rating. In September 2004, Moody's upgraded the State's outlook from stable to positive.

OVERVIEW OF THE FINANCIAL STATEMENTS

This discussion and analysis is an introduction to the State's basic financial statements, which comprise three components: 1) government-wide financial statements, 2) fund financial statements, and 3) notes to the financial statements. This report also contains additional required supplementary information (General Fund budgetary schedule, pension funding progress and contributions) and other supplementary information (combining financial statements) in addition to the basic financial statements. These components are described below.

Government-wide Financial Statements

The Statement of Net Assets and the Statement of Activities are two financial statements that report information about the State, as a whole, and about its activities that should help answer this question: Is the State, as a whole, better off or worse off as a result of this year's activities? These statements include all non-fiduciary assets and liabilities using the accrual basis of accounting. The current year's revenues and expenses are taken into account regardless of when cash is received or paid. The Statement of Net Assets (page 50) presents all of the State's assets and liabilities, with the difference between the two reported as "net assets". Over time, increases and decreases in net assets measure whether the State's financial position is improving or deteriorating.

The Statement of Activities (pages 52 and 53) presents information showing how the State's net assets changed during the most recent fiscal year. All changes in net assets are reported as soon as the underlying events giving rise to the change occur, regardless of the timing of related cash flows. Therefore, revenues and expenses are reported in these statements for some items that will only result in cash flows in future fiscal periods (e.g. uncollected taxes and earned but unused vacation leave).

Both statements report three activities:
Governmental Activities – Most of the State's basic services are reported under this category. Taxes and intergovernmental revenues generally fund these services.

Business-type Activities – The State charges fees to customers to help it cover all or most of the cost of certain services it provides. The State's Unemployment Compensation Fund, the N.C. State Lottery Fund, and the EPA Revolving Loan Fund are the predominant business-type activities.

Discretely Presented Component Units – Component units are legally separate organizations for which the elected officials of the primary government are financially accountable. A description of the component units and an address for obtaining their separately issued financial statements can be found beginning on page 72. All component units are combined and displayed in a separate discrete column in the government-wide financial statements to emphasize their legal separateness from the State. In addition, financial statements for major component units are presented in the notes to the financial statements (pages 145 and 146).

Fund Financial Statements

The fund financial statements provide more detailed information about the State's most significant funds (i.e., major funds) – not the State as a whole. A fund is a fiscal and accounting entity with a self-balancing set of accounts that the State uses to keep track of specific sources of funding and spending for particular purposes. In addition to the major funds, page 170 begins the individual fund data for the non-major funds. The State's funds are divided into three categories, governmental, proprietary, and fiduciary, and they use different accounting approaches.

Governmental funds -- Most of the State's basic services are reported in the governmental funds, which focus on how cash and other financial assets that can readily be converted to cash flow in and out (i.e., inflows and outflows of spendable resources) and the balances left at year-end that are available for spending (i.e., balances of spendable resources). Consequently, the governmental fund financial statements provide a detailed short-term view that helps users determine whether there are more or fewer financial resources that can be spent in the near future to finance the State's programs. The State prepares the governmental fund financial statements using the modified accrual basis of accounting and a current financial resources measurement focus. Because this information does not encompass the additional long-term focus of the government-wide statements, a reconciliation schedule, which follows each of the governmental fund financial statements, explains the relationships (or differences) between them. Information is presented separately in the governmental fund financial statements for the General Fund, the Highway Fund, and the Highway Trust Fund, all of which are considered to be major funds. Data for all other governmental funds are combined into a single aggregated presentation. Individual fund data for each of these nonmajor governmental funds is provided in the form of combining statements elsewhere in this report.

Proprietary funds -- When the State charges customers for the services it provides, whether to outside customers or to other agencies within the State, these services are generally reported in proprietary funds. Proprietary funds (enterprise and internal service) utilize accrual accounting; the same method used by private sector businesses. Enterprise funds are used to report activities for which fees are charged to external users for goods and services. The Unemployment Compensation Fund, the N.C. State Lottery Fund, and the EPA Revolving Loan Fund are our most significant enterprise funds. Internal service funds are used to report activities that provide goods and services to the State's other programs and activities on a cost-reimbursement basis, such as the State Property Fire Insurance Fund, the Motor Fleet Management Fund, Computing Services Fund, and the State Telecommunications Services Fund. Because the State's internal service funds predominantly benefit governmental rather than business-type functions, they have been included within governmental activities in the government-wide financial statements.

Proprietary funds provide the same type of information as the government-wide financial statements, only in more detail. Information is presented separately in the proprietary fund financial statements for the Unemployment Compensation Fund, the N.C. State Lottery Fund, and the EPA Revolving Loan Fund, all of which are considered to be major funds. Conversely, separately aggregated columns are presented for the nonmajor enterprise funds and the internal service funds. Individual fund data for the nonmajor enterprise funds and internal service funds is provided in the form of combining statements elsewhere in this report.

Fiduciary funds – Fiduciary funds are used to account for resources held for the benefit of parties outside the government. Fiduciary funds are not reflected in the government-wide financial statements because the resources of those funds are not available to the support the State's own programs. The accounting used for fiduciary funds is much like that used for proprietary funds. The State's fiduciary activities are reported in separate Statements of Fiduciary Net Assets and Changes in Fiduciary Net Assets. These funds include pension and other employee benefit trust funds, private-purpose trust funds, investment trust funds, and agency funds.

Notes to the Financial Statements

The notes provide additional information that is essential to a full understanding of the data provided in the government-wide and fund financial statements. The notes to the financial statements can be found beginning on page 70 of this report.

Required Supplementary Information

Following the basic financial statements and notes to the financial statements is Required Supplementary Information (RSI), which accompanies the basic financial statements. The RSI is mandated by the GASB and includes General Fund budgetary comparison schedules reconciling the statutory to the generally accepted accounting principles (GAAP) fund balances at fiscal year-end, and pension plan trend information related to funding progress and contributions.

Other Supplementary Information

Other supplementary information includes the introductory section, the combining financial statements for non-major governmental funds, non-major enterprise funds, internal service funds, fiduciary funds, and non-major discretely presented component units.

FINANCIAL ANALYSIS OF THE STATE AS A WHOLE

Over time, increases or decreases in net assets serve as a useful indicator of whether a government's financial position is improving or deteriorating. The State's combined net assets increased $2.78 billion or 10.7% over the course of this fiscal year's operations. The net assets of the governmental activities increased $2.46 billion or 9.9% and business-type activities increased $319.02 million or 29.2%. The following table was derived from the government-wide Statement of Net Assets:

Net Assets
June 30, 2006 and 2005
(dollars in thousands)

	Governmental Activities		Business-type Activities		Total Primary Government	
	2006	2005	2006	2005	2006	2005
Current and other non-current assets	$ 15,171,216	$ 12,609,752	$ 1,717,372	$ 1,439,494	$ 16,888,588	$ 14,049,246
Capital assets, net	29,159,235	27,542,758	53,029	54,645	29,212,264	27,597,403
Total assets	44,330,451	40,152,510	1,770,401	1,494,139	46,100,852	41,646,649
Long-term liabilities	7,281,649	7,027,869	14,064	13,018	7,295,713	7,040,887
Other liabilities	9,614,902	8,152,804	345,662	389,466	9,960,564	8,542,270
Total liabilities	16,896,551	15,180,673	359,726	402,484	17,256,277	15,583,157
Net assets:						
Invested in capital assets, net of related debt	28,035,283	26,435,216	44,196	44,007	28,079,479	26,479,223
Restricted	890,602	1,314,397	1,286,477	970,615	2,177,079	2,285,012
Unrestricted	(1,491,985)	(2,777,776)	80,002	77,033	(1,411,983)	(2,700,743)
Total net assets	$ 27,433,900	$ 24,971,837	$ 1,410,675	$ 1,091,655	$ 28,844,575	$ 26,063,492

The largest component of the State's net assets ($28.08 billion) reflects its investment in capital assets (land, buildings, machinery and equipment, state highway system, and other capital assets), less related debt still outstanding that was used to acquire or construct those assets. Restricted net assets are the next largest component ($2.18 billion). Net assets are restricted when constraints placed on their use are 1) externally imposed by creditors, grantors, contributors, or laws or regulations of other governments or 2) legally imposed through constitutional provisions. The remaining portion, unrestricted net assets, consists of net assets that do not meet the definition of "restricted" or "invested in capital assets, net of related debt."

The government-wide statement of net assets for governmental activities reflects a negative $1.49 billion unrestricted net asset balance. The State of North Carolina, like many other state and local governments, issues general obligation debt and distributes the proceeds to local governments and component units. The proceeds are used to construct new buildings and renovate and modernize existing buildings on the State's community college and university campuses, assist county governments in meeting their public school building capital needs, and to provide grants and loans to local governments for clean water and natural gas projects. Of the $6.45 billion of bonds and certificates of participation outstanding at June 30, 2006, $5.49 billion is attributable to debt issued as state aid to component units (universities and community colleges) and local governments. The balance sheets of component unit and local government recipients reflect ownership of the related constructed capital assets without the burden of recording the debt obligation. The policy of selling general obligation bonds and funneling the cash proceeds to non-primary government (non-State) entities has been in place for decades. However, by issuing such debt, the State is left to reflect significant liabilities on its statement of net assets (reflected in the unrestricted net asset component) without the benefit of recording the capital assets constructed or acquired with the proceeds from the debt issuances. Additionally, as of June 30, 2006, the State's governmental activities have significant unfunded liabilities for compensated absences in the amount of $374.8 million (see Note 7 to the financial statements). These unfunded liabilities also contribute to the negative unrestricted net asset balance for governmental activities.

The following financial information was derived from the government-wide Statement of Activities and reflects how the State's net assets changed during the fiscal year:

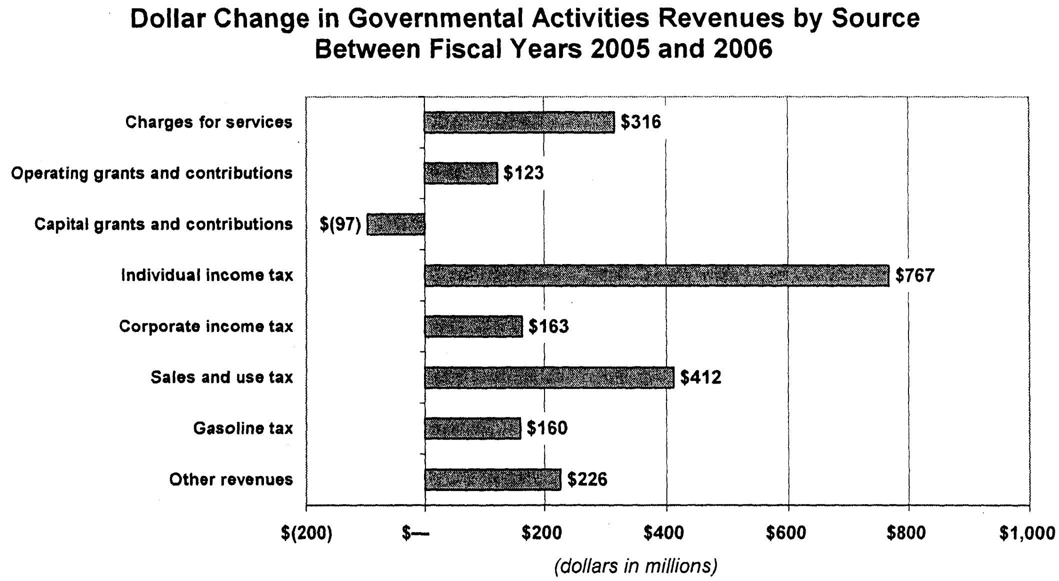
Changes in Net Assets
For the Fiscal Years Ended June 30, 2006 and 2005
(dollars in thousands)

	Governmental Activities		Business-type Activities		Total Primary Government	
	2006	2005	2006	2005	2006	2005
Revenues:						
Program revenues:						
Charges for services	$ 1,988,001	$ 1,672,482	$ 1,402,464	$ 1,145,976	$ 3,390,465	$ 2,818,458
Operating grants and contributions	11,503,844	11,380,864	64,085	54,760	11,567,929	11,435,624
Capital grants and contributions	914,090	1,011,451	258	452	914,348	1,011,903
General revenues:						
Taxes						
Individual income tax	9,336,745	8,569,320	—	—	9,336,745	8,569,320
Corporate income tax	1,306,193	1,143,458	—	—	1,306,193	1,143,458
Sales and use tax	5,033,040	4,621,098	—	—	5,033,040	4,621,098
Gasoline tax	1,514,626	1,354,699	—	—	1,514,626	1,354,699
Franchise tax	628,029	613,033	—	—	628,029	613,033
Highway use tax	577,237	580,118	—	—	577,237	580,118
Insurance tax	442,297	442,228	—	—	442,297	442,228
Beverage tax	233,315	220,782	—	—	233,315	220,782
Inheritance tax	133,158	135,107	—	—	133,158	135,107
Other taxes	482,552	306,991	—	—	482,552	306,991
Tobacco settlement	140,969	143,586	—	—	140,969	143,586
Unrestricted investment earnings	123,170	76,864	—	—	123,170	76,864
Miscellaneous	37,248	53,488	4	79	37,252	53,567
Total revenues	34,394,514	32,325,569	1,466,811	1,201,267	35,861,325	33,526,836
Expenses:						
General government	1,039,513	914,471	—	—	1,039,513	914,471
Primary and secondary education	8,215,445	7,698,357	—	—	8,215,445	7,698,357
Higher education	3,472,024	3,575,576	—	—	3,472,024	3,575,576
Health and human services	13,491,119	13,364,916	—	—	13,491,119	13,364,916
Economic development	647,434	621,247	—	—	647,434	621,247
Environment and natural resources	676,049	567,252	—	—	676,049	567,252
Public safety, corrections and regulation	2,304,900	2,106,656	—	—	2,304,900	2,106,656
Transportation	1,781,865	1,795,585	—	—	1,781,865	1,795,585
Agriculture	112,467	80,787	—	—	112,467	80,787
Interest on long-term debt	264,287	249,433	—	—	264,287	249,433
Unemployment compensation	—	—	849,945	824,934	849,945	824,934
N.C. State Lottery	—	—	153,125	—	153,125	—
EPA Revolving Loan	—	—	11,414	7,170	11,414	7,170
Regulatory commissions	—	—	28,526	25,974	28,526	25,974
Insurance programs	—	—	16,051	13,535	16,051	13,535
North Carolina State Fair	—	—	10,497	10,759	10,497	10,759
Other business-type activities	—	—	10,255	9,753	10,255	9,753
Total expenses	32,005,103	30,974,280	1,079,813	892,125	33,084,916	31,866,405
Increase (decrease) in net assets before contributions and transfers	2,389,411	1,351,289	386,998	309,142	2,776,409	1,660,431
Contributions to permanent funds	4,674	2,288	—	—	4,674	2,288
Transfers	67,978	(11,620)	(67,978)	11,620	—	—
Increase (decrease) in net assets	2,462,063	1,341,957	319,020	320,762	2,781,083	1,662,719
Net assets - beginning - restated	24,971,837	23,629,880	1,091,655	770,893	26,063,492	24,400,773
Net assets - ending	$ 27,433,900	$ 24,971,837	$ 1,410,675	$ 1,091,655	$ 28,844,575	$ 26,063,492

Governmental Activities

For fiscal year 2006, revenues outpaced expenses and when combined with transfers from the State's business-type activities, an increase of $2.46 billion in net assets resulted for governmental activities. Total revenues increased 6.4% in fiscal year 2006 to $34.39 billion. The increase in revenues is attributable mostly to higher than expected growth in individual income, corporate income, and sales and use tax collections. Additionally, the legislature increased driver's license, vehicle registration, and other motor vehicle fees, effective October 1, 2005. Gasoline tax collections were higher because of increases in the motor fuels tax rate. Gasoline taxes are indexed to the wholesale price of fuel, which increased rapidly because of Hurricane Katrina. Net transfers-in were much higher in fiscal year 2006 due to the new State lottery.

The following chart reflects the dollar change in the revenues by source of governmental activities between fiscal years 2005 and 2006:



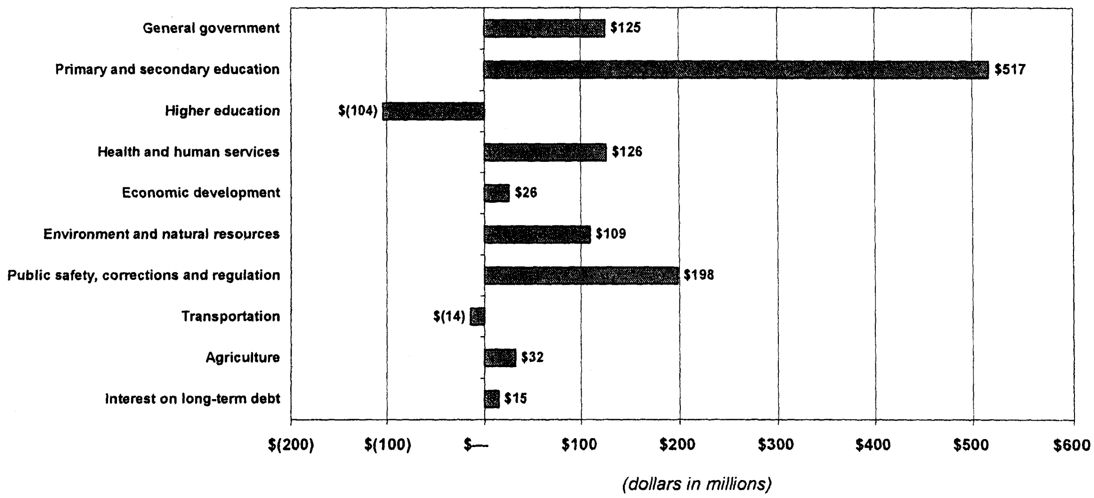
Total expenses increased by only 3.3% to $32.01 billion, primarily because of minimal growth (less than 1%) in the State's largest functional area, health and human services (HHS). For comparison, HHS expenses increased by 14.1% in 2005 and 10.5% in 2004.

Several factors helped to curb HHS spending. The General Assembly froze the reimbursement rates for most Medicaid service providers to the level authorized in fiscal year 2005. Moreover, the new Medicare Part D prescription drug plan resulted in lower costs to the State for drugs funded by Medicaid. Effective January 1, 2006, Medicare Part D, not Medicaid provides for outpatient prescription drug coverage to dual eligibles (i.e., individuals who are both Medicare and Medicaid eligible). However, because of a clawback provision, State's are required to pay most of their estimated savings to the Medicare program to help finance Part D coverage for low-income beneficiaries. State's are required to pay the federal government 90% of their estimated savings in calendar year 2006 and 75% in subsequent years. Another contributing factor to the slower HHS growth is related to the number of Disproportionate Share Hospital (DSH) payments. Due to the late approval of the State plan and new DSH methodology, only six months of DSH payments were made in fiscal year 2006. Additionally, expenses in prior years were much higher because of new initiatives to the Medicaid program. No new programs or initiatives were added to the Medicaid program for the 2006 fiscal year.

Despite enrollment increases, higher education expenses fell in fiscal year 2006 due to larger distributions of higher education bond proceeds in the prior year. Distributions of bond proceeds to colleges and universities were $725 million in fiscal year 2005 compared to $291 million this year. Primary and secondary education expenses continued to grow because of enrollment increases and teacher pay raises and bonuses.

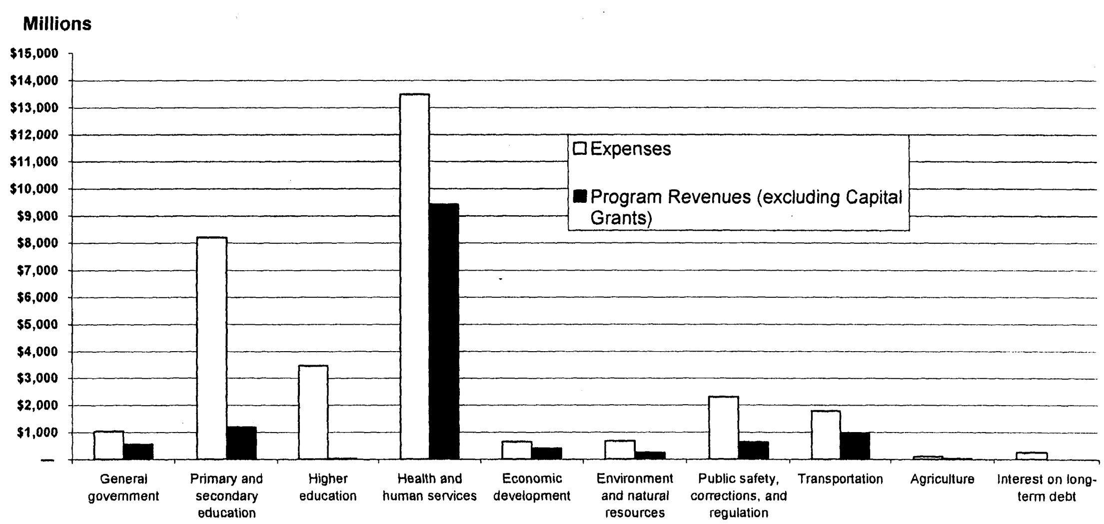
The following chart reflects the dollar change in the functional expenses of governmental activities between fiscal years 2005 and 2006:

Dollar Change in Governmental Activities Functional Expenses
Between Fiscal Years 2005 and 2006



The following chart depicts the total expenses and total program revenues of the State's governmental functions. This format identifies the extent to which each governmental function is self-financing through fees and intergovernmental aid or draws from the general revenues of the State.

Expenses - Governmental Activities
Fiscal Year Ended June 30, 2006



Business-type Activities

Business-type activities reflect an increase in net assets of $319.02 million or 29.2%, primarily because of the strong financial results of the Unemployment Compensation Fund. For fiscal year 2006, the Unemployment Compensation Fund had an operating income (excess of operating revenues over operating expenses) of $253 million. The Unemployment Compensation Fund and the EPA Revolving Loan Fund comprise 90.9% of the total net assets of business-type activities. The N.C. State Lottery Fund has no net assets since its net profits are distributed to the State's governmental activities, as required by statute. A more detailed discussion of the State's business-type enterprise activities is provided in the following section (see Enterprise Funds).

FINANCIAL ANALYSIS OF THE STATE'S FUNDS

The State uses fund accounting to ensure and demonstrate compliance with finance-related legal requirements.

Governmental Funds

The focus of the State's governmental funds is to provide information on near-term inflows, outflows, and balances of spendable resources. As of the end of the fiscal year, the State's governmental funds reported combined ending fund balances of $5.23 billion, a 28% increase from the prior fiscal year-end (as restated). The majority of the increase is related to the revenue growth in the General Fund and Highway Fund (major governmental funds) and to a $64.59 million transfer from the N.C. State Lottery Fund (major enterprise fund) to the Education Lottery Fund (nonmajor special revenue fund). The lottery funds are required by statute to be used for educational purposes. The major governmental funds are discussed individually below.

General Fund

The General Fund is the chief operating fund of the State. The fund balance of the General Fund more than doubled from $953.51 million at June 30, 2005 (as restated) to $1.93 billion at June 30, 2006. The increase is explained primarily by higher than expected growth in individual income, corporate income, and sales and use taxes. For individual income taxes, withholding tax collections grew by 8% and collections of estimated taxes and final payments grew by 21%. The withholding growth rate is similar to that of a pre-recession economy and reflects both job and wage growth. Increases in estimated and final payments also reflect changes in non-wage income. The growth in sales and use taxes occurred despite other offsetting factors, such as higher gas prices and a rise in short-term interest rates. The robust real estate market and improving job market helped to offset these negatives. Corporate income taxes, which are highly volatile over the business cycle, grew primarily because of improved demand for products and services.

For the fiscal year ended June 30, 2006, the State changed its methodology for reporting individual income taxes, which increased beginning fund balance by $1.04 billion (see Note 21). A more detailed analysis of the General Fund is provided in the budgetary highlights section below.

2005-06 General Fund Budgetary Highlights

The enacted General Fund budget was founded upon an overall nominal economic (real growth plus inflation) growth rate of 4.8% for 2005-06. The appropriated budget included provisions that were designed to increase General Fund revenues. The most significant revenue adjustment was the continuation of two temporary tax increases that were scheduled to expire in 2003. In 2001, the General Assembly temporarily raised the State sales tax rate by a half-cent to 4.5% and the highest individual income tax rate from 7.75% to 8.25%. The 2005-06 budget continued the State sales tax rate at 4.5% and the 8.25% income tax bracket. In addition, the General Assembly approved tax changes to comply with the Streamlined Sales Tax Agreement by equalizing rates of telecommunications, satellite television, candy, and funeral services. North Carolina has now satisfied the terms of the agreement. The budget also included a 25 cents per pack increase in the cigarette tax effective September 1, 2005. The following table summarizes the 2006 revenue enhancements (dollars in millions).

Revenue Enhancements – 2006 Fiscal Year

Maintain State sales tax at 4.5%	$ 417.1
Maintain top income tax rate at 8.25%	39.8
Change tobacco tax rate	118.8
Change sales, use, and excise taxes	54.9
Other changes	(7.4)
Total 2006 enhancements	$ 623.2

The majority of funding increases for 2006 were for education, human services, and employee benefit programs. The budget provided full funding for enrollment increases in the public schools ($135 million), the University of North Carolina System ($74.2 million), and the community college system ($7.8 million). In addition, the budget included disadvantaged student supplemental funding ($22.5 million) and low wealth funds ($20 million) to enhance public school instructional programs and student achievement throughout the State. Funds were also provided to support at-risk children. These funds include an additional 3,200 slots for the Governor's More-at-Four Program ($16.6 million), which prepares at-risk four-year-old children for success in school. It also provided funds for ABC teacher bonuses earned in the 2004-05 school year ($100 million).

The budget provided $360 million in 2005-06 to support employee benefit programs. Specifically, it contained a 2.25% recurring compensation increase for all staff on the teacher salary schedule, a 2% or $850 flat amount (whichever is greater) for other state employees, as well as an additional 2% increase for community college faculty and professional staff. In addition, the State Health Plan received funds to cover increased employee health care premiums ($108.6 million). Finally, the budget included $25 million to continue repayment of funds withheld from the Retirement System in 2000-01 due to the budget crisis.

State funding for the Medicaid Program totaled $2.3 billion in 2005-06 and the total Medicaid budget was $8.8 billion. The General Assembly reduced General Fund appropriations for the Medicaid Program by $118.8 million in fiscal year 2005-06. The most significant reduction resulted from freezing Medicaid rates for most Medicaid service providers ($62.5 million). Other reductions include improved utilization management of in-home personal care services, increased recipient co-payments, and further implementation of drug utilization management. The General Assembly also clarified that counties are responsible for paying 15% of the federal Medicare Part D clawback payments under the Medicare Modernization Act of 2004.

General Fund Budget Variances

The original General Fund budget, including state appropriations and appropriations supported by departmental receipts, serves as a starting point or plan for the Governor to execute the General Fund budget pursuant to the powers granted by the Executive Budget Act. At the state level in North Carolina, it is not unusual for the budget to change during the fiscal year in relation to budget adjustments made to accommodate departmental receipts. The General Fund budget supported by state appropriation, is a subset of the General Fund financial schedule presented in the CAFR as required supplementary information. The current CAFR schedule reflects all spending required to support the State's General Fund activities and the funding to support those activities, including state tax and non-tax revenues, federal revenues, student tuition, and other fees, licenses, and fines.

Under current state budget management practice, particularly related to departmental federal receipts, primary emphasis is placed on comparisons of the final authorized budget and actual spending.

At the state level, budgetary cuts related to state appropriations are implemented by decreasing allowable actual expenditures, as opposed to decreasing the state appropriation through a formal legislative process. The Governor and state agencies maintain legal authority to spend the dollars originally appropriated to them; however, in recent years the actual spending has been limited by the collection of tax and nontax revenue. In extremely rare cases, the General Assembly has held special sessions to formally amend the state appropriation budget.

The portion of the original budget comprising departmental receipts is not intended to be the sole controlling point to manage the State's General Fund budget. The final budget includes amendments for departmental receipts collected during the fiscal year as allowed by law. General Fund departmental receipts are typically authorized for expenditure within the activity that generated the receipt. Historically, final estimated receipts have varied significantly from the original estimate at the beginning of the fiscal year. State agencies by law must spend departmental receipts prior to spending tax and nontax supported appropriations. If departmental receipts are higher than expected, appropriated dollars may go unspent and be re-appropriated in a subsequent fiscal year.

Variances – Original and Final Budget

In general, the variances between original and final budget are attributable to the timing and length of the budget preparation process. The original budget for the 2005-06 fiscal year was prepared approximately 18 months prior to the final budget existing at June 30, 2006. The final budget reflects all budget revisions made throughout the fiscal year to adjust for known facts. Furthermore, it cannot be assumed that each agency accurately prepares their budget. Consequently, when the original budget is compared to the final budget, it would be expected that significant variances can occur.

The *federal funds* budget variance between original and final budget was $1.4 billion. The Department of Public Instruction (DPI) was the primary contributor to the variance, which occurred because of gross understatements of the original federal budget during the continuation budget process. DPI was in the midst of a department-wide reorganization in which the federal funds budget was to be allocated among several different divisions upon completion of the reorganization. As a result, DPI made a one time decision to not estimate its federal funds for fiscal year 2005-06, but to wait until the actual federal fund budget awards were posted by fiscal year 2005-06 budget revisions during the fiscal year.

The budget increase for *intra-governmental transactions* revenue is primarily attributable to the following: $198.9 million of statewide encumbrance carry forward amounts from fiscal year 2004-2005 and $143 million of Department of Health and Human Services (DHHS) Medicaid Disproportionate Share. None of these amounts were included in the original budget.

The budget increase for *contributions, gifts, and grants* of $498.3 million is attributable primarily to DHHS's budgeting of state match throughout the fiscal year, as opposed to including a reasonable original budget estimate. The budget increase for *Universities* of $237.2 million is attributed to underestimated tuition amounts and the budgeting of fiscal year 2004-05 carry-forward amounts.

For expenditures, the variances between the original budget and final budget are related to the corresponding revenue budget variances. As revenue budget accounts are increased, a corresponding increase occurs in the expenditure budget accounts. In addition to those increases, agency expenditure budgets were also increased by the allocation of statewide reserves, such as the legislative salary increase, hospitalization, retirement, and salary adjustment.

Variances - Final Budget and Actual Results

Actual revenues collected exceeded final budget for several reasons. First, the revenue forecast was on the conservative side of "most likely". Secondly, this forecast was prepared months prior to the beginning of the fiscal year and as the time period between a fiscal year and forecast preparation increases, forecasted amounts become less accurate. Finally, the economy performed much better than anticipated. Strong employment and income growth fueled individual income and sales tax collections that exceeded expectations. In addition, corporate collections continued to surge due to strong corporate profits and improvement in the business climate.

Departmental *federal funds* actually received by agencies were $1.32 billion less than the final budget. The three agencies primarily responsible for this variance were DPI ($813.1 million), DHHS ($348 million), and the Department of Crime Control and Public Safety ($117.7 million). Actual federal draw downs are reflective of the actual expenditures of these federal funds. Therefore, if qualifying costs are not incurred by an agency, the actual drawdown of federal funds could be significantly less than what has been budgeted. This was the situation in fiscal year 2005-06.

For expenditures, the variances between final budget and actual expenditures for *primary and secondary education, health and human services,* and *public safety, corrections, and regulation* occurred because actual departmental revenues were less than the budgeted revenues; therefore, expenditures that depended on the receipt of these funds could not be made.

Highway Fund

The Highway Fund dates back to 1921, which is when the N.C. General Assembly first imposed the gasoline tax. It accounts for most of the activities of the North Carolina Department of Transportation (DOT), including the maintenance and construction of the State's primary and secondary road systems, the State Highway Patrol, the Division of Motor Vehicles (DMV), and transit and rail. The primary revenue sources of the Highway Fund are federal funds, three-fourths of gasoline taxes, vehicle registration fees, and driver's license fees.

The fund balance of the Highway Fund increased from $383.3 million at June 30, 2005 to $568.79 million at June 30, 2006, an increase of 48.4%. Total revenues increased by $125.71 million or 4.7% primarily because of increases in gasoline taxes and fees, licenses, and fines. The legislature increased motor vehicle license and registrations fees effective October 1, 2005. These fees include driver's license, vehicle registration, and other fees collected by DMV. Gasoline tax collections rose due to the June 2005 rate increase from 26.6 to 27.1 cents per gallon and a second increase in January 2006 from 27.1 to 29.9 cents per gallon. Gasoline taxes are indexed to the wholesale price of fuel over a six-month period, which increased rapidly following Hurricane Katrina.

Total expenditures decreased by $79.46 million or 3.1%. This was due to a decrease in costs due to natural disasters compared to the previous fiscal year. In 2005, several major storms affected the western part of the state resulting in significant damage to the road network. DOT also implemented efficiency in cash management initiatives to counteract cash constraints due to escalating inflation. This approach was implemented to offset the effects of construction cost inflationary factors that have averaged 13.5% over the last several years compared to an historical rate of 3.5%. Transfers-in decreased from $222.16 million in 2005 to $85.91 million in 2006. Prior to 2002, State match for federal aid projects resulted from interfund transfers from the Highway Trust Fund to the Highway Fund. Due to legislative changes and improved accounting software, the state match is allocated directly from the Highway Trust Fund, eliminating the need for the transfers. The remaining transfer is for projects that were funded prior to this change. As these projects are completed, the transfer balance will continue to decrease.

In September 2004, the State Board of Transportation approved a new long-range plan that prioritizes transportation investment for the next 25 years. The Statewide Transportation Plan provides a blueprint for greater investment in maintenance, preservation, and modernization of the State's existing highway system as well as other transportation options such as rail and public transportation. The share of transportation dollars spent on new highway projects will drop from 45% to 26%. The highway needs of the State's growing population will be accommodated in part by maintaining and upgrading existing roads and by increasing anti-congestion measures such as synchronized traffic signals.

The centerpiece of the plan is the Recommended Investment Scenario (Scenario), which outlines priorities from the estimated $57 billion, in today's dollars, expected to be available over the next 25 years for transportation investment. Based on the Scenario, the DOT will be able to meet an additional 10% of its maintenance and preservation needs and nearly 25% more modernization infrastructure needs. Additionally, the scenario proposes increasing DOT's investment in other transportation modes. The plan also identifies $122 billion in total transportation needs and states that DOT will only be able to meet one half of the State's 25-year transportation needs at its current funding levels, regardless of how DOT's resources are allocated. Implementation of the Scenario will be gradual.

Highway Trust Fund

Legislation creating the Highway Trust Fund was passed by the General Assembly in 1989. It was established to provide a dedicated funding mechanism to meet highway construction needs in North Carolina. The Highway Trust Fund also provides extra money for the State's municipalities to adequately maintain their streets and it pays the debt service on the State's general obligation bonds issued for highway purposes.

The principal revenue sources of the Highway Trust Fund are highway use taxes, one-fourth of gasoline taxes, and various title and registration fees. The enabling legislation also specifies that a designated amount will be transferred each year to the General Fund (see Note 9 to the financial statements). The amounts transferred to the General Fund for fiscal years 2006 and 2005 were $252.55 million and $243.77 million, respectively. The amount to be transferred for fiscal year 2007 was reduced to $55 million. The General Assembly enacted legislation during the 2005-06 Session that repealed the requirement for the General Fund to repay the $125 million (plus interest) advanced from the Highway Trust Fund during the 2002-03 fiscal year. In the prior fiscal year, this advance was reclassified to a transfer to the General Fund.

The fund balance of the Highway Trust Fund decreased substantially from negative $15.36 million at June 30, 2005 to negative $135 million at June 30, 2006. Higher construction inflation and non-appropriated spending for the Governor's "Moving Ahead" (see below) and Senate Bill 1005 initiatives, contributed to the larger fund deficit. Total revenues increased by $45.2 million or 4.4%, primarily because of increases in gasoline taxes and fees, licenses, and fines. The legislature increased motor vehicle license and registrations fees effective October 1, 2005. These fees include title fees and other fees collected by DMV. However, due to a decrease in new vehicle sales, title fee collections were only marginally above the previous year and Highway Use Tax collections were down slightly from the previous year.

Total expenditures decreased by $188.81 million or 17.9%. This was due to a decrease in contract lettings and lower expenditures in the "Moving Ahead" and Senate Bill 1005 initiatives. The Department implemented efficiency in cash management initiatives as discussed previously.

In 2003, the General Assembly passed the Governor's "Moving Ahead" transportation initiative to allow, over two years, the use of $630 million of Highway Trust Fund cash balances for highway preservation, modernization, and maintenance. More than 2,200 miles of highway are being improved through "Moving Ahead". Additionally, it allows $70 million for public transit, rail, ferry, bicycle, and pedestrian projects. Through June 30, 2006, "Moving Ahead" cumulative expenditures totaled $420.3 million of the $700 million authorized. For fiscal years 2006 and 2005, transportation expenditures increased by $132.5 million and $227.6 million, respectively, due to the advancement of the Governor's "Moving Ahead" transportation initiative.

Bond proceeds of $300 million were realized in September 2004 to reimburse the Highway Trust Fund for expenditures of prior years. These bonds constitute the remaining portion of the $950 million highway bond authorization approved by the voters in November 1996 (Note: $250 million of such bonds were issued in 1997 and $400 million were issued in 2003). For fiscal year 2006, the debt service on highway bonds was $93.56 million.

Enterprise Funds

The State's enterprise funds or business-type activities provide the same type of information found in the government-wide financial statements, but in more detail. The major enterprise funds are discussed individually below.

Unemployment Compensation Fund

The net assets of the Unemployment Compensation Fund (Trust Fund) increased by $249.02 million during the current fiscal year, an increase of 96.4% from the prior fiscal year-end. The net asset growth is explained by the State's lower unemployment rate and by a 20% surcharge on unemployment contributions that became effective January 1, 2005, as required by state statute. The surcharge, which is projected to remain in effect through December 31, 2007, was assessed because of the fund's low reserves in prior years. The State's unemployment rate fell from 5.4 percent in June 2005 to 4.6 percent in June 2006. The State had a net gain of 93,400 jobs, or 2.4% increase, from July 2005 to July 2006, ranking among the national leaders and outpacing the Southeast region. Declines in manufacturing jobs have been more than offset by growth in professional and business services, financial activities, and education and health services. The State unemployment rate is down significantly from the recession peak in 2002, when the rate climbed to 6.7%.

The operating income (excess of operating revenues over operating expenses) was $253 million this year versus $244.32 million in 2005. Unemployment benefit expenses increased 3.7% in fiscal year 2006 to $848.36 million. At June 30, 2006, the short-term debt balance was zero compared to $113.69 million in 2005. To ensure timely payment of unemployment benefits, the State received repayable advances from its Federal Unemployment Account and issued tax anticipation notes (see attached Note 6 to the financial statements). The State was able to save millions of dollars in interest payments by selling tax anticipation notes instead of borrowing exclusively from the federal government. The use of short-term borrowing came about in early 2002 when an economic downturn caused the State to pay significantly more in unemployment benefits than it received in employer contributions. In May 2006, the State officially ended borrowing from the federal government to cover unemployment benefits. The Trust Fund's cash and cash equivalent balances now equal $166.7 million.

The 2003 Session of the General Assembly enacted legislation to help preserve the integrity of the unemployment insurance tax system. Session Law 2003-67 (Senate Bill 326) clarifies that an employer cannot avoid an undesirable unemployment insurance rate by shifting employees to a newly created company with a more desirable tax rate. This practice is known as State unemployment tax avoidance or "SUTA dumping."

N.C. State Lottery Fund

The N.C. Education Lottery (Lottery) began operations after July 1, 2005; therefore, the financial statements reflect only a partial fiscal year. The first full time, permanent employee was hired in December 2005. The first lottery tickets (instant game) began selling on March 30, 2006, and the first on-line (Powerball) game tickets began selling on May 30, 2006. The Lottery borrowed $4 million from the State Treasurer in February 2006 to help cover start-up expenses before the start of ticket sales. These funds were repaid to the State Treasurer in April 2006.

Since the 2005-06 fiscal year was a start-up period, the Lottery had a significant number of initial purchases and one time expenditures for temporary employees. Temporary employees were needed to help operate the Lottery until the permanent staff was hired. As required by the enabling legislation, the Lottery's net profit of $64.59 million was transferred to the Education Lottery Fund (nonmajor special revenue fund).

The budget for 2006-2007 was approved by the Lottery Commission to provide $401 million to the Education Lottery Fund. The Lottery is on schedule to complete phase two of its start-up operations by the end of October 2006. Phase one of Lottery operations involved the implementation of instant and Powerball games. Phase two will include both Pick 3 and Pick 5 daily games.

As established in the enabling legislation, lottery funds are to be distributed for educational purposes as follows:

1. 50% to support reduction of class size in early grades and to support prekindergarten programs for at-risk four-year-olds who would otherwise not be served in high-quality settings *(Note: to this point, these programs have been funded by the General Fund).*
2. 40% for public school construction.
3. 10% to the State Education Assistance Authority to fund college and university scholarships.

EPA Revolving Loan Fund

The net assets of the EPA Revolving Loan Fund increased by $66.75 million during the current fiscal year, which was a 9.4% increase from the prior fiscal year-end. Operating income was $10.9 million (excess of operating revenues over operating expenses). Net nonoperating revenues were $47.4 million, consisting primarily of federal capitalization grants and investment earnings. The $8.7 million transferred in from other governmental funds (i.e., special revenue funds) consisted of clean water bond proceeds and additional funds to meet a required federal match.

Capital Asset and Debt Administration

Capital Assets

As of June 30, 2006, the State's investment in capital assets was $29.21 billion, an increase of 5.85% from the previous fiscal year-end (see table below).

Capital Assets as of June 30
(net of depreciation, dollars in thousands)

	Governmental Activities		Business-type Activities		Total	
	2006	2005	2006	2005	2006	2005
Land	$ 9,439,616	$ 8,913,829	$ 3,147	$ 3,147	$ 9,442,763	$ 8,916,976
Buildings	1,824,190	1,632,941	14,698	15,510	1,838,888	1,648,451
Machinery and equipment	566,018	554,484	2,462	1,839	568,480	556,323
Infrastructure:						
State highway system	15,368,302	14,247,222	—	—	15,368,302	14,247,222
Other infrastructure	77,240	79,058	28,972	30,769	106,212	109,827
Intangible assets	105,256	106,045	1,457	1,569	106,713	107,614
Art, literature, and other artifacts	60,485	48,975	—	—	60,485	48,975
Construction in progress	1,718,128	1,960,204	2,293	1,811	1,720,421	1,962,015
Total	$ 29,159,235	$ 27,542,758	$ 53,029	$ 54,645	$ 29,212,264	$ 27,597,403
Total percent change between fiscal years 2005 and 2006	5.87 %		(2.96)%		5.85 %	

This year's major capital asset additions were for highway construction ($1.4 billion), highway land improvements ($479 million) and the construction of correctional facilities ($34 million).

The largest component of capital assets is the State highway system. North Carolina has a 79 thousand mile highway system, making it the second largest state-maintained highway system in the nation. The most recent report on the condition of the State highway system (December 2004) noted that while the system continues to grow, the traditional highway maintenance funds necessary to maintain it have not changed significantly when adjusted for inflation.

The 2002-2003 Session of the General Assembly authorized the issuance of up to $300 million of special indebtedness to finance the repair and renovation of state facilities and related infrastructure that are supported by the State's General Fund. Of the $300 million, approximately $157 million will be allocated to the University of North Carolina System. Each of the 16 constituent institutions of the UNC System will receive a portion of the proceeds for repairs and renovations. The remaining $143 million of the proceeds will be used to make repairs and renovations to various state facilities. At year-end, the authorized but unissued repair and renovation debt was $175 million.

In fiscal year 2006, the N.C. Department of Correction completed construction on Maury Correctional Institution (Maury) in Greene County and Bertie Correctional Institution (Bertie) in Bertie County, both of which are 1,000 bed close custody prisons. Maury began accepting inmates in April 2006. Bertie has an inmate occupancy date of August 2006. Total construction and design costs for Maury and Bertie were $82.3 million and $84.2 million, respectively. Another 1,000 bed close custody prison is under construction in Columbus County, with an estimated completion date of February 2008. The total estimated cost of this facility is $104.3 million. The primary funding sources for all three prisons were certificates of participation.

The Department of Correction is undertaking construction initiatives to address a prison cell shortfall and to allow for the implementation of sentencing reform. The State's correctional facility population has more than doubled since 1980 to approximately 38,000 inmates as of November 2006. The rapid growth in inmates is attributable to increases in the State's population, increases in length of stay in correctional facilities, and changes in criminal laws.

As further detailed in Note 20(F) to the financial statements, the State has commitments of $1.43 billion for the construction of highway infrastructure, which are expected to be financed by gasoline tax collections, motor vehicle fees, and federal funds. Other commitments for the construction and improvement of state government facilities totaled $580 million, which are expected to be financed primarily by debt proceeds (certificates of participation), state appropriations, and federal funds.

More detailed information about the State's capital assets is presented in Note 5 to the financial statements.

Long-term Debt

At year-end, the State had total long-term debt (bonds and similar debt payable) outstanding of $6.52 billion, an increase of 0.5% from the previous fiscal year-end (see table below).

Outstanding Debt as of June 30
(dollars in thousands)

	Governmental Activities		Business-type Activities		Total	
	2006	2005	2006	2005	2006	2005
General obligation bonds	$ 5,738,815	$ 5,698,535	$ —	$ —	$ 5,738,815	$ 5,698,535
Revenue bonds	255,045	265,045	8,800	9,070	263,845	274,115
Certificates of participation	454,060	475,170	—	—	454,060	475,170
Notes payable	60,841	37,107	1,457	1,569	62,298	38,676
Total	$ 6,508,761	$ 6,475,857	$ 10,257	$ 10,639	$ 6,519,018	$ 6,486,496
Total percent change between fiscal years 2005 and 2006	**0.51 %**		**(3.59)%**		**0.50 %**	

During the 2005-06 fiscal year, the State issued $370 million in general obligation bonds and entered into installment financing contracts (e.g., notes payable) exceeding $30 million. The new general obligation debt consisted of $300 million in higher education bonds (see next page) and $70 million in clean water bonds for providing grants and loans to local government units. The majority of the installment contracts were for the financing of energy conservation improvements at the N.C. Museum of Art and the downtown state government complex. Under these contracts, energy savings are guaranteed to exceed costs. The State is authorized to finance up to $100 million for energy conservation projects, of which $76.1 million remains authorized but unissued as of October 31, 2006. The State has undertaken these projects to reduce the use of energy, water, and other utilities in state facilities in order to provide its citizens with an example of energy efficiency.

The State's general obligation bonds are secured by the full faith, credit, and taxing power of the State. The revenue bonds issued by the State are secured solely by specified revenue sources. 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 any other property of the State. Installment financing contracts are secured by a lien on facilities or equipment.

The debt service payments on COPs, lease-purchase revenue bonds, and installment financing contracts are subject to appropriation by the General Assembly. If the State defaulted on its repayments, no deficiency judgment could be rendered against the State, but the state property that serves as security could be disposed of to generate funds to satisfy the debt. Failure to repay the debt would have negative consequences for the State's credit rating. Article 9 of Chapter 142 of the General Statutes prohibits the issuance of special indebtedness (e.g.., COPs and lease-purchase revenue bonds) except for projects specifically authorized by the General Assembly. The use of alternative financing methods provides financing flexibility to the State and permits the State to take advantage of changing financial and economic environments.

Higher Education Authorization

The 1999-2000 Session of the General Assembly authorized the issuance of up to $3.1 billion of higher education improvement bonds, which were subsequently approved by the voters of the State. The $3.1 billion bond authorization represents the largest debt authorization in the State's history. The proceeds of these general obligation bonds are being used solely to construct new buildings and to renovate and modernize existing buildings on the State's 58 community college and 16 University of North Carolina campuses. These improvements are needed to meet enrollment demands and to ensure that the State's college and university buildings meet modern code requirements and are equipped to prepare graduates for twenty-first century jobs. The bond legislation passed by the General Assembly specifies the amount of bond funding that will flow to each community college and university campus. At year-end, the authorized but unissued higher education bonds were $403.5 million.

Recent Debt Legislation

The State budget bill for fiscal year 2006-07 authorized the issuance of up to $672.1 million of special indebtedness (e.g., COPs) to finance the following projects:

- $40 million to construct new buildings and renovate existing buildings at the N.C. Museum of Art.
- $20 million to complete the Central Region Psychiatric Hospital for the N.C. Department of Health and Human Services (DHHS).
- $24.8 million for facility costs of a new Secondary State Data Center.
- $45.8 million for facility costs of a new Center City Classroom Building at the University of North Carolina at Charlotte.
- $101 million for facility costs for the DHHS Public Health Laboratory and Office of the Chief Medical Examiner.
- $145.5 million for facility costs of the Eastern Regional Psychiatric Hospital for DHHS.
- $132.2 million for facility costs of the Regional Medical Center and Mental Health Center of the N.C. Department of Correction.
- $162.8 million for facility costs of the Western Regional Psychiatric Hospital for DHHS.

Additional legislation was enacted during the 2005-06 session of the General Assembly that authorized the issuance of special indebtedness of up to $20 million for the purchase of State game lands and up to $20 million for the construction of a parking facility in downtown Raleigh.

The previous session of the General Assembly authorized the N.C. Department of Transportation to issue "GARVEE" bonds or other eligible debt financing instruments to finance federal-aid highway projects. These bonds are Grant Anticipation Revenue Vehicles, authorized by federal law, that permit states to use anticipated future federal highway funds to finance highway project construction. According to the Federal Highway Administration, candidate projects for GARVEE financing are typically larger projects that have the following characteristics:

- They are large enough to merit borrowing rather than pay-as-you-go grant funding, with the costs of delay outweighing the costs of financing;
- They do not have access to a revenue stream (such as local taxes or tolls) and other forms of repayment (such as state appropriations) are not feasible; and
- The sponsors (generally state DOTs) are willing to reserve a portion of federal aid highway funds in future years to satisfy debt service requirements.

Total debt would be constrained by the amount of federal aid authorized in the prior federal fiscal year, which was approximately $953 million for federal fiscal year 2005, the last year for which data is available. More than a dozen other states are already using this type of financing, which Congress authorized in 1995.

Debt Affordability Advisory Committee

During the 2003-04 Session, the General Assembly created a Debt Affordability Advisory Committee (Committee) to annually advise the Governor and the General Assembly on the estimated debt capacity of the State for the upcoming ten fiscal years. The Committee is responsible for preparing an annual debt affordability study and establishing guidelines for evaluating the State's debt burden. The Committee is required to report its findings and recommendations to the Governor, the General Assembly, and the Fiscal Research Division of the General Assembly by February 1 of each year.

In February 2006, the State Treasurer completed the most recent Debt Affordability Study for North Carolina. The report provides the Governor and the General Assembly with a basis for assessing the impact of future debt issuance on the State's fiscal position and enables informed decision-making regarding both financing proposals and capital spending priorities. A secondary purpose of the report is to provide a methodology for measuring, monitoring and managing the State's debt levels, thereby protecting, and perhaps enhancing North Carolina's bond ratings.

The Committee adopted the following target and ceiling guidelines as the preferred measure used to determine the amount of net tax-supported debt that can be prudently authorized by the State:

- Net Tax-Supported Debt Service as a percentage of General Tax Revenues should be targeted at no more than 4% and not exceed 4.75%.

The definition of net tax-supported debt excludes obligations of component units, Highway Fund debt paid from Highway Fund revenues, non tax-supported special indebtedness paid from trust funds, and other self-supporting debt such as revenue bonds and short-term tax anticipation notes.

According to the report, all of the State's debt ratios are below median levels for all 50 states and for a group of six states rated "triple A" by all three rating agencies. Thus, the study concludes that North Carolina's debt is considered low and is manageable at current levels. Credit rating agencies consider a debt affordability study as a positive factor when evaluating issuers and assigning credit ratings.

Credit Ratings

Credit ratings are the rating agencies' assessment of a governmental entity's ability and willingness to repay debt on a timely basis. Credit ratings are an important factor in the public credit markets and can influence interest rates a borrower must pay.

The State's general obligation bonds are rated AAA by Fitch Ratings and AAA with a "stable" outlook by Standard & Poor's Ratings Services, the highest ratings attainable. Moody's Investors Service (Moody's) rates the State's general obligation bonds at Aa1 with a "positive outlook", one half step below their highest rating of Aaa. All three agencies base their prime ratings on the State's strong, diverse economic base, its sound financial management, and low debt levels.

In August 2002, Moody's downgraded the State's credit rating for general obligation debt from "AAA" to "Aa1", representing the first time since 1960 that North Carolina had less than a AAA rating. While Moody's praised the strength of executive powers available to insure a balanced budget, it advised that the primary reasons for the downgrade were the State's continued budget pressure, reliance on non-recurring revenues, and weakened balance sheet. Also, Moody's commented that the task of restoring structural budget balance and rebuilding reserves faces political and economic obstacles. In September 2004, Moody's revised the State's outlook from stable to positive and noted the following:

> *"This rating reflects the State's slowly stabilizing economy, its improving tax revenues, its conservative debt policy, and its effective financial management. While general fund balances remain negative, flexible cash reserves outside the general fund are ample, and pension funding is exceptionally strong. Moody's expects that the state will continue to take actions to restore structural balance and rebuild reserves."*

The COPs and lease-purchase revenue bonds issued by the North Carolina Infrastructure Finance Corporation are rated "AA+" by Standard & Poor's, "AA+" by Fitch, and "Aa2" by Moody's.

Limitations on Debt

The Constitution of North Carolina (Article 5, Section 3) imposes limitations upon the increase of certain state debt. It restricts the General Assembly from contracting debts secured by a pledge of the faith and credit of the State, unless approved by a majority of the qualified voters of the State, except for the following purposes:

1. To fund or refund a valid existing debt;
2. To supply an unforeseen deficiency in the revenue;
3. To borrow in anticipation of the collection of taxes due and payable within the current fiscal year to an amount not exceeding 50 percent of such taxes;
4. To suppress riots or insurrections; or to repel invasions;
5. To meet emergencies immediately threatening the public health or safety, as conclusively determined in writing by the Governor; and
6. For any other lawful purpose, to the extent of two-thirds of the amount by which the State's outstanding indebtedness shall have been reduced during the preceding biennium.

More detailed information about the State's long-term liabilities is presented in Note 7 to the financial statements.

Next Year's Budget and Rates

The General Assembly and the Governor adopted a conservative revenue forecast for fiscal year 2006-07. The baseline growth estimate was 3.1%, well below the economic growth forecasts of North Carolina's university and bank economists.

Tax changes include reducing the State sales tax rate from 4.5% to 4.25% effective December 1, 2006, reducing the top income tax rate from 8.25% to 8% effective January 1, 2007, increasing the cigarette tax from 30 cents to 35 cents per pack effective July 1, 2006, and capping the gasoline tax at current levels. In addition, a $195.2 million reduction in the transfer from the Highway Trust Fund to the General Fund is recommended for fiscal year 2006-07. This reduction would repay the $125 million one time borrowing made to offset a budget shortfall as well as the $80 million inflationary increase adopted in fiscal year 2002-03.

Conditions Expected to Impact Future Operations

State Health Plan

The State Health Plan made available a Preferred Provider Organization (PPO) option to all eligible participants, effective October 1, 2006, as an alternative to the State's indemnity plan. The indemnity plan was the only option that had been offered prior to this time. The PPO option provides for improved health benefits at a lower cost to the State. PPO plans contract with various physicians, hospitals, and other providers to form medical care networks. For the State Health Plan, PPO members receive services at lower premiums and reduced out-of-pocket costs when they use in-network providers. Approximately 330,000 eligible participants selected the new PPO plan offerings during the recent enrollment period. The State Health Plan provides coverage to approximately 600,000 teachers, state employees, and retirees, with a budget of approximately $2 billion.

Escheats Fund

Legislation passed in 2005 authorized the State Treasurer to diversify the investments of the Escheats Fund. Previously, the Fund was limited to participating in the Long Term Investment Portfolio. The State Constitution mandates that proceeds of the Escheat Fund shall be used to aid needy and worthy North Carolina students enrolled in public institutions of higher education. The continuing demand on resources at the universities and community colleges has necessitated regular tuition increases. The establishment of a modern investment allocation strategy aimed at increasing returns was identified as a way to enhance the Fund's constitutionally provided purpose. Under the new provisions, the State Treasurer is authorized to invest up to 20% of the assets of the Escheats Fund in private equity investments. As of June 30, 2006, $20 million has been invested into a Real Estate Investment Fund. In fiscal year 2007, investments into public equity and alternative investments funds are expected.

Repayment of Escrowed Retirement Trust Funds

The State withheld $212.5 million in contributions to the Teachers' and State Employees' Retirement System, the Consolidated Judicial Retirement System, and the Legislative Retirement System to balance the State budget in 2001. The State committed to repaying the funds by 2008. As of June 30, 2006, approximately $138 million had been repaid. The budget for 2006-07 included another payment to the escrowed debt of $30 million. The balance of the debt is now $44.9 million.

Providing Retirement Benefits

It is widely anticipated that the progression of the baby boomer cohort from full-time career status into retirement will have significant economic, social, and political impact throughout the country. Predicting specific ramifications of this phenomenon is difficult. In North Carolina we anticipate some impact to the State's public sector workforce, as boomers increasingly leave active service and retire, and to the state and local government retirement systems. The impact to the retirement systems could be both financial and administrative.

Administratively, the significant increase in the number of retirements to process and maintain will challenge current operations. The total number of members receiving a retirement benefit in the state and local system is approximately 173,000 (includes system retirees, beneficiaries, and members receiving a disability retirement allowance). That number is projected to increase to 345,000 by the year 2025 - an approximate 100% increase in the total number of state and local retirees maintained by the agency over the next 18 years. To help address this need, the Retirement Systems Division is currently increasing organizational efficiencies by implementing a $34 million replacement of its information technology system that will go-live in October 2007.

Financially, the North Carolina retirement systems are expected to continue the trend of robust fiscal health (the system's funding has averaged 109% for the last 6 years). Any substantive cost increases will not primarily be driven by the cost of providing an actual pension, since employees and employers fund the pension over an employee's service career. However, a significant increase in cost may come from providing cost of living adjustments (COLAs) for a significantly larger retiree pool since those are not pre-funded.

Health Care Benefits for Retirees and Beneficiaries

Based on a unit credit cost method and the State's pay-as-you-go approach as of December 31, 2005, the actuarial results are as follows:

Funding method	Not advance funded
Actuarial cost method	Unit credit
Actuarial accrued liability	$23.9 billion
Assets	$ 0.1 billion
Unfunded accrued liability	$23.8 billion
Annual required contribution	$ 2.4 billion

The claims cost of 2006 benefits, on a cash basis, was $539 million. The General Assembly and the Governor are responsible for managing the State's postemployment health care obligations. Any significant changes in benefit or eligibility provisions would be reflected in subsequent actuarial valuations. Additional information about the State's postemployment health care benefits is presented in the letter of transmittal and in Note 13A to the financial statements.

Requests for Information

This financial report is designed to provide our citizens, taxpayers, customers, and investors and creditors with a general overview of the State's finances and to demonstrate the State's accountability for the money it receives. If you have questions about this report or need additional financial information, contact the North Carolina Office of the State Controller, Accounting and Financial Reporting Section, 1410 Mail Service Center, Raleigh, N.C. 27699-1410. In addition, this financial report is available on the Office of the State Controller's internet home page at http://www.ncosc.net/financial/financial.html.