NOTE 7: LONG-TERM LIABILITIES

A. Changes in Long-Term Liabilities

Primary Government. Long-term liability activity for the year ended June 30, 2006, was as follows (dollars in thousands):

	Balance July 1, 2005 (as restated)	Increases	Decreases	Balance June 30, 2006	Amounts Due Within One Year
Governmental activities:					
Bonds and similar debt payable:					
General obligation bonds	$5,698,535	$ 370,000	$ (329,720)	$ 5,738,815	$ 343,615
Lease-purchase revenue bonds	265,045	—	(10,000)	255,045	10,000
Certificates of participation	475,170	—	(21,110)	454,060	21,420
Less deferred amounts:					
For issuance discounts	(1,175)	—	454	(721)	—
On refunding	(119,653)	—	16,594	(103,059)	—
Add issuance premium	339,004	15,700	(41,451)	313,253	—
Total bonds and similar debt payable	6,656,926	385,700	(385,233)	6,657,393	375,035
Notes payable	37,107	30,688	(6,954)	60,841	26,334
Capital leases payable	297	26,745	(163)	26,879	982
Arbitrage rebate payable	—	508	—	508	—
Compensated absences	320,595	270,792	(216,592)	374,795	36,679
Net pension obligation	2,044	14,544	(14,961)	1,627	—
Workers' compensation	5,500	583	(817)	5,266	1,122
Deferred death benefit payable	400	—	(60)	340	210
Cost settlement payable	5,000	151,500	(2,500)	154,000	109,000
Governmental activity long-term liabilities	$7,027,869	$ 881,060	$ (627,280)	$ 7,281,649	$ 549,362
Business-type activities:					
Bonds payable:					
Revenue bonds	$ 9,070	$ —	$ (270)	$ 8,800	$ 280
Total bonds payable	9,070	—	(270)	8,800	280
Notes payable	1,569	—	(112)	1,457	112
Compensated absences	2,379	2,650	(1,222)	3,807	195
Business-type activity long-term liabilities	$ 13,018	$ 2,650	$ (1,604)	$ 14,064	$ 587

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, $3.861 million of internal service funds compensated absences are included in the above amounts.

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, 2006, was as follows (dollars in thousands):

	Balance July 1, 2005	Increases	Decreases	Balance June 30, 2006	Amounts Due Within One Year
University of North Carolina System:					
Bonds payable:					
Revenue bonds	$1,737,063	$ 412,160	$ (129,840)	$ 2,019,383	$ 180,876
Certificates of participation	31,185	—	(1,395)	29,790	1,755
Less deferred amounts:					
For issuance discounts	(52,499)	—	3,928	(48,571)	—
On refunding	(27,064)	(2,286)	2,070	(27,280)	—
Add issuance premium	25,043	21,263	(2,360)	43,946	—
Total bonds payable	1,713,728	431,137	(127,597)	2,017,268	182,631
Notes payable	69,780	98,787	(39,917)	128,650	38,344
Capital leases payable	43,649	63,155	(3,379)	103,425	9,042
Arbitrage rebate payable	3,795	116	(3,622)	289	20
Annuity and life income payable	10,688	1,342	(1,051)	10,979	973
Compensated absences	233,424	206,350	(171,384)	268,390	27,534
Total long-term liabilities	$2,075,064	$ 800,887	$ (346,950)	$ 2,529,001	$ 258,544

Long-term liabilities of nongovernmental component units of the University of North Carolina System are excluded from the above amounts. At June 30, 2006, nongovernmental component unit foundations and similarly affiliated organizations of the University of North Carolina System had total long-term liabilities of $336.963 million, of which $17.178 million was due within one year and $319.785 million was due in more than one year.

	Balance July 1, 2005	Increases	Decreases	Balance June 30, 2006	Amounts Due Within One Year
North Carolina Housing Finance Agency:					
Bonds payable:					
Revenue bonds	$1,311,865	$ 400,000	$ (146,985)	$ 1,564,880	$ 178,050
Less deferred amounts:					
For issuance discounts	(19,569)	(2,780)	3,306	(19,043)	—
On refunding	(145)	—	40	(105)	—
Total bonds payable	1,292,151	397,220	(143,639)	1,545,732	178,050
Arbitrage rebate payable	297	308	(257)	348	144
Compensated absences	583	347	(272)	658	30
Total long-term liabilities	$1,293,031	$ 397,875	$ (144,168)	$ 1,546,738	$ 178,224

	Balance July 1, 2005	Increases	Decreases	Balance June 30, 2006	Amounts Due Within One Year
State Education Assistance Authority:					
Bonds payable:					
Revenue bonds	$1,921,562	$ 806,300	$ (169,208)	$ 2,558,654	$ 506,300
Total bonds payable	1,921,562	806,300	(169,208)	2,558,654	506,300
Arbitrage rebate payable	2,801	1,352	—	4,153	74
Compensated absences	190	75	(9)	256	9
Total long-term liabilities	$1,924,553	$ 807,727	$ (169,217)	$ 2,563,063	$ 506,383

B. Bonds, Certificates of Participation, and Notes Payable

Bonds, certificates of participation, and notes payable at June 30, 2006 were as follows (dollars in thousands):

	Interest Rates	Maturing Through Year	Original Issue Amount	Outstanding Balance
Primary Government:				
Governmental activities				
General obligation bonds	2.13% - 6.90%*	2028	$ 8,201,384	$ 5,738,815
Lease-purchase revenue bonds	2.00% - 5.25%	2024	272,045	255,045
Certificates of participation	3.25% - 5.25%	2025	489,840	454,060
Notes payable	2.89% - 6.00%	2016	74,416	60,841
Business-type activities				
Revenue bonds	3.38% - 4.21%*	2026	$ 9,905	$ 8,800
Notes payable	0.00%	2019	1,569	1,457
Component Units:				
University of North Carolina System				
Revenue bonds	1.63% - 10.00%*	2036	$ 2,329,204	$ 2,019,383
Certificates of participation	3.00% - 5.00%	2035	31,545	29,790
Notes payable	0.91% - 9.45%*	2035	147,563	128,650
North Carolina Housing Finance Agency				
Revenue bonds	2.00% - 8.25%*	2043	$ 3,341,066	$ 1,564,880
State Education Assistance Authority				
Revenue bonds	3.45% - 6.35%*	2035	$ 2,609,850	$ 2,558,654

* For variable rate debt, interest rates in effect at June 30, 2006 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, 2006, totaled $502.7 million as follows: higher education $403.5 million and clean water $99.2 million.

The amount of authorized but unissued debt of the primary government subject to annual appropriation requirements at June 30, 2006 totaled $682.4 million as follows: repair and renovation $175 million, universities $337.1 million, hospital $49 million, prisons $52.4 million, youth facilities $22 million, parks $20.8 million, and guaranteed energy savings contracts $26.1 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 $54.97 million (2001B) and $54.97 million (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

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 $107.46 million, with JP Morgan Chase Bank effective February 1, 2006. 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 0.1% 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 0.15%. 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 0.25%.

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% (Prime plus 2% after 60 days) is payable quarterly and upon draw repayment. At June 30, 2006, no purchase draws had been made under the line of credit.

The line of credit agreement expires on January 31, 2007. However, between November 3, 2006, and December 3, 2006, 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 ($21.48 million 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, 2006.

The Student Housing Facilities Revenue Demand Bonds (Series 2003) has an Irrevocable Letter of Credit (LOC) for $21.82 million. 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, 2006, the LOC rate for the bonds was 1.4% and the total amount drawn on it was $907 thousand.

The Foundation paid Wachovia Bank, N.A. a commitment fee of $109 thousand for the letter of credit on the date the bonds were issued. Additionally, the Foundation paid credit facility fees in the amount of $76 thousand 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 thousand. 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%. 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, 2006, the remarketing fee rate for the bonds was 0.13%.

State Education Assistance Authority – Guaranteed Student Loan Revenue Bonds, Series 2005A

In October, 2005, the Authority issued Guaranteed Student Loan Revenue Bonds, Series 2005A, in the amount of $506.3 million consisting of four tranches of tax-exempt bonds totaling $471.6 million and two tranches of taxable bonds totaling $34.7 million. This series of bonds matures on September 1, 2035, but $12.4 million must be retired by mandatory sinking fund redemption on October 1, 2012. The proceeds of this issuance were used to finance student loans, refund the Authority's outstanding Series 1995A bonds, make a deposit to the operating fund, and pay issuance costs. While bearing interest at a weekly rate, the bonds are subject to purchase on demand with seven day's notice to the tender agent.

Payment of principal and interest on the Series 2005A bonds is insured by a financial guaranty insurance policy by Ambac Assurance Corporation. The Authority has entered into a standby bond purchase agreement with a commercial bank for each respective tranche. Pursuant to each agreement, the respective bank has agreed to purchase any bonds of that respective tranche that have been tendered for purchase during the term of the agreement.

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 - General Revenue Bonds, Series 2003B

On June 20, 2003 the University issued tax-exempt variable rate revenue demand bonds in the amount of $45.66 million 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 0.13% 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, 2006, 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 $45.07 million of demand bonds was "put" and not resold, the University would be required to pay $11.22 million a year for 5 years under this agreement assuming an 8.75% 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 million (2001A) and $55 million (2001B) that have a final maturity date of February 15, 2031. The bonds are subject to mandatory sinking fund redemption that began on February 15, 2002. A portion of the proceeds was used to reimburse the Hospitals for $75 million 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-Thuringen 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 0.25% with the new long-term agreement that became effective on July 11, 2005. The percentage will remain 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 0.5% 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, 2006, 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 $104.8 million of demand bonds was "put" and not resold, the Hospitals would be required to pay $25.79 million a year for 5 years under the installment loan agreement assuming an 8.25% 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 $63.77 million (2003A) and $34.25 million (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 $88.33 million 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% of the available commitment for Series 2003A and for Series 2003B, 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.

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%; for Series 2003B, the rate equals Prime Rate for the first 90 days and then equals Prime plus 1%) 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, 2006, 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 $62.84 million of demand bonds was "put" and not resold, the Hospitals would be required to pay $24.26 million a year for 3 years under the installment loan agreement assuming a 9.35% 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 $33.76 million of demand bonds was "put" and not resold, the Hospitals would be required to pay $12.93 million a year for three years under the installment loan agreement assuming a 9.25% interest rate (Prime plus 1%).

The current expiration date of the Series 2003A Agreement is July 1, 2008 and July 31, 2008 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 $499.87 million 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 3.28% (Swap 1) and 3.09% (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 4.45%.

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 million 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 section within this note (see section F). 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	$ 675,955		

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 $499.87 million matches the $499.87 million 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 3.28% (Swap 1) and 3.09% (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).

Terms - Swap 3. This swap began July 1, 2003, with a notional amount of $355 million 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 $675.96 million matches the $675.96 million 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 risen since execution of swaps 1 and 2, the swaps have positive fair values of $7.18 million (Swap 1) and $9.26 million (Swap 2) at June 30, 2006. The 2005 basis rate swaps had valuations at June 30, 2006 of: $14.06 million (Counterparty 1), $8.72 million (Counterparty 2), and $5.7 million (Counterparty 3). 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

Credit risk. The swaps' fair value represented the State's credit risk exposure to the counterparty as of June 30, 2006. The State's maximum possible loss is equivalent to the aggregate fair value of the swaps. The current counterparty ratings for each swap are presented in the table below:

Swap Counterparty	Moody's Investors Service	Standard & Poor's	Fitch Ratings
Swap 1	Aa1	AA	AA-
Swap 2	Aaa	AAA	-
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 million, 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 million, 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 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). 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 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 3.28% (Swap 1) and 3.09% (Swap 2) and the synthetic rates as of June 30, 2006 of 3.79% (Swap 1) and 3.6% (Swap 2). As of June 30, 2006, the average rate on the State's variable rate bonds was 3.93%, whereas 64% of LIBOR was 3.42%. 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.

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, 2006, there was no basis risk as the State was paying BMA equal to 3.97% and receiving 4.43% (70% of LIBOR plus 69 basis points). LIBOR is 5.35% at June 30, 2006. 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. 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 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 $9.91 million 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 with Bank of America, N.A. was effective April 1, 2001, based on a notional amount of $9.91 million to mature on September 1, 2025. The swap's notional amount of $9.91 million matches the $9.91 million 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 5.33% at June 30, 2006). On the other hand, the bond's variable-rate coupons (2.70% at June 30, 2006) are closely associated with the variable BMA, which was 3.97% as of June 30, 2006.

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 $385 thousand (Bank of America, N.A.) as of June 30, 2006. 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, 2006, 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, 2006 of 4.71% (0.74% + 3.97%) reflecting a Bond Rate/LIBOR relationship of 17.64% 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

Swap 1

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 million 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, 2006, rates were as follows:

	Terms	Rates
Fixed payment to Lehman	Fixed	5.24%
Variable payment from Lehman	BMA	3.61%
Net interest rate swap payments		1.63%
Variable rate bond coupon payments		3.95%
Synthetic interest rate on bonds		5.58%

Fair value. As of June 30, 2006, the swap had a fair value of negative $2.55 million. 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, 2006, 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 million 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 for unsecured long-term debt at June 30, 2006.

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.

Swap 2

Future swap. The University entered into an interest rate swap agreement with the Bank of New York (BNY) for $150 million to be effective December 1, 2007. The University has the option to (1) issue variable rate bonds in December 2007, thereby effectively creating synthetic fixed-rate debt, or (2) unwind the swap, capturing the value of the movement of interest rates from the issuance date, and issuing traditional fixed rate bonds.

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, 2006 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	$ 8,600	10/1/1999	4.57%	67% of LIBOR	$(442)	12/01/2019	A1 / AA- / A+
General Revenue 2003B	24,655	6/20/2003	3.54%	BMA[1]	2,045	10/01/2027	Aa1 / AA /AA-
Total	$33,255				$1,603		

[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.

Because rates have changed since the effective dates of the swaps, the 1999A swap has a negative fair value as of June 30, 2006. 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, 2006.

As of June 30, 2006, the University was exposed to credit risk on the swap with a positive fair value. The State's maximum possible loss is equivalent to the positive fair value of the swap. 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. To mitigate the potential for credit risk, if the counterparty's credit quality falls below A3 as determined by Moody's or A- as determined by S&P, the swap will be collateralized by the counterparty with cash, U.S. government or agency securities. If the counterparty is required to collateralize, then the collateral will be posted with a third party custodian or secured party. The swap agreements entered into by the University are held with separate counterparties. 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, 2006, the BMA rate was 3.97%, whereas 67% of LIBOR was 3.57%.

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.

Future swap. The University has also entered into an interest rate swap agreement for $50 million to be effective September 1, 2008, on a General Revenue Bond Issue planned for 2008.

North Carolina Central University

In October of 2003, the North Carolina Capital Facilities Finance Agency issued Student Housing Facilities Revenue Bonds ($21.48 million 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 $21.48 million 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 3.52% (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 $17.18 million hedges 80% of the $21.48 million variable-rate bonds. The combined notional value of the swaps and the combined principal amount of the associated debt is declining. Under the swaps, the Foundation pays Wachovia Bank, N.A. a fixed rate of 3.52% (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.

Fair value. Because interest rates have risen since execution of the swaps, the swaps have positive fair values of $361 thousand (Swap 1) and $244 thousand (Swap 2) as of June 30, 2006. The swaps' positive fair value 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, 2006, the Foundation was exposed to credit risk because the swaps had a positive fair value. The exposed credit risk is 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 at June 30, 2006.

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 3.52% and the actual rate of 3.76% (Swap 1) at June 30, 2006. As of June 30, 2006, the rate on the Foundation's Bonds was 3.98%, whereas 70% of LIBOR was 3.73%. 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 2.72% (Swap 2) at June 30, 2006. As of June 30, 2006, the rate on the Foundation's Bonds was 3.98%, whereas the BMA index was 3.97%. 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 $63.77 million and Series 2003B for $34.25 million. 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, 2006, rates were as follows:

	Terms	2003A Rates	2003B Rates
Fixed payment to BOA	Fixed	3.48%	3.48%
Variable payment from BOA	LIBOR	3.49%	3.49%
Net interest rate swap payments		-0.01%	-0.01%
Variable rate bond payments		4.00%	3.95%
Synthetic interest rate on bonds		3.99%	3.94%

The swap agreement has a mark-to-market value of $3.01 million as of June 30, 2006. 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, 2006, the Hospitals are exposed to credit risk 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, 2006, 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 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.

NOTES TO THE FINANCIAL STATEMENTS

North Carolina Housing Finance Agency

Objective. The Agency has entered into interest rate swaps in connection with its $78.7 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 swap 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, 2006 were as follows (dollars in thousands).

Series	Counterparty	Counterparty Credit Rating Moody's/S&P	Notional Amount	Date of Swap	Maturity Date of Swap	Fixed Rate	Fair Values
15	UBS AG	Aa2/AA+	$19,205	5/8/2003	7/1/2032	3.51%	$ 685
16	Bank of America, N.A.	Aa2/AA-	19,485	9/16/2003	7/1/2032	3.81%	266
17	Bank of America, N.A.	Aa2/AA-	20,000	12/11/2003	7/1/2032	3.73%	253
18	Goldman Sachs Mitsui Marine	Aa3/AA+	20,000	4/20/2004	1/1/2035	3.29%	1,141
			$78,690				$2,345

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 4.05% as of June 30, 2006.

In total, the swaps have a positive fair value of $2.345 million as of June 30, 2006. 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.

Credit risk. All of the Agency's swaps rely upon the performance of the third parties who serve as swap counterparties, and as a result the Agency is exposed to credit risk – i.e., the risk that a swap counterparty fails to perform according to its contractual obligations. The appropriate measurement of this risk at the reporting date is the fair value of the swaps, as shown in the column labeled "Fair Values" in the table above. The Agency is exposed to credit risk in the amount of any positive net fair value exposure to each counterparty. As of June 30, 2006, the Agency was exposed to a total of $2.345 million of credit risk to 3 counterparties. To mitigate credit risk, the Agency maintains strict credit standards for swap counterparties. Additionally, credit events can trigger certain termination provisions or collateral provisions as outlined in the swap documents.

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 swap 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.

	Principal or Notional Amount (dollars in thousands)				
Bond Series	Counterparty1	Counterparty 2	Counterparty 3	Series Total	Call Date / Swaption 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	$ 337,977	$ 202,787	$ 135,191	$ 675,955	

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 million 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. The terms of the swaptions are listed below, which include counterparty credit ratings as of June 30, 2006.

	Based on Respective Notional Amounts			
Counterparty	Swaption Annuity Payment Received	Fixed Rate Paid by the State	Variable Rate Received by the State	Counterparty Credit Rating Moody's/S&P
Counterparty 1	28 Basis Points	4.8%	BMA	Aa2/AA-
Counterparty 2	28 Basis Points	4.8%	BMA	Aa3/A+
Counterparty 3	28 Basis Points	4.8%	BMA	Aaa/AAA

Fair value. As of June 30, 2006, the swaptions had fair values of negative $10.03 million (Counterparty 1), negative $5.62 million (Counterparty 2) and negative $3.66 million (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, 2006, 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 4.8% fixed rate.

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, 2006 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

	Governmental Activities						
	General Obligation Bonds			Certificates of Participation		Lease-Purchase Revenue Bonds	
Fiscal Year Ending June 30	Principal	Interest	Interest Rate Swaps, Net	Principal	Interest	Principal	Interest
2007	$ 343,615	$ 268,712	$ (1,215)	$ 21,420	$ 21,648	$ 10,000	$ 11,712
2008	342,715	253,461	(1,215)	21,760	20,824	10,000	11,374
2009	339,320	237,177	(1,215)	22,110	19,925	10,000	11,041
2010	339,200	220,893	(1,215)	22,470	18,963	10,000	10,615
2011	339,360	204,143	(1,215)	22,880	18,026	10,000	10,154
2012-2016	1,708,610	770,067	(4,693)	121,475	73,294	50,000	43,665
2017-2021	1,566,240	372,748	(824)	134,460	41,829	78,000	30,116
2022-2026	726,755	83,050	—	87,485	9,525	77,045	5,889
2027-2031	33,000	1,485	—	—	—	—	—
Total	$ 5,738,815	$ 2,411,736	$ (11,592)	$ 454,060	$ 224,034	$ 255,045	$ 134,566

	Governmental Activities		Business-type Activities				
	Notes Payable		Revenue Bonds			Notes Payable	
Fiscal Year Ending June 30	Principal	Interest	Principal	Interest	Interest Rate Swaps, Net	Principal	Interest
2007	$ 26,334	$ 4,527	$ 280	$ 290	$ 71	$ 112	$ —
2008	10,060	1,277	295	280	69	112	—
2009	4,281	801	305	270	66	112	—
2010	2,594	672	320	259	64	112	—
2011	1,779	590	335	248	61	112	—
2012-2016	15,793	1,924	1,910	1,055	260	561	—
2017-2021	—	—	2,380	691	170	336	—
2022-2026	—	—	2,975	235	58	—	—
Total	$ 60,841	$ 9,791	$ 8,800	$ 3,328	$ 819	$ 1,457	$ —

The general obligation bonds include $355 million of variable rate debt without interest rate swaps. For this debt, the variable interest rates change on a weekly basis and are based on the rate paid by each bank. The banks base their rate on what they perceive to be the market (7-day) for debt of this type given the credit standing of the unit of government. The general obligation bonds also include $499.87 million of variable rate debt with interest rate swaps (see Note 7E).

Component Units

	University of North Carolina System						
	Revenue Bonds			Certificates of Participation		Notes Payable	
Fiscal Year Ending June 30	Principal	Interest	Interest Rate Swaps, Net	Principal	Interest	Principal	Interest
2007	$ 72,764	$ 91,829	$ 183	$ 1,755	$ 863	$ 38,344	$ 4,392
2008	73,980	88,209	177	1,810	1,182	16,864	3,375
2009	76,660	84,728	195	1,870	1,128	17,140	2,779
2010	76,335	81,063	263	1,930	1,064	17,372	2,172
2011	77,810	77,800	254	2,000	989	6,230	1,649
2012-2016	405,350	336,556	1,042	7,350	3,739	3,200	7,324
2017-2021	373,509	247,834	480	2,435	2,858	—	6,903
2022-2026	319,610	167,614	(65)	3,035	2,251	—	6,903
2027-2031	164,985	111,504	(27)	3,820	1,467	—	6,903
2032-2036	378,380	46,053	—	3,785	447	29,500	5,356
Total	$ 2,019,383	$ 1,333,190	$ 2,502	$ 29,790	$ 15,988	$ 128,650	$ 47,756

	Revenue Bonds				
	North Carolina Housing Finance Agency			State Education Assistance Authority	
Fiscal Year Ending June 30	Principal	Interest	Interest Rate Swaps, Net	Principal	Interest
2007	$ 178,050	$ 73,845	$ (61)	$ —	$ 117,324
2008	74,735	66,879	(62)	—	117,324
2009	36,995	64,668	(61)	—	117,324
2010	38,755	63,101	(61)	—	117,324
2011	39,800	61,376	(55)	—	117,324
2012-2016	225,885	275,739	(212)	540,704	546,804
2017-2021	207,550	217,645	(132)	325,000	415,722
2022-2026	252,290	167,393	(81)	—	352,965
2027-2031	328,120	88,274	(32)	270,000	310,197
2032-2036	168,880	21,972	—	1,422,950	157,733
2037-2041	13,820	1,162	—	—	—
Total	$ 1,564,880	$ 1,102,054	$ (757)	$ 2,558,654	$ 2,370,041

For revenue bonds of the University of North Carolina System and the State Education Assistance Authority, the fiscal year 2007 principal requirements exclude demand bonds classified as current liabilities (see Note 7D).

H. Bond Defeasances

The State and its component units have defeased certain bonds through current and/or advance refundings. New debt proceeds from current refundings may be used to repay the old debt immediately while new debt proceeds from advance refundings are placed 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.

Component Units

University of North Carolina System

University of North Carolina at Chapel Hill

On August 30, 2005, the University issued $404.96 million in General Revenue and Revenue Refunding Bonds, Series 2005A, with an average interest rate of 4.9%. The refunding component of this bond was used to advance refund $6.25 million of outstanding Housing System Revenue Bonds, Series 1997A, with an average interest rate of 4.98%; $9.9 million of Parking System Revenue Bonds, Series 1997A, with an average interest rate of 5.6%; $8.75 million of Student Fee Revenue Bonds, Series 2000, with an average interest rate of 5.36%; and $33.31 million of General Revenue Bonds, Series 2001A, with an average interest rate of 5.23%. This advance refunding was undertaken to reduce total debt service payments by $4.16 million over the next 23 years and resulted in an economic gain of $3.42 million. At June 30, 2006, the outstanding balance was $5.85 million for the defeased Housing System Revenue Bonds, Series 1997A; $9.9 million for the defeased Parking System Revenue Bonds, Series 1997A; $8.75 million for the defeased Student Fee Revenue Bonds, Series 2000; and $33.31 million for the defeased General Revenue Bonds, Series 2001A.

State Education Assistance Authority

On October 27, 2005, the Authority issued $506.3 million in Series 2005A Student Loan Revenue Bonds with an average interest rate of 4.03%. The refunding component of this issue was used for a current refunding of $12.35 million of outstanding Series 1995A Student Loan Revenue Bonds with an average interest rate of 6.19%. The refunding was undertaken to reduce total debt service payments by $2.03 million over the next 9 years and resulted in an economic gain of $1.61 million.

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, 2006, the outstanding balance of prior year defeased bonds was $1.3 billion for the primary government and $79.1 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 12 years after the date of issue.