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, 2009. 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 decreased by $2.265 billion or 7.1% as a result of this year's operations. Net assets of governmental activities decreased by $1.2 billion, or 4%, due to the unprecedented declines in tax revenues. Net assets of business-type activities decreased by $1.065 billion, or 56.15%, due to a substantial operating loss in the Unemployment Compensation Fund. At year-end, net assets of governmental activities and business-type activities totaled $28.806 billion and $831.605 million, respectively.

— Component units reported net assets of $16.417 billion, a decrease of $412.655 million or 2.45% from the previous year. The majority of the net asset decrease is attributable to the University of North Carolina System, a major component unit.

Fund Financial Statements:

— The fund balance of the General Fund decreased from $1.678 billion at June 30, 2008 (as restated) to negative $775.864 million at June 30, 2009. The State appropriated most of the beginning unreserved fund balance, appropriated $1.155 billion of federal recovery funds, reduced expenditures, and transferred amounts from other funds to finance a revenue shortfall of $2.983 billion.

— The fund balance of the State Highway Fund increased from $975.885 million at June 30, 2008 (as restated) to $1.021 billion at June 30, 2009, an increase of 4.65%. The fund balance growth, which was attributable to increases in federal funds, was partly offset by decreases in gasoline taxes and motor vehicle fees.

— The fund balance of the Highway Trust Fund decreased from negative $158.753 million at June 30, 2008 (as restated) to negative $169.629 million at June 30, 2009, a decrease of 6.85%. Decreases in highway use taxes, gasoline taxes, and motor vehicle fees contributed to the larger fund deficit.

— The net assets of the Unemployment Compensation Fund decreased from $847.69 million at June 30, 2008 to negative $298.761 million at June 30, 2009. The decrease is directly related to the rise in North Carolina's seasonally adjusted unemployment rate from 6.1% in June 2008 to 11% in June 2009.

— Net ticket sales of the N.C. State Lottery Fund (Lottery) increased 22.4% from the previous fiscal year, surpassing $1 billion for the second straight year. As required by law, the Lottery's net profit of $413.929 million was transferred to the Education Lottery Fund (nonmajor special revenue fund) to support educational programs.

Capital Assets:

— The State's investment in capital assets (net of accumulated depreciation) was $34.314 billion, an increase of 4.91% from the previous fiscal year-end.

— This year's major capital asset additions were for highway construction ($1.3 billion), highway land improvements ($477 million), construction of correctional facilities ($51 million), and construction of youth development centers ($34 million).

Long-term Debt:

— The State had total long-term debt outstanding (general obligation bonds, special indebtedness, and GARVEE bonds, adjusted for deferred amounts) of $7.368 billion, an increase of 1.87% from the previous fiscal year-end. The State issued $600 million of limited obligation bonds to finance various State and university capital projects.

— North Carolina remains one of only seven states to enjoy top-tier rankings (i.e., AAA) from all three credit rating agencies.

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 and other postemployment benefits 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 54) 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 56 and 57) 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:
<u>Governmental Activities</u> – Most of the State's basic services are reported under this category. Taxes and intergovernmental revenues generally fund these services.

<u>Business-type Activities</u> – 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.

<u>Discretely Presented Component Units</u> – 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 76. 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 165 and 166).

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 192 begins the individual fund data for the nonmajor 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 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 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 74 of this report.

Required Supplementary Information

Required Supplementary Information (RSI) follows the basic financial statements and notes to the 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 fund balances at fiscal year-end, and pension plan and other postemployment benefits trend information related to funding progress and contributions.

Other Supplementary Information

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

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 decreased $2.265 billion or 7.1% over the course of this fiscal year's operations. The net assets of the governmental activities decreased $1.2 billion or 4% and business-type activities decreased $1.065 billion or 56.15%. The following table was derived from the government-wide Statement of Net Assets:

Net Assets
June 30, 2009 and 2008
(dollars in thousands)

	Governmental Activities		Business-type Activities		Total Primary Government	
	2009	2008	2009	2008	2009	2008
Current and other non-current assets	$ 10,048,969	$ 15,223,629	$ 1,829,597	$ 2,252,278	$ 11,878,566	$ 17,475,907
Capital assets, net	34,283,111	32,675,405	30,612	32,063	34,313,723	32,707,468
Total assets	44,332,080	47,899,034	1,860,209	2,284,341	46,192,289	50,183,375
Long-term liabilities	8,691,184	8,578,101	5,441	4,682	8,696,625	8,582,783
Other liabilities	6,835,004	9,314,580	1,023,163	383,359	7,858,167	9,697,939
Total liabilities	15,526,188	17,892,681	1,028,604	388,041	16,554,792	18,280,722
Net assets:						
Invested in capital assets, net of related debt	32,348,957	30,984,578	30,612	32,063	32,379,569	31,016,641
Restricted	715,546	877,915	1,003,613	1,773,018	1,719,159	2,650,933
Unrestricted	(4,258,611)	(1,856,140)	(202,620)	91,219	(4,461,231)	(1,764,921)
Total net assets	$ 28,805,892	$ 30,006,353	$ 831,605	$ 1,896,300	$ 29,637,497	$ 31,902,653

The largest component of the State's net assets ($32.38 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 ($1.719 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 $4.259 billion unrestricted net asset balance. The State of North Carolina, like many other state and local governments, issues general obligation debt and special indebtedness 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 $7.368 billion of bonds and special indebtedness outstanding at June 30, 2009, $5.319 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, 2009, the State's governmental activities have significant unfunded liabilities for a court judgment payable of $731.703 million and compensated absences of $424.281 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, 2009 and 2008
(dollars in thousands)

	Governmental Activities		Business-type Activities		Total Primary Government	
	2009	2008	2009	2008	2009	2008
Revenues:						
Program revenues:						
Charges for services	$ 2,137,273	$ 2,181,235	$ 2,452,021	$ 2,237,965	$ 4,589,294	$ 4,419,200
Operating grants and contributions	14,123,077	12,301,356	1,120,736	83,695	15,243,813	12,385,051
Capital grants and contributions	1,035,742	826,646	125	6,589	1,035,867	833,235
General revenues:						
Taxes						
Individual income tax	8,661,565	10,676,156	—	—	8,661,565	10,676,156
Corporate income tax	997,206	1,357,670	—	—	997,206	1,357,670
Sales and use tax	4,911,656	5,159,453	—	—	4,911,656	5,159,453
Gasoline tax	1,523,496	1,579,847	—	—	1,523,496	1,579,847
Franchise tax	799,113	738,741	—	—	799,113	738,741
Highway use tax	440,749	566,132	—	—	440,749	566,132
Insurance tax	500,438	505,936	—	—	500,438	505,936
Beverage tax	263,553	258,193	—	—	263,553	258,193
Inheritance tax	103,811	158,178	—	—	103,811	158,178
Tobacco products tax	242,071	249,664	—	—	242,071	249,664
Other taxes	316,819	339,109	—	—	316,819	339,109
Tobacco settlement	175,838	168,583	—	—	175,838	168,583
Unrestricted investment earnings	106,738	238,239	—	—	106,738	238,239
Miscellaneous	66,500	49,345	—	—	66,500	49,345
Total revenues	36,405,645	37,354,483	3,572,882	2,328,249	39,978,527	39,682,732
Expenses:						
General government	1,329,539	1,232,088	—	—	1,329,539	1,232,088
Primary and secondary education	10,098,851	10,631,920	—	—	10,098,851	10,631,920
Higher education	3,951,862	4,207,410	—	—	3,951,862	4,207,410
Health and human services	16,179,227	14,951,585	—	—	16,179,227	14,951,585
Economic development	637,876	746,471	—	—	637,876	746,471
Environment and natural resources	722,722	753,909	—	—	722,722	753,909
Public safety, corrections and regulation	2,742,952	2,627,007	—	—	2,742,952	2,627,007
Transportation	1,970,408	1,941,207	—	—	1,970,408	1,941,207
Agriculture	110,314	119,297	—	—	110,314	119,297
Interest on long-term debt	289,211	304,020	—	—	289,211	304,020
Unemployment compensation	—	—	3,255,448	1,002,866	3,255,448	1,002,866
N.C. State Lottery	—	—	877,403	712,718	877,403	712,718
EPA Revolving Loan	—	—	7,868	12,454	7,868	12,454
Regulatory commissions	—	—	37,644	34,791	37,644	34,791
Insurance programs	—	—	14,970	17,556	14,970	17,556
North Carolina State Fair	—	—	14,053	12,828	14,053	12,828
Other business-type activities	—	—	6,583	6,364	6,583	6,364
Total expenses	38,032,962	37,514,914	4,213,969	1,799,577	42,246,931	39,314,491
Increase (decrease) in net assets before contributions and transfers	(1,627,317)	(160,431)	(641,087)	528,672	(2,268,404)	368,241
Contributions to permanent funds	3,248	3,894	—	—	3,248	3,894
Transfers	423,608	346,848	(423,608)	(346,848)	—	—
Increase (decrease) in net assets	(1,200,461)	190,311	(1,064,695)	181,824	(2,265,156)	372,135
Net assets - beginning - restated	30,006,353	29,816,042	1,896,300	1,714,476	31,902,653	31,530,518
Net assets - ending	$ 28,805,892	$ 30,006,353	$ 831,605	$ 1,896,300	$ 29,637,497	$ 31,902,653

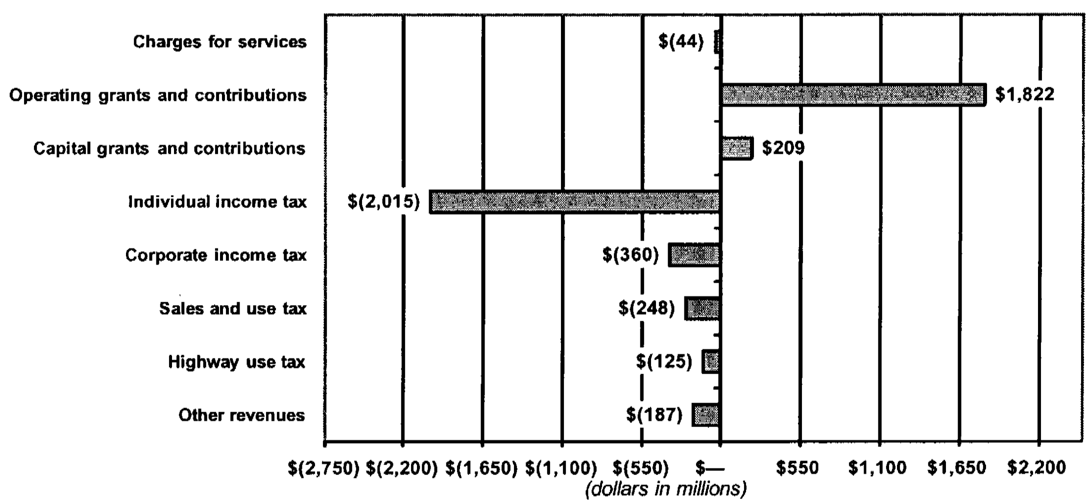
Governmental Activities

The downturn in the State and national economy translated into unprecedented declines in tax revenues for the 2009 fiscal year, resulting in a $1.2 billion decrease in net assets of governmental activities. Even after the recognition of federal recovery funds, total revenues decreased by 2.54% to $36.406 billion. Total expenditures grew slowly at 1.38% to $38.033 billion. The slow growth in total expenditures is attributable to the significant decline in tax revenues and by the actions taken by the Governor during the fiscal year to reduce spending. However, transfers-in were higher in fiscal year 2009 due to the larger net profits achieved by the N.C. Education Lottery, a business-type activity.

On February 17, 2009 the U.S. Congress enacted the American Recovery and Reinvestment Act of 2009 (ARRA). A direct response to the economic crisis, the ARRA has three immediate goals: 1) create new jobs as well as save existing ones, 2) spur economic activity and invest in long-term economic growth, and 3) foster unprecedented levels of accountability and transparency in government spending. To help achieve these goals, the ARRA assisted states with their budget shortfalls. The ARRA provides that funds be distributed over three years: 2009, 2010, and 2011. In response to this legislation, the Governor established the North Carolina Office of Economic Recovery and Investment to coordinate the State's handling of ARRA funds and state-level economic recovery initiatives. During the 2009 fiscal year, the State recognized $1.165 billion of ARRA funds (federal recovery funds), which are included in operating grants and contributions (i.e., program revenues).

The following chart reflects the dollar change in the revenues by source of governmental activities between fiscal years 2008 and 2009:

Dollar Change in Governmental Activities Revenues by Source Between Fiscal Years 2008 and 2009



Spending decreased in the majority of the State's functional areas, with the major exceptions being general government; health and human services; and public safety, corrections, and regulation. Primary and secondary education had the largest decrease in dollars, which was due primarily to a court judgment rendered against the State in the previous fiscal year. In 2008, a Superior Court judge ruled that the State owed $749.886 million for certain civil fines and penalties that should have been remitted to North Carolina public schools and not diverted to other uses (see Note 21 to the financial statements). Despite enrollment increases, higher education expenses fell in fiscal year 2009 due to significant budget cuts and to larger distributions of higher education bond proceeds in the previous fiscal year. The increase in general government expenses was due primarily to the General Assembly appropriating $250 million to the State Health Plan to pay claims expenses and to resolve cash flow issues.

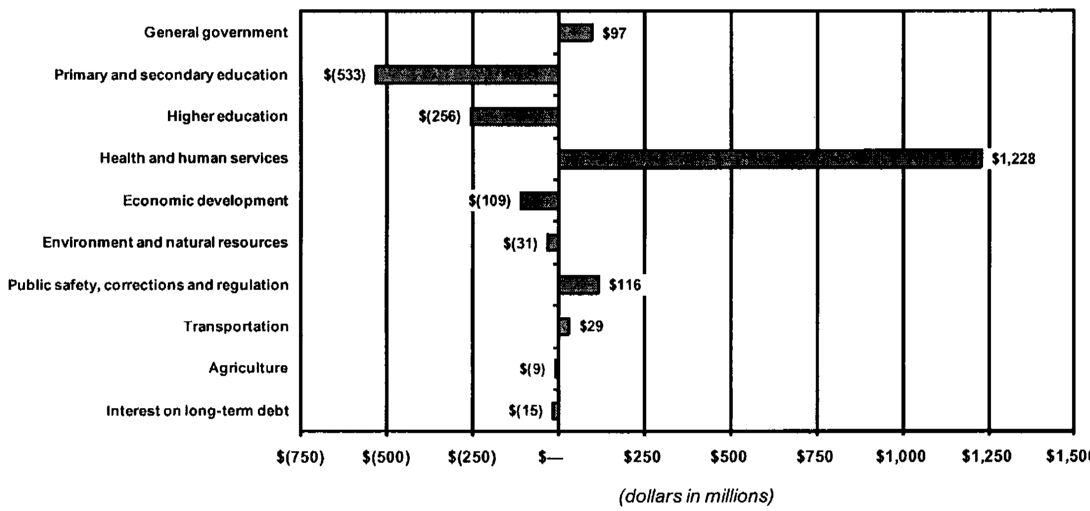
Higher education expenses are financed primarily by State appropriations. The State Constitution provides that "the benefits of the University North Carolina and other public institutions of higher education, as far as practicable, be extended to the people of the State free of expense."

The growth in health and human services is the result of increased spending for Medicaid (the State's largest public assistance program). The State experienced a substantially increased enrollment in the Medicaid program due to the economic downturn in North Carolina. Because the State receives federal matching funds for the Medicaid Program, there was also a corresponding increase in operating grants and contributions (i.e., program revenues).

Medicaid is a federal entitlement program, which means individuals found eligible for Medicaid have legal rights to receive services and cannot be denied coverage by the State. In North Carolina, Medicaid is administered by the State and counties and financed with federal, State, and county funds. Higher growth rates occur during years of economic distress and when major Medicaid expansions are enacted. Lower growth rates occur when the Medicaid eligible population is stable or declining.

The following chart reflects the dollar change in the functional expenses of governmental activities between fiscal years 2008 and 2009:

Dollar Change in Governmental Activities Functional Expenses Between Fiscal Years 2008 and 2009

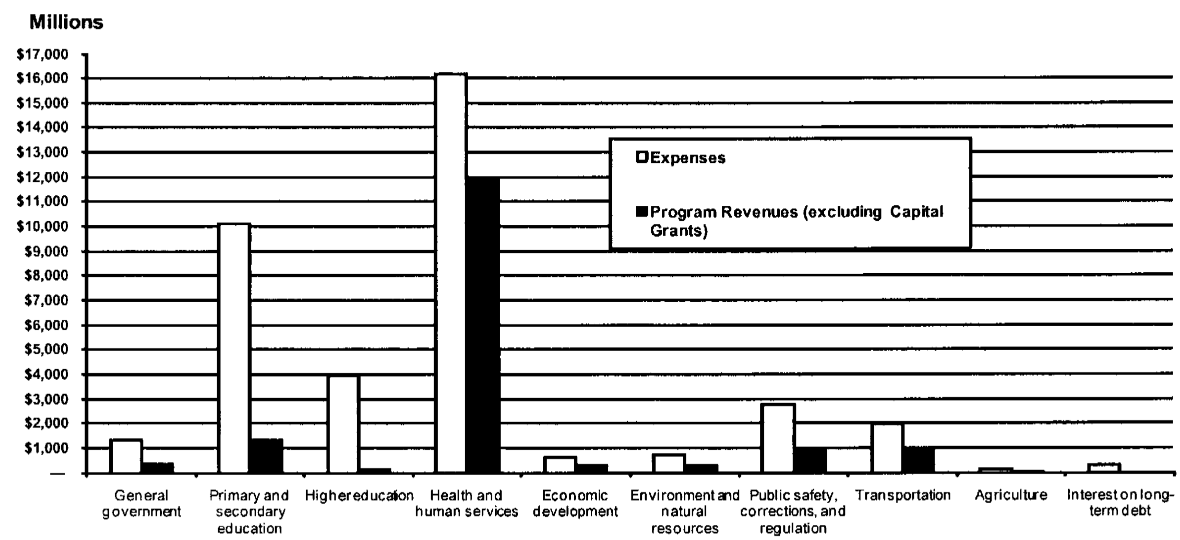


The 2007 Session of the General Assembly enacted legislation requiring the State to assume the counties' share of the nonfederal share of Medicaid costs over a three-year period, beginning October 1, 2007. To provide resources to assume these costs, the legislation phases out the local sales tax by one-half cent and makes a corresponding increase in the State sales tax rate. Below is a schedule of the Medicaid funding changes and the shift in local sales tax to the State:

Date	Medicaid Funding Change	Shift Local Sales Tax to State
10-01-07	State assumes 25% of counties' share	
7-01-08	State assumes 50% of counties' share	
10-01-08		50% of ½% local sales tax is shifted to State
7-01-09	State assumes 100% of counties' share	
10-01-09		Remaining 50% is shifted to State

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, 2009



Business-type Activities

Business-type activities reflect an overall decrease in net assets of $1.065 billion or 56.15%, primarily because of the financial results of the Unemployment Compensation Fund. For fiscal year 2009, the Unemployment Compensation Fund had an operating loss (excess of operating expenses over operating revenues) of $2.177 billion. The Unemployment Compensation Fund and the EPA Revolving Loan Fund comprise over 84% 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 $2.889 billion, a decrease of 48.97% from the prior fiscal year-end (as restated). The primary contributor to the decline was the General Fund, which had a $2.454 billion decrease in fund balance in 2009. The substantial decrease in total fund balance of governmental funds was partially offset by the receipt of federal recovery funds, primarily in the General Fund, and by unspent debt proceeds reported in other governmental funds. The State issued debt in the current fiscal year for state and university capital improvement projects. 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 declined substantially from $1.678 billion at June 30, 2008 (as restated) to negative $775.864 million at June 30, 2009. For fiscal year 2009, the State appropriated most of the beginning unreserved fund balance, appropriated $1.155 billion of federal recovery funds, reduced expenditures, and transferred amounts from other funds (and statutory reserves) to finance a General Fund revenue shortfall (excess of total expenditures over total revenues) of $2.983 billion. Despite the receipt of federal recovery funds, total revenues of the General Fund decreased for the first time in seven years. General Fund tax revenues decreased dramatically. A sharp rise in the State's unemployment rate contributed to a 2% decline in withholding tax payments by employers and a 31.1% decline in final income tax payments by taxpayers. Refunds of individual income taxes increased 13.8%. Additionally, the tax rate on higher income taxpayers was reduced from 8% to 7.75% for tax year 2008. Corporate income taxes, which are highly volatile over the business cycle, decreased by 25.61%. Even with a rise in the State sales and use tax from 4.25% to 4.5%, effective October 1, 2008, sales and use tax revenues decreased by 4.94%. The rise in the State unemployment rate contributed to a downturn in consumer spending. The housing sector was impacted most by the decline. A more detailed analysis of the General Fund is provided in the budgetary highlights section below.

2008-09 General Fund Budgetary Highlights

Because of recessionary economic conditions in the nation and North Carolina, the Governor became aware that actual receipts for the current fiscal year would not meet expenditures anticipated and budgeted by the 2008 General Assembly. Accordingly, on January 13, 2009, the Governor issued Executive Order No. 6, *Budget Administration Due to National Economic Slowdown*, to ensure that a deficit was avoided. The State Constitution requires the Governor to affect the necessary economies in State expenditures to maintain a balanced budget.

Executive Order No. 6 ordered the Office of State Budget and Management to do the following: 1) reduce, as necessary, State expenditures from funds appropriated to operate State departments and institutions, resulting in reversions of $1.7 billion, 2) halt expenditures for capital improvement projects for which State funds have been appropriated but not placed under State contract, resulting in reversions of $175.9 million ($40 million was also transferred from capital improvement projects that were completed but had unexpended funds), 3) transfer, as necessary, non-General Fund and non-Highway Fund receipts into the General Fund to support appropriation expenditures, which included $386.6 million from the Rainy Day Fund, $337.5 million of cash balances from other funds, and $10.1 million from three other statewide reserves, and 4) other steps as specified in the Order.

The single largest funding priority of the General Assembly was compensation increases for teachers and State employees, which totaled $368 million. Teachers and instructional support staff received an average increase of 3%. University and community college faculty also received an additional 3%. Most of the other State-funded positions received increases of 2.75%.

The State Health Plan (Plan) required additional funding in fiscal year 2009. Budget projections originally developed at the beginning of the fiscal biennium indicated that the Plan's cash balance would decrease by $61.8 million in fiscal year 2009. The Plan developed a revised budget for fiscal year 2009 as a result of its financial performance in fiscal year 2008 and to address forecasting concerns. The Plan's revised budget projected a $124.7 million cash shortfall at year-end. The General Assembly appropriated $250 million from the State's Savings Reserve Account to cover the shortfall and to ensure the Plan had sufficient cash reserves to start the 2010 fiscal year.

One of the major budget drivers for the General Fund is the Medicaid Program. In recent years, annual increases have averaged over 10%, primarily due to increases in caseload and overall health care costs. State funding for the Medicaid Program totaled $3.18 billion in 2008-09 (compared to $2.92 billion in 2007-08) and the total Medicaid budget was $11.74 billion. During the current fiscal year, the Medicaid Program experienced substantial increases in enrollment as a result of the economic downturn, and this growth has continued in fiscal year 2010. In response, the State has implemented significant changes designed to reduce the overall expenditures of the program, while attempting to preserve access to critical services. Legislative changes include reductions in provider rates, changes in programs and clinical policy, increasing recipient co-pays, implementing or modifying specific contracts to reduce costs or improve drug rebates, and eliminating both vacant and filled positions. Overall, these changes will result in approximately $1.5 billion of total expenditures (federal and state) being removed from the Medicaid Program in fiscal year 2010. During the 2007 legislative session, the General Assembly enacted Session Law 2007-323, a historical fiscal policy change that began a three-year phase-out of the financial participation of county governments in covering the cost of Medicaid.

The new Central Regional Hospital in Butner opened in September 2008 and will serve patients from 26 counties. This hospital is the first of three new state-operated psychiatric hospitals being built in North Carolina.

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 State 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 2008-09 fiscal year was prepared by the Governor's staff approximately 18 months prior to the beginning of fiscal year 2008-09 and 30 months prior to the final budget existing at June 30, 2009. The final budget reflects all budget revisions made throughout the fiscal year to adjust for known facts as well as supplemental adjustments approved in the 2008 Short Session of the General Assembly. Therefore, the original budget is an estimate based on information that is 18 months old. Consequently, when the original budget is compared to the final budget, it would be expected that significant variances can occur.

Additional factors leading to variances between original and final budget in fiscal year 2008-09 include the following:

1) Awarding of new unanticipated federal grants and/or the awarding of unanticipated increased or decreased amounts in long-standing federally supported programs. This also leads to the necessity of budgeting the unanticipated required state match.
2) Statewide encumbrance carry-forward budgeted amounts from fiscal year 2007-08 totaled $354.6 million.
3) Allocation of statewide reserves to agencies and universities for the purposes of legislative increases, salary adjustments, retirement and hospitalization formula adjustments, contingency and emergency, and information technology related programs, and other budgeted statewide reserves.
4) Receipt of and budgeting of over-realized receipts, prior year earned revenues, and unanticipated donations or grants.
5) Inaccurate and unreasonable revenue and expenditure budget amounts entered by the agency during the continuation budget preparation process.
6) Budgeting of American Recovery and Reinvestment Act federal funds that increased the final revenue and expenditure budgets.

Variances - Final Budget and Actual Results

Actual total revenue collected (both tax and non-tax) was significantly below budgeted amounts in fiscal year 2008-09. Similar to the experience in many other states, the December 2008 recession caused unprecedented declines in North Carolina's revenue collections. While North Carolina's revenue forecast anticipated a slowdown, it did not expect a financial market collapse and major recession. This translated into historic declines in sales and use tax collections and individual income tax collections, North Carolina's two largest revenue sources.

Departmental federal funds actually received by agencies were less than the final authorized budgeted federal fund revenues. A variance between the budget and actual federal funds will usually occur because federal fund actual receipts are reflective of the actual expenditures. Therefore, if qualifying federal costs are not incurred by an agency, the actual receipt of federal funds could be significantly less than what has been budgeted.

The expenditure variances between the final budget and actual for the functional areas of education; health and human services; and public safety, correction, and regulation is primarily a result of the revenue shortfall during fiscal year 2008-09. Measures taken by the Governor to prevent expenditures that exceeded the tax and non-tax revenue collected included a significant reduction in the allotment of cash to all state agencies, universities and institutions. Therefore, expenditures and requirements that are dependent upon the receipts of these revenues could not occur.

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 (NCDOT), including the maintenance and construction of the State's primary and secondary road systems, the Division of Motor Vehicles, the State Highway Patrol, transit, rail and ferry system. 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 $975.885 million at June 30, 2008 (as restated) to $1.021 billion at June 30, 2009, an increase of 4.65%. Total revenues increased by $97.5 million or 3.41% primarily because of an increase in federal funds, grant anticipation revenue vehicle (GARVEE) debt service reimbursement, increased apportionments for the National Highway System Program and an increase in the Obligation Formula Limit allowed NCDOT to increase billings from the Federal Highway Administration resulting in an increase in federal revenues. However, the increase in federal funds was partially offset by decreases in gasoline taxes, investment earnings, and Division of Motor Vehicle (DMV) fees. Although wholesale gasoline and diesel prices were down in fiscal year 2009 compared to 2008, overall consumption decreased from the previous year especially in the diesel category which was down 11.39%. This resulted in an overall decrease of $46.34 million or 3.98% in gasoline taxes in the Highway Fund. In the previous fiscal year, $287.57 million in GARVEE's were issued. This innovative financing tool was used to accelerate the funding of transportation improvement projects across the State by leveraging future federal transportation revenues. At June 30, 2009, $51.99 million of the GARVEE proceeds were unspent. In August 2009, $242.52 of additional GARVEE bonds were issued.

Transportation expenditures decreased by $83.23 million or 3.07%. In response to declining revenues early in the fiscal year, NCDOT initiated a hiring and salary freeze and requested all business units reduce spending by 6%. Contract lettings for various transportation improvement projects were also delayed due to the economic conditions. Debt service expenditures increased significantly due to the GARVEE bonds issued in the previous fiscal year.

Population growth is placing an increasing demand on the State's transportation system. North Carolina's population grew from 8.05 million in 2000 to 9.39 million in 2009, an increase of 16.65%. This growth is expected to continue for the foreseeable future. The U.S. Census estimates North Carolina's population growing to approximately 12.2 million by 2030, which would place the state as the seventh most populated state in the country. According to the 2008 Report on the Condition of the State Highway System prepared by the Division of Highways, over the past 10 years (1998 to 2007), the number of paved miles increased by almost 11% and the square footage of bridge deck area grew by over 23%. During this same 10 year period, vehicle miles traveled increased by over 26%. This rapid increase in vehicle miles traveled places a heavier burden on the existing infrastructure and accentuates the need for additional capacity, safety, and maintenance funding to address the deterioration in service created by the increase in traffic. Furthermore, many of the State's highways were built as farm-to-market roads and were not designed to handle the heavy traffic volumes of today and other highways such as the interstate highway system, which has celebrated its 50th anniversary, are nearing the end of their functional life.

Transportation is fundamental in continuing North Carolina's prosperity and quality of life as the state's population continues to grow. To address the growing demand on the transportation system, increased cost of supplies, and declining funding, NCDOT continues to seek innovative solutions to meet the growing stress on the transportation system. In response to declining motor fuels tax and the decreasing purchasing power of the Highway Fund, Session Law 2009-108 repealed the cap on the motor fuels tax and set the variable portion of the tax at 12.4 cents per gallon or 7% of the average wholesale price whichever is greater, thus setting a floor of 29.9 cents per gallon. This will remain in place through June 30, 2011.

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 a specific set of highway construction needs in North Carolina. Additionally, the Highway Trust Fund provides supplemental allocations for secondary road construction, supplemental assistance to municipalities for local street projects, and 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 2009 and 2008 were $147.53 million and $172.54 million, respectively.

The fund balance of the Highway Trust Fund decreased from negative $158.753 million at June 30, 2008 (as restated) to negative $169.629 million at June 30, 2009, a decrease of 6.85%. Total revenues decreased by $158.4 million or 14.8% primarily because of decreases in highway use taxes, gasoline taxes, and DMV fees. The highway use tax, 3% on most sales, represents a major funding source for the Highway Trust Fund. Due to the economic downturn of 2009, the decrease in auto sales resulted in a $125.4 million or 22.15% decrease in use taxes along with a $15 million decrease in title fees. The factors contributing to the decrease in gasoline tax revenues were discussed previously in the analysis of the Highway Fund. Total expenditures decreased by $127.3 million or 14.92%. Moving Ahead construction expenditures decreased by $23 million as the program continues project completions. Intrastate expenditures decreased by $170.7 million due to the completion or near completion of several projects including the US70 Clayton Bypass. Prior year sub-recipient expenditures were reclassified for $85 million from the Highway Fund to the Highway Trust Fund.

The 2008 Report on the Condition of the State Highway System also noted that since passage of the Highway Trust Fund in 1989, the Department of Transportation has paved over 10 thousand miles of unpaved secondary roads, leaving only 3,400 miles of secondary roads to be paved. In view of the fact that the paved secondary road system has not kept up with the demands of increased urbanization and traffic, the 2006 Session of the General Assembly approved changes in the General Statutes that govern the use of secondary road construction funds. House Bill 1825, effective July 1, 2006 until June 30, 2010, allows the use of these funds, originally designated to pave secondary roads, on the paved secondary road system in order to improve their functionality through safety, modernization, and condition improvements.

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) decreased from $847.69 million at June 30, 2008 to negative $298.761 million at June 30, 2009. This decrease is directly related to the decline in the State and national economies. Over the last 12 months, North Carolina employment is down by over 197 thousand workers and unemployment has increased by over 224 thousand people. During this same period, North Carolina's seasonally adjusted unemployment rate rose from 6.1% in June 2008 to 11% in June 2009. The largest employment losses were realized in the following sectors: Manufacturing (-73,600), Construction (-43,300), Professional and Business Services (-41,100), and Trade, Transportation, and Utilities (-38,700).

The Trust Fund's operating margin (operating revenues less operating expenses) was negative $2.177 billion this year compared to $90.44 million in 2008. Unemployment benefit expenses increased 225% in fiscal year 2009 to $3.253 billion. Because of depleted cash balances, the Trust Fund borrowed funds from the U.S. Treasury, beginning in February 2009, to ensure uninterrupted payment of unemployment benefits. At June 30, 2009, the short-term debt balance was $728.773 million compared to zero at the previous fiscal year-end. These advances will be repaid with subsequent employer contributions. It is anticipated that this borrowing will continue through the next fiscal year-end. The advances from the U.S. Treasury are currently interest free through December 31, 2010. A 20% surcharge on unemployment contributions, effective January 1, 2005 as required by statute, remained in effect during the current fiscal year. The surcharge is still in effect because the balance in the Trust Fund has not reached the trigger "off" level.

During this period of high unemployment, the federal government has provided various types of assistance to extend benefits. This year, the State received multiple types of assistance that are classified as nonoperating revenues. They are as follows:

1. The Emergency Unemployment Compensation extension began in July 2008 and provided $714 million in assistance. This program was extended in February 2009 and the extension provided an additional $136 million in benefits.
2. In February 2009, the American Recovery and Reinvestment Act provided additional assistance in two forms:
   - The Federal Additional Compensation program provided an additional $25 a week to every benefit payment. The State began making payments in April and provided an additional $132 million in assistance through June 30, 2009.
   - The Extended Benefit (EB) and High Unemployment Period 100% programs were implemented where the Federal government pays 100% of the benefits for those states that have triggered on to EB. The State began making payments in April and provided an additional $19 million in benefits through June 30, 2009.

N.C. State Lottery Fund

The N.C. Education Lottery (NCEL) first began selling game tickets on March 30, 2006 (instant game) and first began selling multi-state on-line (Powerball) game tickets on May 30, 2006. As required by enabling legislation, net revenues of the NCEL are transferred four times a year to the N.C. Education Lottery Fund (a nonmajor governmental fund). The NCEL transferred $413.929 million to the N.C. Education Lottery Fund in 2009 to support educational programs for the State. The amount transferred in 2008 was $348.31 million. At year end, the net assets of the NCEL are zero. The NCEL has no changes in the net assets from year to year.

For fiscal year 2009, net ticket sales increased 22.4% from the previous fiscal year, surpassing $1 billion for the second straight year. Significant financial highlights include the following: two new instant games were introduced with chances to win lifetime annuities; a third daily draw online game, Carolina Pick 4, was launched in April; the number of retailers was increased to over six thousand; and 45 new instant scratch-off games were created and released every two to four weeks.

The Lottery Commission approved a budget for 2009-10 to provide $370 million to the State's Education Lottery Fund, representing a 4% decrease from the previous year's budget. The budgeted decrease reflects the current economic conditions in the State and its impact on lottery ticket sales. 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 date, 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 $78.419 million during the current fiscal year, an 8.5% increase from the prior fiscal year-end. Operating income was $11.125 million (operating revenues less operating expenses). Net nonoperating revenues were $58.914 million, consisting primarily of federal capitalization grants and investment earnings. The $8.684 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, 2009, the State's investment in capital assets was $34.314 billion, an increase of 4.91% 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	
	2009	2008	2009	2008	2009	2008
Land	$ 11,222,414	$ 10,676,804	$ 3,452	$ 3,452	$ 11,225,866	$ 10,680,256
Buildings	2,024,434	1,865,345	16,587	17,277	2,041,021	1,882,622
Machinery and equipment	669,665	683,829	3,795	4,038	673,460	687,867
Infrastructure:						
State highway system	18,032,846	17,081,956	—	—	18,032,846	17,081,956
Other infrastructure	100,075	97,092	6,246	6,764	106,321	103,856
Intangible assets	103,828	103,423	—	—	103,828	103,423
Art, literature, and other artifacts	67,162	66,389	—	—	67,162	66,389
Construction in progress	2,062,687	2,100,567	532	532	2,063,219	2,101,099
Total	$ 34,283,111	$ 32,675,405	$ 30,612	$ 32,063	$ 34,313,723	$ 32,707,468
Total percent change between fiscal years 2009 and 2008	4.92 %		(4.53)%		4.91 %	

This year's major capital asset additions were for highway construction ($1.3 billion), highway land improvements ($477 million), construction of correctional facilities ($51 million), and construction of youth development centers ($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 2008) noted that while the system continues to grow, the traditional highway maintenance funds have increased, but not enough to keep up with inflation and system growth.

During the 2008-2009 fiscal year, the State completed construction of a 1,000 bed close custody prison in Columbus County. The total cost of this facility was $102.85 million. The primary funding source for this facility was certificates of participation (COPs). In addition, COPs have been authorized for the planning and construction of a new regional 120 bed medical center and 216 bed mental health center to be located at Central Prison in Raleigh. The estimated cost for the construction of the medical and mental health centers is $153.6 million, of which $132.2 million will be financed by COPs. At year-end, construction in progress for the Central Prison medical center totaled $42.1 million. The State has scheduled for closure seven correctional facilities, which will all occur in fiscal year 2010. Also, three facilities will be converted from medium to minimum custody.

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 over 40 thousand inmates as of November 2009. 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 21(F) to the financial statements, the State has commitments of $1.38 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 $761.66 million, which are expected to be financed primarily by debt proceeds (special indebtedness), 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 outstanding (general obligation bonds, special indebtedness, and grant anticipation revenue vehicle (GARVEE) bonds, adjusted for deferred amounts) of $7.368 billion, an increase of 1.87% from the previous fiscal year-end (see table below).

Outstanding Debt as of June 30
(adjusted for deferred amounts, dollars in thousands)

	Governmental Activities	
	2009	2008
General obligation bonds	$ 5,169,265	$ 5,533,760
Special Indebtedness:		
Lease-purchase revenue bonds	225,045	235,045
Certificates of participation	919,585	965,880
Limited obligation bonds	600,000	—
GARVEE bonds	241,820	287,565
Deferred debt premiums	275,131	287,272
Less: Deferred debt discounts and amounts on refundings	(63,011)	(77,049)
Total bonds and similar debt payable	$ 7,367,835	$ 7,232,473
Total percent change between fiscal years 2009 and 2008	**1.87 %**	

During the 2008-09 fiscal year, the State issued $600 million in limited obligation bonds, representing the State's first use of this type of debt. The proceeds of the bonds will be used to finance various State and university capital improvement projects, which were authorized for special indebtedness financing by previous sessions of the General Assembly.

The State issues two types of tax-supported debt: general obligation bonds and various types of "special indebtedness" (i.e., debt not subject to a vote of the people). General obligation bonds are secured by the full faith, credit, and taxing power of the State and require approval by a majority of voters. The payments on special indebtedness are subject to appropriation by the General Assembly and may also be secured by a lien on facilities or equipment. The General Statutes (Chapter 142, Article 9) prohibits the issuance of special indebtedness except for projects specifically authorized by the General Assembly. Different forms of special indebtedness, also known as appropriation-supported debt, are authorized. One form, "financing contract indebtedness" includes lease-purchase revenue bonds and certificates of participation and has been used by the State historically. The other form is limited obligation bonds, which may be issued by the State directly rather than through the N.C. Infrastructure Finance Corporation, a conduit issuer. 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. The GARVEEs are a revenue bond-type debt instrument where the debt service is to be paid solely from federal transportation revenues. The GARVEEs were issued in October 2007 to accelerate the funding of transportation improvement projects across the State.

The State's long-term debt (general obligation bonds, special indebtedness, and GARVEE bonds) has increased significantly in recent years, rising from $3.478 billion in 2002 to $7.368 billion in 2009, in part due to large issuances for higher education capital projects. Prior to 2004, the State only issued general obligation debt. The following is a summary of recent debt authorizations.

The 2009-10 Session of the General Assembly modified the way that existing authorized and unissued indebtedness may be financed in the future. Projects may be financed using general obligation bonds up to a limit of $488 million or with appropriation supported special indebtedness financing up to a limit of $1.482 million. Projects may also be financed in total by some combination of general obligation bonds and special indebtedness (except guaranteed energy savings contracts).

Special Indebtedness

The 2009-10 Session of the General Assembly reduced special indebtedness authorizations for various projects by over $115 million to generate additional debt capacity.

The 2008-09 Session of the General Assembly authorized the issuance of up to $734.03 million of special indebtedness as follows: $512.22 million for higher education projects, $109.09 million for correctional facilities, $50 million for acquiring State park lands and conservation areas and, $62.72 million for other State projects.

The 2007-08 Session of the General Assembly authorized the issuance of up to $669.15 million of special indebtedness as follows: $481.14 million for higher education projects, $120 million to acquire State park land, natural heritage land, and to acquire waterfront properties or develop facilities for the purposes of providing public and commercial waterfront access, $35 million for an education and visitors center at Tyron Palace, and $33.01 million for correctional facilities.

The 2006-07 Session of the General Assembly authorized the issuance of up to $672.1 million of special indebtedness as follows: $429.3 million for psychiatric hospitals and a public health laboratory for the Department of Health and Human Services, $132.2 million for medical and mental health centers for the Department of Correction, $45.8 million for higher education projects, and $64.8 million for other State projects.

Repair and Renovation Authorization

The 2002-03 Session of the General Assembly authorized the issuance of $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 was allocated to the University of North Carolina System. Each of the 16 constituent institutions of the UNC System received a portion of the proceeds for repairs and renovations. The remaining $143 million of the proceeds was used to make repairs and renovations to various state facilities. The State has issued all of the authorized repair and renovation debt.

Higher Education Authorization

The 1999-00 Session of the General Assembly authorized the issuance of $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 were 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 were 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 21st century jobs. The bond legislation passed by the General Assembly specifies the amount of bond funding that flows to each community college and university campus. The State has issued all of the authorized higher education bonds.

Clean Water and Natural Gas Authorization

The 1997-98 Session of the General Assembly authorized the issuance of $1 billion of clean water and natural gas general obligation bonds, which were subsequently approved by the voters of the State. The bonds proceeds were used to provide grants and loans to local governments for clean water projects ($800 million) and to provide grants and loans for construction of natural gas facilities to facilitate the expansion of natural gas service to unserved areas of the State ($200 million). The State has issued all of the authorized clean water and natural gas bonds.

Highway Bond Authorization

The 1995-96 Session of the General Assembly authorized the issuance of $950 million of highway general obligation bonds, which were subsequently approved by the voters of the State. The bond proceeds were allocated to pay capital costs for urban loops ($500 million), highways in the Intrastate System ($300 million), and for paving unpaved roads of the secondary highway system ($150 million). The State has issued all of the authorized highway bonds.

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 2009, 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%;
- Net tax-supported debt as a percentage of personal income should be targeted at no more than 2.5% and not exceed 3.0%; and
- The amount of debt to be retired over the next ten years should be targeted at no less than 55% and not decline below 50%.

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 non-General Fund supported trust funds, other self-supporting or non-tax supported debt such as revenue bonds and short term tax anticipation notes, and other postemployment benefits.

North Carolina has exhausted its capacity for debt. The State currently maintains a reasonable level of debt when compared with its peer group composed of the other states rated "triple A" by all three credit rating agencies. 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 bond credit ratings are as follows:

State of North Carolina
General Obligation Bond Credit Ratings

Rating Agency	Rating	Outlook
Fitch Ratings	AAA	Stable
Moody's Investors Service	Aaa	Stable
Standard & Poor's Rating Services	AAA	Stable

These ratings are the highest attainable from all three rating agencies. A triple-A bond rating means that North Carolina has followed well-defined financial management policies and has demonstrated strong debt management practices. The State's proactive responses and history of taking early action to mitigate the impact of revenue declines were recognized. North Carolina remains one of only seven states to enjoy top-tier rankings from all three of the credit rating agencies.

The limited obligation bonds issued during the 2008-2009 fiscal year were assigned ratings of AA+ by Fitch Ratings, Aa1 by Moody's Investors Service, and AA+ by Standard & Poor's. Special indebtedness is not subject to a vote of the people and its repayment is based on the State's annual debt service appropriation. For these reasons, special indebtedness is rated lower than the State's general obligation bonds and typically carries a higher interest rate.

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

Similar to other states, the financial sector problems and rapid decline in economic conditions have led to historic revenue declines in North Carolina. Because of the sluggish economy, the General Assembly projected baseline General Fund revenues to decline by 1.6% in fiscal year 2009-10. Substantive tax and revenue adjustments included by the General Assembly and in the approved budget are as follows:

- A temporary increase in the general state rate of sales and use tax from 4.5% to 5.5%, effective September 1, 2009. The increase is scheduled to expire on July 1, 2011.
- An individual income tax surcharge of 2% or 3% is imposed on taxpayers who meet certain income requirements. The surcharge expires for taxable years on or after January 1, 2011.
- A corporate income tax surcharge of 3% is imposed on corporations subject to income tax. The surcharge expires for taxable years on or after January 1, 2011.
- The following state excise taxes were increased: beer from 53.177 cents to 61.71 cents per gallon, unfortified wine from 21 cents to 26.34 cents per liter, fortified wine from 24 cents to 29.34 cents per liter, liquor from 25% to 30% of sales, cigarettes from 1.75 cents to 2.25 cents per individual cigarette, and tobacco products other than cigarettes from 10% to 12.8% of the cost price of the products.
- The 2009-10 State budget included the following adjustments to availability for the above taxes: sales tax increase - $803.5 million, individual income tax surcharge - $172.8 million, corporate income tax surcharge - $23.1 million, and various excise tax increases - $68.8 million.

Because of the economic volatility in the State and nation and the need to exercise fiscal restraint, the Governor, on August 14, 2009, issued Executive Order No. 21, *Reduce Monthly Budget Allotments for the 2009-10 Fiscal Year*. It ordered the Office of State Budget and Management to reduce monthly allotments by 5% of each agency's certified budget. Special exceptions were provided.

Conditions Expected to Impact Future Operations

State Health Plan

The 2009-10 Session of the General Assembly enacted a number of changes to the State Health Plan's preferred provider organization (PPO) benefits and programs, including medical and prescription drug copayment changes, the discontinuance of the PPO Plus Plan, and the establishment of a new Comprehensive Wellness Initiative (CWI). The CWI was developed to encourage Plan members to make healthier lifesytle choices. It will provide support to Plan members by assisting them to quit using tobacco and to maintain a healthy weight. Benefit changes enacted by the General Assemby are anticipated to save $135.7 million in fiscal year 2010. The General Assemby also added various provisions governing the oversight and monitoring of the State Health Plan, including a mandate to conduct an independent comprehensive audit of the State Health Plan and a separate provision to establish a "Blue Ribbon Task Force." The task force will study and make recommendations regarding Plan governance, the types of benefits and health plans offered, and the affordability of dependent coverage.

In addition to addressing key legislative changes, the Plan increased its health coaching capacity to address chronic disease management and increase program return on investment; implemented a worksite wellness program to engage public school employees in healthly lifestyle behaviors; and implemented several pharmacy programs to offer more affordable generic drugs, increase adherence, and reduce Plan costs.

State Contributions to the Pension Fund

The current economic climate has greatly contributed to a loss of more than 14% in fiscal year 2009 for the North Carolina Retirement Systems. Funding the retirement system is a shared responsibility among employees, employers, and investment earnings. For the past several years, investment earnings of the Teachers' and State Employees' Retirement System (TSERS) have accounted for 77% of pension funding. Investment earnings were high enough in recent years to allow the General Assembly to significantly reduce its annual contribution to the TSERS below the normal rate of 6.3% of payroll. This is the state's match to the employee contribution of 6%, which is automatically deducted from their monthly paycheck. Due to investment losses, in order to fully-fund TSERS benefits, the General Assembly will need to increase its contribution to the TSERS back to above the normal contribution amount, roughly $684 million, in the second year of the biennium.

Expansion of Investment Authority

Legislation was recently passed that provides the investment team within the Department of State Treasurer (Department) the flexibility and tools to increase portfolio return and better manage risk. This expansion of the investment authority allows for 5% of the portfolio to be invested in credit opportunities. Currently, credit investments are classified under fixed income or alternative asset classes. Non-investment grade securities are now also allowed. Additionally, 5% of the portfolio can be invested in inflation resistant assets such as commodities, timber, real estate, and treasury inflation protected securities. Currently, there is authority to invest in these assets, but they fall under real estate, fixed income, and alternatives and are not a focused strategy. The third allowance is to invest in Exchange Traded Funds, a more efficient way to execute stock trades. The Department can manage passive stock funds (indexes) in-house in order to save costs and gain market knowledge. Currently, all stock management is outsourced. Finally, this change adds a liquidity requirement to the investment team's selection of investments. The requirement is designed to ensure that funds are available to meet the cash needs of the retirement system. This expansion will also make it possible for investments to produce the expected return that can meet the actuarial assumed return of 7.25% for the State's pension plans.

Escheats Fund

Interest earned on investments of the Escheats Fund (Fund) underwrites college scholarships. Over time, the number and size of programs dependent on the Fund grew and now the State is using the Fund's principal to meet obligations. At the current rate of withdrawal, the Fund will have a negative balance by fiscal year 2012.

The Fund consists of a variety of assets. Though most can be liquidated, the State cannot do so without realizing a significant loss to the portfolio. The State is under contractual obligations that require that certain funds may not be redeemed nor liquidated before their term limits. There are still several years remaining before the end of the respective terms, and the State is contractually obligated to meet these commitments.

Federal Recovery Funds

The State expects to receive additional federal funds under the American Recovery and Reinvestment Act of 2009. Currently, the General Fund budget for 2009-10 includes $1.375 billion of federal recovery funds and the 2010-11 budget includes $1.02 billion. The State also expects to receive $729.27 million of federal recovery funds in fiscal years subsequent to 2008-09 for highway infrastructure and $24.97 million for public transportation initiatives.

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.osc.nc.gov/financial/financial.html .