

MANAGEMENT'S DISCUSSION AND ANALYSIS

This section of the State of North Dakota's (the State's) Comprehensive Annual Financial Report presents a discussion and analysis of the State's financial performance, providing an overview of the activities for the fiscal year ended June 30, 2006. Please read it in conjunction with the transmittal letter at the front of this report and with the State's financial statements, which follow this section.

FINANCIAL HIGHLIGHTS

Government-wide:

The assets of the State exceeded its liabilities at fiscal year end by \$4.6 billion (reported as net assets), an increase of \$448 million from the previous year. The net assets of governmental activities increased by 13.8% while the net assets of the business-type activities showed an increase of 5.96%.

Fund Level:

As of the close of fiscal year 2006 the State's governmental funds reported combined ending fund balances of \$1.9 billion, an increase of \$352 million. Of this amount, \$888 million represents unreserved fund balance, with the remaining amount of \$1 billion reserved for specific purposes, such as debt service, capital projects, and permanent trust for education. At the end of the fiscal year, unreserved fund balance for the General Fund was \$413 million.

The enterprise funds reported net assets at year-end of \$1.7 billion, an increase of \$96 million during the year.

Long-term Debt:

The State's total debt (bonds and notes payable) increased during the fiscal year to \$1.64 billion, an increase of \$100 million, or 6.4%, which represents the net difference between new issuances and payments and refundings of outstanding debt. During the year the State issued \$404 million in bonds and \$637 million in notes.

More detailed information regarding these activities and funds is included in Note 3I.

OVERVIEW OF THE FINANCIAL STATEMENTS

This discussion and analysis is an introduction to the State's basic financial statements, which consists of three components: 1) government-wide financial statements, 2) fund financial statements, and 3) notes to the financial statements. This report also contains other supplementary information in addition to the basic financial statements.

Government-wide Statements

The government-wide financial statements provide a broad view of the State's operations in a manner similar to a private-sector business. The statements provide both short-term and long-term information about the State's financial position, which assists in assessing the State's economic condition at the end of the fiscal year. 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 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 are an indicator of whether the State's financial position is improving or deteriorating.

The Statement of Activities presents information showing how the State's net assets changed during the most recent fiscal year. All changes in net assets are reported as soon as the underlying events giving rise to the change occur, regardless of the timing of related cash flows. Therefore, revenues and

expenses are reported in these statements for some items that will only result in cash flows in future fiscal periods (e.g., uncollected taxes and earned but unused vacation leave).

Both statements report three activities:

Governmental Activities – The activities in this section are primarily supported by taxes and intergovernmental revenue. Most of the State's basic services, such as education, health and human services and transportation, are reported under this category.

Business-type Activities – These functions are intended to recover all or a significant portion of their costs through user fees and charges to external users of goods and services. The Bank of North Dakota, Workers Compensation, and the University System are examples of the State's business-type activities.

Discretely Presented Component Units – These are operations for which the State has financial accountability but they have certain independent qualities as well. These entities operate similar to private-sector business and the business-type activities described above. The State has 18 discretely presented component units. Financial information for these entities is presented separately from the financial information presented for the primary government.

The government-wide financial statements can be found immediately following this discussion and analysis.

Fund Financial Statements

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 a particular purpose. The State, like other state and local governments, uses fund accounting to ensure and demonstrate compliance with finance related legal requirements.

The basic fund financial statements begin immediately after the government-wide statements and provide more detail about the major individual funds. The State's funds are divided into three categories – governmental, proprietary, and fiduciary. It is important to note that these fund categories use different accounting approaches and should be interpreted differently.

Governmental funds -- Most of the State's basic services are reported in the governmental funds. Governmental funds are used to account for essentially the same functions reported as governmental activities in the government-wide financial statements. However, unlike the government-wide financial statements, the governmental fund financial statements focus on the near-term inflows and outflows of spendable resources. They also focus on the balances left at year-end that are available for future spending. Such information may be useful in evaluating whether there are more or fewer financial resources that can be spent in the near future to finance the State's programs. These funds are reported using modified accrual accounting, which measures cash and all other financial assets that can readily be converted to cash.

Because the focus of governmental funds is narrower than that of the government-wide financial statements, it is useful to compare the information presented for governmental funds with similar information presented for governmental activities in the government-wide financial statements. By doing so, readers may better understand the long-term impact of the government's near-term financing decisions. Both the governmental fund balance sheet and the governmental fund statement of revenues, expenditures, and changes in fund balances provide a reconciliation to facilitate this comparison between governmental funds and the governmental activities. These reconciliations are presented on the page immediately following each governmental fund financial statement.

Governmental funds include the General Fund and special revenue, capital project, debt service, and permanent funds. The State has several governmental funds, of which three (3) are considered major individual funds. Those three are the General Fund, the Federal Fund, and the School Permanent Trust Fund. Each of these major funds is presented in a separate column in the governmental fund balance

sheet and in the governmental fund statement of revenues, expenditures and changes in fund balance. The remaining governmental funds are combined in a single aggregated column on the basic fund statements. Individual fund data for each of these nonmajor governmental funds can be found in the other supplementary information section of this report.

Proprietary funds – Services for which the State charges customers a fee are generally reported in proprietary funds. The state maintains two different types of proprietary funds, enterprise funds and internal service funds. Enterprise funds report activities that provide supplies and services to the general public. Internal service funds report activities that provide supplies and services for the State's other programs and activities. Like the government-wide statements, proprietary funds use the accrual basis of accounting. Although the basis of accounting is the same for the government-wide and proprietary fund statements, reconciliation between these statements is presented because of the allocation of internal service funds' net income.

The State has four (4) major enterprise funds: The Bank of North Dakota, Housing Finance, University System, and Workforce Safety and Insurance. These four funds are each presented in separate columns on the basic proprietary fund financial statements. The remaining enterprise funds are combined in a single total column on these statements. Individual fund data for each of the nonmajor enterprise funds can be found in the other supplementary information section of this report.

The State's internal service funds are reported as governmental activities on the government-wide statements, because the services they provide predominantly benefit governmental activities. The State's five (5) internal service funds are reported on the basic proprietary fund financial statements in a single combined column. Individual fund data for the internal service funds is provided in the form of combining statements found elsewhere in this report.

Fiduciary funds -- The State acts as a trustee, or fiduciary, for its employee pension plans. It is also responsible for other assets that, because of a trust arrangement, can be used only for the trust beneficiaries. The State's fiduciary activities are reported in separate Statements of Fiduciary Net Assets and Changes in Fiduciary Net Assets. These funds, which include pension (and other employee benefit) trust, investment trust, private-purpose trust, and agency funds, are reported using accrual accounting. The government-wide statements exclude fiduciary fund activities and balances because the State cannot use these assets to finance its operations.

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 the fund financial statements. The notes to the financial statements can be found immediately following component units' financial statements.

Required Supplementary Information

The basic financial statements are followed by a section of required supplementary information. This section includes a budgetary comparison schedule, which includes reconciliation between the statutory fund balances for budgetary purposes and the fund balances for the General Fund and Federal Fund as presented in the governmental fund financial statements.

Other Supplementary Information

Other supplementary information includes combining financial statements for non-major governmental, non-major enterprise, internal service, and fiduciary funds. These funds are added together, by fund type, and presented in single columns in the basic financial statements.

FINANCIAL ANALYSIS OF THE GOVERNMENT AS A WHOLE

As noted previously, net assets may serve over time as a useful indicator of a government's financial position. The State's combined net assets (governmental and business-type activities) totaled \$4.6 billion at the end of fiscal year 2006. Net assets increased 9.7% from the prior fiscal year.

State of North Dakota's Net Assets (Expressed in Thousands)

	Governmental Activities		Business-Type Activities		Total Primary Government	
	2005	2006	2005	2006	2005	2006
Current and Other Assets	\$1,970,752	\$2,317,282	\$4,697,809	\$4,962,990	\$6,235,218	\$6,514,553
Capital Assets	1,223,594	1,295,151	668,949	699,548	1,892,543	1,994,699
Total Assets	<u>3,194,346</u>	<u>3,612,433</u>	<u>5,366,758</u>	<u>5,662,538</u>	<u>8,127,761</u>	<u>8,509,404</u>
Long-Term Liabilities						
Outstanding	249,406	360,935	2,082,838	2,085,153	2,332,244	2,446,088
Other Liabilities	367,263	353,347	1,647,417	1,849,561	1,581,338	1,437,341
Total Liabilities	<u>616,669</u>	<u>714,282</u>	<u>3,730,255</u>	<u>3,934,714</u>	<u>3,913,582</u>	<u>3,883,429</u>
Net Assets						
Invested in Capital Assets, Net of Related Debt	1,094,551	1,077,843	505,916	516,243	1,600,467	1,594,086
Restricted	1,046,115	1,281,417	393,237	391,313	1,439,352	1,672,730
Unrestricted	437,011	538,891	737,349	820,268	1,174,360	1,359,159
Total Net Assets	<u>\$2,577,677</u>	<u>\$2,898,151</u>	<u>\$1,636,502</u>	<u>\$1,727,824</u>	<u>\$4,214,179</u>	<u>\$4,625,975</u>

NOTE: The Governmental Activities amounts and Business-Type Activities amounts do not cross foot to the total Primary Government column because internal balances are reported separately as internal receivables and internal payables. A total internal balance remains due to certain Business-Type Activities having different fiscal year ends than the Governmental Activities.

The largest component (36%) of the State's net assets is restricted net assets. These restricted net assets represent resources that are subject to external restrictions, constitutional provisions, or enabling legislation on how they can be used. The remaining portion, unrestricted net assets, may be used at the State's discretion, but often have limitations on use based on State statutes.

Thirty-four percent (34%) of the State's net assets reflects its investment in capital assets such as land, buildings, equipment, and infrastructure (roads, bridges and other immovable assets) less any related debt outstanding that was needed to acquire or construct the assets. The State uses these capital assets to provide services to citizens; consequentially, these assets are not available for future spending. Although the State's investment in its capital assets is reported net of related debt, it should be noted that the resources need to repay this debt must be provided from other sources, since the capital assets themselves cannot be used to liquidate these liabilities.

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

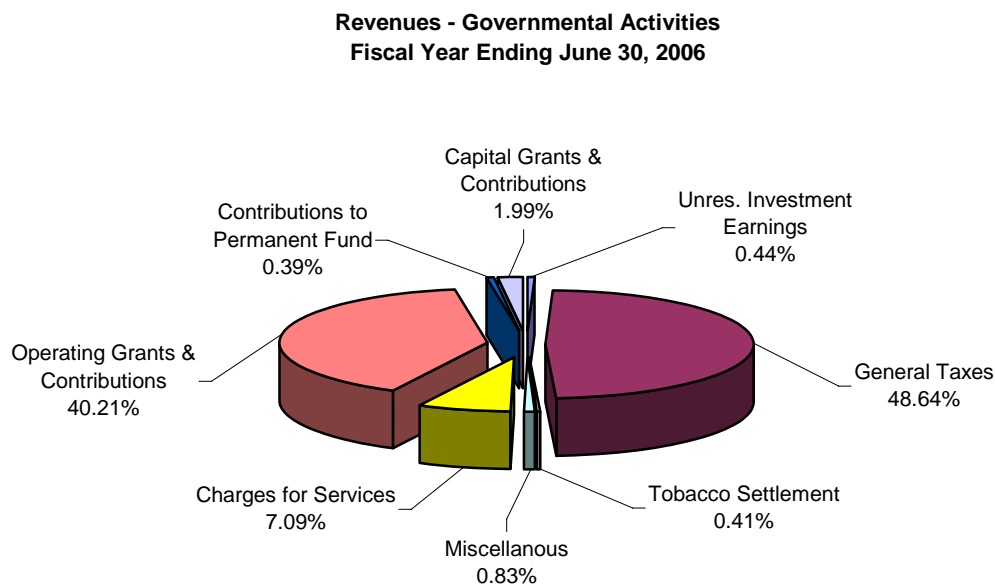
State of North Dakota's Changes in Net Assets
(Expressed in Thousands)

	Governmental Activities		Business-Type Activities		Total Primary Government	
	2005	2006	2005	2006	2005	2006
Revenues:						
Program Revenues:						
Charges for Services	\$ 171,779	\$ 201,847	\$ 741,172	\$ 794,071	\$ 912,951	\$ 995,918
Operating Grants & Contributions	1,084,731	1,144,749	304,001	283,315	1,388,732	1,428,064
Capital Grants & Contributions	81,850	56,557	5,998	577	87,848	57,134
General Revenues:						
Income Taxes	320,049	432,072	-	-	320,049	432,072
Sales Taxes	630,179	678,821	-	-	630,179	678,821
Other Taxes	220,751	276,771	-	-	220,751	276,771
Investment Earnings	4,106	12,409	-	-	4,106	12,409
Tobacco Settlement	12,830	11,712	-	-	12,830	11,712
Other	22,337	23,696	-	-	22,337	23,696
Total Revenues	<u>2,548,612</u>	<u>2,838,634</u>	<u>1,051,171</u>	<u>1,077,963</u>	<u>3,599,783</u>	<u>3,916,597</u>
Expenses						
General Government	243,437	264,911	-	-	243,437	264,911
Education	486,221	496,821	-	-	486,221	496,821
Health and Human Services	826,832	854,450	-	-	826,832	854,450
Regulatory	17,966	19,677	-	-	17,966	19,677
Public Safety and Corrections	132,997	145,480	-	-	132,997	145,480
Agriculture and Commerce	55,796	54,458	-	-	55,796	54,458
Natural Resources	53,440	62,431	-	-	53,440	62,431
Transportation	300,322	372,245	-	-	300,322	372,245
Interest on Long Term Debt	8,104	12,881	-	-	8,104	12,881
Bank of North Dakota	-	-	57,502	71,264	57,502	71,264
Housing Finance	-	-	45,922	46,580	45,922	46,580
Loan Programs	-	-	13,889	17,236	13,889	17,236
Mill and Elevator	-	-	95,223	101,198	95,223	101,198
State Lottery	-	-	18,917	15,622	18,917	15,622
Unemployment Compensation	-	-	43,394	43,314	43,394	43,314
University System	-	-	696,918	743,271	696,918	743,271
Workforce Safety and Insurance	-	-	183,466	116,021	183,466	116,021
Other	-	-	6,436	14,922	6,436	14,922
Total Expenses	<u>2,125,115</u>	<u>2,283,354</u>	<u>1,161,667</u>	<u>1,169,428</u>	<u>3,286,782</u>	<u>3,452,782</u>
Increase (decrease) in Net Assets Before Contributions and Transfers	423,497	555,280	(110,496)	(91,465)	313,001	463,815
Contributions to Permanent Fund Principal	13,636	11,156	-	-	13,636	11,156
Transfers	(170,925)	(215,089)	167,350	188,109	(3,575)	(26,980)
Increase in Net Assets	266,208	351,347	56,854	96,644	323,062	447,991
Net Assets - Beginning -As Restated	2,311,469	2,546,804	1,579,648	1,631,180	3,891,117	4,177,984
Net Assets- Ending	<u>\$ 2,577,677</u>	<u>\$ 2,898,151</u>	<u>\$ 1,636,502</u>	<u>\$ 1,727,824</u>	<u>\$ 4,214,179</u>	<u>\$ 4,625,975</u>

Governmental Activities

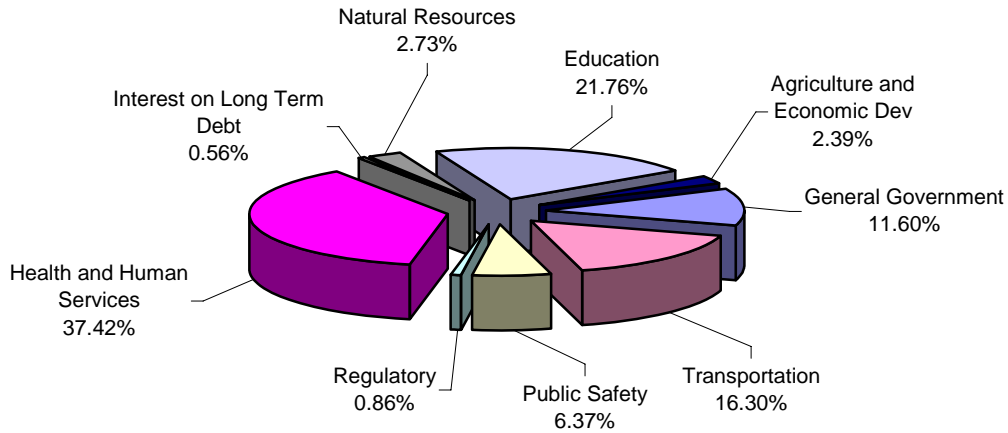
Governmental Activities increased the State's net assts by \$351 million, compared to a \$266 million increase in the prior fiscal year. The largest increases in the State's revenues for fiscal year 2006 were from the State's tax revenues. Individual and corporate income taxes increased 35%, oil and gas taxes increased 29%, and sales and use taxes increased 7.7%. The increase in individual income tax and sales tax collections is due to strong gains in the North Dakota economy, including expansion of the retail tax base throughout the state and significant job growth both from new jobs and wage gains in existing jobs. The growth in corporate income tax came from record audit collections and a very strong business sector. The strength in these collections is due in part to oil companies' record profits. Oil and gas tax revenues rose because of record high world oil prices that raise the taxable base and have led to increases in the state's oil production. Expenses for total governmental activities increased 7%, with the major increase in the transportation function. Significant costs for this function during the fiscal year include the demolition and reconstruction of the Four Bears Highway Bridge and the addition of two lanes to a section of Highway 2. None of the other governmental functions had substantial increases.

The following chart depicts revenues of the governmental activities for the fiscal year:



The chart on the following page depicts expenses of the governmental activities for the fiscal year:

**Expenditures - Governmental Activities
Fiscal Year Ending June 30, 2006**



Business-type Activities

Net assets of the business-type activities increased by \$97 million during the fiscal year. Factors contributing to these results included:

The net assets of the Bank of North Dakota increased \$9 million primarily due to a \$7 million decrease in transfers to the State's General Fund.

Workforce Safety and Insurance's (WSI) net assets increased \$32 million primarily due to underwriting and investing activities. Underwriting consists of pricing premiums to cover the workers compensation loss exposure, with changes in the loss estimates recognized in the current year of operations. WSI reported investment income of \$39.4 million during 2006, while increasing their loss estimates only \$6.4 million.

The net assets of Housing Finance increased \$4.9 million as a result of program operations and financing activities.

The North Dakota State University System net assets increased \$29 million during 2006, as a result of increases in tuition, room and board rates, and increased grant and contract awards. These increases contributed to an operating revenue increase of 9% while operating expenses increased only 5%.

The net assets of the Unemployment Compensation Fund increased \$21.8 million as a result of the ongoing tax increases intended to move the Fund towards stability and solvency, as well as a robust economy with growing employments and lower levels of insurance claims. The 1999 Legislature established a seven year time frame in which to build the Fund to a target level to ensure its solvency. As a result of this plan along with a robust economy, this target level was reached during the year.

FINANCIAL ANALYSIS OF THE STATE'S FUNDS

Governmental Funds

As the State completed the year, its governmental funds reported combined fund balances of \$1.9 billion, an increase of \$352 million from the prior fiscal year. Approximately \$790 million of this total amount constitutes unreserved fund balance, which is available for appropriation for the general purposes of the funds. The remainder of fund balance is reserved and is not available for new spending because it has already been dedicated to various commitments such as long-term receivables, debt service, and capital projects.

The General Fund is the chief operating fund of the State. At the end of current fiscal year, unreserved fund balance of the General Fund was \$413 million and reserved fund balance was \$2 million. Total fund balance rose during the fiscal year by \$150 million, due to increases in tax revenues. Individual income and corporate income taxes had the largest increase, nearly \$90 million, followed by sales and use taxes with a \$32 million increase. By the end of fiscal year 2006 General Fund revenues increased 12% from the prior year.

The School Permanent Trust Fund balance at June 30, 2006 improved by \$78 million from the prior year, largely because of an increase in royalties income.

The Federal Fund balance at June 30, 2006 decreased \$2 million due to increased unavailable revenues.

Proprietary Funds

The State's proprietary funds provide the same type of information found in the government-wide financial statements, but in more detail. The increases in the net assets of the proprietary funds are discussed under "Business-type Activities" above.

General Fund Budgetary Highlights:

The State has a biennial appropriated budget. The fiscal year ended June 30, 2006, was the first year of the 2005-07 budget cycle.

At the beginning of the 2005-07 budget cycle, there was an increase in the original budget of \$8 million. The majority of this increase is due to the authorized carryover of general fund appropriation authority from the 2003-05 biennium, which is reported as an appropriation adjustment for the 2005-07 budget. Some of those carryover amounts are noted below.

Several state agencies were authorized by appropriation laws to carryover a portion or all of their general fund appropriation for various purposes, including the Office of Management and Budget, \$.9 million, Legislative Council and Assembly, \$2.2 million, Department of Commerce, \$1 million, and the University System, \$2.6 million. Various other state agencies received smaller amounts of carryover totaling \$.7 million. A few agencies also received general fund carryover dollars from the 2003-05 biennium for capital construction projects. These capital construction carryover dollars totaled \$.7 million.

There were no expenditures in excess of general fund spending authority.

CAPITAL ASSETS AND DEBT ADMINISTRATION

Capital Assets: At the end of the fiscal year 2006, the State had invested nearly \$2 billion, net of accumulated depreciation, in a broad range of capital assets. Depreciation charges for this fiscal year totaled \$104 million.

State of North Dakota's Capital Assets
(Net of Depreciation, Expressed in Thousands)

	Governmental Activities		Business-Type Activities		Total Primary Government	
	2005	2006	2005	2006	2005	2006
Land and Land Improvements	\$ 44,208	\$ 47,262	\$ 18,397	\$ 18,117	\$ 62,605	\$ 65,379
Building & Building Improvements	216,344	214,778	391,982	401,537	608,326	616,315
Equipment	105,675	114,355	144,703	145,134	250,378	259,489
Infrastructure	569,336	549,958	88,158	88,195	657,494	638,153
Construction in Progress	288,031	368,798	25,709	46,565	313,740	415,363
Total	\$ 1,223,594	\$ 1,295,151	\$ 668,949	\$ 699,548	\$ 1,892,543	\$ 1,994,699

The total increase in the State's investments in capital assets for the current fiscal year was 5% in terms of net book value. However, actual expenditures to purchase or construct capital assets were approximately \$245 million for the year. Almost half of this amount was used to construct or reconstruct assets at the University Systems and for highway construction. More detailed information on the State's capital assets can be found in Note 3F to the financial statements.

Long-term Debt: Article X, Section 13 of the Constitution of North Dakota provides that the state may issue or guarantee the payment of bonds provided that all bonds in excess of \$2 million are: secured by first mortgage upon property and no further indebtedness may be incurred by the state unless evidenced by a bond issue; authorized by law, for a certain purpose; provisioned to pay the interest semiannually, and pay the principal within 30 years. The law authorized the bond issue must specifically appropriate the provisions to the payment of the principal and interest of the bond. The State has no general obligation bonds outstanding at June 30, 2006.

The State does have a number of revenue bonds outstanding at June 30, 2006. Current state statutes empower certain state agencies and the Building Authority, a component unit of the State, to issue bonds as part of their activities. This debt is not backed by the full faith and credit of the State of North Dakota. The principal and interest on revenue bonds issued by state agencies is payable from designated revenue sources. The Building Authority's bonds generate revenue to finance the construction and improvements of State buildings. Revenues derived from leases on the buildings fund the debt service requirements.

The Bank of North Dakota has advances from the Federal Home Loan Bank in the amounts of \$275.6 million. The advances have a fixed rate of interest, ranging from 2.98 percent to 7.35 percent.

More detailed information regarding the State's long-term obligations is presented in Note 3I to the financial statements.

State of North Dakota's Outstanding Debt
(Expressed in Thousands)

	Governmental Activities		Business-Type Activities		Total Primary Government	
	2005	2006	2005	2006	2005	2006
Revenue Bonds	\$ 204,240	\$ 287,016	\$ 887,350	\$ 1,038,233	\$ 1,091,590	\$ 1,325,249
Notes Payable	5,613	32,314	445,080	283,509	450,693	315,823
Total	\$ 209,853	\$ 319,330	\$ 1,332,430	\$ 1,321,742	\$ 1,542,283	\$ 1,641,072

The State's total debt increased by 6.4% during the current fiscal year.

ECONOMIC CONDITION AND OUTLOOK

North Dakota's economy has showed steady growth during the 2005-07 biennium, with broad revenue growth spread throughout many tax types.

The agricultural economy remains strong, with high commodity process. Wheat prices have recently reached a ten-year high.

High oil prices have led to increased oil exploration activity and increased tax collections for oil extraction and production. Oil activity is at its highest level in two decades. Forty-five rigs are currently operating in the state compared to 33 rigs one year ago, and only 24 rigs two years ago. Up to a dozen additional oil rigs are anticipated to be moved into the state from Montana during the next year as oil companies increase exploration investment in North Dakota. Each oil rig represents up to 40 direct jobs and 80 indirect jobs.

The state's unemployment rate declined slightly during the third quarter of 2006 to 3.3 percent. Retail and finance employment growth has remained strong; service industries and energy have also contributed to job growth.

Moody's Economy.com predicts that after "several years of outperforming the nation, the North Dakota economy is expected to moderate to a slower growth trace in the near term," but the overall outlook remains positive.

CONTACTING THE STATE'S OFFICE OF FINANCIAL MANAGEMENT

This financial report is designed to provide our citizens, taxpayers, customers, investors, and creditors with a general overview of the State's finances and to demonstrate the State's accountability for the money it receives. Questions about this report or additional financial information should be addressed to the State of North Dakota, Office of Management and Budget, 600 E. Boulevard, Dept. 110, Bismarck, ND 58505.