MANAGEMENT'S DISCUSSION & ANALYSIS

ABOUT THIS REPORT

The Department of Transportation's (DOT) Performance and Accountability Report (PAR) for Fiscal Year 2006 (Report) provides performance and financial information that enables Congress, the President, and the public to assess the performance of the Department relative to its mission and stewardship of the resources entrusted to it. This Report satisfies the reporting requirements of the following major legislation:

- Chief Financial Officers Act of 1990
- Government Performance and Results Act of 1993
- Government Management Reform Act of 1994
- Reports Consolidation Act of 2000

Under the Reports Consolidation Act of 2000, agencies are permitted to submit combined reports in implementing statutory requirements for financial and performance management reporting to improve the efficiency of executive branch performance.

These reports are combined in the PAR, which consists of the Annual Performance Report required by the Government Performance and Results Act of 1993, with annual financial statements required under the Chief Financial Officers Act of 1990, as amended by the Government Management Reform Act of 1994, and other reports such as management assurances on internal controls, and Inspector General assessments of an agency's management challenges.

You may view this report online at http://www.dot.gov. You may also have additional copies of the report mailed to you by writing a request to:

U.S. Department of Transportation
Office of the Chief Financial Officer (Room 10101)
400 7th Street S.W.
Washington, D.C. 20890

HOW THIS REPORT IS ORGANIZED

Management's Discussion and Analysis (MD&A)

The Management's Discussion and Analysis (MD&A) section provides a summary of the entire Report. It includes an organizational overview; a summary of the most important performance results and challenges for FY 2006; a brief analysis of financial performance; a brief description of systems, controls, and legal compliance; and information on the Department's progress in implementing the President's Management Agenda. The MD&A also addresses the management challenges identified by the Department's Inspector General and a summary of the Inspector General's audit report.

The Performance Report

The Performance Report section contains the annual program performance information required by the Government Performance and Results Act of 1993 (GPRA) and includes all of the required elements of an annual program performance report as specified in OMB Circular A-11, *Preparation, Submission and Execution of the Budget*. The results are presented by Strategic Goal.

The Financial Report

The Financial Report section contains the Department's financial statements, notes, required supplementary information, supplementary information pertaining to the Department's stewardship of Federal assets, related Inspector General's Audit Report, and other accompanying information.

DOT MISSION AND VALUES

MISSION

The National objectives of general welfare, economic growth and stability, and the security of the United States require the development of transportation policies and programs that contribute to providing fast, efficient, and convenient transportation at the lowest cost consistent with those and other National objectives, including the efficient use and conservation of the resources of the United States.

VALUES

PROFESSIONALISM

As accountable public servants, we exemplify the highest standards of excellence, integrity, and respect in the work environment.

TEAMWORK

We support each other, respect differences in people and ideas, and work together in ONE DOT fashion.

CUSTOMER FOCUS

We strive to understand and meet the needs of our customers through service, innovation, and creativity. We are dedicated to delivering results that matter to the American people.

ORGANIZATION

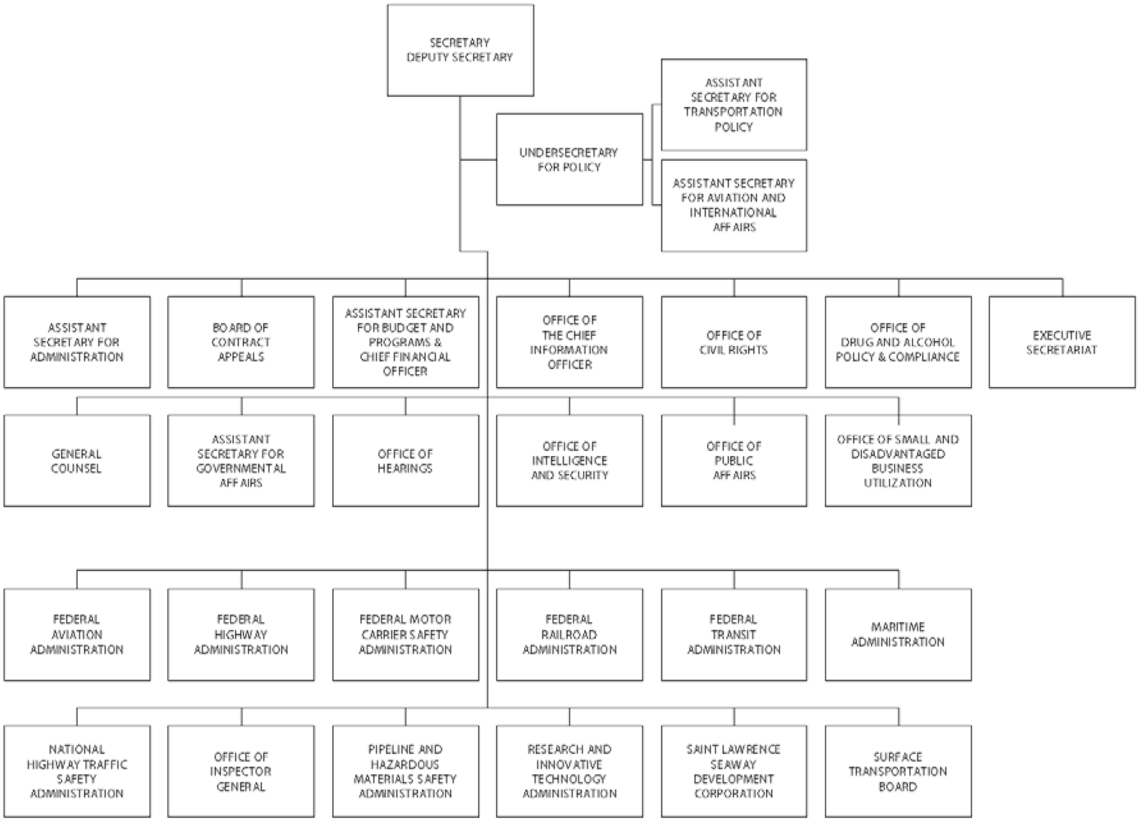
HISTORY

Established in 1967, DOT sets Federal transportation policy and works with State, local, and private sector partners to promote a safe, secure, efficient, and interconnected National transportation system of roads, railways, pipelines, airways, and seaways. DOT's overall objective of creating a safer, simpler, and smarter transportation program is the guiding principle as we move forward to achieve specific goals.

HOW WE ARE ORGANIZED

DOT employs almost 60,000 people across the country, in the Office of the Secretary of Transportation (OST) and through twelve Operating Administrations (OAs) and bureaus, each with its own management and organizational structure.

The Office of the Secretary of Transportation provides overall leadership and management direction, administers aviation economic programs, and provides administrative support. The Office of Inspector General (OIG) and the Surface Transportation Board (STB), while formally part of DOT, are independent by law.



OVERVIEW OF LEGISLATIVE AUTHORITIES

The DOT strategic plan summarizes the legislative authorities of each Operating Administration. To provide a context for the reader, the highlights of the responsibilities of each Operating Administration are listed below.

Office of the Secretary. The Office of the Secretary (OST) oversees the formulation of national transportation policy and promotes intermodal transportation. Other responsibilities range from negotiation and implementation of international transportation agreements, assuring the fitness of U.S. airlines, enforcing airline consumer protection regulations, issuance of regulations to prevent alcohol and illegal drug misuse in transportation systems and preparing transportation legislation.

Federal Aviation Administration. The Federal Aviation Administration's (FAA) mission is to promote aviation safety and mobility by building, maintaining, and operating the Nation's air traffic control system; overseeing commercial and general aviation safety through regulation and inspection; and providing assistance to improve the capacity and safety of our airports.

Federal Highway Administration. The mission of the Federal Highway Administration (FHWA) is to enhance mobility through innovation, leadership, and public service.

Federal Motor Carrier Safety Administration. The Federal Motor Carrier Safety Administration's (FMCSA) primary mission is to prevent commercial motor vehicle-related fatalities and injuries.

Federal Railroad Administration. The Federal Railroad Administration's (FRA) mission is to ensure that our Nation has safe, secure, and efficient rail transportation that enhances the quality of life for all.

Federal Transit Administration. The Federal Transit Administration (FTA) provides leadership, technical assistance, and financial resources for safe, technologically advanced public transportation that enhances mobility and accessibility, improves America's communities, preserves the natural environment, advances economic growth, and ensures that transit systems are prepared to function during and after criminal or terrorist attack.

Maritime Administration. The Maritime Administration's (MARAD) mission is to promote the development and maintenance of an adequate, well-balanced U.S. merchant marine that is sufficient to carry the Nation's domestic waterborne commerce and a substantial portion of its waterborne foreign commerce, and to serve as a naval and military auxiliary in time of war or national emergency.

National Highway Traffic Safety Administration. The National Highway Traffic Safety Administration's (NHTSA) mission is to save lives, prevent injuries and reduce economic costs due to road traffic crashes through education, research, safety standards, and enforcement activity.

Office of Inspector General. The Inspector General Act of 1978, as amended, established the Office of Inspector General (OIG) as an independent and objective organization within the DOT. The OIG's mission is to promote economy, effectiveness, and efficiency and to prevent and detect fraud, waste, and abuse in DOT operations and programs by conducting and supervising independent and objective audits and investigations.

Pipeline and Hazardous Materials Safety Administration. The Pipeline and Hazardous Materials Safety Administration (PHMSA) is dedicated to safety and security by working toward the elimination of transportation-related deaths and injuries in hazardous materials and pipeline transportation, and by promoting transportation solutions that enhance communities and protect the natural environment.

Research and Innovative Technology Administration. The Research and Innovative Technology Administration (RITA) is dedicated to the advancement of DOT priorities for innovation and research in transportation technologies and concepts. Innovations that will improve our mobility, promote economic growth, and ultimately deliver a better integrated transportation system.

Saint Lawrence Seaway Development Corporation. The U.S. Saint Lawrence Seaway Development Corporation (SLSDC), a wholly owned government corporation and an OA of DOT, is responsible for the operations and maintenance of the U.S. portion of the St. Lawrence Seaway between Montreal and Lake Erie.

Surface Transportation Board. The Surface Transportation Board (STB) is charged with promoting substantive and procedural regulatory reform in the economic regulation of surface transportation, and with providing an efficient and effective forum for the resolution of disputes and the facilitation of appropriate business transactions.

PERFORMANCE HIGHLIGHTS

Secretary Mary E. Peters is committed to ensuring that our transportation system remains safe, secure, and efficient and that it serves as the engine that drives our Nation's economy. Because economic activity and global trade are increasing, our roads, railways, pipelines, public transit systems, airways, and waterways are experiencing increasing growth in demand.

This Administration is working to ensure that our transportation system has the capacity to accommodate the needs of a growing and prosperous America. Below, we present the highlights of our fiscal year (FY) 2006 results in our five strategic areas: safety, mobility, global connectivity, environmental stewardship and security. We also present our internal organizational achievements that enhance DOT's performance as a results-driven Federal agency.

SAFETY

Transportation makes possible the movement of people and goods fueling our economy and improving our quality of life. Development of transportation systems has become a major determinant of a nation's economic success. At the same time, transportation exposes us to the risk of harm. While we have made progress in making all modes of transportation safer, the Department's top priority and central focus remains improving safety. All modes of transportation have a share in achieving our strategic safety goal: *Enhance public health and safety by working toward the elimination of transportation-related deaths and injuries.*

For the first time in many years, DOT is reporting that the highway fatality rate increased on our Nation's roads and highways. The fatality rate per 100 million vehicle-miles traveled (VMT) was 1.47 in 2005, up from 1.45 in 2004. Actual fatalities for this period increased 1.4 percent to 43,443, which is the highest level since 1990. While firmly committed to meeting the 1.0 fatality rate goal, the Department realizes that we will not achieve this goal by FY 2008 as originally planned. The Department will need the assistance of State and local governments, along with the entire traffic safety community to achieve this goal.

Our central strategies for reducing the increasing rate of highway fatalities and injuries are to reduce alcohol-impaired driving, increase safety belt use, reduce the rising motorcycle fatality rate, and improve the safety of commercial vehicle operations. Some of the approaches to increased highway safety the Department is pursuing are:

- National Highway Traffic Safety Administration (NHTSA) provided funds to the ten States with the highest fatality rates to facilitate implementation of effective programs, including periodic and sustained high-visibility enforcement efforts and media campaigns.

- NHTSA initiated the new national advertising campaign delivering the message *Drunk Driving: Over the Limit; Under Arrest*. As part of this campaign, States conduct impaired driving enforcement crackdowns during the Labor Day weekend and the December holiday season.

- FMCSA has begun developing recommended practices for on-board safety technologies in large trucks, including collision warning systems, adaptive cruise control, and stability systems.

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The increase in 2005 vehicle fatalities comes from the rise in the number of motorcycle fatalities and the increase in pedestrian fatalities over the previous year, which more than compensate for the slight decrease in motor vehicle occupant fatalities (- 0.7 percent). Motorcycles continue to be of particular concern, playing a large role in the increase with a 13 percent increase in motorcycle fatalities in 2005, to a total of 4,553, an increase of more than 115 percent since 1997. The number of pedestrian fatalities increased from 4,675 in 2004 to 4,881 in 2005, a 4.4 percent increase. All of this underscores the need for a renewed, aggressive and coordinated effort to make America's roads safer.

Although FAA did not meet its commercial aviation safety measure this year, this remains one of the safest periods in aviation history. Since 2001, there have been 50 million successful flights. This represents 2.7 billion passengers who have flown on commercial jet aircraft in the United States without an onboard fatality—nine times the population of our country. Accidents involving passenger fatalities have a rate of about one every 18 million departures.

Rail and transit safety continue to improve. Based on preliminary estimates, DOT expects to exceed the FY 2006 target of 16.80 rail-related accidents/incidents per million train miles, limiting accidents/incidents to 16.14 per million train miles. This improvement was accomplished while the overall number of train-miles nationally rose almost 3 percent. The rail industry also saw a 4.3 percent decrease in accidents during that period, from 14,496 to 13,875. Transit safety continues to exceed expectations. In FY 2006, transit fatalities decreased from 0.428 in FY 2005 to 0.344 per 100 million passenger miles traveled. Strong growth in transit ridership and the continued expansion of transit service significantly increased the number of transit passenger miles in FY 2006 over FY 2005.

DOT's safety performance results from targeting unsafe practices for improvement, partnering with an ever-widening group of stakeholders to leverage our resources, and fostering the use of Web-enabled and other technologies to achieve safer transportation.

MOBILITY

Historically, the mobility that transportation provides has helped define us as a people and as a Nation. Our ability to travel from place to place allows us to connect with other people, work, school, and marketplaces throughout the United States and around the world. In partnerships with the States and private transportation providers, we have made continuous improvements in mobility as stated in our strategic goal: *Advance accessible, efficient, intermodal transportation for the movement of people and goods*. Highlights of our results are presented below.

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Recent forecasts indicate that commercial aviation is rebounding. FAA exceeded its target for percentage of flights arriving within 15 minutes of schedule in FY 2006. To manage the increased air traffic, FAA continued to focus on easing congestion in eight metropolitan areas; improving overall capacity at the Nation's top 35 airports; building new runways; enhancing access to reliever airports for general aviation operations; and increasing traffic coordination and communication by using new technologies. In FY 2006, we opened four new runways, one each in Minneapolis-St. Paul, Cincinnati, St. Louis, and most recently in Atlanta, the world's busiest airport. The recent commissioning of a new runway at Atlanta-Hartsfield Airport, allows for 33 percent more operations a year.

Mobility and accessible transportation go hand-in-hand. For our aging population and for persons with disabilities, we must be proactive to ensure their mobility and access to transportation, now and in the future. For FY 2006, DOT met both of its performance targets measuring compliance with the Americans with Disabilities Act (ADA). An estimated 97 percent of bus fleets are now ADA compliant, either being lift-equipped or having low floors to accommodate wheelchairs and people with limited mobility. Approximately 92 percent of key rail stations are also ADA compliant, increasing transportation access for all of our citizens.

Work continued to improve the pavement condition on the Nation's highways. The results from this year show that 54.2 percent of our roads meet the "good-rated" ride quality standard, not quite meeting the target for FY 2006. However, FHWA has found that more improvement is needed in key states that have the most influence on the nationwide results in order to meet the higher standard.

The percent of travel nationwide that is under congested conditions is estimated to be 32.1 percent in calendar year 2006, which meets this year's target. Although the congestion levels continue their upward trend, DOT's efforts have contributed to slowing the rate of the increase. Based on the current state of the highway system, DOT expects that the congestion levels will continue to rise if there is no significant change in transportation system capacity or existing operating practices.

FHWA intensified its efforts to manage highway capacity through the implementation of pricing strategies. The Agency developed a Tolling and Pricing Primer for states and other public entities that provide a comprehensive perspective of federal tolling and pricing initiatives, including public-private partnerships and innovative financing programs.

GLOBAL CONNECTIVITY

Transportation systems within and among nations are lifelines to economic growth, to less restricted trade, and greater cultural exchange. A domestic and international intermodal approach is central to DOT's role in promoting global connectivity. Our strategies to address transportation in the global economy have two prongs. One is directed toward opening international transportation markets and the other is directed toward the improvement of essential, intermodal transportation linkages.

Supporting economic growth is a fundamental purpose of our transportation network. Transportation facilitates distribution of goods and creates economic value for the producer. Our strategic goal: *Facilitate a more efficient domestic and global transportation system that enables economic growth and development*, concerns the efficiency of transportation, an important part of our competitive edge in global trade.

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In an effort to provide greater access to international transportation markets and assure a minimum standard of safety within those markets, the Department conducts negotiations for Open Skies agreements, enters into Open Skies agreements, and enters into Bilateral Aviation Safety Agreements once the Open Skies agreements are in place.

Open Skies agreements have made it possible for the airline industry to provide the opportunity for better quality, lower priced, and more competitive air service in thousands of international city-pairs to an increasing portion of the world's population. As a result of newly implemented Open Skies agreements, DOT increased the number of potential air transportation customers to 3.01 billion, an increase over

FY 2005. In FY 2006, the Department reached Open Skies agreements with Canada, Cameroon, Kuwait and several other countries. We now have 75 Open Skies agreements with countries all over the world.

In FY 2006, DOT entered into four Bilateral Aviation Safety Agreements (BASA), exceeding its performance target. These agreements improve global understanding of U.S. safety regulations, processes, and procedures, which leads to better international regulatory oversight. The BASAs allow FAA to focus on U.S. safety priorities by relying on the capabilities and technical expertise of other civil aviation authorities and minimizing duplication of efforts.

The Saint Lawrence Seaway is the international shipping gateway to the Great Lakes, with almost 50 percent of Seaway traffic traveling to and from overseas ports, especially in Europe, the Middle East and Africa. The Great Lakes Seaway System offers access and competitive costs with other routes and modes to the interior of the country, so it is critical that the locks maintained by the Saint Lawrence Seaway Development Corporation (SLSDC) be open and navigable continuously during the navigation season. Once again SLSDC met its target, making the Seaway available for shipping 99 percent of the season.

ENVIRONMENTAL STEWARDSHIP

While transportation ties us together as a Nation, it can also produce unwanted side effects such as air and water pollution, the loss of ecosystems and disruption of communities. Americans want solutions to transportation problems that are consistent with sound environmental planning. DOT is committed to avoiding or mitigating the adverse environmental effects that can accompany transportation as stated in our strategic goal: *Promote transportation solutions that enhance communities and protect the natural and built environment*. Highlights of our results follow.

For the first time since we began measuring the activity in FY 2002, conformity lapses for transportation systems fell far below the target. On average, the Nation experienced approximately six air quality transportation conformity lapses in any given month. In FY 2006, the 12-month moving average number of areas in a conformity lapse was 1.3. In FY 2005, EPA announced that States and cities would have to meet a new, more stringent requirement for fine particulates in the air by April 2006. In anticipation of this deadline, DOT and EPA conducted numerous workshops, training sessions, and other outreach activities to raise awareness and to prepare State departments of transportation, State air agencies, and Metropolitan planning organizations to meet the requirements. As a result of the advanced preparation, many of the areas formerly in non-attainment status were able to meet conformity determinations by the April 2006 deadline.

Once again, DOT exceeded its target of creating/replacing at least 1.5 acres of wetlands for every acre affected by Federal-aid Highway projects, achieving a ratio of 2.6 to 1 in FY 2006. DOT is proud of its nine year track record of exceeding the target. In a demonstration of commitment to environmental stewardship and ecosystem conservation, DOT has begun using a new measure to assess the impact of projects on entire ecosystems rather than limiting the impact to a site-specific area. Traditional mitigation for transportation impacts tend to be site-specific, with little consideration of how the project fits into the context of the surrounding ecosystem. Under the ecosystem approach, the frame of reference and project objectives are broader and are applied within a defined geographic framework such as an eco-region, watershed, species range, or transportation planning area.

The Maritime Administration (MARAD) has more than 130 obsolete and deteriorating ships awaiting disposal that pose potentially costly environmental threats to the waterways near where they are stored. Due to legal, financial, and regulatory factors that have complicated the disposal effort, MARAD did not meet the congressionally mandated disposal schedule. However, in FY 2006, MARAD removed 25 obsolete ships, 23 of which were either high or moderate priority vessels. They completed dismantling of 20 additional ships, some of which were removed from the MARAD fleet sites in earlier fiscal years.

SECURITY

Our transportation system must remain a vital link for mobilizing our armed forces for military contingencies and for supporting civilian emergency response. Examples of our achievements under our strategic goal: *Balance homeland and national security transportation requirements with the mobility needs of the Nation for personal travel and commerce*, are described below.

DOT provided sealift services to the Department of Defense (DoD) in support of Operation Iraqi Freedom during the redeployment phase of the war. In addition to the availability of commercial U.S.-flag vessels, MARAD has 48 government-owned Ready Reserve Force vessels available to satisfy DoD's surge sealift requirements, a decrease of 10 vessels from FY 2005. MARAD, in conjunction with DoD, also negotiates an agreement with each DoD-designated commercial strategic port specifying which facilities will be needed to conduct a military deployment. These ports are expected to make their facilities available to the military within 48 hours of written notice. While DOT did not meet the shipping capacity performance target of 94 percent availability within mobilization timelines, MARAD did meet its target for commercial strategic port availability, and in fact achieved 100 percent readiness within established timelines.

The Department continues to focus on emergency preparedness through the Office of Intelligence, Security, and Emergency Response. In FY 2006, DOT established the Transportation Management Unit in Baton Rouge, Louisiana, to manage the Federal response activities for Gulf Coast evacuations and emergencies during the hurricane season. The Office was involved in the implementation of protective measures for the transportation system in response to several international terrorism threats.

ORGANIZATIONAL EXCELLENCE

Secretary Peters has challenged the Department to renew its commitment to a culture of foresight and continuous improvement, which is essential to achieving our strategic goals. We have put this into practice as evidenced by DOT's achieving the Office of Management and Budget's "green" rating for four of the five government-wide President's Management Agenda (PMA) initiatives.

DOT's Inspector General released the annual report on the Department's consolidated financial statements, for which we were issued an qualified opinion. Consolidated financial statements show how the Department is accountable for budgetary resources, provided by American, taxpayers for Federal transportation activities. Individual audits were also conducted for the Aviation and Highway Trust Funds, which both received qualified opinions.

DOT continues its stewardship of taxpayer monies through its management of large transportation projects. Project financial plans are approved at the Department level and reviewed yearly to track any significant cost and schedule deviations. Areas of program risk are identified earlier so that managers can implement the necessary changes in a timely fashion.

To ensure a secure infrastructure, DOT has certified and accredited 90 percent of its information technology (IT) systems. This provides management with an acceptable level of assurance that all systems either meet a minimum level of baseline requirements or have plans of action and milestones to mitigate any remaining risks.

FINANCIAL HIGHLIGHTS

Preparing these statements is part of the Department's goal to improve financial management and to provide accurate and reliable information that is useful for assessing financial performance and allocating resources. Departmental management is responsible for the integrity and objectivity of the financial information presented in the financial statements.

The financial statements and financial data presented in this Report have been prepared from the accounting records of the DOT in conformity with generally accepted accounting principles (GAAP). GAAP for Federal entities are the standards prescribed by the Federal Accounting Standards Advisory Board (FASAB).

OVERVIEW OF FINANCIAL POSITION

ASSETS

The Consolidated Balance Sheet shows the Department had total assets of $65.1 billion at the end of FY 2006. This represents a decrease of $903 million (1.4 percent) over the previous year's total assets of $66.0 billion. The decrease is primarily the result of a decrease of $1.5 billion in Fund Balance with Treasury and a $823 million increase in investments. The Department's assets reflected in the Consolidated Balance Sheet are summarized in the following table.

Assets By Type • Dollars in Thousands	**2006**	**%**	**2005**	**%**
Fund Balance with Treasury	$ 27,692,908	42.6	$ 29,140,842	44.2
Investments	19,824,151	30.5	19,000,999	28.8
General Property, Plant & Equipment	15,455,811	23.8	15,325,392	23.2
Inventory and Related Property, Net	897,494	1.4	939,639	1.4
Direct Loans and Guarantees, Net	618,179	1.0	760,448	1.2
Accounts Receivable	315,987	0.5	503,424	0.8
Cash and Other Assets	261,091	0.4	297,802	0.5
Total Assets	**$ 65,065,621**	**100.0**	**$ 65,968,546**	**100.0**

LIABILITIES

The Department had total liabilities of $13.7 billion at the end of FY 2006. This represents a 6.3 percent increase over the previous year's total liabilities of $12.9 billion, which is reported on the Consolidated Balance Sheet and summarized in the following table.

Liabilities By Type • Dollars in Thousands	2006	%	2005	%
Other Liabilities	$ 4,622,073	33.8	$ 5,019,980	39.0
Grant Accrual	5,546,895	40.5	4,086,728	31.7
Accounts Payable	424,993	3.2	408,755	3.2
Federal Employee and Veterans' Benefits Payable	950,466	6.9	1,007,303	7.8
Environmental and Disposal Liabilities	953,634	7.0	1,003,585	7.8
Debt	839,357	6.1	952,536	7.4
Loan Guarantees	345,864	2.5	393,451	3.1
Total Liabilities	**$ 13,683,282**	**100.0**	**$ 12,872,338**	**100.0**

Of the total liabilities, $3.2 billion were not covered by budgetary resources. The $3.2 billion is primarily comprised of $361 million liabilities to other Federal agencies (intragovernmental), $951 million liability to Federal Employees' and Veterans' Benefits Payable, $954 million of environmental and disposal liabilities, and $922 million of other liabilities with the public.

NET POSITION

The Department's Net Position at the end of FY 2006 on the Consolidated Balance Sheet and the Consolidated Statement of Changes in Net Position is $51.4 billion, a $1.7 billion (3.2 percent) decrease from the previous fiscal year. Net Position is the sum of the Unexpended Appropriations and Cumulative Results of Operations.

RESULTS OF OPERATIONS

The results of operations are reported in the Consolidated Statement of Net Cost and the Consolidated Statement of Changes in Net Position.

PROGRAM COSTS

The Department's total net cost of operations for FY 2006 was $61.8 billion.

Net Program Costs • Dollars in Thousands	**2006**	**%**	**2005**	**%**
Surface Transportation	$ 46,527,176	75.28	$ 42,309,410	74.34
Air Transportation	14,453,211	23.39	14,029,096	24.65
Maritime Transportation	457,525	0.74	278,914	0.49
Costs Not Assigned to Programs	390,463	0.63	261,911	0.46
Less Earned Revenues Not Attributed to Programs	30,985	-0.05	25,165	-0.04
Cross-Cutting Programs	7,355	0.01	8,728	0.02
Net Cost of Operations	**$ 61,804,745**	**100.0**	**$ 56,862,894**	**100.0**

Surface and air costs represent 98.67 percent of the Department's net cost of operations. Surface transportation program costs represent the largest investment for the Department at 75.28 percent of the Department's net cost of operations; Air transportation is the next largest investment for the Department at 23.39 percent of the Department's net cost of operations.

RESOURCES

BUDGETARY RESOURCES

The Combined Statement of Budgetary Resources provides information on how budgetary resources were made available to the Department for the year and their status at fiscal year-end. For the 2006 fiscal year, the Department had total budgetary resources of $112.5 billion, compared to the FY 2005 levels of $114 billion.

The Department's FY 2006 budget authority of $115.8 billion primarily consists of $60.8 billion of appropriations received and $51.9 billion of borrowing and contract authority. The Department incurred obligations of $65.6 billion for the 2006 fiscal year, a 6.6 percent decrease over the $69.8 billion of obligations incurred during FY 2005. Outlays reflect the actual cash disbursed against the Department's obligations.

FINANCING

The Consolidated Statement of Financing reconciles the resources available to the Department to finance operations with the net costs of operating the Department's programs.

HERITAGE ASSETS AND STEWARDSHIP LAND INFORMATION

Heritage assets are property, plant and equipment that are unique for one or more of the following reasons: historical or natural significance; cultural, educational, or artistic importance; or significant architectural characteristics.

Stewardship Land is land and land rights owned by the Federal Government but not acquired for or in connection with items of general property, plant and equipment.

The Department's Heritage assets consist of artifacts, museum and other collections, and buildings and structures. The artifacts and museum and other collections are those of the Maritime Administration. Buildings and structures include Union Station (rail station) in Washington, D.C., which is titled to the Federal Railroad Administration.

Financial information for Heritage assets is presented in the Financial Section of this Report under the Financial Statements and Required Supplementary Information.

LIMITATIONS OF THE FINANCIAL STATEMENTS

The principal financial statements have been prepared to report the financial position and results of operations of the Department of Transportation, pursuant to the requirements of 31 U.S.C. 3515 (b).

While the statements have been prepared from the books and records of the Department of Transportation in accordance with generally accepted accounting principles (GAAP) for Federal entities and the formats prescribed by the Office of Mangement and Budget (OMB), the statements are in addition to the financial reports used to monitor and control budgetary resources, which are prepared from the same books and records.

The statements should be read with the realization that they are for a component of the U.S. Government, a sovereign entity.

SYSTEMS, CONTROLS, AND LEGAL COMPLIANCE

FEDERAL MANAGERS' FINANCIAL INTEGRITY ACT

The Federal Managers' Financial Integrity Act (FMFIA) requires agencies to conduct an annual evaluation of their management controls and financial systems and report the results to the President and Congress. The Secretary of Transportation then prepares an annual Statement of Assurance based on these internal evaluations.

As a subset of the FMFIA Statement of Assurance, DOT is required to report on the effectiveness of internal control over financial reporting, which includes safeguarding of assets and compliance with applicable laws and regulations, in accordance with the requirements of Appendix A of OMB Circular A-123. A separate discussion on Appendix A is located at the end of this section.

The Secretary of Transportation has issued a qualified Statement of Assurance for FY 2006. A copy of the Statement of Assurance is included in this section under *Management Assurances*. The Department evaluated its management control systems and financial management systems for the fiscal year ending September 30, 2006. This evaluation provided reasonable assurance and formed the basis of the Secretary's Statement of Assurance that the objectives of the FMFIA were achieved in FY 2006.

FMFIA ANNUAL ASSURANCE PROCESS

The FMFIA review is an agency self-assessment of the adequacy of financial controls in all areas of the Department's operations—program, administrative, and financial management.

OBJECTIVES OF CONTROL MECHANISMS
1. Financial and other resources are safeguarded from unauthorized use or disposition.
2. Transactions are executed in accordance with authorizations.
3. Records and reports are reliable.
4. Applicable laws, regulations, and policies are observed.
5. Resources are efficiently and effectively managed.
6. Financial systems conform to government-wide standards.

Managers within the Department, being in the best position to know and understand the nature of the problems they face, establish appropriate control mechanisms to ensure Departmental resources are sufficiently protected from fraud, waste, and abuse, and to meet the intent and requirements of the FMFIA.

The head of each Operating Administration and Departmental office submits an annual statement of assurance representing the overall adequacy and effectiveness of management controls within the organization to the Assistant Secretary for Budget and Programs/Chief Financial Officer (CFO). FMFIA material weaknesses and material nonconformances are also reported along with remediation plans to correct the material weakness or nonconformance. Specific guidance for completing the end of fiscal year assurance statement and reporting on material deficiencies is issued annually by the Department's Office of Financial Management.

CRITERIA FOR REPORTING MATERIAL WEAKNESSES AND NONCONFORMANCES

A material weakness under FMFIA must fall into one or more of the categories below plus merit the attention of the Executive Office of the President and/or the relevant Congressional oversight committees.

CRITERIA FOR REPORTING A MATERIAL WEAKNESS
1. Significant weakness of the safeguards (controls) against waste, loss, unauthorized use or misappropriation of funds, property, or other assets. 2. Violates statutory authority, or results in a conflict of interest. 3. Deprives the public of significant services, or seriously affects safety or the environment. 4. Impairs significantly the fulfillment of the agency's mission. 5. Would result in significant adverse effects on the credibility of the agency.

A material nonconformance under FMFIA must fall into one or more of the categories below plus merit the attention of the Executive Office of the President or the relevant Congressional oversight committees.

CRITERIA FOR REPORTING A MATERIAL NONCONFORMANCE
1. Prevent the primary accounting system from centrally controlling financial transactions and resource balances. 2. Prevent compliance of the primary accounting system, subsidiary system, or program system under the Office of Management and Budget Circular A-127.

SUMMARY OF FY 2006 FMFIA MATERIAL WEAKNESSES

Status of Internal Controls—FMFIA, Section 2

DOT has two material weaknesses under Section 2. One of the material weaknesses - Timely Processing of Transactions and Accounting for the Construction in Progress (CIP) Account at the Federal Aviation Administration (FAA) is a carryover from FY 2005. Financial Management, Oversight, and Reporting at the Highway Trust Fund (HTF) is a new material weakness.

Timely Processing of Transactions and Accounting for the CIP Account. Last year we reported that FAA did not have effective processes to capitalize headquarters-based projects in a timely manner. During FY 2006, FAA took action to resolve the elements of the FY 2005 prior year material weakness associated with property accounting by working with the Air Traffic Organization (ATO) on a comprehensive review of projects totaling $1.2 billion. However, significant improvements still need to be made including strengthening policies and procedures over CIP accounting, establishing controls to ensure that policies and procedures are being followed, and continuous monitoring of accounts. In addition, FAA must ensure that supporting documentation for capitalization of fixed assets is properly managed and maintained.

Financial Management, Reporting, and Oversight at the HTF. During FY 2006, several issues existed in financial management, reporting and oversight at the HTF. These issues include, improper recording of journal entries, lack of controls in place to track and monitor journal entries, inadequate controls over grant accruals, and lack of policies and procedures addressing abnormal balances.

The following table shows the Department's progress with correcting and closing material weaknesses.

DEPARTMENT OF TRANSPORTATION STATISTICAL SUMMARY OF PERFORMANCE SECTION 2, INTERNAL CONTROLS			
NUMBER OF MATERIAL WEAKNESSES			
	NUMBER OF REPORTED FOR THE FIRST TIME IN:	FOR THAT YEAR, NUMBER THAT HAVE BEEN CORRECTED:	FOR THAT YEAR, NUMBER STILL PENDING:
1999 Report	1 FAA Property, Plant and Equipment (PP&E)	0	0
2000 Report	0 FAA PP&E (R)	0	0
2001 Report	1 FAA PP&E (R) Information Security Program	0	0
2002 Report	2 Information Security Program (R) FTA Management FAA Contracts	1 FAA PP&E	0
2003 Report	2 Information Security Program (R) FAA Contracts (R) HTF Financial Mgmt. Reconciling Transactions (Eliminations)	1 FTA Management	0
2004 Report	2 HTF Financial Mgmt. (R) Reconciling Transactions (Eliminations) (R) HTF Grants Financial System Controls	2 Information Security Program FAA Contracts	0
2005 Report	1 HTF Financial Mgmt. (R) HTF Grants (R) FAA Reconciliations	2 Reconciling Transactions Financial System Controls	1 FAA Reconciliations/CIP
2006 Report	1 FAA Reconciliations/CIP (R) HTF Financial Reporting	2 HTF Financial Mgmt. HTF Grants	1 FAA Reconciliations/CIP (R)
1999–2006 Total	10	8	2
Of the total number corrected, how many were corrected in 2006 2 ; (R) - Repeat			

Status of Financial Management Systems—FMFIA, Section 4

DOT reported again this year that the Department was not in substantial compliance with OMB Circular A-127. For FY 2006, this noncompliance consists of three issues: Preparation of Financial Statements; Use of a Standard General Ledger (credit reform/loans); and Federal Accounting Standards (cost accounting).

The following table shows the Department's progress with correcting and closing material nonconformances.

DEPARTMENT OF TRANSPORTATION STATISTICAL SUMMARY OF PERFORMANCE SECTION 4, FINANCIAL MANAGEMENT SYSTEMS			
	NUMBER OF MATERIAL NONCONFORMANCES		
	NUMBER OF REPORTED FOR THE FIRST TIME IN:	FOR THAT YEAR, NUMBER THAT HAVE BEEN CORRECTED:	FOR THAT YEAR, NUMBER STILL PENDING:
1999 Report	0	0	0
2000 Report	1 FFMIA Nonconformance 1.a. Preparation of Financial Statements 1.b. Standard General Ledger 1.c. Managerial Cost Accounting	0	1 FFMIA Nonconformance 1.a. Preparation of Financial Statements 1.b. Standard General Ledger 1.c. Managerial Cost Accounting
2001 Report	1 Information Security Program FFMIA Nonconformance (R)	0	0
2002 Report	0 Information Security Program (R) FFMIA Nonconformance (R)	0	0
2003 Report	0 FFMIA Nonconformance (R)	1 Information Security Program	0
2004 Report	1 Financial System Controls FFMIA Nonconformance (R)	0	0
2005 Report	0 FFMIA Nonconformance (R)	1 Financial System Controls	0
2006 Report	0 FFMIA Nonconformance (R)	0	0
2000–2006 Total	3	2	1
Of the total number corrected, how many were corrected in 2006 _0_; (R) - Repeat			

APPENDIX A, INTERNAL CONTROL OVER FINANCIAL REPORTING

Appendix A of OMB Circular A-123 emphasizes management's responsibility for establishing and maintaining effective internal control over financial reporting. Appendix A requires agencies to maintain documentation of the controls in place and of the assessment process and methodology management used to support its assertion as to the effectiveness of internal control over financial reporting. Agencies are also required to test the controls in place as part of the overall FMFIA assessment process. The assurance statement related to the assessment performed under Appendix A acts as a subset of the Overall Statement of Assurance reported pursuant to Section 2 of the FMFIA legislation. Management's assurance statement as it relates to Appendix A is based on the controls in place as of June 30. The assurance statement is located in the following section of this report.

DOT is reporting a limitation of scope for its assurance statement on internal controls over financial reporting due to its two year implementation of Appendix A. During FY 2006, DOT identified 12 key business processes that are material to financial reporting. Of these 12 processes, six were documented and tested in FY 2006. The remaining key business processes will be documented and tested during FY 2007 as described in our implementation plan.

MANAGEMENT ASSURANCES—OMB CIRCULAR A-123

THE SECRETARY OF TRANSPORTATION
WASHINGTON, D.C. 20590

NOV - 9 2006

The President
The White House
Washington, DC 20500

Dear Mr. President:

The U.S. Department of Transportation's (DOT) management is responsible for establishing and maintaining effective internal control and financial management systems that meet the objectives of the Federal Managers' Financial Integrity Act (FMFIA). All departmental organizations are subject to Sections 2 and 4 of the FMFIA except the Saint Lawrence Seaway Development Corporation, which reports under the Government Corporations Control Act.

The DOT is able to provide a qualified statement of assurance that the internal controls and financial management systems meet the objectives of FMFIA, with the exception of two material weaknesses reported under Section II and one non-conformance reported under Section IV. DOT's qualified statement of assurance is based on the limited scope assurance we are providing under Appendix A and the material weaknesses and non-conformances reported under Section 2 and Section 4 of FMFIA. The details of the exceptions are provided in Enclosure B.

The DOT conducted its assessment of the effectiveness of internal control over the effectiveness and efficiency of operations and compliance with applicable laws and regulations in accordance with OMB Circular A-123, *Management's Responsibility for Internal Control.* Based on the results of this evaluation, DOT identified two material weaknesses in its internal control over the effectiveness and efficiency of operations and one non-compliance with applicable laws and regulations as of September 30, 2006. Other than the exceptions noted below, the internal controls were operating effectively and no other material weaknesses were found in the design or operation of the internal controls.

> For FY 2006, DOT has two material weaknesses in internal controls (Section 2) and one material nonconformance (Section 4).
>
> Of the FY 2006 material weaknesses (Section 2), one is new and one is repeated and still in the process of being corrected. The repeat material weakness is: Timely Processing of Transactions and Accounting for the Construction in Progress Account (CIP) at the Federal Aviation Administration (FAA). The new material weakness is Financial Management, Reporting, and Oversight at the Highway Trust Fund (HTF).

In FY 2006, DOT has one repeat material nonconformance (Section 4) in financial system controls, which is still in the process of being corrected.

<u>Material Weaknesses (Section 2)</u>
Material weaknesses are deficiencies in the design or operation of internal controls that do not reduce to a relatively low level the risk that significant errors, fraud, or noncompliance could occur and not be detected by employees in the normal course of performing their duties. The two material weaknesses are:

1. Timely Processing of Transactions and Accounting for the CIP Account.
Last year we reported that FAA did not have effective processes to capitalize headquarters-based projects in a timely manner. During Fiscal Year (FY) 2006, FAA took action to resolve the elements of the FY 2005 prior year material weakness associated with property accounting by working with the Air Traffic Organization (ATO) on a comprehensive review of projects totaling $1.2 billion. However, significant improvements still need to be made including strengthening policies and procedures over CIP accounting, establishing controls to ensure that policies and procedures are being followed, and continuous monitoring of accounts. In addition, FAA must ensure that supporting documentation for capitalization of fixed assests is properly managed and maintained.

2. Financial Management, Reporting, and Oversight at the HTF.
During FY 2006, several issues existed in financial management, reporting and oversight at the HTF. These issues include, improper recording of journal entries, lack of controls in place to track and monitor journal entries, inadequate controls over grant accruals, and lack of policies and procedures addressing abnormal balances.

<u>Material Nonconformance (Section 4)</u>
Nonconformances (Section 4) in internal controls represent deficiencies in the design or operation of internal controls that could adversely affect the DOT consolidated financial statements. The material nonconformance is:

1. Compliance with the Federal Financial Management Improvement Act (FFMIA) of 1996.
Last year, we reported that FAA was not in substantial compliance with FFMIA because five of its seven key financial systems that support data entered into our Delphi financial system did not substantially comply with FFMIA compliance categories listed in OMB Circular A–127, Section 7. Although corrective actions were initiated to correct these deficiencies, the issues still remained during FY 2006.

For 2006, we are reporting that FAA was not in compliance with Federal accounting standards due to their inability to provide representation that the CIP balance and activity was fairly stated and in accordance with applicable accounting standards, as of and for the year ended, September 30, 2006. During FY

2006 we are reporting that the HTF agencies continue to be non-compliant with FFMIA due to the lack of common data elements or functionality in the feeder systems, which prevent the feeder systems from being fully integrated with the core accounting system, Delphi.

Appendix A, Internal Control Over Financial Reporting

In addition, DOT conducted its assessment of the effectiveness of internal control over financial reporting, which includes safeguarding of assets and compliance with applicable laws and regulations, in accordance with the requirements of Appendix A of OMB Circular A-123. The Department is reporting a scope limitation for its assurance statement on internal control over financial reporting due to its two-year implementation of Appendix A. DOT identified 12 key business processes that are material to financial reporting and documented and tested six of these key business processes in Fiscal Year 2006. The remaining six key business processes will be documented and tested during Fiscal Year 2007 as described in our Office of Management and Budget (OMB) – approved Implementation Plan.

Based on the results of this evaluation, DOT identified no material weaknesses in its internal control over financial reporting as of June 30, 2006.

Enclosure A provides a Statistical Summary of Performance. Details about the material weaknesses and our corrective plan of action and milestones with estimated completion dates are provided in Enclosure B (for Section 2) and in Enclosure C (for Section 4).

Respectfully,

Mary E. Peters

Mary E. Peters

Enclosure A – Statistical Summary of Performance under Section 2 and Section 4 of the FMFIA.
Enclosure B – Description of Pending Material Weaknesses (Section 2).
Enclosure C – Description of Pending Material Nonconformance (Section 4).

FEDERAL FINANCIAL MANGEMENT IMPROVEMENT ACT

The Federal Financial Management Improvement Act of 1996 (FFMIA) requires that agencies' financial management systems provide reliable financial data in accordance with generally accepted accounting principles and standards. Under FFMIA, financial management systems must substantially comply with three requirements — Federal financial management system

requirements, applicable Federal accounting standards, and the U.S. Government Standard General Ledger (SGL). In addition, agencies must determine annually whether their systems meet these requirements. This determination is to be made no later than 120 days after the earlier of (a) the date of receipt of the agency-wide audited financial statement, or (b) the last day of the fiscal year following the year covered by such statement.

To assess conformance with FFMIA, the Department uses OMB Circular A-127 survey results, FFMIA implementation guidance issued by OMB, results of OIG and GAO audit reports, annual financial statement audits, the Department's annual Federal Information Security Management Act (FISMA) Report, and other relevant information. The Department's assessment also relies a great deal upon evaluations and assurances under the FMFIA, with particular importance attached to any reported material weaknesses and material nonconformances.

FFMIA OF 1996 NONCOMPLIANCE ISSUES

In FY 2006, DOT reported that the Department was not in compliance with FFMIA. For FY 2006, this noncompliance consists of: Federal financial management information systems requirements and Federal accounting standards.

Federal Financial Management Information Systems Requirements. FAA, FHWA, and FTA were not in compliance with Federal financial management information systems requirements. Key financial systems used by FAA, FHWA, and FTA which feed or support the financial data in the core accounting system do not comply substantially with the categories of FFMIA compliance listed in OMB Circular No. A-127, Section 7—Financial Management System Requirements. Specific weaknesses in these systems are in the following areas:

- Does not adhere to functional and Computer Security Act requirements;
- Inadequate systems and processing documentation;
- Lacks adequate internal controls;
- Lacks adequate training and user support; and,
- Lacks appropriate maintenance.

Federal Accounting Standards. FAA management was unable to provide representation that the CIP balance and activity was fairly stated and in accordance with applicable accounting standards, as of and for the year ended, September 30, 2006.

FFMIA OF 1996 FINANCIAL MANAGEMENT SYSTEMS STRATEGY

During FY 2006, DOT continued its financial management strategy to improve financial systems by supporting business modernization and by standardizing and integrating financial and program data. By standardizing systems, DOT is poised to achieve the goals of the President's Management Agenda.

The DOT financial system enterprise architecture includes: Delphi (DOT's core financial system, which uses Oracle Financials commerical-off-the-shelf software without customizations) and CASTLE (new time and attendance and Labor Distribution system interfaced with Delphi), along with OA managerial cost accounting, procurement management, and grants management systems. DOT plans to further integrate cost accounting, procurement and grants systems with Delphi and to expand Delphi capability by piloting two new modules: Loan Management and Enterprise Planning and Budgeting. As a designated Federal Shared Service Provider, DOT will continue its mission to market our Delphi financial system and accounting services to new clients and to help government agencies further standardize and streamline business processes and realize greater economies of scale.

DOT has been implementing our FFMIA corrective action plan through several initiatives. First, DOT addressed FAA's budgetary and proprietary reconciliation problems and reduced suspense balances by consolidating accounting services into our Enterprise Services Center (ESC) in Oklahoma City. Second, DOT sunset several redundant systems, including our legacy payroll and HR systems following our migration to DOI's Federal Personnel and Payroll system (FPPS). Third, DOT replaced six stand-alone travel systems with our implementation of the GovTrip e-Travel system.

FEDERAL INFORMATION SECURITY MANAGEMENT ACT

The Federal Information Security Management Act (FISMA) requires Federal agencies to identify and provide security protections commensurate with the risk and magnitude of harm resulting from the loss of, misuse of, unauthorized access to, or modification of information collected or maintained by or on behalf of the agency. DOT maintains one of the largest portfolios of information technology (IT) systems among Federal civilian agencies; it is therefore essential that the Department protect these systems, along with their sensitive data. In FY 2006, DOT's IT budget totaled about $2.5 billion.

The Inspector General's office tested a representative subset of DOT systems, including contractor-operated or -maintained systems that had undergone systems security certification reviews in order to determine whether DOT had complied with Government standards for (1) assessing system risks, (2) identifying security requirements, (3) testing security controls, and

(4) accrediting systems as able to support business operations. The Inspector General also performed a detailed follow-up review of the Department's process for managing remediation of known security deficiencies.

During FY 2006, the Inspector General reported that the Department made noticeable improvement in tracking, prioritizing, and correcting security weaknesses, further noting that aggressive action was taken to identify systems containing personally identifiable information for proper security protection, including procuring encryption software to secure all laptop computers. The full FY 2006 FISMA report can be found at www.oig.dot.gov.

SAS 70 REVIEW ON DOT'S FINANCIAL MANAGEMENT SYSTEM

The Department's report summarizes the results of a review of system security controls over the DOT Enterprise Service Center's (ESC) Delphi Financial Management System. The ESC performs accounting and financial management functions for DOT and other Federal agencies. It is maintained by Federal Aviation Administration employees at the Mike Monroney Aeronautical Center in Oklahoma City, Oklahoma, under the strategic direction of the Departmental Chief Financial Officer.

ESC is one of four financial management Centers of Excellence (Federal Shared Service Providers) designated by the Office of Management and Budget to provide a financial management system and accounting services to other government agencies. In addition to all DOT Operating Administrations, the ESC also supports the National Endowment for the Arts, the Commodity Futures Trading Commission, and the Institute of Museum and Library Services, and in the summer of 2006 signed up the Government Accountability Office as its newest customer. The Office of Management and Budget requires Centers of Excellence to provide client agencies with an independent audit report in accordance with the American Institute of Certified Public Accountants' (AICPA) Statement of Auditing Standards (SAS) 70.

This year's SAS 70 audit was conducted by Clifton Gunderson, LLP, of Calverton, Maryland. The DOT Office of Inspector General performed a quality control review of this audit work to ensure that it complied with applicable standards.

The Clifton Gunderson SAS 70 audit report, dated May 31, 2006, concluded that management's description of controls for the Delphi Financial Management System presents fairly, in all material respects, the controls that had been placed in operation as of May 31, 2006. In addition, on 9 out of 10 control objectives, the independent auditor concluded that controls are suitably designed and were operating effectively during the period from October 1, 2005, through May 31, 2006. The full OIG report can be found on their Web site at www.oig.dot.gov. ESC Delphi management developed a detailed Corrective Action Plan to implement Clifton Gunderson's recommendations to further strengthen Delphi controls.

Follow-up Review

Since the issuance of its May 31, 2006 report, Clifton Gunderson completed a follow-up review covering the period from June 1, 2006 through September 30, 2006 fiscal year end. The purpose of this follow-up review was to determine whether any significant changes had been made to Delphi's operating environment. The follow-up review documented the corrective actions that have been implemented to strengthen Delphi controls in accordance with the SAS 70 recommendations.

IMPROPER PAYMENTS INFORMATION ACT OF 2002

In FY 2006, the Department continued implementing efforts to meet requirements of the Improper Payments Information Act of 2002 (IPIA), which requires that agencies (1) review programs and activities and identify those susceptible to significant improper payments (2) estimate the amount of improper payments in identified programs and activities, (3) report to Congress on the amount and causes of improper payments, and (4) report to Congress on actions to reduce such payments.

In FY 2005, the Department successfully completed its second review of ten programs determined to be susceptible to significant improper payments. While these reviews found no significant improper payments, for those programs involving payments to grantees, the reviews did not address payments made by grantees. To address payments by grantees, the Department developed and tested a model for estimating the amount of improper payments in the Federal Highway Administration's (FHWA) Federal-aid Highway Program and committed to developing and testing a model for estimating the amount of improper payments in the Federal Transit Administration's (FTA) Formula Grants Program and the Federal Aviation Administration's (FAA) Airport Improvement Program. Former Section 57 of OMB Circular A-11 designated these as programs susceptible to significant improper payments.

In FY 2006, the Department re-engaged AOC Solutions, Inc., to execute the model developed for the Federal-aid Highway Program nationwide and to develop and test the models for the FTA Formula Grants Program and the FAA Airport Improvement Program. The samples designed to execute the model are of sufficient size to yield an estimate with a 90 percent confidence interval within +/- 2.5 percent points around the estimate of the percentage of erroneous payments, as prescribed by OMB. The results of these efforts are discussed below.

FEDERAL-AID HIGHWAY PROGRAM

The Department with the aid of a contractor developed and executed a sampling plan to test project payments in all 50 States and two territories that received funding under this program. The objectives of this effort were to: estimate the amount of improper payments nationwide and assist the FHWA in developing test criteria and procedures for monitoring highway project payments in the future through its Financial Integrity Review and Evaluation (FIRE) Program.

The nationwide testing program was executed by personnel from the 52 FHWA division offices and covered Federal payments to grantees over the five month period October 1, 2005 through February 28, 2006. Time and resource constraints limited the period of coverage. In FY 2007, the testing will cover a 12-month period.

The sampling plan involved a multi-staged statistical approach that included the selection of 513 State payments and then 928 testable line items from those payments for testing. The test procedures applied to the line items were designed to test a range of administrative elements and contractual elements. Tests of administrative elements included determining whether payments were properly approved, billed at the correct Federal participation rate, and whether billings and payments were mathematically accurate. Tests of contractual elements included determining whether payments were in accordance with contract rates/prices for specified materials and whether material quality tests indicated that materials met contractual requirements.

Improper payments totaling $125,508.56 were found in the sample of 928 tested items selected from a population of 10,116 items. The projection of this result to the population of program payments for the five-month period results in an improper payment estimate of $30.15 million +/- $35.04 million. This projection does not meet OMB's definition of significant improper payments ($10 million and 2.5 percent of total program payments). The improper payments reported resulted from factors such as data entry errors, missing approvals, incorrect cost allocations, and unallowable charges. The FHWA will implement fully its FIRE Program in FY 2007 to monitor State and territory payments and provide a mechanism for assisting these entities with effectively addressing operational issues that result or could result in improper payments.

FTA FORMULA GRANTS PROGRAM

The Department and the FTA developed and tested a model for testing grantee payments under this Program. The objectives of the FY 2006 effort were to develop the model and field test it at two grantees and to assist the FTA in incorporating the test procedures in its statutorily required Triennial Review Program. The FY 2006 model development and testing effort were not designed to provide a nationwide or program-wide estimate of improper payments.

The review covered federal payments to two grantees during the period October 1, 2005 through June 30, 2006 and related payments by these grantees. To execute the review, a two-stage statistical approach was used to select the line items for testing. The model's test procedures examined a range of administrative and contractual elements similar to those tested in the Federal-aid Highway Program.

For the first grantee, the review found administrative and contractual compliance as addressed in the test model and no improper payments. For the second grantee, improper payments totaling $11,664.08 were found in the sample of tested payments. The sample size was 18 payments selected from a population of 100 payments. The projection of this result to the population of payments under the Program by the grantee is an improper payment estimate of $252,000.00.

In FY 2007, the Department and the FTA will expand the Triennial Review Program to provide an estimate of the amount and rate of improper payments for the grantees subject to the 2007 Triennial Review. Chapter 49 U.S.C. Section 5307 requires a triennial review of agencies receiving Urban Area Formula Grant Funds. The Triennial Review assesses compliance with Federal regulations in 23 areas

FAA AIRPORT IMPROVEMENT PROGRAM (AIP)

The Department and the FAA developed and tested a model for testing grantee payments under this Program. The objectives of the FY 2006 effort were to develop the model and field test it at one grantee and to assist the FAA in incorporating the test procedures in its grants management oversight and AIP review programs. The FY 2006 model development and testing effort was not designed to provide a nationwide or program-wide estimate of improper payments.

The review covered Federal payments to a single grantee during the period October 1, 2005 through June 30, 2006 and related payments by this grantee. To execute the review, a two-staged statistical approach was used to select the line items for testing. As with the FTA Formula Grants Program, the model's test procedures examined a range of administrative and contractual elements similar to those tested in the Federal-aid Highway Program.

The review found administrative and contractual compliance as addressed in the test model and no improper payments.

The pilot effort identified several opportunities for maximizing the effectiveness of future improper payment reviews. Notably, the structure of AIP project funding is an important consideration in designing an IPIA review. Federal payments that cover only a portion of eligible costs incurred can be characterized as reimbursements for a percentage of allowable payments made during a period rather than reimbursements for specific payments. The model was modified accordingly and should provide for an effective and efficient review.

In FY 2007, the Department and the FAA will apply the test model nationwide to estimate the amount and rate of improper payments for the AIP.

SCORECARD ON THE PRESIDENT'S MANAGEMENT AGENDA

HUMAN CAPITAL INITIATIVE

Goal: Develop a Department-wide human capital workforce strategy to address future workforce gaps, eliminate skill gaps in critical occupations, develop performance-based incentives for the workforce, ensure citizen-centered, delayered, and mission-focused organizations; strengthen leadership skills, and ensure a robust leadership pipeline; improve the measurement and evaluation of human capital strategies; and integrate e-Government and Competitive Sourcing strategies.

FY 2006 Status: Green

FY 2006 Progress: Green

How DOT is Meeting PMA Challenges: DOT's Human Capital Plan focuses on long-term management of the DOT workforce and is aligned with the OPM/OMB Standards for Success.

- Met hiring timelines for General Schedule vacancies—68 percent were completed within 45 days; we also set hiring timeline targets for the Senior Executive Service. The Department met the requirement to notify applicants of hiring decision status—84 percent were notified within 45 days;
- Identified Mission Critical Occupation (MCO) Competency and Leadership Gap Analysis targets; provided MCO Resource Chart;
- Met IT Workforce Report hiring targets;
- Submitted updates to the Improvement Plan for Human Resource Management Competency Gap Analysis;
- Identified targets for improving the quality and number of applicants in the hiring process;
- Verified leadership bench strength numbers in agency pilot program;

- Implemented performance management system improvement strategies in the pilot project with FMCSA; identified Federal Railroad Administration as the next mode to participate in the expanded pilot project;
- Received OPM approval of the revised Succession Plan;
- Met accountability system requirements, received OPM approval; conducted five on-site accountability reviews; and,
- Began the Career Patterns initiative.

COMPETITIVE SOURCING INITIATIVE

Goal: Improve the consistency for defining commercial and inherently governmental inventories across the Department. Identified competable activities, provided strategic direction for competitive sourcing and human capital initiatives, and developed and shared high-quality intellectual capital within the Department and other agencies.

FY 2006 Status: Green

FY 2006 Progress: Yellow

How DOT is Meeting PMA Challenges: In FY 2006, DOT was awarded a Green rating for competitive sourcing. To receive this rating, DOT completed the following:

- Provided updated green competition plan to OMB;
- Made performance decisions on the National Highway Transportation Safety Administration competition;
- Completed competitive sourcing policy document; and,
- Shared lessons learned within the Department and with other agencies.

However, DOT drops to yellow in progress due to limited competitions planned for fiscal years 2007-2008.

IMPROVED FINANCIAL MANAGEMENT INITIATIVE

Goal: Develop financial management systems capable of producing more timely and accurate information, and maintain a record of unqualified opinions on our financial statements.

FY 2006 Status: Red

FY 2006 Progress: Green

How DOT is Meeting PMA Challenges: DOT's Office of Financial Management provides overnight closing and produces statements every month and at year-end. These statements, with the exception of the Statement of Financing, are prepared directly from trial balances from Delphi utilizing the Financial Statement Solution (FSS). In 2006, the FSS was further enhanced to run overnight. Additonal actions include the following:

- FHWA Financial Management - Put into production Release 2 of Delphi Financial Statement Solution to enhance preparation of statements; results were produced overnight 75 percent faster;
- FHWA Grants Management - Field offices conducted Financial Integrity Review and Evaluation (FIRE) reviews using revised FHWA headquarters order;
- FAA improved transaction processing:
    - Process for reconciling Subsidiary to General Ledger completed monthly;
    - Achieved significant progress reducing Suspense Account balances;
    - Completed significant cleanup for Construction In Progress balances affecting prior fiscal years' activity; and,
    - Automated Budgetary to Proprietary reconciliations; reflected in improved financial reporting.
- Reported monthly corrective action plan progress to OMB; and,
- Provided preliminary Federal Manager's Financial Integrity Act assurance statements with draft FY 2006 A-123 testing results.

E-GOVERNMENT INITIATIVE

Goal: To better justify and track costs and performance of information technology projects, as well as participate in government-wide initiatives that automate and simplify how the public deals with the government and reduce redundancies and increase efficiencies across government-wide.

FY 2006 Status: Green

FY 2006 Progress: Yellow

How DOT is Meeting PMA Challenges: During FY 2006, the Department's efforts on the E-Government initiative had a number of important successes: DOT met established requirements and made further improvements in enterprise architecture, privacy, and capital planning.

- Finalized milestones for quarterly Enterprise Architecture reporting with OMB and submitted the first report before the end of FY 2006;
- Acheived certification and accreditation for more than 99 percent of operational Information Technology systems;
- Provided quarterly Earned Value Management variance and high risk reports;
- Provided a status update on FAA's Earned Value Management System Plan of Action & Milestones for applicable systems;
- Completed all E-Government implementation plan milestones; and,
- Completed FY 2006 milestones for FAA to the Government Accountability Office High Risk list plan.

BUDGET AND PERFORMANCE INTEGRATION INITIATIVE

Goal: To better integrate budget and performance functions by integrating respective staff work; developing plans and budget with outcome goals, output targets, and resources requested in the context of past results; charging full budgetary costs of programs; and documenting program effectiveness.

FY 2006 Status: Green

FY 2006 Progress: Green

How DOT is Meeting PMA Challenges: In FY 2006, DOT achieved its goals in this area and maintained a green score by completing the following:

- Published the Department's 2006–2011 Strategic Plan;
- Submitted the DOT efficiency measures report;
- Submitted a budget request to OMB that clearly articulated the performance impact of implementing a budget at the target level, and supported by sound and thorough analysis and performance data; and
- Provided marginal cost of performance information in each modal administration's FY 2008 OMB budget submission in accordance with OST guidance.

ELIMINATING IMPROPER PAYMENTS INITIATIVE

Goal: Develop financial management systems capable of producing more timely and accurate information, and eliminating improper payments to DOT vendors/customers.

FY 2006 Status: Green

FY 2006 Progress: Red

How DOT is Meeting PMA Challenges: During FY 2006, DOT took significant steps towards the implementation of the Improper Payments Information Act (IPIA) of 2002. DOT's efforts focused on program areas in three of our largest Operating Administrations: FHWA Highway Planning and Construction Program, FTA Formula Grants, and FAA Airport Improvement Program.

- FHWA Planning and Construction
  - State testing is nearing completion and work is transitioning to the data analysis phase;
  - Received completed workbooks from 50 out of 52 States and Territories; 50 States, Puerto Rico and the U.S. Virgin Islands; and,
  - Identified $82 thousand in improper payments.
- FTA Formula Grants
  - Completed FTA test model;
  - Received grantee payment data from Minneapolis and Charlotte transit organizations and selected test samples; and,
  - Made arrangements for conducting testing.
- FAA Airport Improvement Program
  - Finalized baseline test model; and,
  - Selected samples from Washington Airports Authority and began testing payments.

REAL PROPERTY INITIATIVE

Goal: Use sound real property management of real property resources for diverse transportation missions, maintaining the quality of real property assets managed, and disposing of assets that are no longer required.

FY 2006 Status: Yellow

FY 2006 Progress: Green

How DOT is Meeting PMA Challenges: DOT continues to make progress under this initiative. The Real Estate Management System used by DOT is a single-point inventory, contains the required performance metrics, and is compatible with the government-wide real property database.

- Completed necessary system enhancements to provide DOT real property information to the Federal real property database by the first quarter of FY 2007;
- Submitted prioritized investment list of assets across DOT portfolio of assets;
- Continued to close the inventory and performance data gaps for full constructed asset level reporting;
- Continued identifying draft performance measure targets and goals; and,
- Revised draft 3-year timeline, including narrative of initiatives supported by specific capital actions.

OTHER MANAGEMENT INFORMATION, INITIATIVES, AND ISSUES

IMPLEMENTING OMB CIRCULAR A-123

During FY 2006, DOT modified its implementation plan for OMB Circular A-123 and obtained approval from OMB to implement A-123, Appendix A over a 2-year cycle. DOT has successfully completed the first year of our implementation plan, including:

- Conducted detailed entity-level assessments of the control environment in each of our organizations to determine how well internal controls were designed and functioning and to assist managers in evaluating current internal controls;
- Established the DOT Internal Control Senior Assessment Team (ICSAT) and the Internal Control Working Group (ICWG);
- Trained the ICSAT, ICWG, and key business process owners on the requirements of A-123;
- Completed documentation and testing for six of our twelve key business processes; and,
- Developed corrective action plans to address findings identified during testing and worked to complete the remaining corrective actions.

In addition to finishing work on corrective actions, DOT is currently planning the documentation and testing efforts for the second group of key business processes, which will be tested during FY 2007.

In the upcoming months, DOT will continue educating its management and staff on effective internal controls to prevent fraud, waste, abuse, and mismanagement of resources. Our management training focuses on the applicable laws and regulations; on how to implement segregation of duties; and on how to properly record and document transactions, conduct risk assessments, test controls, implement corrective action plans and monitor progress. We are also developing internal controls training to be included in the orientation for all new employees and additional web-based training for DOT staff.

DOT is also continuing its efforts to fully integrate our internal control program with the annual financial statement audits, FMFIA, Improper Payments Improvement Act (IPIA) program, and other related activities with the goal of realizing significant efficiencies and savings. The integration of these potentially overlapping efforts will result in a more comprehensive platform for top management to utilize in assessing and managing risk and vulnerability across the Department.

CONSOLIDATED AUTOMATED SYSTEM FOR TIME AND LABOR ENTRY

In September 2006, the Department implemented a DOT-wide system for Automated Leave Requests 2006 (CASTLE 3.3 release). This new feature allows employees simple online entry of leave requests and immediate email notification of leave approval by their supervisor. A handy online Employee Leave Calendar showing leave requests and approval status is included with this new request system.

Approving officials receive immediate notification of leave requests and are able to easily approve those leave requests online. There is also a Group Leave Calendar showing requested leave and approval status for all employees in the timekeeping group. This feature can be used for workforce planning.

Timekeepers will be able to select a special button to automatically fill the timecard with leave information from approved leave requests. There is also a helpful Leave Discrepancy Report to identify discrepancies between leave requests and the leave recorded on an employee's timecard. Another valuable feature of this system is the online history of leave requests.

MANAGERIAL COST ACCOUNTING

Managerial cost accounting identifies, tracks, and analyzes the total costs attributable to a particular task, job, or program. The purpose of managerial cost accounting is to provide program managers with cost information required to accurately report program efficiency and to develop a program's future budget. DOT's Operating Administrations (OAs) are working aggressively to implement managerial cost accounting systems in order to provide their managers with cost information to make better informed decisions.

Several OAs made substantial process in implementing full cost accounting during FY 2006. The Federal Transit Administration (FTA) has completed the majority of its cost accounting implementation. FTA is using a commercial off the shelf software to import administrative, salary and benefit, and grant expenses from existing systems. FTA employees also began using activity codes to record their time and attendance using the Labor Distribution Reporting (LDR) function within CASTLE. By doing so, FTA has been able to assign salary and benefit expenses to

activities. FTA has already provided their Executive Management Team (EMT) with preliminary reports from the cost accounting system. FTA plans to finalize the reports and begin distributing them to the EMT and other managers monthly starting in November 2006.

During FY 2006, the Federal Aviation Administration (FAA) completed its implementation of the cost accounting system by implementing the remaining two lines of business, Aviation Safety and Airports. FAA is now providing cost accounting information to all lines of business. Labor distribution has been implemented in all of the lines of business and in most of the staff offices, covering over 45,000 employees. FAA plans to implement the remaining staff offices consisting of approximately 1,500 employees in FY 2007.

The Federal Lands Highway Program of the Federal Highway Administration is in the process of developing a solution within Oracle's Project Accounting module which will provide reports to manage their programs and projects. The goal of the solution is to capture program, project, and task information on the budget distribution and execution transactions in order to generate reports for financial managers, program managers, and engineers. A data warehouse is being developed which will enable Federal Lands to retrieve the data they need to manage their programs and projects in various formats. The solution will be completed in January 2007.

In addition to the progress noted above, FRA and FHWA also implemented LDR and are using activity codes to record employee time. The vast majority of DOT's employees are now using LDR to record their time.

The Government Accountability Office recognized DOT's leadership and cited progress in Managerial Cost Accounting (MCA) in their report titled "Managerial Cost Accounting (MCA) in the Departments of Education, Transportation, and Treasury" as follows:

> "Transportation has in recent years shown strong leadership in developing MCA systems both Department-wide and at the individual operating administrations (OA). According to Transportation officials, the 12 OAs were developing MCA systems tailored to their respective needs, which should be able to interface with Delphi – an integrated financial management system, a component of which could be used by OAs for cost accounting. One of the two largest OAs, the Federal Aviation Administration (FAA), was mandated to develop a cost accounting system in 1996, and had implemented MCA in two business lines covering over 80 percent of its budget."

DOT will continue to take the steps necessary to integrate program and accounting data. DOT will work with the remaining small OAs during FY 2007 to implement their managerial cost accounting plans.

INSPECTOR GENERAL'S TOP MANAGEMENT CHALLENGES

DOT OFFICE OF INSPECTOR GENERAL'S APPROACH

The Office of Inspector General (OIG) issues its annual report on DOT's top management challenges to provide a forward-looking assessment for the coming fiscal year. The purpose of the report is to aid DOT's agencies in focusing attention on and mapping work strategies for the most serious management and performance issues facing the Department.

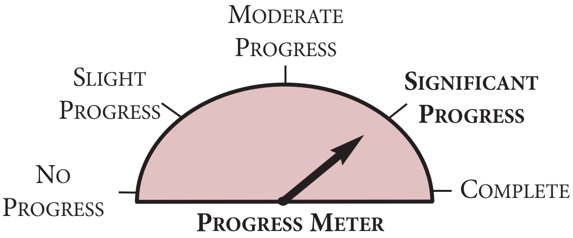
In selecting the challenges for each year's list, the OIG continually focuses on the Department's key strategic goals to improve transportation safety, capacity, and efficiency. In addition to the OIG's vigilant oversight of DOT programs, budgetary issues, and progress milestones, it also draws from several dynamic factors to identify key challenges. These include new Departmental initiatives, cooperative goals with other Federal departments, recent changes in the Nation's transportation environment and industry, as well as global issues that could have implications for the United States' traveling public. As such, the challenges included on the OIG's list vary each year to reflect the most relevant issues and provide the most useful and effective oversight to DOT agencies.

As required by OMB Circular A-136, the OIG's report briefly assesses DOT's progress in addressing the challenges identified. To track management challenges identified from year to year, the OIG provides an exhibit to the report that compares the current list of management challenges with the list published the previous fiscal year. In addition, the OIG may refine the scope of the management challenge from year to year based on program developments, external factors, or other information that becomes available.

The Department recognizes that management challenges are not issues that are easily solved. In many cases they require investments or upgrades to technology or substantial changes in long-standing procedures or program activities. To completely address a management challenge may take more than one fiscal year. Since the OIG may refine the scope of the management challenge based on information that may become available during the year, it can be difficult to provide a context showing how far along the Department is in resolving a particular challenge. To provide perspective on the Department's progress, we have provided a self assessment showing the achievements toward resolving the challenge as currently defined. The result is displayed via the Progress Meter icon. DOT hopes that this approach will provide perspective toward gauging the Department's progress in resolving a management challenge.

1. MANAGEMENT CHALLENGE: WORKING WITH OTHER AGENCIES TO RESPOND TO DISASTERS AND ADDRESS TRANSPORTATION SECURITY

Responding to Hurricane Katrina and Other National Disasters



The attacks of September 11, 2001, along with the destruction of the Gulf Coast by Hurricanes Katrina and Rita highlighted the need for a well-defined, well coordinated, interagency approach to preparing for and responding to catastrophic events. Under the Federal Government's National Response Plan, the DOT is responsible for coordinating and providing Federal and civil transportation support, as directed by the Federal Emergency Management Agency (FEMA) during times of national emergency.

To provide a centralized, effective program, the Office of Intelligence, Security, and Emergency Response (OET), in the Office of the Secretary (OST), performs coordinated crisis management functions for multimodal transportation emergencies, including:

- natural disasters;
- technological incidents / accidents;
- labor strikes;
- security situations, such as domestic criminal acts or international terrorist acts; and,
- national defense mobilization.

To facilitate interdepartmental and intermodal coordination during times of crisis, DOT established the Crisis Management Center (CMC). During the London transportation bombings, for example, the CMC was staffed with many of DOT's emergency coordinators from each operating administration for full-time around-the-clock operations. CMC personnel regularly communicate with Federal, State, and local entities to acquire, confirm, and communicate

information prior to reporting to senior DOT officials. DOT also has a representative in the Department of Homeland Security's Operations Center to further facilitate communications during times of emergency.

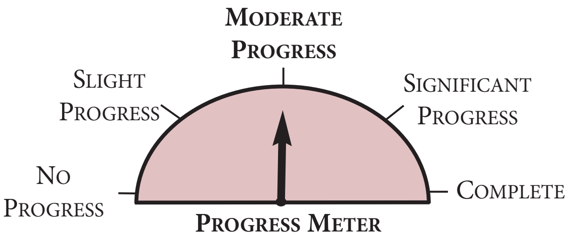
The Department played a significant role in responding to the Gulf Coast hurricanes. More than $2.7 billion in FHWA Emergency Relief (ER) funds were provided in late 2005 (first quarter of FY 2006) to assist States in the repair and recovery of Federal-aid highways damaged by hurricanes. These funds were instrumental in assisting the Gulf Coast region with needed recovery efforts following the devastating impact from Hurricanes Katrina, Rita, and Wilma. Repairs to the I-10 Twin Spans bridge in Louisiana, the replacement of two bridges on U.S. 90 in Mississippi that were completely destroyed, and debris removal that opened closed roadways were funded using ER resources. In addition, ER funds were used for repairs to traffic signals, guardrail replacement, and restoration of washed-out pavements and shoulders caused by extensive flooding all over the Gulf Coast region.

In the rush to restore transportation services as quickly as possible, it was also important that DOT's Operating Administrations provide proper stewardship over the resources devoted to the recovery effort. Incorporating lessons learned from the Gulf Coast hurricane relief effort, DOT's Chief Financial Officer issued cost reporting guidance in July 2006, to the Department for future emergency responses and related activities. This guidance identified statutory authorities for relief efforts; provided instructions to each Operating Administration on how to account for direct, indirect, and other costs associated with relief efforts; and mandated specific reporting requirements so management could provide the proper oversight.

To support the Department's responsibilities during national emergencies, the FAA's Southern Region awarded a competitive contract in 2002 to provide the bulk of transportation services designated to the region by FEMA. To administer the contract, the FAA Southern Region, assigned to the newly established Emergency Transportation Center (ETC) in Baton Rouge two experienced, full-time senior contracting officers. These contracting officers have implemented procedures directly responsive to Inspector General recommendations. Specifically, they have implemented procedures to randomly evaluate costs and pricing tendered by the current contractor, by comparing relevant market prices for the same or similar assets or services to determine fair market value. The contracting officers, in conjunction with other ETC personnel, enter transactions into the PRISM/Delphi cost accounting system as soon as possible after terms of agreement are reached with the contractor for particular tasks.

The FAA has also completed mitigating strategies to ensure the timeliness and tracking of credit card purchases through the use of the US Bank's computer system, Access Online. As of July 2006, all purchase card transactions in all FAA regions, centers, and headquarters offices are tracked with Access Online.

Addressing Transportation Security



There is a growing interdependency among Federal agencies to work together to secure the U.S. transportation system and protect the users of the transportation system from criminal and terrorist acts. The imperative for DOT is to effectively integrate new security measures into its existing safety regimen and to do so in a way that promotes stronger security without degrading transportation safety and efficiency.

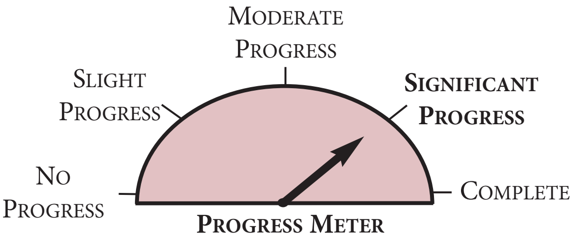
Significant progress was made in providing timely and accurate information to support federal, State and local response activities. For example, the FAA collaborated with many of our stakeholders to design an Airport Status Report that will be issued daily during periods of emergency. This report assists those responsible for the dispatch and operation of responding aircraft by providing specific information on the availability and usability of airport infrastructure, navigation aids, runways, and support facilities within a declared emergency or disaster area. It will also aid pilots operating in crisis environments by alerting them of compromised airport conditions, thereby facilitating informed and safer decisions. This type of communication flow continues to increase the FAA's ability to help the first-responders make critical decisions that reduce the effects of natural disasters and other crisis events.

DOT and the Department of Homeland Security (DHS) are implementing a Memorandum of Understanding (MOU) to improve cooperation and coordination in promoting the safety, security, and efficient movement of people and goods throughout the U.S. transportation system. We have established MOU annexes and agreements between DHS and the Federal Railroad Administration, Pipeline and Hazardous Materials Safety Administration, Federal Transit Administration, Federal Aviation Administration, and the Maritime Administration. These annexes clearly define the roles and responsibilities of each organization and provide the structure, processes, and oversight of research and development, emergency communications, and enforcement activities. Under the National Infrastructure Protection Plan, the modal agencies are working with their DHS counterparts to develop modal-specific security regulations or directives that ensure security issues are balanced with safety and efficiency.

With the experiences of Hurricanes Katrina and Rita behind us along with our growing collaboration with the Department of Homeland Security and other federal agencies, the Department has made great progress in our ability to respond to disasters and address transportation security. Although we may conclude that we have met the challenge presented by the Office of the Inspector General, the issue of disaster preparedness must be continually monitored and adjusted as needs dictate. DOT will take advantage of every opportunity to evaluate internal practices and partner with federal, State, and local officials to improve our disaster response capabilities as well as our support to the security of the Nation's transportation sector.

2. MANAGEMENT CHALLENGE: GETTING THE MOST FOR EVERY TAXPAYER DOLLAR INVESTED IN HIGHWAY AND TRANSIT PROJECTS

Actions by FHWA and the States Are Needed To Provide Oversight of Highway Funds to Ensure Projects Are Delivered On Time, Within Budget, and Free From Fraud.



In a 2003 Report to Congress, FHWA outlined its efforts to develop a more multi-disciplinary approach towards project management and oversight activities of highway projects. During the past three years, the Agency has addressed key areas including: 1) optimizing the use of internal staffing; 2) increasing training for existing and new staff; and 3) implementing specific stewardship and oversight initiatives. In addition, FHWA has taken steps to use available funds more efficiently across its project portfolio and to minimize improper payments.

As part of its efforts to optimize internal staffing, FHWA continued a program to move Agency employees beyond reviewing and approving project level actions to ensuring the effectiveness of local processes in major project drivers such as financing, cost control, schedule performance, and transportation planning.

FHWA continues to develop a multidisciplinary workforce. After a Department-wide assessment identified a skill gap in the financial management area, FHWA revised both the existing position descriptions and the available training opportunities for financial managers. This was done to

clearly identify financial management job duties and responsibilities so training could be aligned accordingly. In addition to new training options for financial managers, FHWA provided training for project managers including offerings in cost estimating and risk management. The FHWA is also addressing skill gaps by changing the mix of new hires to a multidisciplinary focus that includes positions other than those in civil engineering, which was traditionally the focus of recruitment efforts.

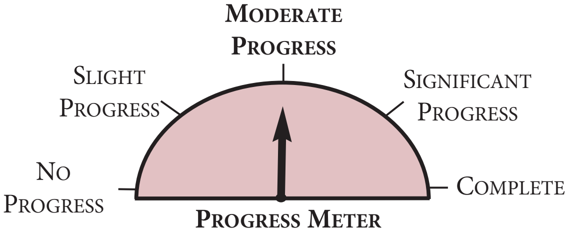
To increase project oversight for major programs, a project oversight manager position is being assigned to the largest projects. The major duties of the project oversight manager include ensuring the credibility of cost estimates/schedule milestones as well as overseeing completion of required activities at major project milestones.

FHWA's stewardship and oversight role was strengthened in SAFETEA-LU legislation passed last year. The legislation requires FHWA to conduct an annual review of the State departments of transportation financial management systems and project delivery systems, develop minimum standards for estimating project costs, and periodically evaluate State practices in these areas. It also places requirements for a project management plan and financial plan on all major projects of $500 million or more, and requires each State to provide a value engineering analysis on each Federal-aid project with a total cost of $25 million or more, a bridge project of $20 million or more, and other designated projects. In January of this year, the FHWA issued Interim Major Project Guidance based on the philosophy of expanding the FHWA oversight role to optimize its positive influence in the management of major projects.

FHWA revised regulation 23 CFR 630, Subpart A, Project Authorization and Agreements in order to better manage available funding and minimize inactive obligations. This regulation change assists States and FHWA in monitoring Federal-aid highway projects and provides greater assurance that the Federal funds obligated reflect the current estimated cost of the project. FHWA will revise the Federal obligation amount and reallocate inactive funding obligation balances if a State fails to take action as required by the regulation.

In April 2006, FHWA issued a new directive titled the *Financial Integrity Review and Evaluation Program*. The new directive requires each Federal-aid Division Office to conduct an improper payments review of its programs. In addition, FHWA implemented an improper payments testing and assessment methodology into the normal grant testing procedures.

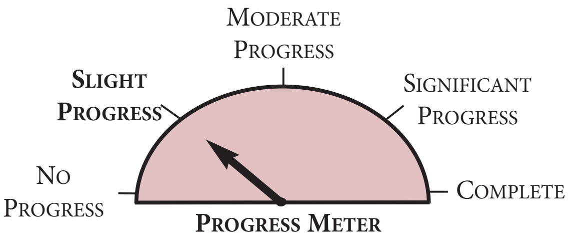
Enhancing Fraud Prevention Capabilities and Taking Aggressive Action Against Those Who Perpetrate Fraud, Including Motor Fuel Tax Evasion.



Detecting, preventing and responding to fraud, waste and abuse in the Federal-aid highway program is an essential component of FHWA's stewardship and oversight mission. FHWA continues to team with the DOT Office of Inspector General in elevating the awareness of fraud prevention. In April, FHWA co-sponsored the 2006 Fraud Prevention Conference, which drew over 300 participants from Federal, State and local governments, and the private sector. Detecting, preventing and responding to fraud are included in the FHWA Contract Administration Core Curriculum Course, which was presented in seven States in FY 2006 and has already been requested by 17 States for FY 2007. FHWA continues to stress the use of fraud indicators and reporting procedures and is working with the transportation and highway industry to report allegations of fraud, waste, and abuse on Federal-aid infrastructure construction projects.

The FHWA and the Internal Revenue Service (IRS) continue to work together to address the issue of evasion of motor fuel and other highway use taxes. An enforcement strategy, signed in January 2006, by the FHWA Administrator and the IRS Commissioner, focuses on enhancing enforcement efforts by developing and modernizing systems to improve service and enforcement; sharing best practices, lessons learned, and expertise with agencies involved with motor fuel and highway use tax enforcement; conducting outreach and education for stakeholders; and continuing research into finding solutions to the problem of tax evasion. Additionally, a Memorandum of Understanding identifying program-related responsibilities, accountability requirements, and funding levels, was also signed in January. FHWA has enlisted the help of a number of states by providing grant funds for intergovernmental enforcement efforts designed to address motor fuel tax evasion. Awards were given for innovative projects that involved a number of agencies working together with identified performance objectives. Project team leaders will submit an annual report presenting a summary of the project, accomplishments, as well as other comments on the project experience. FY 2006 was the first year intergovernmental grants were provided to the states through a competitive process. Grant funding is available through FY 2009.

Tough Decisions Ahead in Choosing Between Competing Transit Needs



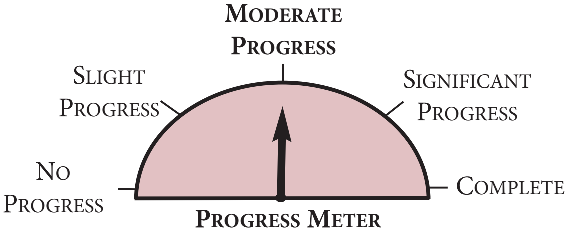
FTA's New Starts program encourages the submission of transit proposals that produce significant transportation benefits at a reasonable cost. Many worthwhile proposals are received each year. Unfortunately, the program is over subscribed – the total cost of proposals received exceeds the available funding. Therefore, it is incumbent upon FTA to have a prioritization process that funds only those programs that yield the greatest benefits to the public.

The current New Starts evaluation and rating process evaluates transit proposals using the following criteria: project cost estimates, benefits, and performance impacts for various planning alternatives. A thorough application of a planning alternatives analysis will result in reliable cost estimates, impacts, and benefits of these alternatives sufficient to make an informed decision. Through this process, FTA emphasizes the need for reliable ridership forecasts and cost estimates by including reliability of forecasting methods as an evaluation criterion.

While the current New Starts evaluation and rating process provides an evaluation and rating framework that enables FTA to make sound decisions on the competing transit needs, the process will be improved in the future by replacing the three-level rating scale with a five-level scale.

3. MANAGEMENT CHALLENGE: BUILDING ON RECENT INITIATIVES TO FURTHER STRENGTHEN SURFACE SAFETY PROGRAMS

Addressing Highway Safety Problems Where Serious Injuries and Fatalities Persist



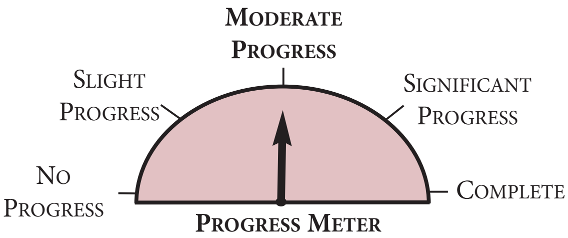
To reduce the number and rate of fatalities in traffic related crashes, the FHWA launched a performance based approach to safety in FY 2005 that better focuses resources on 16 identified States where the greatest opportunity exists to save lives. These States continued to receive funding in FY 2006 and FY 2007. In addition to the 16 identified States, a program entitled the Accelerating Safety Activities Program (ASAP) was adopted to support grants for all States to advance safety at the State, multi-State and local level. Over the last two years, 56 ASAP grants were approved.

In continuing to combat this problem, NHTSA made available more than $118 million to the States, the District of Columbia and Puerto Rico for alcohol-impaired driving countermeasure laws or programs, such as administrative license revocation laws and graduated licensing programs, or to meet certain performance criteria based on their alcohol-related fatality rates. Within this program, the ten States with the highest impaired driving fatality rates received extra funding. NHTSA will work closely with these ten States to facilitate implementation of effective programs, including periodic and sustained high-visibility enforcement efforts and media campaigns. NHTSA initiated the new national advertising campaign delivering the message "Drunk Driving: Over the Limit: Under Arrest." As part of this campaign, States conduct impaired driving enforcement crackdowns during the Labor Day weekend and the December holiday season. Additionally in FY 2006, NHTSA further enhanced its impaired driving program with continued emphasis on assisting high-risk populations (e.g., underage drinkers, 21 to 34 year-olds, individuals with high blood alcohol levels and repeat offenders). NHTSA also completed its demonstration of effective records system improvement strategies. Improved records systems ensure a more comprehensive and consistent approach to the apprehension, adjudication, and sanctioning of impaired drivers.

NHTSA has been effective in promoting safety belt use—steadily increasing the usage rate to a high of 82 percent in 2005. To further increase safety belt use, in FY 2006 NHTSA provided $123.3 million in incentive grant funding to 22 States, the District of Columbia and Puerto Rico that had implemented primary State safety belt use laws. The Safe, Accountable, Flexible, Efficient Transportation Equity Act: A Legacy for Users (SAFETEA-LU) authorizes the Federal surface transportation programs for highways, highway safety, and transit for the 5-year period 2005-2009. SAFETEA-LU established new core safety programs, encouraging safer cars and safer roads, and aggressively discouraging impaired driving while providing real incentives for States to enact stronger belt use laws. These incentives are already showing results. Since the beginning of 2006, three more States, Alaska, Kentucky, and Mississippi, have enacted primary safety belt use laws in direct response to the SAFETEA-LU incentives. In addition, the agency conducted its May 2006 *Click It or Ticket* campaign and encouraged States to increase participation in periodic high-visibility safety belt law enforcement mobilizations with coordinated paid and earned media efforts. Currently, a full National Occupant Protection Use Survey is being conducted to help quantify the results of the campaign's efforts. To reach hard-core safety belt non-users, NHTSA will continue to identify new communication strategies and messages and conduct research and demonstration projects among nighttime drivers, rural populations, pick-up truck drivers, 8-15 year olds, and teens.

Motorcycle rider fatalities have increased for the last eight years. To address this alarming trend, NHTSA issued a final rule in FY 2006 implementing the Motorcyclist Safety grant program. This rule establishes the requirements a State must meet and the procedures it must follow to receive a Motorcyclist Safety grant. The grants are to support rider training, motorist awareness, and impaired driving programs. In FY 2006, NHTSA awarded $5.9 million Motorcycle Safety grant funds to 44 States. Additionally, the agency developed and distributed implementation guidance and recommendations to State and local communities in the National Agenda for Motorcycle Safety. NHTSA also initiated a demonstration program to implement the "best practices" identified from a review of State training and licensing programs. Other NHTSA efforts include forming new partnerships with AARP, insurance companies, and health/medical organizations to assist with older/returning motorcyclists. The agency also recently released its 2006 Motorcycle Safety Program Plan, which provides a comprehensive look at NHTSA motorcycle safety efforts. The document can be found on NHTSA's website at http://www.nhtsa.dot.gov/people/injury/pedbimot/motorcycle/MotorcycleSafety.pdf.

Preventing Fraud in the Commercial Driver's License Program



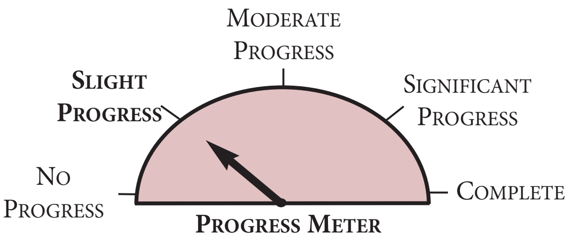
In FY 2006, FMCSA took a proactive approach to prevent fraud in State Commercial Drivers License (CDL) programs. FMCSA has just completed enhanced compliance reviews of 16 State CDL programs to ensure that: 1) States have the proper statutes and administrative procedures to administer their CDL programs in compliance with the Federal requirements, and 2) that State computer systems and licensing procedures are actually being implemented in compliance with the Federal requirements. Findings and recommendations from the compliance reviews have been provided to the States so they can make the necessary improvements to driver licensing issuance and testing procedures in order to reduce their susceptibility to fraud.

In April 2006, FMCSA initiated rulemaking to require covert monitoring of examiners and social security number (SSN) verification of CDL applicants. Currently, FMCSA has encouraged (but not required) States to establish covert oversight for both State and third-party testing examiners and provided grants funding to set up such programs. FMCSA continues to encourage States to perform SSN verification on all drivers, especially CDL holders and encourages the States to apply for CDL grant funds for the verification process. At least 45 States are currently performing SSN verification on CDL applicants and holders. States are required to perform Immigration and Naturalization Service Number verification through the Transportation Security Administration for CDLs with a hazardous materials endorsement. The proposed rulemaking that is under development would require both covert monitoring of examiners and SSN verification of CDL applicants, as well as continuing the current practice of Immigration and Naturalization Service Number verification.

A total of 39 States were awarded $19.6 million in grants to support improvements in State CDL programs and address deficiencies identified in compliance reviews and Inspector General audits. Nearly $2.4 million of this funding was allocated to improve the accuracy, speed, and completeness of driver history information exchanged among the various components of the system—including law enforcement, prosecutors, the courts, employers, and State driver licensing agencies—both within the States and between States.

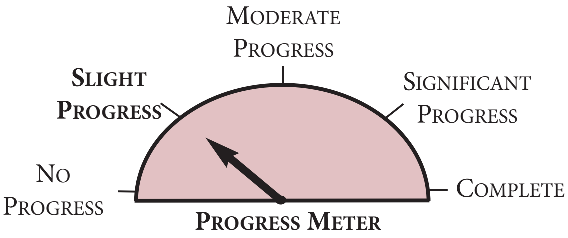
FMCSA has also taken steps to strengthen and modernize information systems associated with the CDL program. Congress recognized the importance of improving data quality by authorizing funding for a State safety data improvement program, known as the Safety Data Improvement Program (SaDIP). In FY 2006, FMCSA received 15 SaDIP applications from States with total funding requests equal to $5.8 million. FMCSA is currently reviewing applications and anticipates that it will award all $2 million in FY 2006 authorized funding to States.

Strengthening Rail Safety Program Oversight and Enforcement



The FRA has the responsibility to ensure the safe operation of the Nation's rail system. The Close Call Confidential Reporting System (CCCRS) is a process for proactively collecting and analyzing leading indicator data, and for improving the safety reporting culture in the railroad industry. Currently, the safety reporting systems in the railroad industry, including FRA's, are reactive systems for reporting accidents that often trigger punitive actions and the withholding of critical safety-related information. While reactive systems are valuable in identifying safety issues, the typically small number of accidents that are reported in such systems hinders effective trend spotting and other analyses. CCCRS reports many more events and thereby allows safety problems to be identified and corrected before accidents can occur. Moreover, CCCRS can significantly reduce accidents and injuries by creating a trusting environment in which critical safety-related information is openly shared for analyses, instead of being actively withheld to avoid punishment or liability.

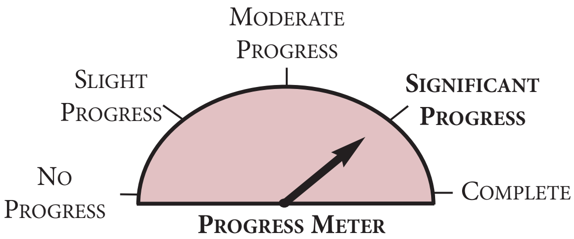
4. MANAGEMENT CHALLENGE: REFORMING INTERCITY PASSENGER RAIL TO IMPROVE PERFORMANCE



To address this challenge, FRA together with the Office of Secretary, has been heavily engaged in promoting a reauthorization of Amtrak that would address many issues surrounding intercity passenger rail. These issues include but are not limited to size, operations and governance of the Nation's passenger rail systems. DOT recognizes that the need for work in these areas is ongoing, particularly in addressing Amtrak's operating accounts and services it provides such as food and beverage and first class services. Through the annual grants to Amtrak, in particular the capital grant, and the Department's presence on the Amtrak board of directors, DOT has been able to assure that capital investments address the company's highest priorities and are consistent with the funding available.

5. MANAGEMENT CHALLENGE: MITIGATING FLIGHT DELAYS AND RELIEVING CONGESTION—ACTIONS NEEDED TO MEET DEMAND

Taking Appropriate Action Against Growing Aviation Delays



In FY 2004, the FAA completed a study analyzing system capacity. The study identified 21 non-Operational Evolution Plan (OEP) airports as potentially needing additional capacity. In FY 2005, phase two of the capacity study was undertaken to enhance the level of detail of the non-OEP airports identified. This included conducting annual service volume studies,

developing capacity benchmarks, and detailing national airspace simulation. In addition, potential solution sets were developed to improve airport capacity. In FY 2006, FAA continued these efforts and analyzed the benefits of the potential solutions through detailed modeling.

The Agency is increasing capacity by working with airports and local communities to build new runways. Four new runways opened at OEP airports in FY 2006 at Atlanta, St. Louis, Cincinnati, and Minneapolis, providing the airports with the potential to accommodate an additional 665,000 annual operations. Runways are under construction at six other airports—Boston, Philadelphia, Los Angeles, Seattle, Washington Dulles, and Chicago O'Hare. Eight projects are in the planning or environmental review stage—one airfield reconfiguration, two runway extensions, two new runways, and three new airports that are expected to provide significant capacity benefits through 2015.

Technological improvements are aggressively being pursued to improve system capacity. In June 2006, the Airspace Flow Program (AFP) was deployed. AFP is a traffic management initiative that identifies constraints in the enroute system, develops a real-time list of flights that are filed into a constrained area, and distributes departure clearance times to meter demand through the area. It allows controllers to delay only those flights that are expected to pass through airspace affected by bad weather and safely meters traffic throughout the constrained area. AFP reduces the number of flight delays and brings an estimated $900 million in cost savings to the airlines and the flying public over ten years. AFP provides flexible, equitable metering of traffic through a constrained area of airspace.

As a result of this new program, the crippling effects of thunderstorms that impact the Nation's airspace system are minimized. Even with limited use of the program to date, the number of required reroutes has declined and routes within the constrained airspace appear to remain useable for longer periods. In addition, with the deployment of the AFP, the FAA has seen a decrease in the number of ground delays for flights destined to the Northeast. AFP initial deployment was limited to select geographical areas in the Northeastern Corridor. FAA expects to continue the geographical expansion of the AFP as the analysis of the procedure becomes mature and familiarization and experience with the process increases.

In addition to these decision support tools, the Agency is continuing to explore and apply state of the art weather forecast information to improve services to our customer, to mitigate the impact of weather on air traffic. Two systems are now in place to help—the Collaborative Convective Forecast Product and Corridor Integrated Weather System.

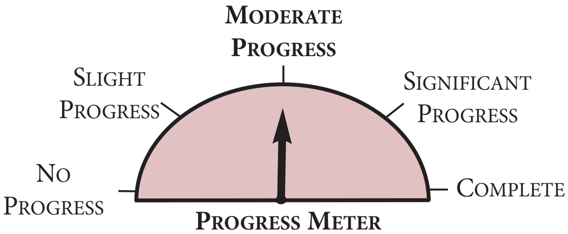
The Collaborative Convective Forecast Product, available during the March to October severe weather season, is a graphical forecast of convection (winds, showers, and thunderstorms) developed specifically for use in strategic planning and the management of air traffic. With this

forecast product, collaborative activities occur more rapidly and traffic management decisions based on weather data are more accurate. The tool provides advance planning for long haul flights and allows for schedule predictability based on 2-4-6 hour forecasts.

The Corridor Integrated Weather System provides a more accurate convective weather forecast out to 120 minutes in the future. The product is deployed on a limited basis at several Air Traffic Control centers as a prototype. Preliminary results indicate contollers are making and coordinating decisions more quickly, which reduced delays due to severe weather. FAA expects that this prototype can be ultimately tested and integrated into the NAS system in the near future.

Procedural changes have also been implemented to improve performance. In FY 2006, the FAA created a new position at the Air Traffic Control Systems Command Center (ATCSCC) called the National Enroute Spacing Position (NESP). The goal of the NESP is to distribute enroute volume efficiently during severe weather or other events that constrain the NAS. As such, the NESP is the focal point when implementing an AFP. The NESP position was implemented as part of a larger concept change at the ATCSCC called the National System Strategy Team (NSST). The NSST was developed to clearly define areas of specific individual responsibility among personnel. Implementing individually assigned and recognized responsibilities in the NSST will improve the efficiency and effectiveness of system-wide planning, coordination, and responsiveness including reroute generation and exit strategy planning.

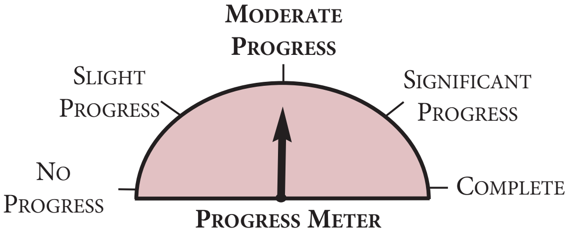
Keeping Planned Infrastructure and Airspace Projects on Schedule to Relieve Congestion and Delays



An integration team comprised of representatives from all appropriate FAA organizations monitors the progress of each new runway construction project and is responsible for ensuring that the runway is commissioned on schedule with all necessary equipment and airspace procedures in place. The team provides quarterly updates to FAA executives on the status of each project and issues relating to the runway project are discussed, assigned to an executive to resolve, and tracked by the integration team to ensure resolution.

Improving the efficiency of existing airport capacity by redesigning airspace is critical for taking full advantage of new runways and enhancing the flow of air travel around existing runways and airports. To support improved investment decisions, FAA commissioned a study that was delivered in March 2006, to estimate the customer benefits of airspace redesign projects and then rank projects based on relative benefits. A prioritization index was developed based on each project's ability to meet FAA agency goals, customer and agency benefits, and risk factors. In FY 2006, when the Airspace Management Program (AMP) budget experienced significant cuts, the airspace prioritization index was used to make difficult funding decisions. Along with this index, the AMP program office completed a quantified assessment of the operational benefits of all proposed projects. This assessment has been used to create an earned-value metric that measures the progress and projected value of a proposed airspace effort. The Airspace Current Benefit State metric is defined as a weighted dollar value of the experienced and expected customer benefits of charted and funded airspace projects.

Exploring Alternatives for Managing Capacity Where Infrastructure and Airspace Redesign Initiatives Are Not Feasible



Over the past several years, the FAA has conducted extensive research efforts to explore the feasibility of various market-based and administrative mechanisms to manage congestion at capacity constrained airports where expansion is not a viable option. For example, the FAA, in concert with the National Center of Excellence for Aviation Operations Research, has initiated research on auctions, congestion pricing, and various administrative solutions.

In FY 2006, the FAA began to promote a more efficient allocation of resources through the use of market-based mechanisms. In August 2006, a congestion management Notice of Proposed Rulemaking (NPRM) for New York's LaGuardia Airport was published in the Federal Register. The proposed rule establishes an operational limit on the number of aircraft landing and taking off at the airport. To offset the effect of this limit, the rule would implement an airport-wide, average aircraft size requirement. The intent is to encourage the use of larger aircraft to increase the number of passengers who use the airport. To maintain a level of service to small communities, FAA proposes to permit a fixed number of operating authorizations for service to

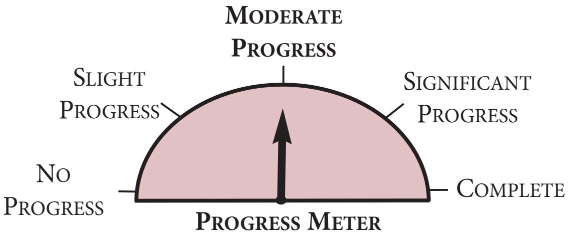
smaller airports, exempt from the aircraft size requirement. The proposed rule also announces the Administration's intent to use market-based mechanisms beginning in 2010. The FAA is directing its efforts toward the publication of the final rule for LaGuardia and developing market-based language in the FAA Programmatic Reauthorization, which must be enacted by the end of FY 2007.

Similarly, FAA published a Final Congestion and Delay rule for Chicago O'Hare International Airport in August 2006. The rule will manage capacity at that airport until the O'Hare Modernization Plan (OMP) expansion yields additional capacity. The first OMP runway is expected to open in November 2008. Therefore, FAA adopted October 2008 as the sunset date for this rule.

Although the rule is temporary, FAA has included market-based elements for the secondary market allowing the purchase, sale, and lease of arrival authorizations by air carriers. The FAA-operated market will be "blind," keeping the bidders' identities secret until the sale has closed and FAA has forwarded the highest bid to the seller. A blind market will advance the goals of promoting the most efficient use of the airspace and maximizing reliance on market forces. This will also ensure that new entrants and all other airlines have an equal opportunity to purchase/lease arrival authorizations.

6. MANAGEMENT CHALLENGE: REAUTHORIZING AVIATION PROGRAMS—ESTABLISHING REQUIREMENTS AND CONTROLLING COSTS ARE PREREQUISITES FOR EXAMINING FAA FINANCING OPTIONS

Control Major Acquisitions Costs—Delivering New Systems that Work on Time and Within Budget and Making Decisions about the Scope of Billion-Dollar Projects that Have Been Delayed



In an effort to better control major acquisition costs and schedules, FAA has implemented a series of executive and management reviews to oversee program progress. Currently, FAA acquisitions over $10 million require the approval of the Chief Financial Officer (CFO). The FAA's Chief

Information Officer now reviews any information technology acquisition in excess of $250,000. The Associate General Counsel also provides a legal review for all procurement actions greater than $100,000.

In addition to the executive-level reviews, the agency has implemented acquisition management controls through the Joint Resource Council (JRC), the ATO Executive Council, and the Capital Investment Team (CIT). The JRC reviews and approves all major investments and the Facilities and Equipment (F&E) budget. It delegates to subordinate boards the authority to approve non-major investments in accordance with the FAA Acquisition Management System (AMS). It also conducts service-level reviews, which provide a FAA-wide overview of operations and investments by service organization.

The ATO Executive Council meets monthly to approve mission need statements of programs beginning the investment process. They review major investments prior to submitting these to the JRC for further review and approval. They also provide review and approval of non-major investments to begin acquisitions. For the Executive Council to approve a program, the program must first complete the ATO-Finance Capital Investment Team review process.

The CIT reviews both the benefits and costs of each ATO investment program, and validates the methodology to determine if benefits are calculated properly, validates the requirements for major investments, and ensures recipient benefits are correctly identified. They also validate the development costs, whether a proper alternatives analysis was conducted, and whether ATO can afford to operate the system once it is developed. As a result of the CIT process, several projects have been restructured, had resources reallocated, or have been terminated. Through these actions, the F&E budget baseline has been decreased by over $450 million dollars.

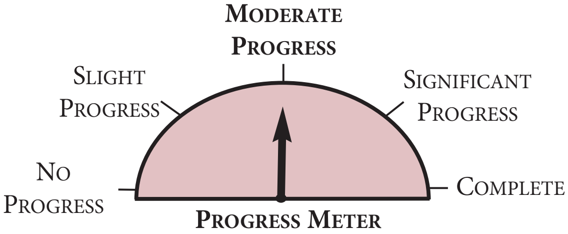
Further, FAA has strengthened its management processes. Recent changes to the Acquisition Management System require major acquisition projects to meet OMB Exhibit 300 standards for business case justification before receiving program approval and funding. Key changes include limiting funding approvals to three – five year segments, training and certifying all project managers, and strengthening the investment analysis process.

In addition, a major earned value management (EVM) effort has been initiated across the agency. For all newly approved IT investments that have funding greater than $10 million, project personnel are required to track and measure program performance in accordance with EVM guidelines. By applying EVM methodologies to its acquisitions, the FAA is able to ensure project planning and control by effectively integrating the project scope of work with cost, schedule, and performance elements.

Implementation of executive and management reviews and wide-ranging processes have resulted in positive, measurable, and dramatic changes in how FAA controls major acquisition costs. FAA is meeting its performance target related to acquisition costs and is meeting 97.4 percent of its

acquisition schedule milestones. More importantly, the FAA is beginning to efficiently and effectively deliver critical technology to the National Airspace System, resulting in increased safety and system capacity for airline passengers.

Get Control of Support Services Contracts

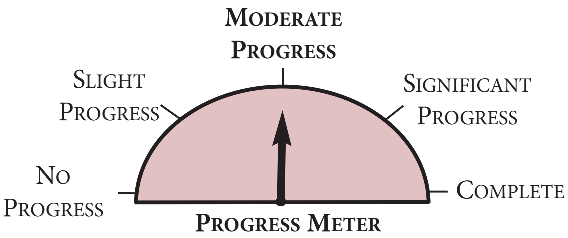


FAA support service contracts now undergo the same rigorous executive and management oversight as do other FAA acquisitions. In addition to the executive reviews discussed in the previous section on controlling major acquisition costs, FAA's Deputy Administrator also plays an important role in reviewing and managing FAA support services costs. For any support service contract where fewer than three bidders are competing for a contract over $1 million, the Deputy Administrator's approval is required. This additional step in the review process insures adequate competition exists in awarding service contracts.

As discussed in the Inspector General's audit report on FAA's National Contracting Service, the agency has also implemented corrective actions to address a practice known as revolving employment - where former FAA employees return as contractor employees. In October 2005, AMS Clause 3.1.7-6, Disclosure of Certain Employee Relationships was implemented. This clause is intended to enforce the Agency's policy of not conducting business with contractors, subcontractors and consultants who have an unacceptable conflict of interest or an unacceptable appearance of a conflict of interest. Additional guidance was implemented in the October 2006, AMS update.

The IG also pointed out in the same audit report that there were variations in the mechanisms used by different FAA organizations in carrying out procurement oversight responsibilities. In response, the FAA is developing a nationwide, uniform procedure for such oversight under the FAA's Acquisition Executive, which will be incorporated into the AMS by January 31, 2007.

Establish Requirements for the Next Generation Air Traffic Management System (NextGen)

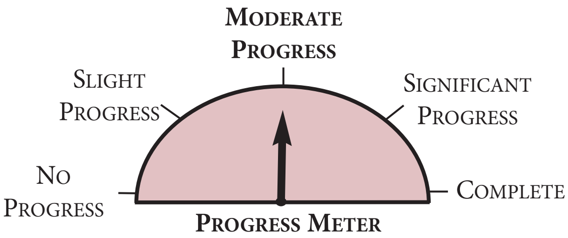


The goal of the Next Generation Air Transportation System (NextGen) is the creation of a more flexible and scalable air transportation system through use of new technologies and capabilities. It will be a data driven system capable of handling new types of aircraft, new industry business models, and the growing demands on capacity expected in the years ahead. Achieving this requires a concerted focus and alignment of efforts in both government and the aviation industry.

The FAA has released an initial draft of the enterprise architecture and its companion concept of operations for stakeholder comment. The concept of operations was developed with the assistance of the private sector and member Federal agencies. The concept forms a baseline to initiate a dialogue with the aviation stakeholder community, to develop the policy agenda, and encourage the research needed to achieve NextGen. An iterative process of defining the concept of operations (ConOps) and enterprise architecture (EA) will continue into early FY 2008, at which time the full breadth and depth of NextGen will have been addressed. However, the ConOps and EA will be further refined over time as research results are achieved, policy decisions are reached, and the impacts of technology breakthroughs are assessed.

In order to better understand the costs and benefits of NextGen, the FAA asked the Next Generation Air Transportation System Institute to host a series of workshops with industry where the critical assumptions and uncertainties underlying future cost estimates can be reviewed, scrutinized, and validated for future use. The workshops have been focused on three objectives. The first has been to focus on specific cost drivers affecting the first five years of the NextGen initiative. The second objective is to develop the assumptions for research and development, facilities, and equipment for the five to fifteen year timeframe. And finally, the third objective is to gain insight into how aviation service and equipment providers view the future of the global marketplace. The workshops have proven highly successful and with this input, the FAA is in a much better position to offer an estimate of the future costs of NextGen. A completed cost benefit case will be developed in FY 2007.

Address the Expected Surge in Air Traffic Controller Attrition and Negotiating an Affordable and Equitable bargaining Agreement



In August 2006, FAA released an updated air traffic controller workforce plan—*A Plan for the Future: The FAA's 10-Year Strategy for the Air Traffic Control Workforce*. The plan provides a comprehensive 10-year strategy to ensure the FAA has an adequate number of controllers available, in the right place, to handle the coming decade's projected air traffic. These resource needs are then tightly aligned to the agency's performance budgets. The plan also outlines how we will hire these new controllers using a schedule designed to provide adequate training lead-time and to address changing air traffic demands over the coming decade.

In FY 2006, the FAA hired and trained new controllers at the level consistent with the updated staffing plan. Controller staffing levels will need to increase each year through 2012 to ensure the number of certified professional controllers in the system stays ahead of expected retirements. Adequate funding requests to hire and train new staff in the future will continue to be consistent with targets set in the controller workforce plan.

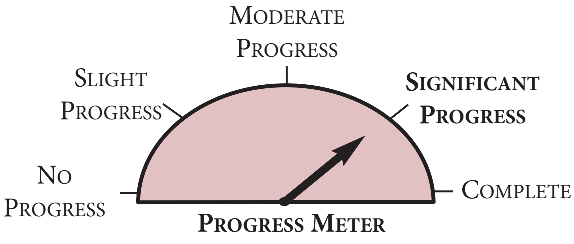
Academy training and facility training capacity improvements have been implemented and further improvements are continuing in order to decrease the time it takes a new hire to become a certified professional controller, from three to five years down to two to three years. Even-flow hiring that links Academy training capacity and facility training capacity has avoided training bottlenecks at both the Academy and in-the-field facilities. Training classes at the Academy are full and two classes have been added to the FAA Academy course schedule for FY 2007 to meet hiring and training needs. Academy graduates will fill targeted air traffic facility vacancies that have been identified through the third quarter of FY 2007.

The FAA has also undertaken several key initiatives to achieve significant reductions in operating costs by ensuring controller productivity measures are in place. Since the release of the first air traffic control workforce plan in December 2004, ATO has introduced methods to save $20,000 per FAA Academy trainee, achieved one-year cost avoidances of $6.4 million, and reduced direct labor costs by almost $1 million.

The FAA implemented new work rules for the nation's air traffic controller workforce which went into effect September 3, 2006, with all past practices and Memorandums of Understanding rendered null and void. The work rules associated with the new National Air Traffic Controllers Association contract ensure that the funding, technology, and people will be in place to provide safe and seamless travel for the flying public, while fairly conpensating controllers.

The new contract restores basic management rights lost in the last agreement. Going forward, the agency will be in charge of daily schedules, work assignments, and decisions regarding the deployment of technology. Significant costs savings are achieved through a new controller pay scale and by eliminating two types of premium pay—Controller Incentive Pay, a second locality pay unique to some controllers, and Controller-in-Charge Pay premium, which had not reduced required supervision as originally intended.

Completing the Cost Accounting System to Control Costs and Improve Operations



During FY 2006, the FAA completed the implementation of the Cost Accounting System (CAS) in the last two lines of business – Airports and Aviation Safety. With the implementation of the CAS across all lines of business, FAA management is able to obtain invaluable management information to assess operational performance and make critical business decisions.

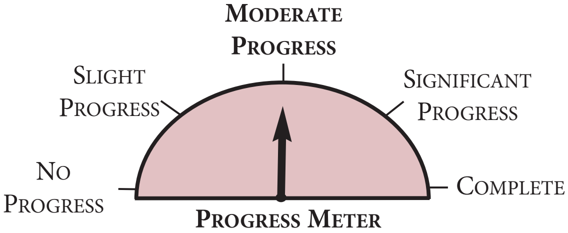
The integration of the Air Traffic Organization (ATO) labor distribution system with the CAS was also completed in FY 2006. An updated version of CAS was implemented in ATO, which uses actual ATO labor distribution data – thereby eliminating the use of the less precise staffing standards to assign ATO labor costs. Tracking data indicates that organization-wide, over 90 percent of labor distribution reporting hours are charged to valid projects and activities and that ATO has been achieving a compliance rate near 92 percent.

Financial information from CAS is also being used to determine past trends and future needs and is coupled with operational data to determine unit costs. ATO managers are driving cost improvements, and measuring those improvements using key financial performance metrics. For example, the ATO has identified economic drivers, such as controlled flights, and manages to a

"full cost per controlled flight" performance target. The ATO also manages to an overall direct to indirect field employee staffing ratio, to assure resources are deployed to support the operational workforce in a cost-efficient manner.

7. MANAGEMENT CHALLENGE: AVIATION SAFETY—DEVELOPING EFFECTIVE OVERSIGHT PROGRAMS FOR AIR CARRIER OPERATIONS, REPAIR STATION MAINTENANCE, AND OPERATIONAL ERRORS

Implement a Risk-Based Approach to Air Carrier and Repair Station Oversight



The FAA has continued implementation and expansion of the Air Transportation Oversight System (ATOS), a proven risk-based approach to air carrier oversight. ATOS enables FAA inspectors to look at the whole system, from pilots to maintenance facilities to flight dispatch to cabin safety. ATOS provides inspectors with the ability to continually adjust the focus of surveillance through the identification and prioritization of risks. Of the 116 major air carriers, 39 are currently under ATOS and the remaining 77 will be under ATOS by December 2007.

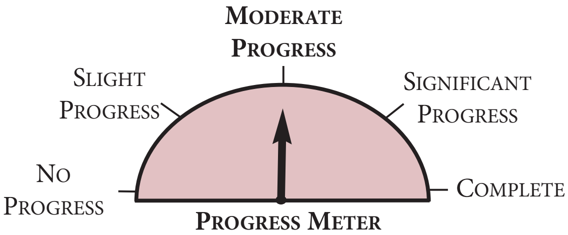
A significant part of air carriers' maintenance work is performed at night or on weekends. To fully address this circumstance, FAA adjusted its surveillance requirements to reflect the amount of maintenance performed during these hours. To support this adjustment, the agency issued new guidance that requires certificate management teams to identify and document how much maintenance is accomplished off-hours and to develop surveillance plans to monitor risks associated with work performed during these times. The guidance also requires managers to ensure that inspectors assess risk, adjust surveillance plans accordingly, and that surveillance reports are annotated to indicate when inspections are accomplished off-hours.

The FAA issued new guidance and proposed rules for the oversight of both domestic and foreign repair stations. For domestic facilities, the guidance establishes a system safety oversight and risk assessment program. A notice of proposed rule making (NPRM) that revises standards for the FAA to certify repair stations is also currently under review at the Department of Transportation.

To provide customers a better understanding of the capabilities of specific repair stations, the FAA has prepared and sent to DOT a NPRM that revises the rating system for repair stations to better reflect evolving technologies and business practices. The proposed rule also requires repair stations to have a self-audit system to assure the repair station only returns to service products that meet all airworthiness requirements.

The FAA continues to conduct a repair station prototype program that uses an air carrier certificate management team structure to strengthen oversight. Advantages of this approach include standardization and control from a central FAA office. The program is targeting large repair stations and companies that operate multiple repair stations or satellite repair facilities. Based on the results, FAA will evaluate expanding this approach in FY 2008.

Ensure Reporting of Operational Errors



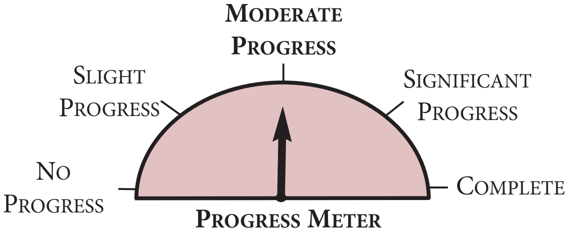
To ensure operational errors are reported, the FAA issued a general notice to all Air Traffic Control facilities to establish an incident audit process. This program was implemented in October 2005, and is fully operational. The incident audit review process contains a highly structured system of checks and balances to ensure the reporting of operational errors. The process requires reviews of Air Traffic Services using existing playback tools to identify operational errors. The playback tools recreate air traffic incidents by replaying recorded radar and voice data. FAA Headquarters is also conducting similar reviews to capture operational errors. Further, the FAA has added a requirement to its Air Traffic Quality Assurance Order that directs all facilities to conduct monthly audits of a random sampling of radar or other data. Each facility or hub prepares a quarterly report of the findings to their respective Service Area Quality Assurance Manager. FAA data indicates the audit program is having the desired effect—facilities are more accurately reporting operational errors and deviations.

To automate this incident audit review process, FAA is currently developing and implementing a nationwide automated software prototype to depict separation conformance in both the terminal and enroute environments called the Traffic Analysis Review Program. This detection technology

applies separation logic to targets, identifies where applicable separation standards are not being maintained, and highlights incidents for further investigation. The FAA is on schedule for initial implementation in the third quarter FY 2007.

8. MANAGEMENT CHALLENGE: IMPROVING INFORMATION TECHNOLOGY INVESTMENT AND COMPUTER SECURITY

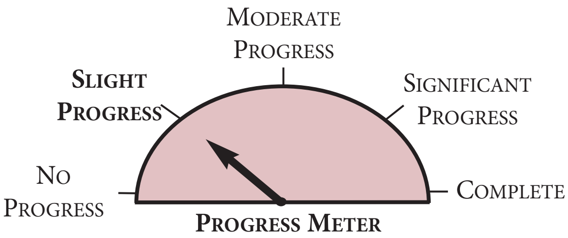
Clarify the Departmental Investment Review Board's Role in Assisting the Secretary to Maximize the Value and Manage the Risk of Major Information Technology Investments



With the cooperation of the DOT General Counsel and FAA's Chief Counsel Offices, the role of the DOT Investment Review Board (IRB) in major IT investments has been more clearly defined. The IRB will continue its oversight role for the entire Department, with the FAA agreeing to voluntarily submit its major investment projects to the IRB for review. The IRB will continue to make recommendations to the FAA with respect to major IT programs as a necessary part of developing the Department's IT portfolio in the budget process. If the FAA chooses not to adopt the Department's recommendations with respect to major IT investments, the Department retains the authority to exclude the project from the Department's budget.

In order to improve management and oversight of IT investments, DOT is revamping its overall governance structure, including changes to the IRB to make it more value added in the oversight process. The IT budget submission schedule will be changed to better align it with the overall budget schedule. Reporting requirements for IT investments will also change to allow managers to identify at-risk or potentially at-risk programs earlier in the acquisition process. The Department's Chief Information Officer intends to have these changes implemented in FY 2007.

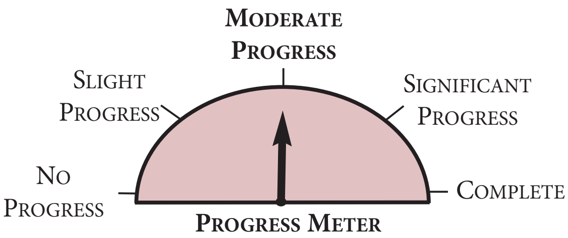
Eliminating Redundant IT Infrastructure Outside of DOT Headquarters to Reduce Operating Costs.



During FY 2006, DOT continued to integrate hardware and software services to its common operating environment. The Department also made gains in eliminating IT redundancy as field office e-mail and desktop workstations were consolidated in several operating administrations. Server migrations were also completed at several field facilities in five different operating administrations.

The Department's focus in FY 2007 will be to plan for the broader remaining activities related to consolidating field office IT infrastructure and eliminating duplication. Consolidating networks and implementing a services support model will be included in the planning process. A comprehensive project plan will be completed and submitted to the CIO Council and the Investment Review Board for review and approval.

Better Securing Operational Air Traffic Control Systems



The Security Certification and Accreditation (C&A) Program is an integral part of FAA's efforts to ensure the security of its information technology systems, including air traffic control systems. The FAA adopted National Institute of Standards and Technology (NIST) guidelines and standards for certification, accreditation, and monitoring of its IT systems. The C&A process

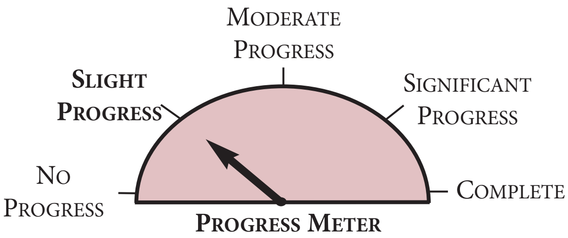
provides FAA senior managers the most complete and accurate information possible on the security status of the agency's information systems so they can make timely, credible, risk based decisions on whether to authorize operation of those systems.

The FAA undertook several initiatives to maintain current certification and authorization (C&A) of its IT systems, which includes air traffic control systems. The FY 2006 goal was to complete C&As on 33 percent of its IT systems, or 95 total C&As. Of the 95 total C&As, 28 were planned to be initial certifications and 67 re-certifications. The agency completed initial C&As on 26 systems (rather than 28 as two developmental systems were not fielded) and recertified 73 systems in FY 2006. Remaining systems will undergo self-assessments as the FAA is required to review all IT systems on a yearly basis using a C&A or self-assessment. In addition, the agency revised the C&A Handbook to reflect NIST guidelines and standards. The agency also established a FY 2006 goal to remediate 20 percent, or 36, of the 180 high-risk weaknesses identified. To date, the FAA has remediated 112 of the targeted 180 vulnerabilities, far exceeding the FY 2006 target.

The FAA took steps to improve its business continuity plan (BCP) to deal with prolonged service disruptions at a major facility that would severely disrupt air traffic, cause significant economic losses, and subject travelers to delays and inconvenience. The FAA has completed actions on recommendation received in FY 2005 to mitigate a prolonged service disruption at an enroute facility. Further, the agency established an engineering team to support continuity plan activities. The BCP team completed an engineering analysis and developed proposed near, mid, and long-term solutions. The team briefed FAA Senior Executives who formalized BCP activity as a priority. By December 2006, the BCP team will develop a schedule and program management plan to support the proposed business continuity plan solutions.

The FAA also designated a focal point for decision-making in long-term disaster recovery. This designation is reflected in an update to the Air Traffic Organization Operational Contingency Plan. The update also reflects the transition from short-term contingency to long-term continuity, which will enable the FAA to deal more effectively with prolonged service disruptions at major facilities.

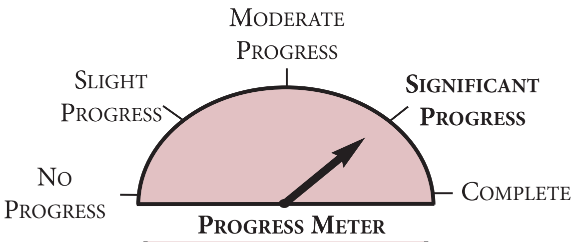
Correcting Weaknesses in the Federal Railroad Administration Network and Enhancing Business Contingency Plans for Critical DOT Systems



In response to the Inspector General's finding, FRA has eliminated a router vulnerability in its administrative network. Using static route statements, all communication from external sources passing through the network's edge routers are now directed to the security firewalls. All firewalls have been upgraded with the latest security software updates/patches, and hardened following the guidance in existing DOT standards. The overall firewall policy being followed is to block all inbound communications traffic unless that traffic is explicitly permitted. This firewall policy was adapted from DOT guidance, the Computer Emergency Response Team/Coordination Center and the SANS (SysAdmin, Audit, Network, Security) Institute. Users have been given training on security awareness and the handling of sensitive data. FRA has also added their headquarters systems to the DOT Windows Active Directory domain in order to ensure compliance with DOT standards.

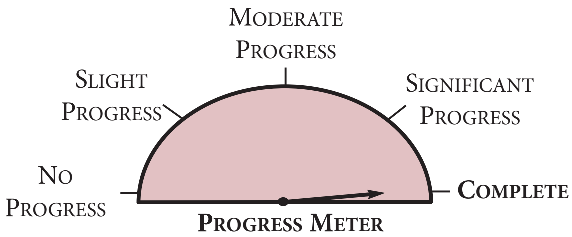
9. MANAGEMENT CHALLENGE: ENSUING THAT REFORMS ARE IMPLEMENTED IN THE MARITIME ADMINISTRATION'S TITLE XI LOAN GUARANTEE PROGRAM

Completing the Development of the Title XI Loan Guarantee Tracking System



During FY 2006, MARAD continued development and implementation of the loan guarantee tracking system. By the second quarter of FY 2007, the computerized monitoring software should be fully capable of meeting the Title XI program's requirements. The computerized monitoring system will be fully developed and operational by the end of FY 2007. The tracking system will increase the program's efficiency in performing the required financial analysis for each Title XI loan guarantee and the tracking of insurance and vessel classification certificates for vessels and shipyards financed by the Title XI program. The computerized monitoring system will help the Title XI program staff minimize defaults since the increased efficiency in performing financial analysis will help identify troubled loan guarantees earlier and provide more time for the staff to take corrective actions when necessary.

Enforcing the Requirements Established To Mitigate Risks of Noncompliant Loans and Pursuing Remedies to Cure Defaults



MARAD has completed an accounting of each borrower's Reserve Fund requirements. MARAD has actively worked to cure any defaults of noncompliant loans and will continue to work with any borrower that is noncompliant on its Reserve Fund deposit requirements.

With the implementation of the new loan guarantee tracking system, MARAD considers this management challenge resolved. In September 2004, the DOT Inspector General issued a follow-up audit on the Title XI Program and stated that MARAD developed policies and procedures that addressed each of their five recommendations from the March 2003, audit report in a satisfactory manner. The Title XI Program has not experienced a loan guarantee pay-off since April 2002.