PART I:
MANAGEMENT DISCUSSION AND ANALYSIS

APPALACHIAN REGIONAL COMMISSION STRUCTURE AND PROGRAMS

Congress established the Appalachian Regional Commission (ARC) to address the profound economic and social problems in the Appalachian Region that made it a "region apart" from the rest of the nation.

The Commission was charged to

- Provide a forum for consideration of problems of the Region and proposed solutions, and establish and use citizens' and special advisory councils and public conferences;
- Provide grants that leverage federal, state, and private resources to build infrastructure for economic and human resource development;
- Generate a diversified regional economy, develop the Region's industry, and build entrepreneurial communities;
- Serve as a focal point and coordinating unit for Appalachian programs;
- Coordinate regional economic development activities and the use of federal agency economic development resources;
- Make the Region's industrial and commercial resources more competitive in national and world markets;
- Improve the skills of the Region's workforce;
- Adapt and apply new technologies for the Region's businesses, including eco-industrial development technologies;
- Improve the access of the Region's businesses to the technical and financial resources necessary to the development of business; and
- Coordinate the economic development activities of, and the use of economic development resources by, federal agencies in the Region.

The challenges confronting Appalachia today are complex. In some areas of the Region, basic needs in infrastructure, the environment, workforce training, and health care still exist. But because the nation and the Region now compete in the global economy, the threshold for success is higher than it once was: high-technology jobs rather than manual labor, college education rather than basic literacy, and telecommunications arteries in addition to highways.

Federal agencies are typically national in focus and narrow in scope, but ARC was created to be regional in focus and broad in scope. No other government agency is charged with the unique role of addressing Appalachian problems and opportunities. No other agency is charged with being simultaneously an advocate for the Region, a knowledge builder, an investor, and a partner at the federal, state, and local levels. These roles represent elements that are essential to making federal investments work to alleviate severe regional disparities in the country: responsiveness to regional needs with a view to global competitiveness, emphasis on the most distressed areas, breadth of scope to address both human and physical capital needs, and flexibility in funding.

The Commission by law directs at least half of its grant funds to projects that benefit economically distressed counties and areas in the Region. In part, ARC gauges its long-term progress toward helping the Region achieve economic parity with the nation in terms of the gradual reduction in the number of such counties and areas over time. The maps on page 16 show the Region's 223 economically distressed counties in 1960 and the 77 counties designated as distressed in FY 2006. The change is dramatic.

ARC is a federal-state partnership, with a governing board composed of a federal co-chair and the governors of the 13 Appalachian states. Because of its partnership approach, ARC is able to identify and help fund innovative grassroots initiatives that might otherwise languish. In many cases, ARC functions as a predevelopment agency, providing modest initial funding that is unavailable from other sources. ARC funds attract capital from the private sector and from other public entities.

Through the years, ARC support has helped address the problem of historically low public and private investment in Appalachia. ARC has effectively used its funds to help communities qualify for, and make better use of, limited resources from other federal agencies. These federal funds, combined with state, local, and private money, provide a broad program of assistance to the Region. In addition, substantial private investment in business facilities and operations has accompanied ARC development projects.

Two independent studies have found that ARC's coordinated investment strategy has paid off for the Region in ways that have not been evident in parts of the country without a regional development approach. A 1995 study funded by the National Science Foundation compared changes in Appalachian counties with their socioeconomic "twin" counties outside the Region over 26 years, from 1965 to 1991. This analysis, controlled for factors such as urbanization and industrial diversification, found that the economies of the Appalachian counties grew significantly faster than their non-Appalachian counterparts. A more recent analysis by Economic Development Research Group has extended this analysis to 2000 and confirmed the earlier findings on the impact of ARC's investment (see page 62).

Management Discussion and Analysis

ARC was reauthorized through fiscal year 2006 with the enactment of the Appalachian Regional Development Act Amendments of 2002, Public Law 107-149. ARC's appropriation for FY 2006 nonhighway programs was $64.8 million. Appendix A provides a history of appropriations to the Commission.

The Commission is a performance-driven organization, evaluating progress and results on an ongoing basis and relying on clearly defined priorities and strategies for achieving them.

Organization: The ARC Partnership Model

The Appalachian Regional Commission has 14 members: the governors of the 13 Appalachian states and a federal co-chair, who is appointed by the president and confirmed by the Senate. Each year one governor is elected by his or her peers to serve as the states' co-chair. The partnership nature of ARC is evident in its policy making: the governors and the federal co-chair share responsibility for determining all policies and for the control of funds. On all Commission decisions, the federal co-chair has one vote, and the 13 governors share one vote. Accordingly, all program strategies, allocations, and other policy must be approved by both a majority of the governors and the federal co-chair. All projects are approved by a governor and by the federal co-chair. This consensus model ensures close collaboration between the federal and state partners in carrying out the mission of the agency. It also gives the Commission a nonfederal character that distinguishes it from typical federal executive agencies and departments.

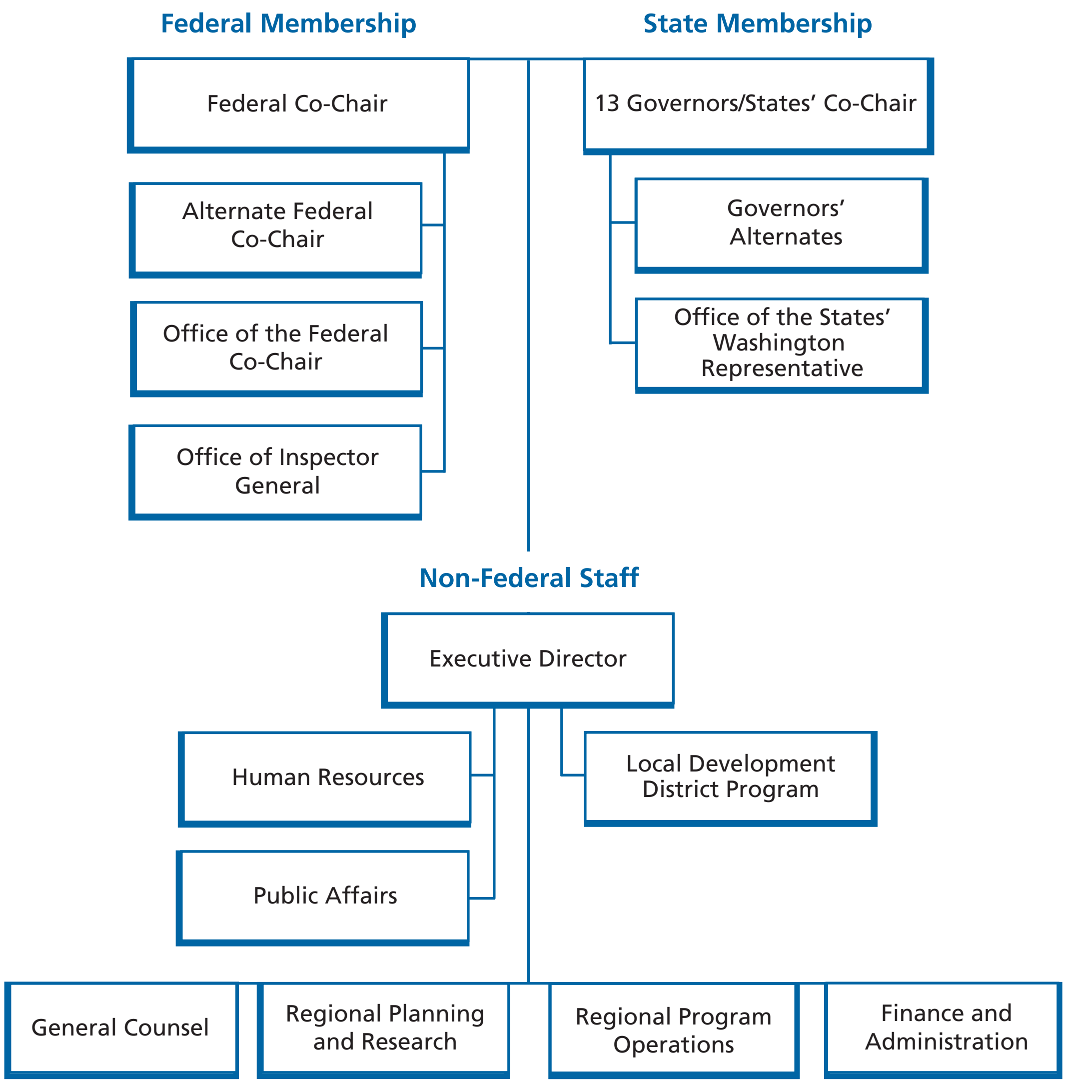
An alternate federal co-chair, who is appointed by the president and confirmed by the Senate, has authority to act as the federal co-chair in his or her absence. State alternates appointed by the governors oversee state ARC business and serve as state-level points of contact for those seeking ARC assistance.

By law, there is an inspector general for the Commission, who reports to the federal co-chair.

In all, there are only 11 federal employees of the Commission, including the federal co-chair's staff and the staff of the Office of Inspector General.

The Commission members appoint an executive director to serve as the chief executive, administrative, and fiscal officer. The executive director and staff are not federal employees. The 48 nonfederal Commission staff are charged with serving both the federal and the state members impartially in carrying out ARC programs and activities, and they provide the legal support, technical program management, planning and research, and financial/administrative management necessary for ARC's programs.

ARC Organization Chart



Public and Private Partnerships

ARC promotes economic and community development through a framework of joint federal and state initiatives. ARC's limited resources are necessary, but obviously not sufficient, for Appalachia to reach parity with the rest of the nation. Therefore, ARC continues a long tradition of building alliances among private and public organizations to focus technical, financial, and policy resources on regional problems. The Appalachian program involves not only Appalachian governors' offices and state agencies, which control other substantial investment resources, but also 72 multi-county development districts in the Region, up to 20 federal agencies, and a host of private organizations and foundations. The Commission further helps create alliances through research, regional forums, advisory councils, and community meetings. One such alliance is ARC's partnership with the Centers for Disease Control and Prevention to implement programs in cancer control and diabetes education, prevention, and treatment.

In FY 2006, across all investment areas, each dollar of ARC funding was matched by $3.14 in non-ARC project funding (public and private) and leveraged $11.55 in private investment attracted as a result of the project.

ARC is often a predevelopment resource, especially in economically distressed areas, providing modest amounts of initial funding that are unavailable from other sources because the community cannot qualify for the support or raise adequate matching funds. Congress recognized, and subsequent experience has shown, that Appalachia for many reasons has been relatively less likely to use the grant resources of large federal agencies. ARC has helped other federal agencies better deploy their programs in the Region through joint funding. The Commission can also allow other federal agencies to use ARC funds under their statutory authorities when their own funds are insufficient for projects; in effect, ARC can provide sufficient match for federal grants on behalf of the poorest Appalachian communities.

ARC's 2002 reauthorization legislation directed the creation of the Interagency Coordinating Council on Appalachia to examine how the impact of federal programs and resources can be maximized in the Region and how greater coordination among federal agencies can yield better returns. The council, chaired by the ARC federal co-chair, has highlighted interagency collaboration and shared funding opportunities, with the aim of increasing attention to Appalachian problems among the federal agencies. ARC also emphasizes collaboration with the private sector whenever possible, as in recent initiatives with the eBay Foundation, Microsoft Corporation, the National Geographic Society, the Claude Worthington Benedum Foundation, Parametric Technology Corporation, and American Electric Power, Southern Company, and other utilities.

A special provision of the Appalachian Regional Development Act authorizes ARC to operate in part as a supplemental grant program. This authority allows ARC funds to be used to increase the allowable participation under federal grant programs, enabling grantees to participate in programs for which they would otherwise be ineligible. In addition, it involves appropriate federal entities to ensure not only program coordination but also compliance with all applicable laws, such as environmental and labor requirements. Accordingly, about half of past ARC grants have been administered under agreements with federal agencies, mainly the Economic Development Administration, Rural Development, the U.S. Department of Housing and Urban Development, and the Federal Highway Administration. Other agreements have involved such agencies as the Army Corps of Engineers and the U.S. Departments of Energy, Labor, and Health and Human Services.

Commission Programs: Getting the Job Done

Congress gave the Commission very broad program discretion to address problems and opportunities in the Region. Accordingly, ARC has emphasized a wide-ranging set of priorities in its grant programs. Projects in recent years have focused on business development, telecommunications and technology infrastructure and use, educational attainment, access to health care, and tourism development. ARC has consistently maintained a focus on the construction of development highways and basic water and waste management facilities.

ARC Strategic Plan

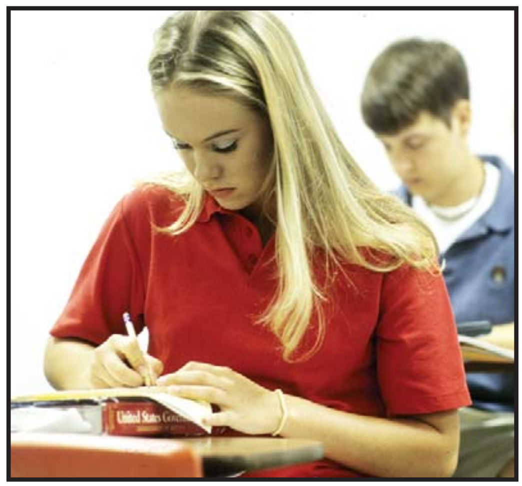
FY 2006 was ARC's second year of operating under its strategic plan, *Moving Appalachia Forward: Appalachian Regional Commission Strategic Plan 2005–2010*, which outlined ARC's mission to be a strategic partner and advocate for sustainable community and economic development in Appalachia, and identified four strategic goals to help Appalachia reach socioeconomic parity with the rest of the nation:

- *Increase job opportunities and per capita income in Appalachia to reach parity with the nation.*
- *Strengthen the capacity of the people of Appalachia to compete in the global economy.*
- *Develop and improve Appalachia's infrastructure to make the Region economically competitive.*
- *Build the Appalachian Development Highway System to reduce Appalachia's isolation.*

As reported in Part II, the Commission demonstrated progress in FY 2006 toward achieving the 10-year performance goals set out in that plan.

In FY 2006, ARC continued funding for its Asset-Based Development Initiative, which helps communities identify and leverage local assets to create jobs, this year focusing on natural


Ann Hawthorne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resources as well as cultural and heritage assets. ARC also continued funding for its Information Age Appalachia initiative, which seeks to stimulate economic growth and improve the standard of living in the Region through telecommunications- and technology-related avenues.

Area Development Program

Area development funds are largely allocated to the Appalachian states by formula to provide flexible assistance for individual community projects. In FY 2006, the Commission allocated by formula $48.6 million, 74 percent of the total ARC appropriation, for use by the states in their area development activities. The states have wide discretion in the use of these funds, within the framework of the strategic plan. Priorities for area development funding are set forth in the Commission's strategic plan, and state and community leaders work together to package funding from public and private organizations to implement those priorities. All ARC nonhighway grants are approved by a governor and by the federal co-chair. See Appendix B for ARC grants approved in FY 2006, by state and category.

Special Focus on Distressed Counties

The Commission targets special resources to the most economically distressed counties and areas in the Region, using a distinctive and very conservative measure of economic distress: per capita market income is not greater than two-thirds of the U.S. average, the three-year unemployment rate is 150 percent of the U.S. average or greater, and the poverty rate is at least 150 percent of the national average; or the poverty rate is at least twice the national average, and one other criterion for distressed status is met. (See the map and list of distressed counties on pages 16 and 17.)

Using similar criteria, ARC also identifies distressed subcounty areas in transitional counties in accordance with the guidance in its legislation. There were 640 distressed subcounty areas in FY 2006, an increase from FY 2005. In FY 2006, 1.4 million Appalachians lived in distressed counties; another 2.1 million lived in distressed subcounty areas.

Distressed county indicators are also used to identify the relative economic status of the other counties in Appalachia. In 2006, ARC used five categories to designate the economic status of the counties in Appalachia—distressed, at risk, transitional, competitive, and attainment.

- *Distressed counties* are the most economically depressed counties. These counties have three-year average unemployment rates at least 1.5 times the national average, per capita market income no greater than two-thirds of the national average, and poverty rates at least 1.5 times the national average; OR they have at least twice the national poverty rate and meet the criteria for either the unemployment or the income indicator.

- *At-risk counties* are counties at risk of becoming economically distressed. These counties have three-year average unemployment rates at least 1.25 times the national average, per capita market income no greater than two-thirds of the national average, and poverty rates at least 1.25 times the national average; OR they meet the criteria for two of the three distressed-level indicators.

- *Transitional counties* have rates worse than the national average for one or more of the three economic indicators but do not meet the criteria for the distressed or at-risk levels.

- *Competitive counties* have three-year average unemployment rates and poverty rates equal to or better than the national average, and per capita market income equal to or greater than 80 percent, but less than 100 percent, of the national average.

- *Attainment counties* have economic indicators equal to or better than the national averages.

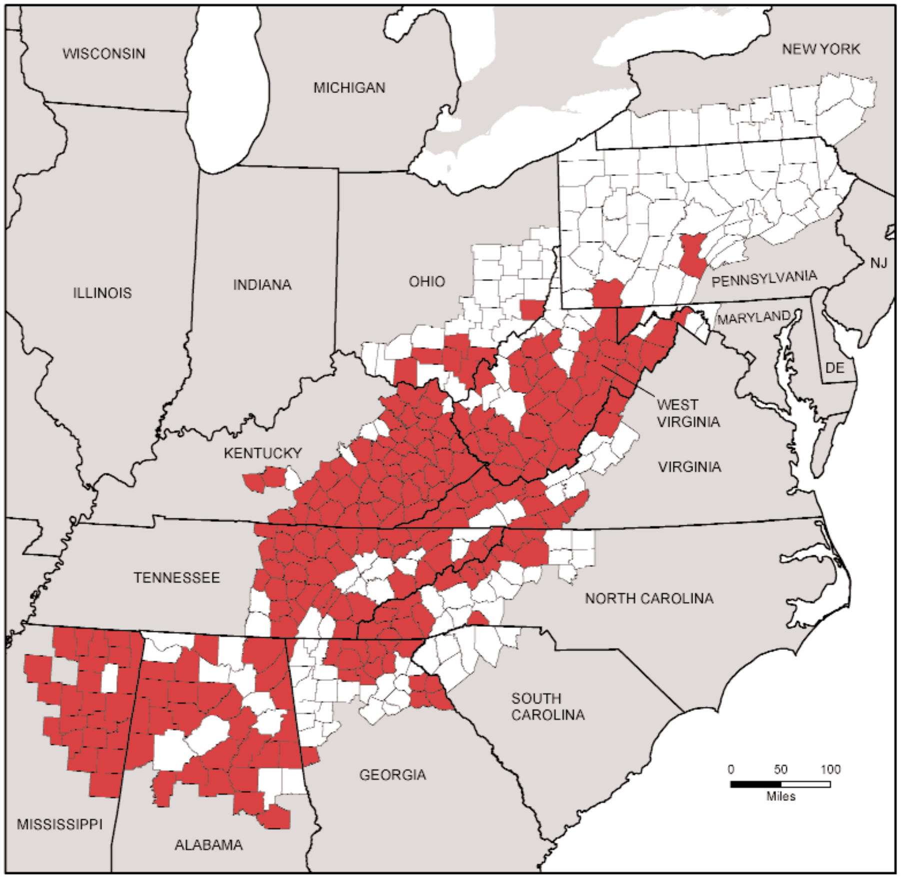
In FY 2006, 77 counties of the 410 counties in the Region were designated distressed counties, 81 were designated at-risk, 222 counties were designated transitional counties, 22 were designated competitive counties, and 8 were designated attainment counties. ARC policy stipulates that competitive counties may receive limited assistance, while funding for attainment counties is virtually eliminated.

Besides allocating funding to benefit distressed counties and areas, ARC has established other policies to reduce economic distress. ARC normally limits its maximum program funding contribution to 50 percent of project costs, but it can increase its funding share to as much as 80 percent in distressed counties.

Distressed Counties in the Appalachian Region

1960

223 Distressed Counties

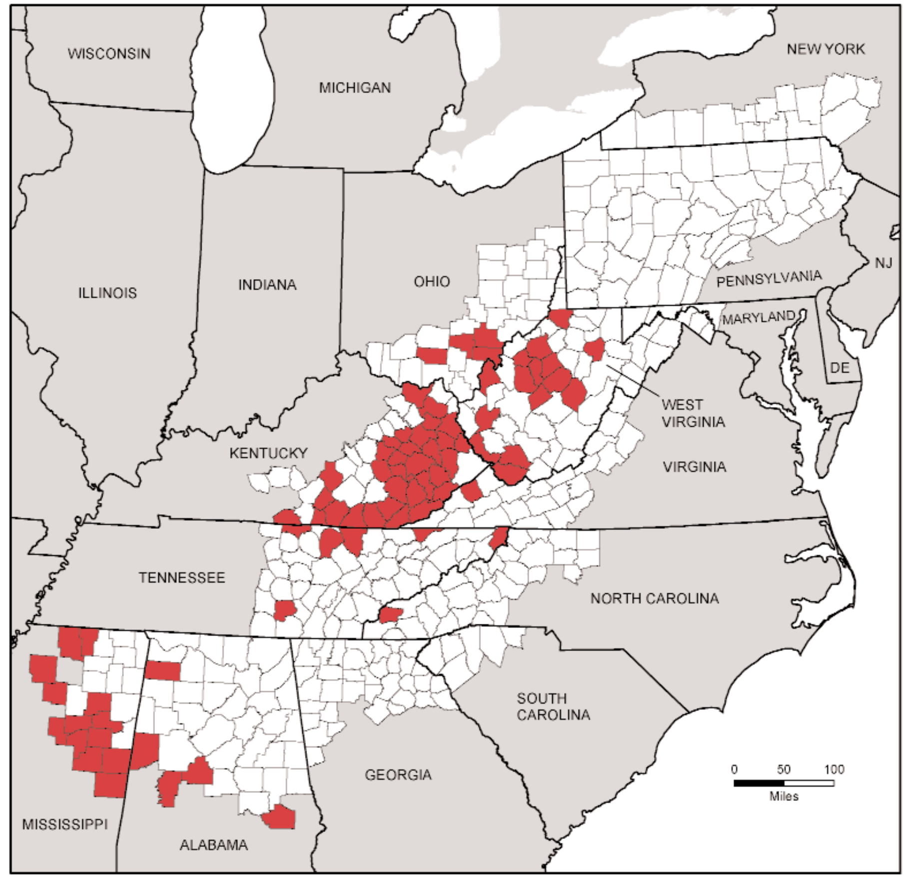


Definition of Distress in 1960:
Distressed counties have an unemployment rate that is at least 1.5 times the U.S. average of 5.1 percent; a per capita market income that is two-thirds or less of the U.S. average of $1,639; and a poverty rate that is at least 1.5 times the U.S. average of 22.1 percent; OR they have 2 times the U.S. poverty rate and qualify on the unemployment or income indicator.

Data Sources:
Unemployment: Census data from USDA, Economic Research Service (ERS), 1960;
Income: U.S. Department of Commerce, Bureau of the Census, 1960;
Poverty: Office of Economic Opportunity data from USDA, ERS, 1960.

FY 2006

77 Distressed Counties



Definition of Distress in Fiscal Year 2006:
Distressed counties have a three-year average unemployment rate that is at least 1.5 times the U.S. average of 5.5 percent; a per capita market income that is two-thirds or less of the U.S. average of $26,420; and a poverty rate that is at least 1.5 times the U.S. average of 12.4 percent; OR they have 2 times the U.S. poverty rate and qualify on the unemployment or income indicator.

Data Sources:
Unemployment: U.S. Department of Labor, Bureau of Labor Statistics, 2001-2003;
Income: U.S. Department of Commerce, Bureau of Economic Analysis, 2002;
Poverty: U.S. Department of Commerce, Census Bureau, 2000.

ARC-Designated Distressed Counties—Fiscal Year 2006

Alabama	Kentucky	Mississippi	North Carolina	Ohio	Tennessee	Virginia	West Virginia
Bibb	Bell	Benton	Graham	Athens	Clay	Dickenson	Barbour
Franklin	Breathitt	Chickasaw		Meigs	Fentress		Braxton
Hale	Carter	Choctaw		Pike	Grundy		Calhoun
Macon	Casey	Clay		Vinton	Hancock		Clay
Pickens	Clay	Kemper			Johnson		Gilmer
	Clinton	Marshall			Scott		Lincoln
	Elliott	Montgomery					Mason
	Estill	Noxubee					McDowell
	Floyd	Oktibbeha					Mingo
	Harlan	Panola					Ritchie
	Jackson	Webster					Roane
	Johnson	Winston					Webster
	Knott	Yalobusha					Wetzel
	Knox						Wirt
	Lawrence						Wyoming
	Lee						
	Leslie						
	Letcher						
	Lewis						
	Magoffin						
	Martin						
	McCreary						
	Menifee						
	Monroe						
	Morgan						
	Owsley						
	Perry						
	Powell						
	Russell						
	Wayne						
	Whitley						
	Wolfe						

Highway Program: The Appalachian Development Highway System

Congress created the Appalachian Development Highway System (ADHS) expressly to provide growth opportunities for the residents of Appalachia—the same benefits afforded the rest of the nation through the construction of the interstate highway system, which largely bypassed Appalachia because of the high cost of building roads through the Region's mountainous terrain. The ADHS, a 3,090-mile system of modern highway corridors that replaces a network of worn, winding two-lane roads, was designed to generate economic development in previously isolated areas, supplement the interstate system, and provide access to areas within the Region as well as to markets in the rest of the nation. (See map on page 19.)

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Authorizations for the ADHS in FY 2006 were provided through the Safe, Accountable, Flexible, Efficient Transportation Equity Act: A Legacy for Users (SAFETEA-LU). SAFETEA-LU authorizes $470 million per year through FY 2009 for the ADHS. Portions of some ADHS corridors have been identified as high priority and will receive additional funding. Although the funds are authorized from the Highway Trust Fund, ARC exercises policy control over the system and the allocation of funds to individual states. This ensures that the governors and the federal co-chair continue to determine where and how the money is used on ADHS highways. Appendices A and C provide information on ADHS authorizations and funding.

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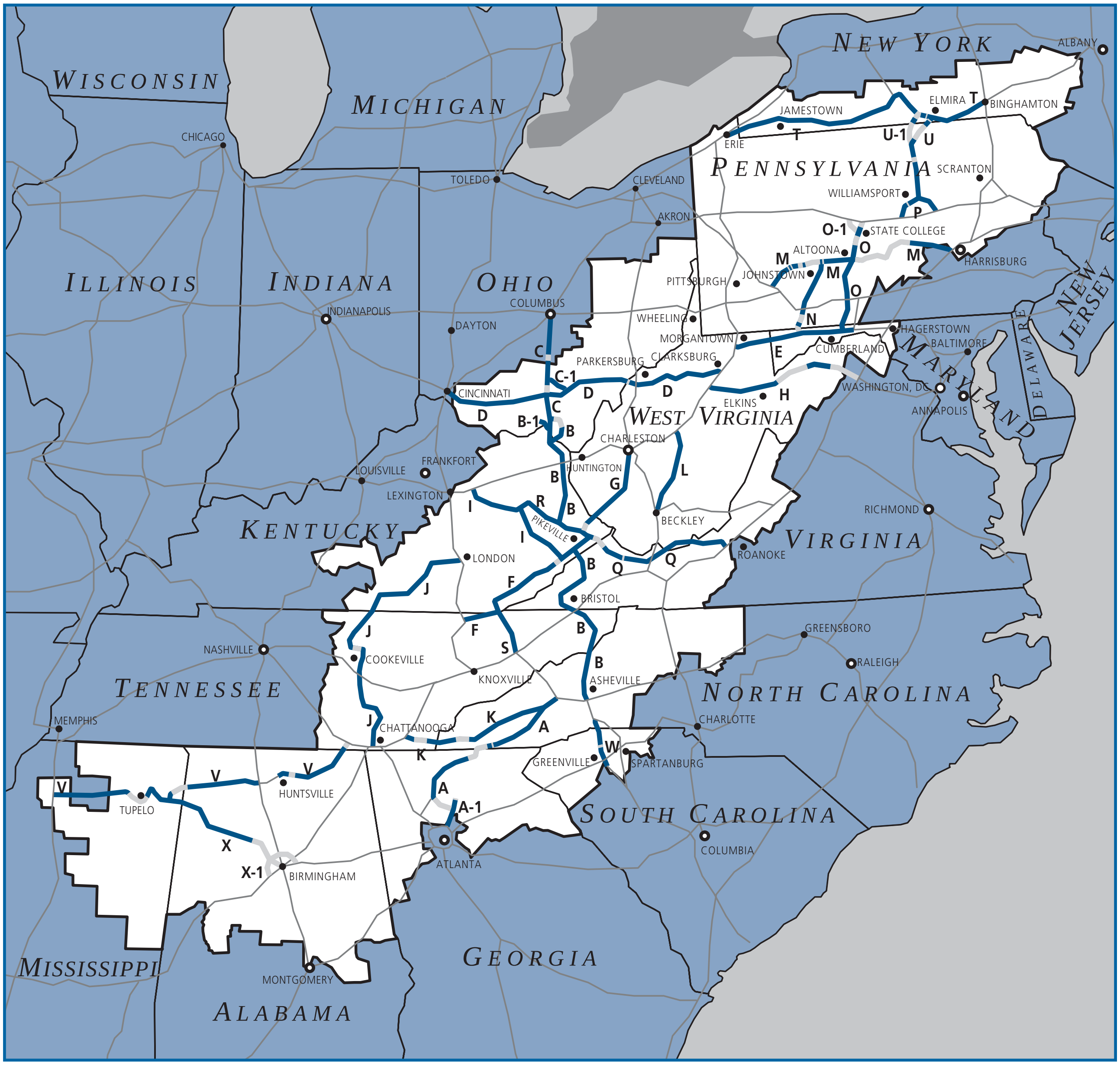
Local Development District Program

ARC's statute underlines the importance of supporting local development districts (LDDs) in the Region. These multi-county planning and development organizations not only serve as the local presence of the ARC program across the Region, but are essential contributors to the program. Every county in the Region is served by an LDD.

Each LDD is governed by a board of directors composed of both local elected officials and nonelected individuals. Many of these state-chartered entities were originally created by state executive orders, but over half are now

Appalachian Development Highway System as of September 30, 2006



Miles Open to Traffic—September 30, 2006

Miles Not Open to Traffic

Interstate System

authorized in state legislation. Some also have 501(c)(3) nonprofit status, enabling them to access support from foundations and other nonpublic sources. The LDDs play four key roles in the development of the Region:

- Providing area-wide planning and program development, and coordination of federal and state funding sources;
- Assisting local governments in providing services, especially in poorer, more isolated communities;
- Promoting public-private partnerships and assisting in business development; and
- Helping communities assess, plan, and conduct a wide range of activities such as job training, business development, telecommunications planning and implementation, and municipal government support.

The Commission has also supported the training and technical assistance activities of the Development District Association of Appalachia (DDAA), an organization of the Region's LDDs. These activities improve member districts' organizational structure and operations, and their ability to effectively implement ARC's strategic plan and regional initiatives.

Appendix D provides a map and list of local development districts serving Appalachia.

Research and Technical Assistance Program

ARC funds research and evaluation studies that produce specific information on socioeconomic and demographic conditions in the Region, including baseline data and trend analysis, economic impact analysis, program evaluation, and regional economic and transportation modeling. ARC-funded research focuses on strategic analyses of key economic, demographic, and quality-of-life factors that affect Appalachia's current and future development prospects. The aim of this research is to help policymakers, administrators, and staff target program resources efficiently, and to provide high-quality research for the general public and research specialists.

ARC also funds program evaluations by outside researchers or consultants to assess whether Commission-funded projects have made a measurable difference in specific social or economic outcomes. The purpose of these evaluations is to determine the extent to which the projects have contributed to the attainment of economic development objectives identified in ARC's strategic plan. In addition, evaluations are used to verify project results and to assess the validity of specific performance measurements for monitoring and evaluating specific types of projects.

Reports and data products are distributed in print and posted on ARC's Web site.

Research started in FY 2006 includes:

- An evaluation of the outcomes from the Appalachian Regional Commission–Oak Ridge National Laboratory Math-Science-Technology Summer Institute;

- An analysis of the college-going and perseverance rates in Appalachia, with an emphasis on evidence, gaps, and best practices in programs;

- An examination of regional performance gaps in lending, bank services, and development finance;

- A program evaluation of the Appalachian Regional Commission's infrastructure and public works projects;
- Two initial design studies for assessment of the impact of completing the Appalachian Development Highway System;
- An analysis of long form decennial census data for trends in family income, income inequality, earnings and skill levels, and consumption measures of quality of life; and
- A study of socioeconomic correlates of health disparities in the Appalachian Region.

Research completed or under way in 2006 includes:

- A study of Appalachian population redistribution and migration in the 1990s;
- A study of the changing patterns of poverty and spatial inequality in Appalachia;
- A study of the defining subregions in Appalachia, with a focus on better alternatives;
- An analysis of trends in economic distress in Appalachia and the United States between 1960 and 2000;
- An assessment of displacement in Appalachia and the non-Appalachian United States between 1993 and 2000, based on the findings of five displaced-worker surveys;
- A study of creating regional advantage in Appalachia, with an emphasis toward strategic response to global economic restructuring;
- An assessment of workforce displacement and adjustment policies in Appalachia's labor markets, based on five case studies;
- An assessment of the impact of trade liberalization on import-competing industries in the Appalachian Region;
- An analysis of gaps in capital funding for drinking water and wastewater infrastructure in Appalachia; and
- A time series and twin-county analysis of the economic effects and development impact of the Appalachian Development Highway System between 1969 and 2004.

Impediments to Progress

Despite recent progress, Appalachia still does not enjoy the same economic vitality and living conditions as the rest of the nation. The Region continues to battle economic distress, concentrated areas of high poverty, unemployment, poor health, educational disparities, and population outmigration that are among the worst in the nation. Appalachia trails the rest of the nation by 17.3 percent in per capita income. Sixty-two percent of Appalachian counties have unemployment rates higher than the national average, and one-fourth of the Region's 410 counties have poverty rates more than 150 percent of the national average.

The Region's isolation and its difficulty in adapting to economic changes over past decades are major factors contributing to the gap in living standards and economic achievement between the Region and the rest of the nation.

The role of the Commission is to help Appalachia reach parity with the rest of the nation. In an era of global competition, that requires a special emphasis on helping the people of Appalachia become a globally competitive workforce.

Civic Capacity

Civic capacity is vital for communities to be strategically ready to take advantage of economic opportunities. Weakness in civic capacity in Appalachia has inhibited the leadership, broad citizen involvement, local strategic planning, and collaboration that are necessary for a sense of empowerment and civic engagement. Low levels of per-capita private foundation funding have contributed to the lack of support for civic capacity, particularly the low rates of formation and survival of community-based nonprofit organizations in the Region.

Economic and Demographic Shifts

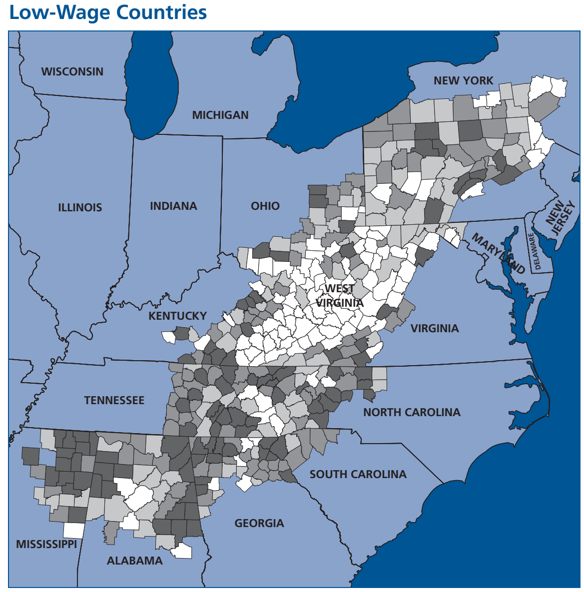
Demographic shifts between 1990 and 2000 have led to a decline in the Region's share of the "prime-age" workforce—those between the ages of 25 and 55, who are entering or reaching their peak earnings potential. The erosion of the high-earnings potential of the workforce in recent years has reversed the Region's upward trend in per capita income, and at the local level has led to declines in the tax base.

The Region has been battered by job losses and structural economic shifts because of global competition and because of its disproportionate reliance on extractive industries and manufacturing.

- The Region continues to face higher levels of competition from low-wage imports than the rest of the nation. Economic forecasts suggest that the Region will face increasing competition from low-wage countries. The map on the right ranks Appalachian counties by degree of exposure to low-wage import competition.

- Primary-metals sectors, such as steel, have lost 21,000 jobs since 1995. Many of these losses have resulted from import penetration and plant relocations overseas.

Appalachian Exposure to Manufacturing Imports from Low-Wage Countries



Quartiles of Exposure

- *Counties in the 4th Quartile (High Exposure)*
- *Counties in the 3rd Quartile*
- *Counties in the 2nd Quartile*
- *Counties in the 1st Quartile (Low Exposure)*

Data Source: Bernard, A.B., Jensen, J.B., and Schott, P.K. 2005. *Assessing the Impact of Trade Liberalization on Import-Competing Industries in the Appalachian Region.*

- The Appalachian apparel industry lost 77,000 jobs between 1995 and 2005, and the textiles industry lost 30,000. Over that decade, one out of five jobs lost in the textile industry nationally occurred in Appalachia, and one out of three jobs lost in the apparel industry occurred in Appalachia. An estimated one-third of the apparel losses and one-half of the textiles losses were due to imports or plant relocations to other countries.

- Appalachian coal-mining employment has fallen from 101,500 workers in 1987 to 49,000 in 2004, largely because of productivity gains.

Access to Capital and Credit

Access to capital and credit is essential to finance and nurture new and existing businesses and entrepreneurs. Chronic gaps in access to capital and credit have often stifled business formation in rural areas, including parts of Appalachia. Despite signs of progress, significant disparities continue to exist in small-business lending in Appalachia. Small-business lending is less accessible in Appalachia's non-metropolitan counties and in counties experiencing economic distress. In addition, the smallest businesses (those with assets under $1 million) and businesses in low- and moderate-income communities experience the least access to credit.

Underinvestment

Research preceding the creation of ARC found that for many reasons, including dearth of leadership and lack of financial and technical resources, Appalachia had not been in a position to take advantage of many federal programs that could help mitigate long-standing problems, much less concentrate a range of investments on the greatest needs. In addition, many programs better addressed mitigation of growth in parts of the nation rather than basic stimulation of growth. This situation has improved over time, but the Region still receives federal economic development assistance disproportionately smaller than its population and its needs. Analyses of the Consolidated Federal Funds Report for 2002 by ARC and U.S. Census Bureau staff found that per capita total direct federal expenditures and obligations in Appalachia were $783 less than the national average. In federal grants alone, the Region falls short of parity with the nation as a whole by $5.4 billion each year.

Water and Wastewater Systems

Most Americans don't realize that access to basic water and wastewater systems remains a critical issue in many smaller, poorer communities in Appalachia. Twenty percent of Appalachian households are still not reached by community water systems, compared with 10 percent nationwide. Forty-seven percent of Appalachian households are not served by public sewer systems, compared with a national average of 24 percent. Appalachian counties require an investment of $26 billion to $40 billion for drinking water and wastewater system infrastructure needs, according to an ARC-funded study published in August 2005.

Small, rural Appalachian communities also face higher investment requirements to address pressing economic development needs while meeting environmental standards. Communities experiencing declining customer bases and low household incomes cannot rely on construction loans (and the resulting rate increases) to meet capital investment needs. The local ability to pay is particularly low in 123 Appalachian counties where the average household income is two-thirds or less of the national average, according to the 2000 Census. These communities need additional technical, managerial, and financial assistance to meet their future needs.

Telecommunications

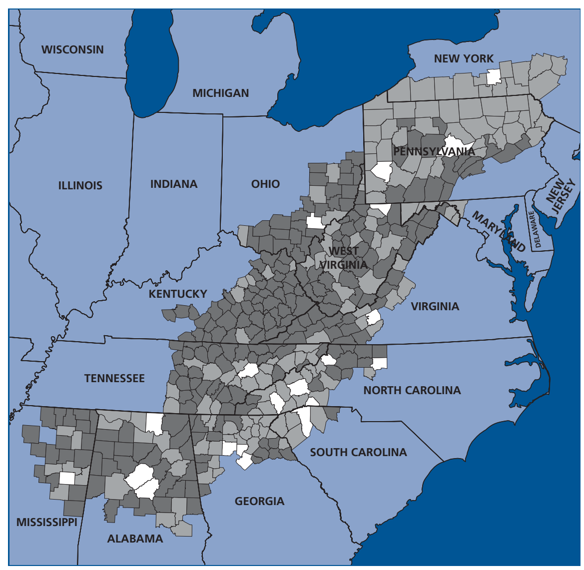
The Appalachian Region continues to lag behind the rest of the nation in access to affordable broadband telecommunications, which is essential to today's commerce. Without special advocacy, technical support, and financial assistance, rural Appalachia is unlikely to meet the president's national goal of universal broadband access by 2007.

Education and Workforce Skills

Vigorous job growth will not occur in areas that lack an educated workforce. Global competition is reinforcing the economic premium on workers in knowledge-based industries, leaving low-skilled or unskilled U.S. workers increasingly vulnerable. ARC seeks to increase the employment rate and productivity of Appalachia's workers, and to attract educated and skilled workers to the Region. Doing so will require considerable improvement in both educational attainment and educational achievement at all levels.

According to the Bureau of Labor Statistics, the 30 fastest-growing occupations will require post-secondary educational attainment levels, special post-secondary certification, or moderate to short-term training. The Region's economy is forecast to add more than 346,000 jobs in these high-growth occupations over the next six years. The current education and technical skill level of the Region's workforce cannot meet this need.

Appalachian Counties with Low College Completion Rates



Percent of Adults Completing a Bachelor's Degree or Higher

Counties Below 50 Percent of the U.S. Average

Counties Between 50 and 99 Percent of the U.S. Average

Counties At or Above the U.S. Average

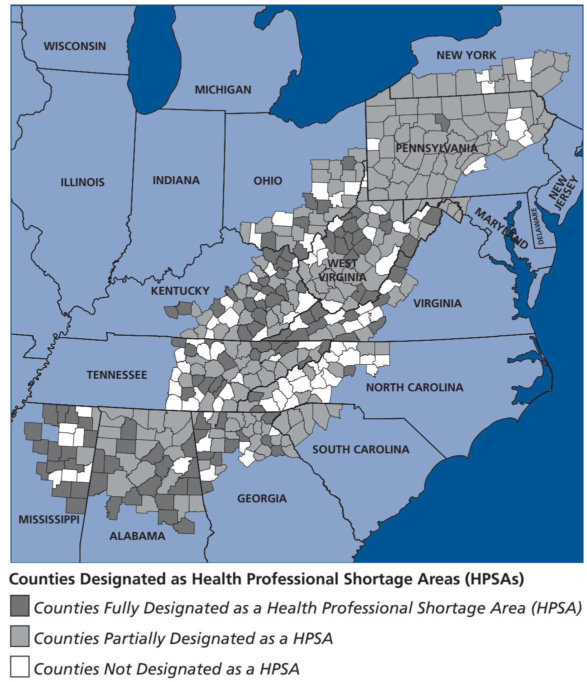
Data Source: U.S. Department of Commerce, Census Bureau, Census 2000, Summary File 3.

In the last decade, the education attainment gap between Appalachia and the rest of the nation has widened: in 1990 the difference between the Region and the nation's share of adults with college degrees was 6.0 percentage points; in 2000 the gap widened to 6.7 percentage points.

Health Care

Health problems continue to impede quality of life as well as economic prospects in some areas of the Region. More than two-thirds of the Region's counties are fully or partially designated by the U.S. Department of Health and Human Services as health professional shortage areas. Most Appalachian counties have had difficulty attracting or retaining basic services such as dentistry, outpatient alcohol treatment, outpatient drug treatment, and outpatient mental health services. In addition, Appalachia suffers from disproportionately high rates of chronic diseases such as cardiovascular disease, cancer, and diabetes.

Appalachian Counties Lacking Adequate Access to Health Care



Data Source: U.S. Department of Health and Human Services, Health Resources and Services Administration, Bureau of Health Professions, March 2003.

Program Assessment Rating Tool

In 2004, the Office of Management and Budget (OMB) conducted its first review of the ARC program using the Program Assessment Rating Tool (PART) and issued a score of adequate. ARC received high scores for clarity of purpose, planning, and management. OMB noted ARC's progress in developing outcome-related measures, but acknowledged the difficulty of performance measurement since ARC co-funds projects with other agencies. ARC revised its metrics to include performance goals for targeting resources to areas of greatest distress, and for leveraging other public and private funds. The agency continues to share performance data and research to clarify the links between federal investment and community change. Part II of this report includes updates to PART information.

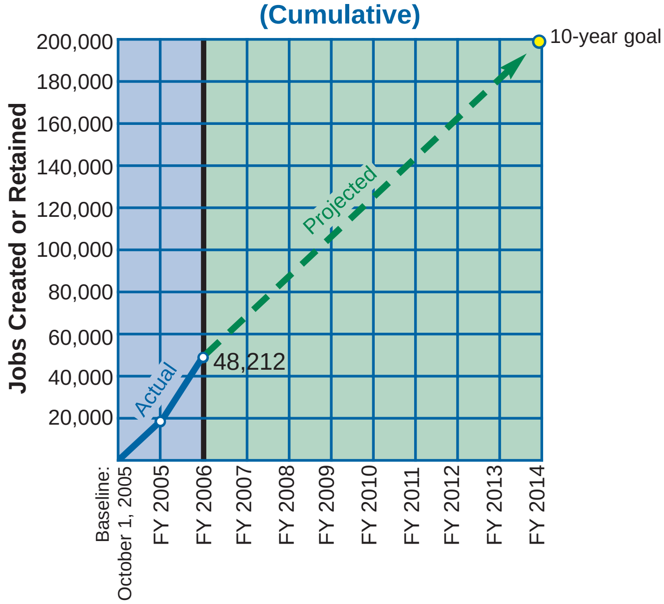
SUMMARY OF ACHIEVEMENTS
Performance Goals and Results for FY 2006 Projects

ANNUAL PERFORMANCE GOAL	FISCAL YEAR 2006 INTERMEDIATE ESTIMATES	RESULTS ACHIEVED
Jobs and Income		
Key Outcome Goal: 20,000 jobs created or retained	28,866 jobs created or retained	Exceeded goal
Leveraging Goal: Achieve a 4:1 leveraged private investment to ARC investment ratio for projects in Goal 1	Achieved a 7:1 ratio	Exceeded goal
Targeting Goal: Direct 50% of grant funds to benefit distressed counties or areas for projects in Goal 1	Directed 46% of funds*	Met 92% of goal
Competitiveness		
Key Outcome Goal: 20,000 students/ trainees with improvements	17,578 students/trainees with improvements	Met 88% of goal
Matching Goal: Achieve a 1:1 non-ARC to ARC investment ratio for projects in Goal 2	Achieved a 2:1 ratio	Exceeded goal
Targeting Goal: Direct 50% of grant funds to benefit distressed counties or areas for projects in Goal 2	Directed 71% of funds*	Exceeded goal
Infrastructure		
Key Outcome Goal: 20,000 households served	30,148 households served	Exceeded goal
Matching Goal: Achieve a 2:1 non-ARC to ARC investment ratio for projects in Goal 3	Achieved a 5:1 ratio	Exceeded goal
Targeting Goal: Direct 50% of grant funds to benefit distressed counties or areas for projects in Goal 3	Directed 70% of funds*	Exceeded goal
Highways		
Key Outcome Goal: 25 miles of the ADHS opened to traffic	30.8 miles of the ADHS opened to traffic	Exceeded goal

** ARC exceeded its overall goal of investing 50% of total ARC nonhighway funds in projects that benefit distressed counties or areas. Project funds are included if the project* primarily or substantially *benefits distressed counties or areas.*

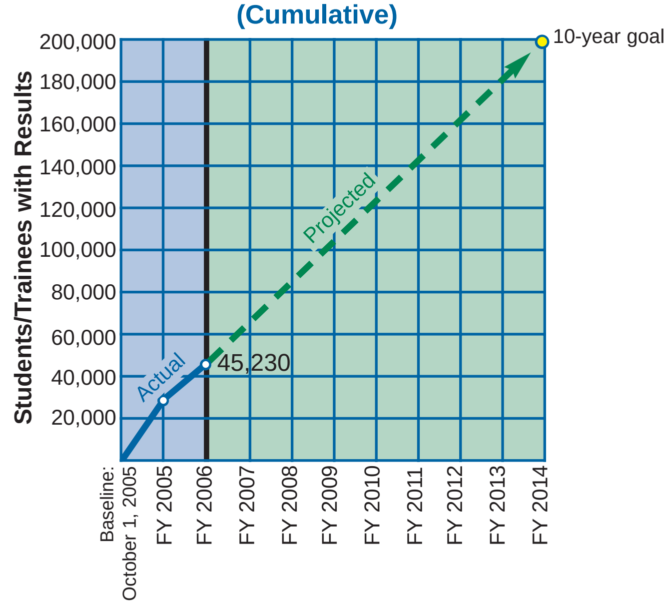
Progress toward ARC Strategic Plan Ten-Year Performance Goals
Fiscal Years 2005–2014

Goal 1: Jobs Created or Retained (Cumulative)



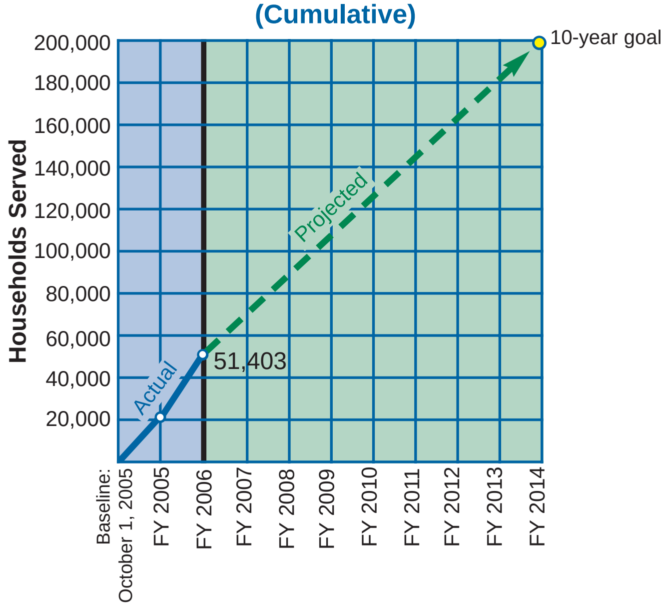
Ten-Year Performance Goal:
200,000 jobs will be created or retained.

Goal 2: Students/Trainees with Results (Cumulative)



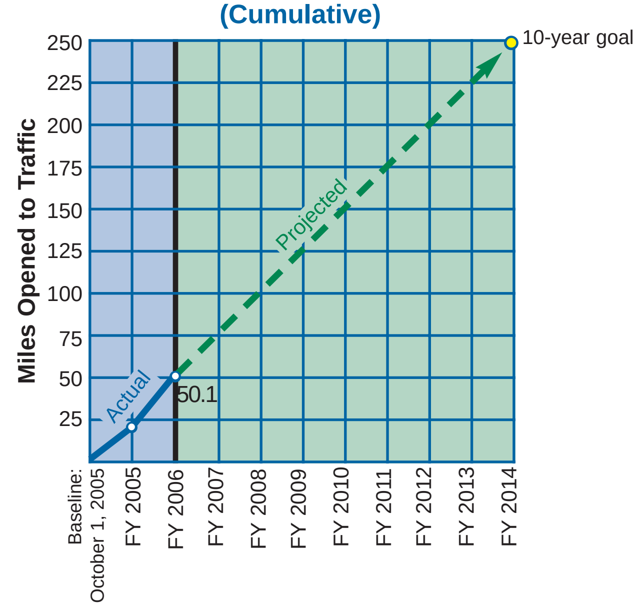
Ten-Year Performance Goal:
200,000 citizens will benefit from enhanced education and job-related skills.

Goal 3: Households Served (Cumulative)



Ten-Year Performance Goal:
200,000 households will be served with new or improved water and sewer infrastructure.

Goal 4: ADHS Miles Opened to Traffic (Cumulative)



Ten-Year Performance Goal:
250 miles of the Appalachian Development Highway System will be opened to traffic.

FINANCIAL MANAGEMENT

Financial Management System

The Appalachian Regional Commission uses a commercial off-the-shelf core accounting system, GLOWS, that is intended for government financial management. The GLOWS system incorporates capabilities to manage obligations, disbursements, the general ledger, and financial reporting. This system, however, is no longer considered a Financial Systems Integration Office–certified financial management system. Thus, during FY 2007, ARC will evaluate viable options for replacing its current system with a cost-efficient solution that meets required standards and ARC's needs.

ARC supplements the GLOWS system with a historical project grant information system, ARC.net, that provides real-time funding, grant status, and performance measurement information, as well as grant-related financial data, in an intranet environment available to staff and key state officials. ARC.net applications are built using off-the-shelf software.

Management's Responsibility for Internal Control

ARC implemented a process for providing audited financial statements in fiscal year 2002, following the guidance of the Accountability of Tax Dollars Act of 2002. ARC, strictly speaking, is not a federal agency as defined in Titles 5 and 31 of the U.S. Code; it is a 501(c)(3) organization with a quasi-federal character. While the Accountability of Tax Dollars Act applies only to executive branch agencies, the Commission has elected to comply with OMB guidance because full disclosure of financial information is consistent with the governmental nature of ARC's mission and operations and its stewardship of public funds. ARC also follows OMB and Department of the Treasury financial reporting requirements, as appropriate.

The Federal Managers' Financial Integrity Act of 1982 (FMFIA) represents sound management practice for managing federal appropriations. FMFIA establishes specific requirements with regard to management controls. The agency must establish controls that reasonably ensure that (1) obligations and costs comply with applicable law; (2) assets are safeguarded against waste, loss, unauthorized use, or misappropriation; and (3) revenues and expenditures are properly accounted for and recorded. In addition, the agency annually must evaluate and report on the control and financial systems that protect the integrity of federal programs. The FMFIA encompasses program, operational, and administrative areas as well as accounting and financial management. In addition, OMB Circular A-123 directs agencies to "take systematic and proactive measures to (1) develop and implement appropriate, cost-effective management controls for results-oriented management; (2) assess the adequacy of management controls in federal programs and operations; (3) identify needed improvements; (4) take corresponding corrective action; and (5) report annually on management controls." Management controls are the organizational structures, policies, and procedures used to help program and financial managers achieve results and safeguard the integrity of their programs.

ARC maintains a written plan of internal control development and testing. The agency's approach is to make management controls an integral part of the entire cycle of planning, budgeting, management, accounting, and auditing.

Testing procedures are based on a team approach and are designed to provide feedback to management on a continuing basis throughout the cycle. ARC recognizes that an appropriate balance of controls must exist in programs and operations. Managers should benefit from controls, not be encumbered by them. Too many controls, especially in an organization as small as the Commission, can result in inefficient and ineffective government. ARC strives to maintain an environment of accountability in which all employees help ensure that government resources are used efficiently and effectively to achieve intended program results with minimal potential for waste, fraud, and mismanagement.

The Commission conducts formal and informal meetings with division managers to identify vulnerable areas and potential control weaknesses. An internal management control committee is also in place to conduct reviews. The committee has conducted an extensive review and testing of internal controls and found them effective. The Office of Inspector General (OIG) conducts independent program reviews and audits. Weekly management team meetings provide an opportunity to address control issues. Finance staff conduct pre-payment examinations of approved payments, as well as oversight reviews of program account obligation and payment details. Finally, the annual financial audit of the agency provides independent assessments of the adequacy of internal controls. The internal control plan assigns responsibility within the organization for follow-up action on any deficiencies.

Fiscal year 2006 was the fourth year ARC was scheduled to produce an audited financial statement. The independent auditors issued an unqualified opinion on the fiscal year 2006 financial statement provided in this Performance and Accountability Report. This is the fourth consecutive year with an unqualified opinion.

Management Follow-Up to Inspector General Recommendations

At the start of the fiscal year, all but five of the audit reports issued by the OIG in previous years had been addressed by ARC management. During fiscal year 2006, the OIG issued 21 reports concerning internal controls, programs grants, and grantees, including a number of intermediary organizations with ARC grants for operating revolving loan funds. The total dollar value of grants and programs audited during fiscal year 2006 was $7.2 million. The inspector general identified $413,016 of this amount as questioned costs and $412,041 as costs that might have been put to better use. At the end of the year, ARC had made management decisions with respect to all but five prior- and current-year OIG reports involving $677,561 in questioned costs and three reports involving $250,680 in costs that the inspector general considered might have been put to better use.

The OIG worked closely with ARC staff to prepare for the production of audited financial statements, and served as an important resource for workshops and meetings in the field to promote sound financial management on the part of ARC grantees. The semi-annual reports of the ARC inspector general, along with contact information, are available to the public on the Commission Web site.

Program Funding Waivers

As mentioned in the section “Appalachian Regional Commission Structure and Programs,” the Commission restricts program funding for economically strong counties. Section 14526 of the Appalachian Regional Development Act authorizes the Commission to grant waivers under certain conditions. In FY 2006, no waivers were granted.

SUMMARY OF FINANCIAL STATUS

Part III of this Performance and Accountability Report includes information about the financial status of the Appalachian Regional Commission. In the unqualified opinion of the independent auditors, M.D. Oppenheim and Company, P.C., the financial statements included in that section fairly represent the financial position of ARC in all material respects. The financial statements include details on ARC's assets, liabilities, and net position. They also include statements of operations and changes in net position, and a statement of cash flows. The financial statements taken together include all the aspects of ARC, including the Office of the Federal Co-Chair, area development programs, and administrative/operational activities performed by ARC.

Assets on September 30, 2006, totaled $91.1 million, and liabilities totaled $4.3 million. Sixty-seven percent of ARC's assets were in the United States Treasury. In addition, 33 percent, or $30.2 million, represented Commission grant funds held by intermediary organizations in Appalachia for the operation of revolving loan funds promoting business development. The federal government retains a residual interest in the loan funds. Remaining assets are accounts receivable, cash, and advances to grantees.

Liabilities included $1.1 million in accounts payable, $2.3 million in accrued leave and pension liability, $249,596 in accrued payroll, and $165,684 in other accrued liabilities.

Total revenues for the year were $43.3 million, and total expenses, including area development grants, were $42.7 million. Revenues notably included $3.3 million in state contributions for the operational expenses of the Commission, pursuant to ARC's legislation. The Commission must rely on congressionally appropriated funds to continue its operations, make grants, and meet its liabilities.

Notes are attached to the financial statements to describe and explain important disclosure information about line items in the statements and related financial policies and programs. Federal budgetary data are included as additional information, describing how the Commission's $50.2 million of budgetary resources was applied. The total of budgetary resources reflects net transfers of $25.9 million of grant funds to other agencies for obligation and administration.