ANNUAL REPORT

ALASKA RAILROAD CORPORATION

1985

PRESIDENT'S LETTER

Unlike New Year's resolutions, business goals and objectives are made with the thought in mind that they will be met, not broken. I am happy to report that after one year of operation as a state-owned corporation, the Alaska Railroad has an impressive scorecard based on the goals we set out to achieve. And it is a trend we expect to continue in the coming years.

Of course, none of this would be possible without the hard work of the corporation employees. Their dedication to the Alaska Railroad makes it possible for the corporation to achieve its objectives.

The overall goal of the Alaska Railroad Corporation is to foster and promote long-term economic growth and development in Alaska by providing transportation services on a self-sustaining basis, at competitive rates, and at the same time generate sufficient funds to upgrade and maintain the physical integrity of the railroad.

To achieve that overall goal, a three-year plan was developed that includes an extensive marketing program to increase our revenues coupled with an intense effort to streamline our operations to reduce our expenses. The result, we believe, will be ample funds to reinvest in modernizing the railroad including purchasing new equipment, upgrading the track and roadbed, and improving our physical plant.

The marketing objectives of our plan include increasing our revenue from petroleum products and our piggyback trailer service. In 1985 we added two new trains that give priority service to these customers, increasing petroleum revenues by 15 percent and piggyback revenues by 20 percent.

In addition, we plan over three years to reduce our losses from passenger service. No railroad makes money on passenger service and the Alaska Railroad is no exception, recording losses of $1.8 million in 1985. With the purchase of two new rail diesel cars in late 1985, we expect to cut those losses by $500,000 in 1986 alone.

While we were attempting to boost our revenues, a major plan was underway to cut expenses by implementing new computerized accounting, personnel, procurement, supply, rail car distribution and preventive maintenance programs. Most of the work had been completed by year end. The remainder of the effort should be complete in 1986.

Two significant cutbacks outlined in our three-year plan are reduction of our vehicle fleet by 25 percent and reduction of our expendable inventory by 30 percent. By the close of the first year we had cut our vehicle fleet by 22 percent and whittled our expendable inventory, including track material, by 18 percent. Most of these items were sold at public auction, adding over $1 million to our cash revenue.

Our most ambitious objectives in the three-year plan are capital expenditures needed to modernize equipment, improve efficiency, and maintain the physical integrity of the railroad.

Equipment purchases planned are 13 new locomotives and 115 new rail cars. In 1985 we bought five locomotives and 45 new rail cars for a total of $9 million. We also plan to replace our old, inefficient construction equipment. In 1985 we spent $600,000 and will purchase another $3 million worth in 1986.

All of these efforts would be fruitless if we did not pledge to devote significant time and money to maintaining our track and roadbed. We spent more on track upkeep in 1985 than at any time in the railroad's recent history. For instance, more miles of rail were replaced this year than following the 1964 earthquake which caused $30 million in damage to the railroad.

With our impressive scorecard of goals set and then achieved, the Alaska Railroad Corporation is well on its way to fulfilling the dream that inspired so many Alaskans to push for its purchase from the federal government. There were, as expected, a few trials and false starts in 1985, and 1986 promises to hold its share of challenges. But I am confident they can all be met.

Frank G. Turpin
President and
Chief Executive Officer

Alaska Railroad Yard in Fairbanks at sunset.

YEAR IN REVIEW

For the Alaska Railroad Corporation, 1985 was a year of changes.

Change is inevitable in any business. It is a natural part of growth. However, for the Alaska Railroad Corporation, 1985 was a year of changes unlike any the Alaska Railroad had ever experienced.

The first and most dramatic change came within the first week of 1985, when on January 5 ownership of the Alaska Railroad was officially transferred from the federal government to the state of Alaska.

That transfer of ownership set the stage for many, many more changes, from management and personnel to policies and procedures. And with those changes a foundation was laid for the prosperous development of the newly formed Alaska Railroad Corporation.

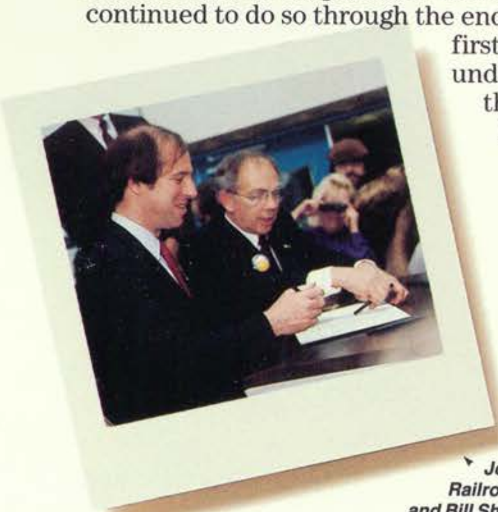
Alaska paid the federal government $22.3 million for the Alaska Railroad. That purchase price included 655 miles of track, 38,000 acres of land including all rights-of-way, 1,545 units of rolling stock including locomotives, freight cars and passenger coaches, and four terminal facilities, one each in Seward, Whittier, Anchorage and Fairbanks.

A NEW CORPORATION

Transfer of railroad ownership to Alaska was made possible by the Alaska Railroad Transfer Act (ARTA), enacted by Congress in 1982. In 1984 the Alaska legislature adopted the Alaska Railroad Corporation Act (ARCA), establishing it as a public corporation of the state that would act as a separate, profit-making entity.

On January 5, 1985, as a result of the transfer, the federal railroad's financial books were closed. On January 6 the new state corporation technically began business with no operating funds. To meet the railroad's immediate money needs, the state legislature allocated, in addition to the sale price, a one-time startup fund of $10.9 million. The money was used to meet the corporation's first month's payroll and to continue several capital improvement projects that had been initiated under the federal system.

Within its first month of operation the new Alaska Railroad Corporation showed a profit, and continued to do so through the end of the year. In its first year of operation under state ownership, the Alaska Railroad Corporation netted $7.1 million, among the largest gains recorded by the railroad in its 62-year history.

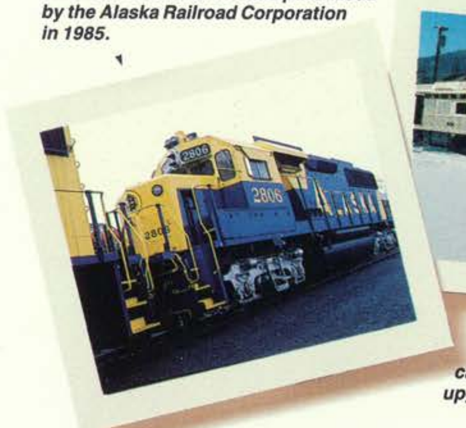


John Riley, Federal Railroad Administrator, and Bill Sheffield, Governor of Alaska, signed an agreement January 5, 1985 to transfer the Alaska Railroad from federal to state ownership.

ARCA provided for the stewardship of the new corporation by a seven-member board of directors appointed by the Governor of Alaska.

The board is responsible for management of the corporation but has delegated certain powers and duties to Frank G. Turpin whom the board selected to serve as the railroad's president to guide the day-to-day operations of the corporation. He joined the railroad immediately upon transfer.

Five new locomotives were purchased by the Alaska Railroad Corporation in 1985.



Two self-propelled rail diesel cars, purchased in late 1985, will upgrade passenger service on the Alaska Railroad.

GOALS FOR 1985

As chief executive officer, Turpin set three goals for the new corporation: earn a profit without seeking state subsidies, broaden management emphasis from a concentration on operations to include marketing and finance, and modernize the railroad's rolling stock, equipment and physical plant.

Giant steps forward were accomplished in 1985 in all three areas. Each step meant changes as the railroad moved away from federal procedures and began operating more like a private business.

The first goal of earning a profit without state subsidies was accomplished in the first year. To control future spending and to get the best value from its revenue, the corporation developed a three-year capital spending program. The plan includes replacement or addition of several units of rolling stock and heavy equipment. The net result will be lower maintenance costs and improved service to customers.

MODERNIZING THE RAILROAD

The three-year plan also tied in with the corporation's goal to modernize the railroad. To improve freight hauling capabilities, 45 new intermodal flatcars called "articulated" cars were purchased for $4.5 million. The first step toward upgrading the aging locomotive fleet was the purchase of five new state-of-the-art diesel locomotives valued at $1 million each. The cars and locomotives arrived in the spring of 1985 and were placed in service immediately. At the close of the year the first of two 48-seat, self-propelled rail diesel cars (RDCs) arrived. The rebuilt cars were purchased to improve and reduce the cost of the winter passenger service and to augment summer and charter services.

The new cars and engines were obtained through a lease/purchase program that allowed the corporation to avoid seeking state subsidies. While the railroad had not been able to take advantage of the lease/purchase option under federal ownership, the corporation's unique position as a quasi-public enterprise enabled the railroad to make the best use of its revenue by leveraging its cash and buying on credit.

Doug Engebretson is a carman for the Alaska Railroad in Fairbanks. An average of 600 employees worked at the railroad in 1985.

NEW MANAGEMENT EMPHASIS

Other changes occurred within the railroad's Finance Department as steps were taken to equalize the emphasis on the three key departments in the railroad: operations, marketing and finance. A computerized accounting system was implemented to improve what had previously been manual procedures. Generally Accepted Accounting Principles (GAAP) were adopted as the railroad's accounting standards, which more closely matched revenue to expenses.

The Marketing Department took a more aggressive stance in seeking business for the railroad. The freight sales division was expanded by the addition of a freight sales manager with responsibility for the sales force in Anchorage and Seattle. Marketing developed and promoted two new unit trains, one for overnight trailer traffic and one for bulk petroleum products, to better meet the needs of Alaska shippers.

The Operations Department, responsible for all train movements and the upkeep on all rolling stock, equipment and track, in 1985 conducted the largest overall roadbed maintenance program in recent years. There were 81,000 linear feet of rail replaced, 26,000 new ties laid and about 200 miles of main line track resurfaced.

OUR EMPLOYEES

With all the changes that occurred at the Alaska Railroad Corporation, it is natural that employees would feel the impact. Steps were taken to streamline some departments while others added personnel. An average of 600 employees worked throughout the year, with peak employment topping the 900 mark during the busy summer construction season.

A significant change occurred in the personnel office when it was tied to the labor relations and the compensation and benefits divisions under the corporate umbrella title of Human Resources Department.

All but about 120 of the corporation's employees are represented by unions. There are seven bargaining units representing five unions: American Federation of Government Employees (blue collar and white collar units), American Train Dispatchers Association, Agents/Operators Unit; American Train Dispatchers Association, Train Dispatchers Unit; Brotherhood of Railway Carmen of the U.S. and Canada, International Association of Machinists and Aerospace Workers, and the United Transportation Union.

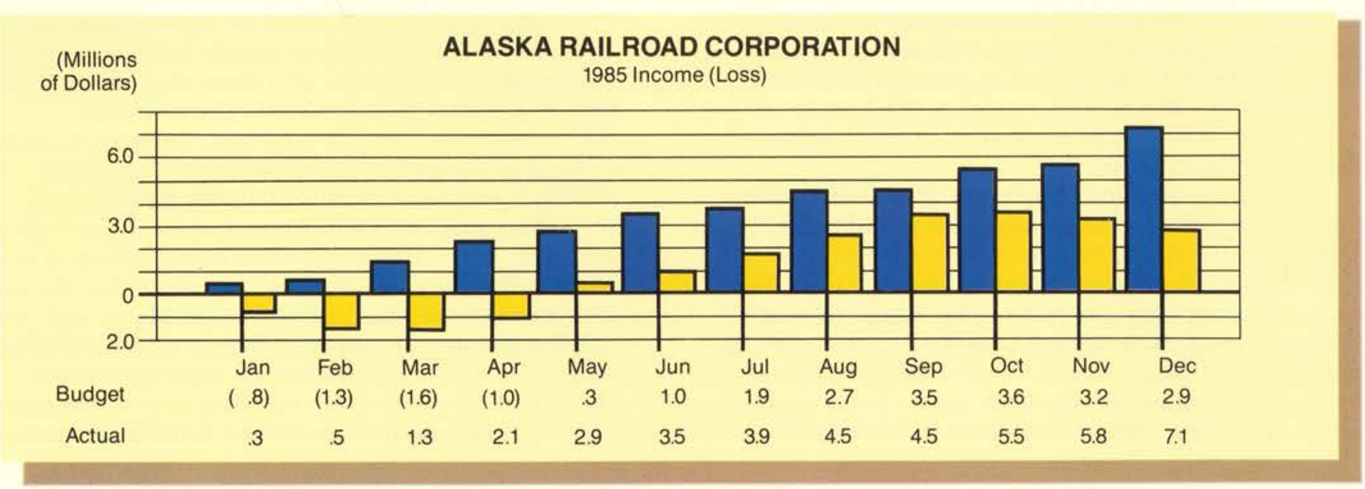
Under federal and state law the union contracts in existence at the time of transfer are to be renegotiated by the corporation within the first two years of operation under state ownership. Beginning in August 1985, for the first time in the history of the Alaska Railroad, all seven bargaining units and management met at the bargaining table to begin hammering out new contracts. Negotiations will continue in 1986.

THE FUTURE

Despite all the changes and reorganization it experienced in 1985, the Alaska Railroad Corporation is looking to 1986 as another year of challenges. An ambitious program is planned to continue to upgrade and improve the railroad's track and roadbed, its rolling stock and its physical plant. A $66 million operating budget was approved by the Board of Directors for 1986 plus $13.3 million in capital improvements.

The Marketing Department will continue its aggressive stance in seeking business for the railroad while providing new, more improved services to meet the customers' needs.

While 1985 was a year of transition for the Alaska Railroad, 1986 is expected to be a year of fine-tuning that will bring the corporation into the forefront of the transportation industry in Alaska.



OPERATIONS

The Operations Department is the part of the railroad most people are familiar with because it is most visible. Operations has three major divisions: Transportation, Motive Power and Equipment, and Engineering. Together these three divisions are responsible for all train movements, for the upkeep of all rolling stock and equipment, and for construction and maintenance of the track and roadbed and all railroad buildings.

Other divisions in Operations are less known, such as Security and Claims, Operating Rules and Hazardous Materials. Security and Claims is responsible for the security of the line including preventing trespassing and for investigating train and train-related accidents. This department also processes all claims for lost or damaged freight and equipment.

The Operating Rules Department administers the railroad's rules program for operating trains and equipment. To ensure understanding and compliance of the operating rules and special instructions, periodic training and testing is provided for operating personnel by this department.

The Hazardous Materials Office is responsible for inspecting equipment, rolling stock and buildings for compliance with corporate rules and regulations regarding the use and transportation of hazardous materials.

ENGINEERING

In 1985 crews replaced about 26,000 crossties, relaid 81,000 linear feet of mainline rail using premium alloy rail, and turned another 40,500 feet of rail on curves. More than one-third of the rail system, or about 200 miles, was surfaced.

Bridge crews repaired and upgraded 23 steel and timber bridges, including the repair or installation of timber stringers, bulkheads, pilings, guard rails and bridge ties.

Maintenance workers installed a new, high technology material at railroad crossings that will provide a better crossing surface for the traveling public.

The single largest maintenance expenditure totalled about $2 million for rehabilitation of five tunnels between mile 51 and 53 of the main line. The two-year, $4 million project, about 50 miles north of Seward, will decrease maintenance of the tunnels and improve operations through that section of track. Work completed by the project contractor in 1985 included rock bolting of all the tunnels, ditching to improve drainage, and pouring four of 10 new reinforced concrete tunnel portals.

The Engineering Department coordinated with the state Department of Transportation and the Municipality of Anchorage in construction of two grade-separated crossings in the Anchorage area. The work included three new railroad bridges at Dimond Boulevard, 76th Avenue, and Campbell Creek, plus 1.6 miles of new mainline track. Work was begun also on the Municipality's West Northern Lights Boulevard project in Anchorage. When completed in 1986 it will be similar to the grade-separated crossing at Dimond Boulevard.

Engineering also coordinated with the Department of Transportation in Fairbanks in making track changes to the Fairbanks Yard to provide space for construction of a highway nearby and an overpass across the Fairbanks Yard. The work included construction of a balloon track to replace the wye and will eliminate a crossing in the middle of the yard.

Most of the work completed by the Engineering Department was designed to improve or enhance other areas of the Operations Department. For instance, electrical service was installed at the Anchorage and Fairbanks van terminals to provide "keep from freezing" (KFF) trailer service. KFF provides shippers with electrical power for heating and preserving goods shipped during the winter in trailers on flat cars.

Increased truck-trailer traffic on the Alaska Railroad led to the construction of a 4,000-foot van track in Whittier to improve trailer-on-flatcar (TOFC) service. Other van terminal improvements were made both at Whittier and Seward including new trackage, lighting and drainage.

Upgrade of 12 miles of the Eielson Branch was begun with the replacement of 4.6 miles of 75-lb. rail with secondhand 115-lb. rail that was replaced on the main line. The branch line serves Ft. Wainwright, North Pole and Eielson Air Force Base. It is used for delivery of coal to fuel the military's power plants. A 4,100-foot siding was constructed on the branch line at North Pole to accommodate increased traffic expected to result from the expansion of the nearby oil refinery.

Throughout the year Engineering employees worked to upgrade and improve the railroad's physical plant. Facilities at Fairbanks, Denali Park, Anchorage and Seward were painted or remodeled; water, heating and sewage systems were improved; and roofs were replaced or insulated to reduce maintenance, repair defects, reduce heat loss and improve appearance and operation.

The single largest physical improvement was construction of boiler plants in several Anchorage facilities as part of the final phase of a three-step utility modernization program that eliminates the railroad's dependence on a nearby high-cost, outmoded, commercial heating plant. The results are significant energy savings and improved working conditions.

The project included installation of five boilers, including three 400-horsepower steam boilers in the old blacksmith shop, which when constructed in the early 1920s was the original railroad boiler plant, and two 125-horsepower hot water boilers in a new building constructed near the Anchorage warehouse area. Three smaller plants were installed to heat the general office building, which houses the Anchorage Passenger

Rehabilitation of five tunnels between Seward and Portage was the single largest track maintenance expenditure in 1985. The $4 million, two-year project will be completed in 1986.

Depot; the annex, which includes the accounting and computer personnel; and the Anchorage freight house, which includes the procurement offices.

This project will be completed in 1986 with installation of an energy management and control system, some minor renovations to buildings, and relocation of the car cleaning facility.

MOTIVE POWER AND EQUIPMENT

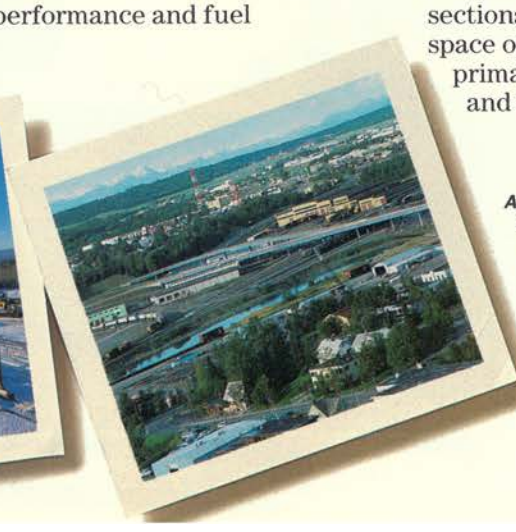
While the Engineering Department was working in 1985 to improve the condition of the railroad tracks, roadbed and physical plant, the Motive Power and Equipment (MP&E) Department acquired new rolling stock and equipment or overhauled much of what was already on hand.

Major purchases included five new state-of-the-art GP49 diesel locomotives manufactured by the Electro Motive Division of General Motors. The 2,800-horsepower locomotives have an anti-wheel-slip system that improves train performance and fuel consumption.

In an effort to improve the reliability of the existing locomotive fleet and to reduce maintenance costs, MP&E completed a major overhaul of the electrical components and trucks on two locomotives and completed the rewire and electrical upgrade to control circuits on a third. A fourth locomotive was repowered with new pistons, cylinder liners and heads.

Several locomotives were judged beyond economical repair and were retired, including No. 1500. An F-7 engine that had a glamorous history with the Alaska Railroad, No. 1500 provided the power for many ceremonial trains including two trains used during transfer ceremonies in January. No. 1500 also was featured in a motion picture filmed on the Alaska Railroad in 1985 called "Runaway Train." It was the grand old lady's last official duty before being retired and donated to a local transportation museum.

To improve freight-hauling capabilities, 45 articulated intermodal cars were purchased for TOFC service. Each car is hinged, or articulated, in three sections to allow for easier train movement. There is space on each car for three trailers. The cars are used primarily for hauling trailers between Anchorage and Fairbanks.



At far left, the railroad yard in Fairbanks includes about 440 acres in the heart of the city. A row of articulated flat cars shown at center awaits trailers for shipment to Anchorage.

Left, the Alaska Railroad owns about 660 acres near downtown Anchorage, most of which is at the mouth of Ship Creek. In the background is the roundhouse where all equipment maintenance and repairs are done.

MP&E began construction of two power cars and wired 15 of the new articulated cars to provide electricity for trailers carrying perishable goods and other commodities that might freeze.

Two self-propelled passenger cars were purchased in 1985 also. The cars, known as rail diesel cars or RDCs, were rebuilt with the installation of twin 347-horsepower Cummins engines and twin-disc transmissions. The first of the two cars was received in December 1985 and was placed in winter passenger service at the start of the new year.

For the first time MP&E placed an employee in the railroad's Seattle office to work exclusively with shippers in solving technical problems related to equipment use and loading requirements. A program establishing new rules for open-top loads was initiated to reduce the cost to shippers for improperly secured or heavy loads.

TRANSPORTATION

Train movements increased dramatically in 1985 and the Transportation Department worked to ensure those movements were made safely and efficiently. Gross trailing ton miles, a measurement for the movement of one ton over one mile, were up 25 percent in 1985 over 1984. Freight traffic accounted for the major portion of this increase, but passenger traffic also rose. Ridership surpassed the quarter-million mark for the first time in the railroad's history.

The first full year of export coal service by the railroad was completed in 1985. A steady source of revenue was derived from the three-unit-trains-a-week movement of coal from the Usibelli mine at Healy to Seward for export to Korea. The contract for hauling export coal began in December 1984 and since its inception 132 coal trains have hauled 671,000 tons of export coal.

In addition, 562,000 tons of coal were moved from Healy to the Fairbanks area to provide fuel for five power plants in Interior Alaska and the military bases at Wainwright, Clear and Eielson.

In May 1985, a new intermodal freight service was inaugurated called the Arctic FOX, or Freight Overnight Express. This service is a unit trailer train that provides six-days-a-week overnight delivery of trailers and containers between Anchorage and Fairbanks. The Arctic FOX operates with an average of 10 articulated flat cars that provide space for about 30 trailers or containers. The FOX hauled 5,832 trailers in its seven months of operation in 1985.

The FOX is the first cabooseless train service operated on the Alaska Railroad and the first service operated with a two-member crew. This was made possible by the addition of train rear-end devices. These end-of-train monitors provide vital information to locomotive engineers operating cabooseless trains. Each device consists of two units, a receiver in the locomotive cab and a transmitter on the rear car of the train. Together these units allow crews to monitor air brake pressure, detect motion in the last car of the train and measure train distances traveled. The units also provide the rear-end car with an FRA-required amber light that automatically turns on at dark.

During the same time the Arctic FOX service was initiated, the Anchorage freight house operations were discontinued. All services for loading and unloading railcars, consolidation of freight, and rubber-tire delivery were contracted to local businesses in an effort to divest from some less profitable, labor-intensive operations. Because of the railroad's rapid growth in the intermodal business, all Anchorage freight house employees were transferred to Intermodal Services, which was established as a separate division within the Transportation Department.

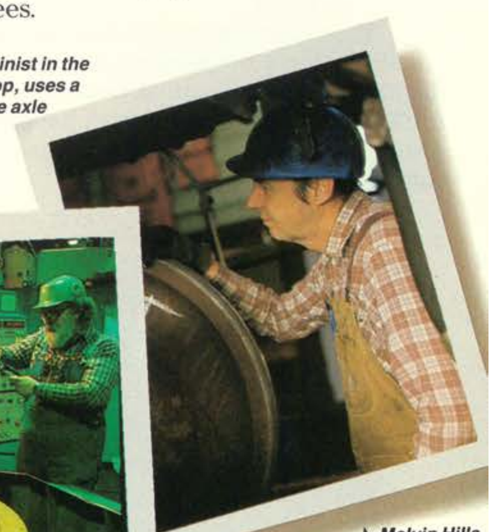
In October, the railroad-owned and operated Healy Hotel was closed and the building sold at public auction. The hotel had been in operation since 1946 and provided lodging and meals for railroad employees.

Jim Trueblood, a locomotive electrician in Anchorage, installs a new bearing on a locomotive engine alternator.

Larry Newsham, technical services manager, inspects loaded rail cars before shipment from Seattle to Anchorage.

Fairbanks carman Kirby Roundtree welds the undercarriage of a rail car.

Chris Brooks, a machinist in the Anchorage wheel shop, uses a caliper to measure the axle bore of a wheel.



Melvin Hills inspects the assembly of a wheel mounted onto a rail car axle. Hills is a carman in the Fairbanks wheel shop.

Because of its high operating and maintenance costs, the hotel was closed in favor of a more economical means of providing these services by contracting with a local motel and cafe at Healy.

In December the second new freight service for 1985 began operating. A daily unit tank train service between Fairbanks and Anchorage, called the Oil Worker Limited or OWL, transports petroleum products from the local oil refinery southbound to Anchorage and gasoline northbound to Fairbanks from storage yards in Anchorage. This daily service greatly improved freight delivery service for these commodities and turnaround time on empty tank cars.

OPERATING RULES

In late 1985, after extensive review and consultation with railroads operating in the Lower 48, the Operating Rules Department began training operating personnel on an innovative new system known as Track Warrant Control. This system is used on many other U.S. railroads and is designed to expedite the movement of trains while providing a safe and efficient operation. It will replace the complicated and time-consuming train order method in use at the Alaska Railroad for decades. Target date for railroad-wide implementation of the Track Warrant Control system is set for February 1986.

SECURITY AND RISK MANAGEMENT

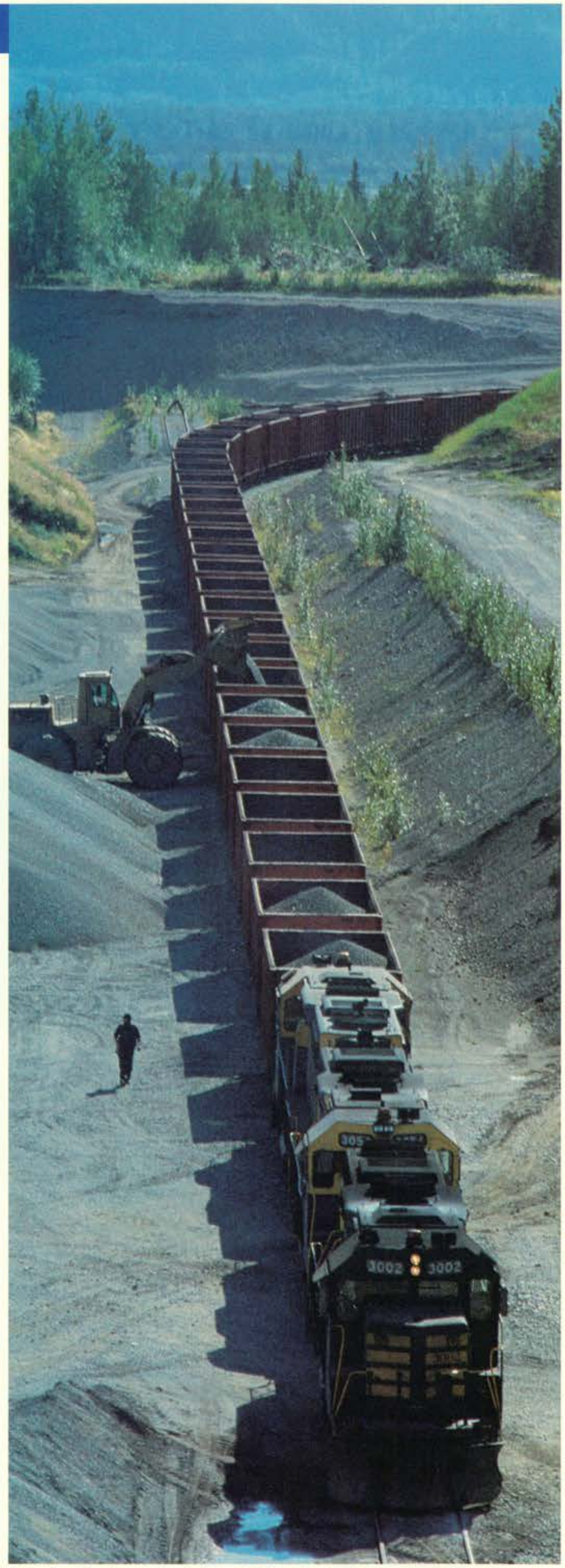
With the transfer of the Alaska Railroad to state ownership, the new corporation was required to organize a risk management program to provide insurance for property damage or loss, theft, fire, vandalism and other potential liabilities. For the first six months of 1985 the railroad operated on an interim program with coverage provided under the state of Alaska's risk management program.

During this interim period a review of the railroad's insurance needs was conducted and a risk management program developed that was marketed to domestic and foreign underwriters.

With the first year of experience as a reference, the risk management program is being assessed and modifications being made as the insurance markets dictate and as the corporation also continues to define and refine its specialized insurance needs.

HAZARDOUS MATERIALS

As part of its continuing safety program, the Alaska Railroad provided training and information regarding the loading and movement of hazardous materials to shippers as well as local fire fighting and emergency services personnel along the railbelt. The Hazardous Materials Specialist provides assistance to customers to ensure that materials shipped on the Alaska Railroad are loaded and placarded in compliance with federal regulations. Examples of materials shipped in 1985 include petroleum products such as gasoline and jet fuel, and chemicals for use in manufacturing.



Gravel unit trains are loaded near Palmer, in the Matanuska Valley, 40 miles north of Anchorage.

MARKETING

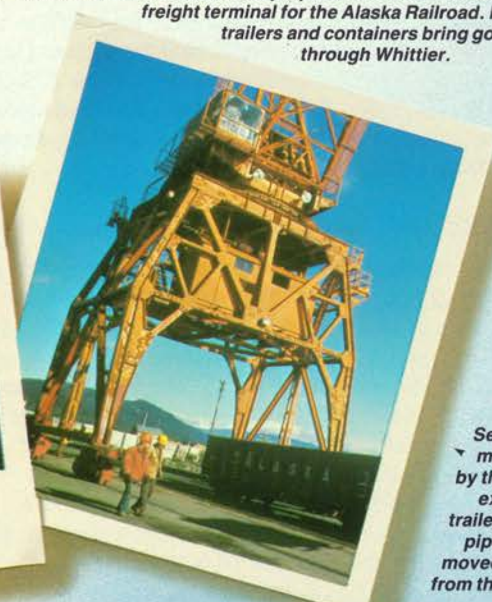
To achieve the business goals of the new railroad, the Marketing Department expanded the activities of the department, placing greater emphasis on developing new markets for the railroad's services.

Marketing's role within the corporation includes selling, pricing, rate and service contracting, cost of service analysis, market planning, market research, market development, customer service, advertising and promotion of both freight and passenger service. It also includes management and development of the real estate holdings of the corporation.

Ridership on the Alaska Railroad totaled 257,000 in 1985, an increase of 10 percent over 1984. Most passengers traveling on the railroad arrived by cruise ship in Whittier, rode the Portage-Whittier shuttle, or rode the express trains serving Denali National Park.

Whittier is one of Alaska's major ports and is also an important freight terminal for the Alaska Railroad. Rail cars, truck trailers and containers bring goods to Alaska through Whittier.

A trailer is shipped on an articulated flat car, one of 45 specially designed cars bought by the railroad in 1985. Each flat car can carry three trailers.



Seward is another major port served by the railroad. Coal exports, rail cars, trailers and imported pipe shipments are moved by the railroad from this small seaport community.

New services developed during 1985 demonstrate the railroad's dedication to customer service. The first of these specialized services was initiated only four months after the railroad transfer. Named the Arctic FOX (Freight Overnight Express), the service provides overnight delivery of high priority, highway trailers between Anchorage and Fairbanks using specially designed articulated flat cars, the first equipment purchased by the railroad in 1985. The efficiency of the FOX operation permits the railroad to compete with motor carriers in this market and pass the cost saving along to the Alaska consumer. Since its inception in May, the popularity of the FOX has steadily increased. By the end of the year it was operating regularly at over 90 percent capacity.

Another priority service begun in 1985 was the OWL (Oil Worker Limited). This daily train transports jet fuel from the petroleum refinery at North Pole to Anchorage, returning to the Fairbanks area with gasoline and other petroleum products. The efficiency of this service has made it possible for the customer to double the shipping volume without increasing the number of tank cars it leases.

FREIGHT SERVICE

Freight service is the most important source of income for the railroad. In 1985 it resulted in three-quarters of the corporation's $67 million in revenue. Passenger service and real estate revenues accounted for another 13 percent of the total.

Over 90 percent of freight revenue is derived from five areas: rail cars from the Lower 48, coal, petroleum, gravel, and TOFC/COFC (trailer on flat car/container on flat car.) The remaining percentage of freight is split between pipe shipments and local freight. Rail cars, coal and TOFC/COFC are handled predominately at two of Alaska's major ports, Seward and Whittier.

One-fifth of the freight revenue is derived from coal shipments, either export or local delivery. Alaska coal is exported to Korea through a major coal transloading facility built at the Port of Seward in 1984. The coal export contract with the Koreans runs through 1992. During the first year of the contract (actually 13 months, including December 1984) 671,000 tons of coal were moved to Seward. That is about 20 percent below the volume projected because of lower consumption by the customer, Korea Electric Power Company.

Coal shipments within Alaska were also lower than expected. Warmer than usual temperatures in

Interior Alaska resulted in reduced consumption by the five power plants in the Fairbanks area and the nearby military bases that use coal for fuel. About 562,000 tons were shipped locally in 1985.

Gravel and sand shipments, which move in unit trains between the Matanuska Valley and Anchorage, were the fifth largest revenue producers among all commodities shipped by rail. These shipments are tied to the cyclical rise and fall of the Anchorage area construction industry, which began to decline in 1985. Although lower activity in highway and building construction is anticipated again in 1986, a high volume of gravel is expected to move via the Alaska Railroad.

The Alaska Railroad connects with a number of water carriers providing a variety of excellent services from the Lower 48 to Alaska ports of Whittier, Seward, and Anchorage. Major rail carriers and truck lines connect with these water carriers at Seattle, Tacoma, and Prince Rupert, British Columbia. The water carriers provide frequent rail car barge, trailer, and container service.

Among the extensive railroad properties are the modern facilities at the ice-free ports of Whittier and Seward. Bulk and container cargos are unloaded at these ports for further transportation via rail and truck.

Interior Alaska covers thousands of square miles, much of it primitive wilderness; and, its towns and settlements are often isolated by distance and terrain. But, although the Alaska Railroad goes no farther than Fairbanks, it uses a combination of transportation modes, including motor carriers, river boats, and aircraft, to carry freight to the remote corners of the state.

Freight is transferred at Nenana to river barges which provide through routes and rates in connection with the railroad. This river freight service extends along the Tanana and Yukon rivers to Fort Yukon, and even to Marshall, just 150 miles from the Bering Sea. The railroad has for decades provided this essential service to the Bush, and is continuing to upgrade transportation facilities and services.

The railroad competes actively for the transportation of imported steel pipe products, which move into Alaska principally through the ports of Seward, Anchorage, and Valdez. The railroad moved 74,000 tons of pipe in 1985.

The *"railbelt"* region of Alaska runs 470 miles from Seward to Fairbanks, connecting southcentral Alaska as well as the Interior and Prudhoe Bay with water carriers from Canada, the Lower 48, and the Pacific Rim.

An aggressive marketing effort and improved service by rail led to a strong recovery in this business in December. Ship traffic through Seward resumed late in the year, discharging pipe for movement to the North Slope oil fields through the railroad's terminal in Fairbanks.

The Alaska Railroad Corporation is a major supplier of transportation services for the petroleum industry. Steel pipe, drilling compounds, machinery, and supplies routinely move over the railroad to Fairbanks for further movement by motor carrier to the North Slope. Massive drilling rigs are fabricated by an Anchorage firm then disassembled for transportation to the oil fields.

PASSENGER SERVICE

The majority of the 257,000 passengers who chose the Alaska Railroad for travel in 1985 arrived on cruise ships through the railroad's port of Whittier, rode the Portage-Whittier shuttle, or rode the express trains serving Denali National Park. Ridership rose by almost 10 percent over 1984, making the year a record for the railroad's passenger train service.

The purchase of two specially rebuilt rail diesel cars (RDCs) received in late 1985 is expected to reduce significantly the cost of wintertime rail service to rural areas, where the greater part of passenger service losses are incurred. These self-propelled passenger cars are available for charter and excursion trains and to supplement other passenger services where necessary.

The Alaska Railroad offers several types of passenger services, depending on season and destination. These services include the Denali express, the rural local service, Whittier shuttle, Seward excursion, and winter service.

The Denali express is the summer service on the Anchorage - Denali Park - Fairbanks route. Trains leave Anchorage and Fairbanks daily from late May to mid-September and serve Denali National Park each way. The Denali express is the last traditional intercity passenger train in the United States and provides spectacular views of Mt. McKinley, the tallest mountain in North America.

The rural, or Bush, service which moves people and their belongings (such as animals, supplies, and food) to remote areas not served by highway or air, is a major public service of the railroad. Bush passengers flag the train at almost any point for personalized service. Wintertime essential Bush and shuttle services during the eight-month season result in about 7 percent of the railroad's annual passenger business. The railroad also provides weekly small freight shipment service to these remote homesites.

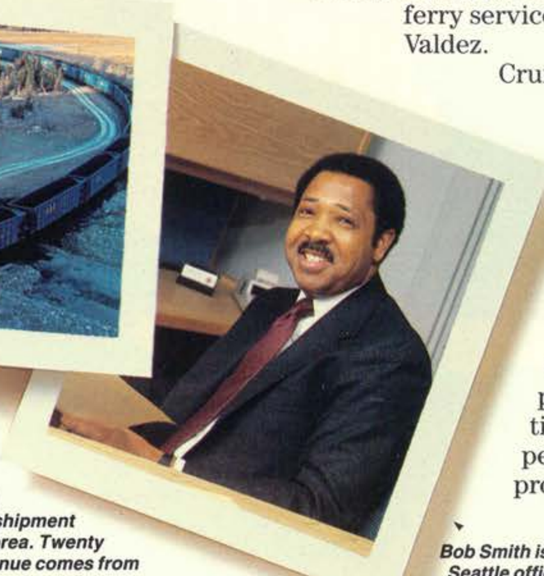
The 12-mile trip from Portage to the community of Whittier is traveled by what is familiarly known as the Whittier shuttle. The shuttle provides the only land access to this small but major seaport town. Passengers may ride the train or in their vehicles that are loaded onto flat cars at Portage. Much of the trip is through tunnels because of the many rugged mountains encountered between Portage and Whittier. The train makes several round trips daily between the two stops in the summer. Connections and reservations are available with the Alaska Marine Highway ferry service from Whittier to Valdez.

Cruise ship service to Whittier and significant increases in recreational use of the Prince William Sound region, coupled with a banner tourist year on the Valdez to Whittier state ferry route, boosted the number of passengers on the Whittier shuttle by over 20 percent. Ridership in 1986 promises to exceed 1985.

This 20,000-gallon tank car is part of the OWL (Oil Worker Limited), a new, daily unit train that brings jet fuel from North Pole to Anchorage, and returns to Fairbanks with gasoline and other petroleum products.

Phil Hibdon, left, and Dennis Smith, railroad marketing representatives, provide pricing information for freight service.

Coal is loaded at the Usibelli coal mine near Healy for shipment to Seward and then Korea. Twenty percent of freight revenue comes from local and export coal.



Bob Smith is a freight salesman in the railroad's Seattle office. His duties include selling freight services, making customer contacts and servicing existing contracts between the Lower 48 and Alaska.

A van loader sets a trailer onto an articulated flat car, which is part of the Arctic FOX (Freight Overnight Express), a service initiated in May 1985. The FOX provides overnight delivery of trailers containing perishables and other priority freight.

Passenger trains to Seward will begin regular service in 1986 after a 30-year absence. The Railroad was the original link between Anchorage and Seward but service was discontinued when highway travel became more popular. During the summer the railroad will offer a weekly day-long excursion from Anchorage to Seward. Passengers will see glistening glaciers, experience the view from high rocky ledges and wind along canyon streams on this 230-mile round trip through some of Alaska's most beautiful mountain territory.

Winter passenger service is provided on a reduced scale during the shoulder season of September to May. Passenger trains travel between Anchorage and Fairbanks twice each month and to Hurricane twice each weekend.

REAL ESTATE

The Alaska Railroad Corporation controls approximately 38,000 acres of land from the ports of Seward, Whittier and Anchorage to the interior city of Fairbanks. Approximately 40 percent of the land is a transportation corridor or railroad rights-of-way. The remaining real estate includes operational and nonoperational parcels within railbelt communities.

Since transfer of the railroad to state ownership, the scope and duties of the Real Estate Department have expanded to include a greater involvement in land-use planning. Coordinated efforts between Operations and Real Estate departments have been initiated to identify surplus lands available for long term lease. This would result in a more efficient use of undeveloped railroad properties. Leasing policies and practices have been written and implemented to create a more equitable and consistent approach to land management. Innovative ground lease techniques such as rent credits for certain non-depreciable lessee improvements and rent caps that create predictable and financially attractive lease documents will be made available under this new policy. Real estate revenues for 1985 were approximately $4.3 million.

During 1985, a study was initiated to analyze and recommend for the department an office automation system to catalog and create a database to store some 1,200 real estate lease and permit contracts. The recommendation will be implemented in 1986.

Positive steps are being taken to develop a closer working relationship within railbelt communities. The Real Estate Department recognizes the need for a more cooperative approach between the Alaska Railroad Corporation and its host municipalities and boroughs.

THE FUTURE

To implement the Marketing Department's diverse role within the railroad, a formal marketing plan was developed by the department and in late 1985 was approved by the Alaska Railroad Corporation Board of Directors. A key element of the plan calls for new, aggressive marketing programs to establish the identity of the Alaska Railroad throughout the Northwest as well as in the Alaska shipping community.

CHIEF COUNSEL'S OFFICE

The Chief Counsel and his staff were kept very busy in 1985 with the myriad legal issues facing the new railroad corporation.

Topics reviewed during the year by the legal staff included real estate, regulatory review of the rail industry and the railroad's rate structure, personnel and labor relations, commercial financing, and risk management.

The State Transfer Team, which was created prior to transfer of ownership of the railroad to coordinate that process, passed responsibility for many legal tasks to the Chief Counsel in the first quarter of 1985. Foremost among these assignments was continuing oversight of the conveyancing of 38,000 acres of railroad parcels and right-of-way from the federal government to the corporation. Survey, description, and procedural issues continue to be overshadowed by Native corporation claims to valuable railroad parcels. The railroad was involved in negotiations with Ahtna, Eklutna and Toghetthele native corporations. An agreement was reached with Ahtna Inc. in 1985. Negotiations will continue in 1986 to resolve the remaining claims.

The interpretation and application of both old and new railroad leases required considerable legal support. Corporate attorneys assisted in development of a new leasing policy and new master lease. The legal office also participated in the development of corporate relations with many state, federal, and military agencies regarding mutual land ownership and management concerns.

The legal staff was instrumental in the financing of millions of dollars in new equipment purchases in 1985 by preparing and negotiating necessary commercial documents. Procurement of equipment and materials also required legal review of solicitation packages and legal assistance in the resolution of bid disputes.

Competitor challenges to the corporation's pricing of piggyback traffic (truck trailers on flat cars) led the Chief Counsel to retain transportation and accounting experts to review the corporation's rate costing practice. The studies confirmed that the corporation's pricing was appropriate.

Competing water carriers fought unsuccessfully to deny the corporation any participation in the Interstate Commerce Commission's exemption of boxcar traffic from regulation. The exemption will permit more freedom in the marketing of transportation services.

Through the first year of state ownership, the corporation received relatively few claims for personal injury and property damage related to railroad operations. Corporate counsel participated in resolution of several of the claims and in review of the corporation's risk management procedures.

Given the breadth of 1985 corporate legal affairs, the Office of the Chief Counsel will be challenged by these and new assignments in 1986.

Cathie McLeod is a clerk-typist in the Fairbanks freight house.

Terry Tur specialist

The Alaska Railroad General Office building in Anchorage was constructed in 1942. It houses most of the corporation's administrative employees.

HUMAN RESOURCES

on and Tim Reed, foreground, are bearing
he Anchorage bearing rebuild shop.

Chris Muniz, a truck driver for the railroad, assists in loading and unloading trailers on flat cars in the Anchorage yard.

An administrative assistant, Shirley Tobin is employed in the railroad's Seattle office.

Betty Elge is the dock agent, and Beverly Clausen, foreground, a clerk-typist, in Seward.

As a federal agency, the Alaska Railroad had adhered to federal hiring practices and personnel procedures. With transfer of ownership to the state, the railroad began to develop and implement policies and procedures that more closely responded to the needs of the new Alaska Railroad Corporation.

In the process, several personnel and employee relations functions were consolidated into one department. The Human Resources Department was created from the old Personnel Office. Added to it were Organization, Compensation and Benefits, Labor Relations, and Health, Safety and Environment. This reorganized department provides a full range of employee relations services for both management and employees. Affirmative action and the streamlining of recruiting and hiring practices are a top priority in better utilization of the work force.

Among the major Human Resources projects in 1985 was conversion of all personnel and payroll records to a fully automated, computerized system. Complete conversion to the new records system was expected by February 1986. This change will allow ready access to employee data and will insure an accurate employee record system.

Human Resources played a significant role in labor negotiations in 1985. According to both the federal transfer and state corporation acts, union contracts in existence at the time of transfer to state ownership are to be renegotiated by the corporation within the first two years of state operation. Beginning in August 1985, for the first time in the history of the Alaska Railroad, representatives from all seven bargaining units and management met at the bargaining table. This unique process called for bargaining with all the unions at once on items common to all the units. By year's end significant steps had been made toward reaching a mutually agreeable master contract.

Negotiations will continue in 1986 to finalize the master agreement after which each bargaining unit will have an opportunity to negotiate an addendum specifically for each union.

UNIONS REPRESENTING RAILROAD EMPLOYEES
(As of December 31, 1985)

Union	Employees
United Transportation Union	128
Brotherhood of Railway Carmen	40
International Association of Machinists and Aerospace Workers	69
American Federation of Government Employees*	288
American Train Dispatchers Association, Agents/Operators	13
American Train Dispatchers Association, Train Dispatchers Unit	5

*Blue collar and white collar units

Administration of all benefits programs for railroad employees is managed by the Organization, Compensation and Benefits Department in Human Resources. This department administers the new life insurance and medical care programs for employees, including vision, hearing and dental care. This new program is designed to cover new employees and transferred employees and was implemented in February 1985.

This department also implemented a pension plan and a tax-deferred savings plan for non-represented employees. These plans allow employees to contribute a portion of their pre-tax earnings to a retirement and investment program. The deferred savings plan allows employees to build funds for their retirement while reducing their current taxes. Employees who participated in the Civil Service Retirement program prior to transfer remain in that system.

A safe workplace and working conditions have always been a priority at the Alaska Railroad. Corporation-wide training programs in first aid and cardiopulmonary resuscitation were provided several times throughout the year by the Safety Office. Safety meetings were held throughout the railroad on a regular basis to keep safety in the forefront of employees' minds while at work and at home.

The result was a reduction in accidents and serious on-the-job injuries. At the close of the year the Alaska Railroad Corporation was in contention with other railroads of similar size for a second place Harriman Award. The Harriman is a national safety award presented by the Federal Railroad Administration. The railroad received a fourth place Harriman in 1984 and a third place in 1983.

BENEFIT PROGRAMS
(As of December 31, 1985)

PENSION PLAN	Federal Retirement System*	Corporation Program	Total
Employee Contributions	$1,338,311.56	$41,634.28	$1,379,945.84
Employer Contributions	$1,338,311.56	$35,389.00**	$1,373,700.56
TOTAL	$2,676,623.12	$77,023.28	$2,753,646.40

* Employees who participated prior to transfer remained in this program after state ownership.

** Employer contributions are based on projected cash payouts, reflecting information received from the trust administrator.

TAX DEFERRED SAVINGS

Employee Contributions***	$232,697.29

***The present plan covers permanent, non-union employees. Union employees may become eligible depending upon the outcome of contract negotiations.

CORPORATION PAID LEAVES
(in hours)

	Earned	Used
Annual Leave	91,533	71,975
Sick Leave	58,547	35,247
Administrative Leave*	—	6,209
Jury Duty	—	1,457
Military Leave	—	312

*Paid leave is granted for such activities as voter registration and voting, representing employee organizations, and attending conferences or conventions that would benefit the corporation.

NUMBER OF EMPLOYEES BY DEPARTMENT

CEO Staff	10
Operations	532
Administration/Human Resources	25
Finance	65
Marketing	27
TOTAL	659

EMPLOYEE YEARS OF SERVICE

Years	Employees	Years	Employees
32	1	14	26
30	1	13	16
29	2	12	13
28	2	11	63
27	2	10	46
25	1	9	19
24	3	8	9
23	5	7	12
22	4	6	32
21	4	5	29
20	8	4	24
19	8	3	33
18	8	2	25
17	10	1	65
16	10	Less than 1	164
15	14		

FINANCE

When the Alaska Railroad changed hands from federal to state government, the Finance Department was a primary recipient for dramatic alterations. The changes were part of a corporate three-year plan generated in early 1985. The Finance Department as well as the corporation met or exceeded its goals for the first year.

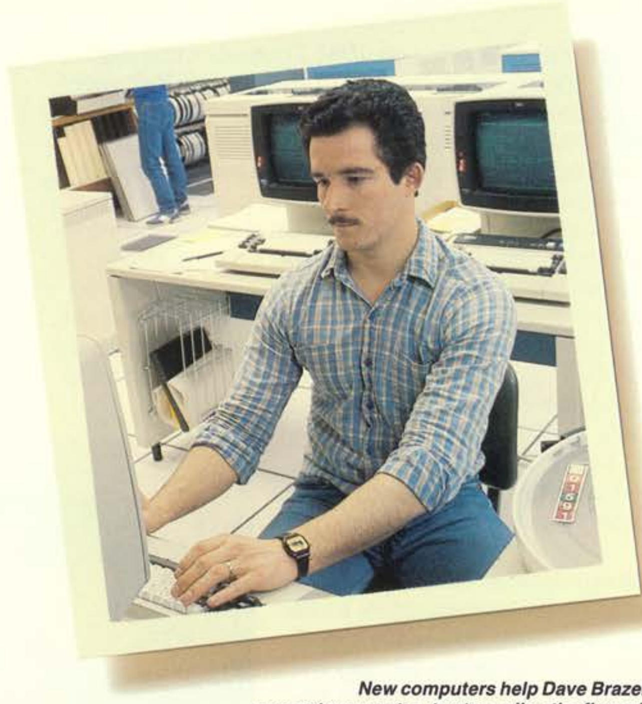
The financial reorganization began with a management-oriented focus on the department. Accordingly, the position of Vice President of Finance was created, with all finance, information systems, procurement and supply departments reporting to this position. Formerly, under federal administration, those departments reported to the Department of Administration.

An important objective outlined in the three-year plan was the purchase of new equipment. Under federal administration all major purchases were paid by cash appropriated by Congress as part of the federal Department of Transportation budget. The new Finance Department was able to prepare a financial package that emphasized lease/purchase agreements for equipment and also established a credit line for the new corporation. The package resulted in the purchase of approximately $12 million in new equipment such as flat cars, locomotives, rail diesel cars and computers. The corporation spent an additional $10 million for improvements to the mainline track, tunnels and other areas.

Installation of an on-line accounting and financial system was another giant step taken by Finance. A new IBM 4361 computer was added which handles accounts payable/receivable, general ledger, inventory, purchasing, payroll and personnel management. The new system uses modern on-line capabilities as the standard for its operations, which prior to transfer had depended on a manual accounting system. In addition to updating the railroad's finance and record keeping capabilities, the Finance Department was responsible for expanding the use of personal computers in several work areas. The new PCs generate a huge time and cost savings in every department in which they are used.

A major activity of the new corporation in 1985 was wrapping up all accounts receivables and payables left behind by the federal government. The Federal Railroad Administration (FRA) contracted with the Alaska Railroad Corporation to collect outstanding accounts receivable and make payments for outstanding federal debts. Over $12 million of federal accounts receivable was collected by the corporation, much of which was more than six months past due. The corporation received a collection fee based on its contract with the FRA.

Another major activity specifically involved the corporation's surplus inventories. The Finance Department streamlined the warehouse and supply operations by eliminating excess inventories through public auctions held throughout 1985, generating approximately $1 million in revenue. A more efficient supply operation has resulted from the reductions.



New computers help Dave Brazell, computer operator, to streamline the financial and record keeping process for the railroad.

The accounting department in Anchorage was substantially updated with the addition of a new computer which handles accounts payable and receivable, general ledger, inventory, purchasing, payroll and personnel management.

The corporation began divesting itself of the gift shop business in 1985. Though not finalized at the close of the year, sale of the Passenger Depot gift shops to the private sector is in progress.

BOARD OF DIRECTORS

When reflecting on 1985 I consider the major accomplishment of the Alaska Railroad Board of Directors was effectively setting the stage under state ownership for the future successful management of the Alaska Railroad.

As directors we fully realize that our first responsibility is to the citizens of Alaska. We also see a need to establish an arena of cooperation and accountability with the Governor and the state legislature. Thanks to the positive response of Governor Bill Sheffield and the oversight committees of the legislature, we were able to establish this bond of trust and were given the latitude to function in a free enterprise environment. This certainly contributed to our success in 1985 and provided a platform on which those who follow in our footsteps may build.

At our regular board meetings, in order to be more responsive to the needs of the communities we serve, as well as our customers, an opportunity is provided at each forum for public comment. It is this exchange that has given the board of directors an opportunity to receive input on such issues as leasing policies, bidding procedures, needs of our employees, and the public response to our services.

This ability to communicate on a local level with management, as well as the board of directors, has provided a vehicle for public communication that was practically nonexistent under federal ownership. I am sure this was the intent of Senator Ted Stevens and the many others who worked so long and hard for state ownership of the Alaska Railroad.

In 1985 we were able to benefit from the momentum of the prior year's economy, a stable work force and some creative management innovations by the railroad management. The result was increased earnings and a profit at the bottom line. However, 1986 will present new concerns. The Alaska Railroad, like any other business in Alaska, is not exempt from the predicted slowdown in the economy. It will take a concerted effort on the part of each of us to continue our first year's success.

The board of directors would be remiss if each member did not thank you for your patience and support during this first year. We are making history with this railroad and it is exciting.

James O. Campbell
Chairman of the Board of Directors

Prior to the transfer of the Alaska Railroad to state ownership in January 1985, a seven-member board of directors for the Alaska Railroad Corporation was appointed by Governor Bill Sheffield. Appointment of the board fulfilled a requirement outlined in the 1983 Alaska Railroad Corporation Act, which established the corporation.

The Alaska Railroad Corporation board is responsible for the management of the corporation but has delegated certain powers and duties to the Chief Executive Officer, Railroad President Frank Turpin.

James O. Campbell is chairman of the board of directors. He was president and general manager of Spenard Builders Supply when his retirement was announced in late 1985. Campbell has worked and served on numerous special committees and community service projects. A resident of Alaska since 1959 he has been an Anchorage assemblyman and president of the Anchorage Chamber of Commerce.

Board vice chairman is **Frank X. Chapados** of Fairbanks. He has been an Alaska resident since his birth in Juneau in 1914, and has worked most of his life in southeastern and interior Alaska. Currently, he is president and general manager of H & S Forwarders, Inc., in Fairbanks. Chapados was elected to the state House of Representatives in 1958, re-elected in 1961, and served as chairman of the Joint House & Senate Finance Committee. He has been active in many civic and community programs including being past president of the Fairbanks Chamber of Commerce. He has worked as an enforcement agent for the U.S. Fish and Wildlife Service and was also a U.S. Marshal in Fairbanks.

Myron M. Christy is the railroad board member from out of state. He resides in San Francisco and fulfills the directive of the legislature that one board member have at least 10 years of management experience in the railroad industry outside Alaska. Christy worked with the Western Pacific Railroad Company from 1950 to 1973 in many positions including president and CEO. Currently he is consultant and director for U.S. Leasing International, Inc.

The Board of Directors, seated from left: Commissioner Loren H. Lounsbury; Board Chairman James O. Campbell; and Lewis E. Dickinson. Standing from left are Gerald D. Valinske; Board Vice Chairman Frances X. Chapados; and Commissioner Richard J. Knapp. Shown separately below left is Myron M. Christy.

Lewis E. Dickinson is a founding partner of DOWL Engineers, a professional engineer and a registered land surveyor. As a railroad board member, he brings with him over 30 years of engineering experience and almost 25 years of business management experience. Prior to founding DOWL Engineers, he worked for the City of Anchorage in the city engineer's office.

Richard J. Knapp is one of the two state commissioners who serve on the railroad board. As commissioner for the Department of Transportation and Public Facilities, Knapp represents the transportation interests of the state. Knapp is a retired rear admiral of the U.S. Coast Guard, one of six appointed by President Carter in 1978. A graduate of the U.S. Coast Guard Academy, he served as district commander of the Coast Guard in Alaska from 1980 to 1984, and has a master's degree in business administration from George Washington University in Washington, D.C.

The second commissioner representing the state of Alaska is **Loren H. Lounsbury,** Commissioner of Commerce and Economic Development. Lounsbury is a 40-year Alaska resident, and graduated from Anchorage High School in 1952. He is a professional engineer and a registered land surveyor. Until his appointment as commissioner in January 1985, he was president of Lounsbury and Associates, Inc. Lounsbury has served on numerous community service boards and is the former Honorary Consul of the Republic of Korea for Anchorage.

Gerald D. Valinske serves on the railroad board as a member of the United Transportation Union, Local 1626. He has been a conductor with the Alaska Railroad since 1975. A 12-year Alaska resident, Valinske worked with the Milwaukee Railroad as a brakeman prior to moving to Alaska. In 1984, he was a lobbyist for the United Transportation Union, American Federation of Government Employees, and the Brotherhood of Railway Carmen.

FINANCIAL REVIEW

Management is responsible for the preparation, integrity and objectivity of the corporation's financial statements. Financial statements are prepared in conformity with generally accepted accounting principles and include amounts based on management's best estimates and judgment.

During 1985 the corporation maintained a system of internal accounting controls and procedures which will be continually reviewed and supported by written policies and guidelines and supplemented by a corporate internal auditor. The system provides reasonable assurance that assets are safeguarded against loss from unauthorized use and that the books and records reflect the transactions of the corporation and are reliable for the preparation of financial statements. The concept of reasonable assurance recognizes that the cost of a system of internal accounting control should not exceed the benefits derived and also recognizes that the evaluation of these factors necessarily requires estimates and judgments by management.

The corporation's financial statements are examined by Ernst and Whinney, independent certified public accountants. Their examination is conducted in accordance with generally accepted auditing standards which includes a study and evaluation of the corporation's system of internal accounting controls. The Auditors' Report appears on the following pages.

The Board of Directors pursues its oversight responsibilities for the financial statements and corporate conduct through its Audit Committee. The Audit Committee is composed of directors who are not officers or employees of the Alaska Railroad Corporation. It meets regularly with members of management, the internal auditors and the independent accountants to discuss the adequacy of the Alaska Railroad's internal controls and financial statements.

In 1985 there were many major changes to the accounting controls and procedures. All financial reporting moved from old software systems on a Burroughs computer or manual calculation to new MSA software on an IBM computer with on-line data access. The accounting methods changed from government accounting to corporate accounting, which follows generally accepted accounting principles. A new cost coding structure was developed to meet these new corporate needs. An extensive cash management process was implemented along with a new capital funding control process. The Audit Committee was established and hired the External Auditor. The Internal Control Function was established to oversee the extensive changes and ensures numerous procedures are being developed to control these new systems.

Marvin J. Yetter

Marvin J. Yetter
Vice President, Finance

REPORT OF INDEPENDENT ACCOUNTANTS

Board of Directors
Alaska Railroad Corporation
Anchorage, Alaska

We have examined the balance sheets of Alaska Railroad Corporation as of December 31, 1985 and January 6, 1985, and the related statements of income, equity, and changes in financial position for the period from January 6, 1985 to December 31, 1985. Our examinations were made in accordance with generally accepted auditing standards and, accordingly, included such tests of the accounting records and such other auditing procedures as we considered necessary in the circumstances.

In our opinion, the financial statements referred to above present fairly the financial position of Alaska Railroad Corporation at December 31, 1985 and January 6, 1985, and the results of its operations and the changes in its financial position for the period from January 6, 1985 to December 31, 1985, in conformity with generally accepted accounting principles applied on a consistent basis.

Ernst + Whinney

Anchorage, Alaska
March 21, 1986

BALANCE SHEET

	December 31, 1985	January 6, 1985
	(In Thousands)	
ASSETS		
CURRENT ASSETS		
Cash and temporary investments	$ 1,911	$10,978
Accounts receivable (less allowance for doubtful accounts of $912,000 at December 31, 1985)	11,275	2,152
Operating materials and supplies — Note C	2,174	1,747
Other current assets	662	
TOTAL CURRENT ASSETS	16,022	14,877
PROPERTIES		
Transportation — Notes C and E:		
Road	10,623	3,847
Equipment	12,765	2,281
Road materials and supplies	3,444	2,319
Construction in progress	3,133	
	29,965	8,447
Less accumulated depreciation	(1,455)	
	28,510	8,447
Nontransportation — Note D:		
Land	13,850	13,850
	42,360	22,297
OTHER ASSETS		
Restricted funds — Note F	600	
Restricted lease proceeds — Note E	220	
	$59,202	$37,174
LIABILITIES AND EQUITY		
CURRENT LIABILITIES		
Accounts payable and accrued liabilities	$ 2,781	
Accrued wages and vacation	4,343	$ 1,266
Notes payable	1,000	
Current portion of capital lease obligations — Note E	1,978	168
Deferred revenues	1,126	2,152
TOTAL CURRENT LIABILITIES	11,228	3,586
CAPITAL LEASE OBLIGATIONS, less current portions — Note E	6,992	339
	18,220	3,925
EQUITY		
Contributed capital — Notes C and F	33,849	33,249
Retained earnings	7,133	
	40,982	33,249
	$59,202	$37,174

See notes to financial statements.

STATEMENT OF INCOME

	Period from January 6, 1985 to December 31, 1985
	(In Thousands)
OPERATING REVENUE:	
Freight — Note H	$51,978
Passenger	4,344
Other	4,670
	60,992
OPERATING EXPENSE:	
Salaries and fringe benefits	35,219
Fuel	5,047
Depreciation	1,455
Provision for doubtful accounts	912
Other	16,680
	59,313
INCOME FROM OPERATIONS	1,679
OTHER INCOME:	
Real estate, less direct expenses of $227,000	4,095
Temporary investments	653
Gain on sale of assets	1,267
	6,015
OTHER EXPENSE:	
Interest	561
NET INCOME	$ 7,133

STATEMENT OF EQUITY

	Contributed Capital	Retained Earnings
	(In Thousands)	
Balance at January 6, 1985	$33,249	
Additional contributed capital	600	
Net income for the period from January 6, 1985 to December 31, 1985		$7,133
Balance at December 31, 1985	$33,849	$7,133

See notes to financial statements.

STATEMENT OF CHANGES IN FINANCIAL POSITION

	Period from January 6, 1985 to December 31, 1985
	(In Thousands)
SOURCE OF FUNDS	
Net income	$ 7,133
Expenses not requiring outlay of funds:	
Depreciation	1,455
TOTAL FROM OPERATIONS	8,588
Increase in accounts payable and accrued liabilities	2,781
Increase in accrued wages and vacation	3,077
Increase in notes payable	1,000
Increase in capital lease obligations	9,321
Contributions of additional capital	600
	25,367
APPLICATION OF FUNDS	
Increase in accounts receivable	9,123
Increase in operating materials and supplies	427
Increase in other current assets	662
Additions to property accounts	21,518
Increase in restricted funds	600
Increase in restricted lease proceeds	220
Decrease in deferred revenues	1,026
Reduction of capital lease obligations	858
	34,434
DECREASE IN CASH	(9,067)
Cash and temporary investments at beginning of period	10,978
CASH AND TEMPORARY INVESTMENTS AT END OF PERIOD	$ 1,911

See notes to financial statements.

NOTE A — ORGANIZATION AND OPERATIONS

The Alaska Railroad Corporation (Corporation) is a public corporation created by the State of Alaska legislature to own and operate the Alaska Railroad (Railroad) and manage the Railroad's rail, industrial, port, and other properties. The effective date of the legislation creating the Corporation was July 6, 1984. The Corporation commenced operations on January 6, 1985 and adopted the accounting policies of a commercial enterprise.

Congress authorized construction of the Railroad in 1914 and operations began in 1923. The federal government operated the Railroad until its sale to the State of Alaska. The Railroad operates 525 route miles, providing both freight and passenger services. The Railroad serves the Alaska cities of Anchorage and Fairbanks as well as the ports of Whittier, Seward, and Anchorage; Denali National Park; and military installations. Vessel and rail barge connections are provided from Seattle, Washington, and Prince Rupert, British Columbia.

NOTE B — SIGNIFICANT ACCOUNTING POLICIES

Temporary Investments: Temporary investments are carried at cost which approximates market value.

Materials and Supplies Inventories: Materials and supplies inventories are carried at the lower of cost (average cost) or market. Road materials and supplies include rail, ties, ballast, and other track materials. It is anticipated that the significant portion of these items will be capitalized when placed into service and, as a result, they are included in transportation properties.

Properties: Properties are stated on the basis of cost. Depreciation and amortization is computed on a straight-line basis over the estimated useful lives of the related assets. Preacquisition depreciable property is being depreciated on a straight-line basis over five years, which represents its estimated remaining life.

Income Taxes: As a public corporation, the Railroad is exempt from Federal and State income taxes.

Intragovernmental Funds: Funds received from the State of Alaska General Fund for operating purposes or that may be used for either operating expenses or capital expenditures at the discretion of the Railroad are recorded as revenues (approximately $280,000 in 1985). Funds received that are restricted to the construction or acquisition of fixed assets or other capital projects are recorded as contributed capital.

Reclassification: Certain January 6, 1985 balance sheet amounts have been reclassified to conform with the December 31, 1985 presentation.

NOTE C — ACQUISITION

On January 6, 1985, the Corporation acquired certain Railroad assets and assumed certain liabilities from the federal government. The sale of the Railroad to the Corporation was authorized under the Alaska Railroad Transfer Act of 1982 (ARTA), which was signed into law on January 14, 1983. ARTA requires the Corporation to operate the Railroad for a period of 10 years from the acquisition date and if this requirement is not met, title to all of the Railroad's assets reverts to the federal government. The purchase price, established under the terms of ARTA, was $22,271,000.

The State of Alaska funded the purchase through a capital contribution to the Corporation. In addition to the purchase price, the State of Alaska contributed $10,978,000 for initial working capital and capital expenditures.

The acquisition has been accounted for as a purchase and accordingly, the purchase price was allocated to assets and liabilities based on their estimated fair market value as determined by independent appraisal. As required by the purchase method of accounting, the excess of estimated fair market value of net assets acquired over the purchase price was applied as a reduction of the amount assigned to noncurrent assets. However, certain new rail and related materials were included in road materials and supplies at their estimated cost - new of $2,077,000. Operating materials and supplies were included in current assets at their allocated purchase basis cost.

The allocation of the purchase price is summarized as follows (in thousands):

Assets acquired:	
Operating materials and supplies	$ 1,747
Transportation properties	8,447
Nontransportation properties	13,850
	24,044
Less assumed liabilities:	
Accrued vacation	1,266
Capitalized lease obligations	507
	1,773
PURCHASE PRICE	$22,271

NOTE D — NONTRANSPORTATION PROPERTIES

Nontransportation properties consist of land not used in Railroad operations. Certain parcels of the land are leased under agreements which are cancellable upon 90 days notice by the lessee. The lease terms vary from two to fifty-five years. Annual rentals on the leases are approximately $4,320,000.

NOTE E — LEASES

The Railroad leases certain locomotives, freight cars, data processing equipment and other property under capital leases. Future minimum lease payments for capital leases as of December 31, 1985 are summarized as follows (in thousands):

Year Ending December 31,	1986	$ 1,978
	1987	1,849
	1988	1,735
	1989	1,498
	1990	1,498
	Thereafter	3,742
		12,300
Amount representing interest		3,330
Present value of net minimum lease payments (including $1,978 classified as current)		$ 8,970

Leased assets under capital leases included in equipment on the accompanying balance sheet of $9,396,085 and $507,000 at December 31, 1985 and January 6, 1985, respectively. The related accumulated depreciation was $344,873 at December 31, 1985.

In accordance with the terms of a lease for freight cars, $220,000 must be kept on deposit with a financial institution for the term of the lease agreement.

NOTE F — CONTRIBUTED CAPITAL

During 1985, the Railroad received $600,000 from the State of Alaska General Fund. These funds are available for and restricted to the purchase of certain equipment. The funds, which had not been spent as of December 31, 1985, are classified as restricted funds in the accompanying balance sheet.

NOTE G — PENSION PLAN

On September 1, 1985, the Railroad adopted a defined benefit pension plan covering permanent non-union employees hired since January 6, 1985. Union members hired since January 6, 1985, may become eligible for participation in the Plan depending upon the outcome of contract negotiations currently in progress. Pension expense is actuarially determined using the projected unit credit method. Pension expense for the period from September 1, 1985 to December 31, 1985 is $45,320. The Railroad's policy is to fund pension costs accrued. Disclosures regarding accumulated plan benefits and plan net assets are not presented as they are not available for the plan's first period ended December 31, 1985.

Federal employees who transferred to the Corporation will continue participation in the Civil Service Retirement System and the contribution required of the Corporation is 7 percent of the transferred employees' payroll.

NOTE H — MAJOR CUSTOMERS

Two Railroad customers accounted for 11 percent and 10 percent of freight revenue in the period ended December 31, 1985.

NOTE I — CONTINGENCIES

The Railroad from time to time may be a defendant in legal proceedings related to the conduct of its business. In the opinion of management, the financial position of the Railroad will not be affected materially by the outcome of any present legal proceedings.

OFFICERS OF THE ALASKA RAILROAD CORPORATION

Frank G. Turpin	President and Chief Executive Officer
Arnold T. Polanchek	Vice President, Operations
Marvin J. Yetter	Vice President, Finance
Dennis A. Robertson	Vice President, Marketing
James B. Blasingame	Director, Administration
J.D. Wood	Director, Human Resources
Larry D. Wood	Chief Counsel
Terry R. Blackwell	Superintendent of Transportation
Francis C. Weeks	Chief Engineer
Michael J. Sudol	Chief Mechanical Officer

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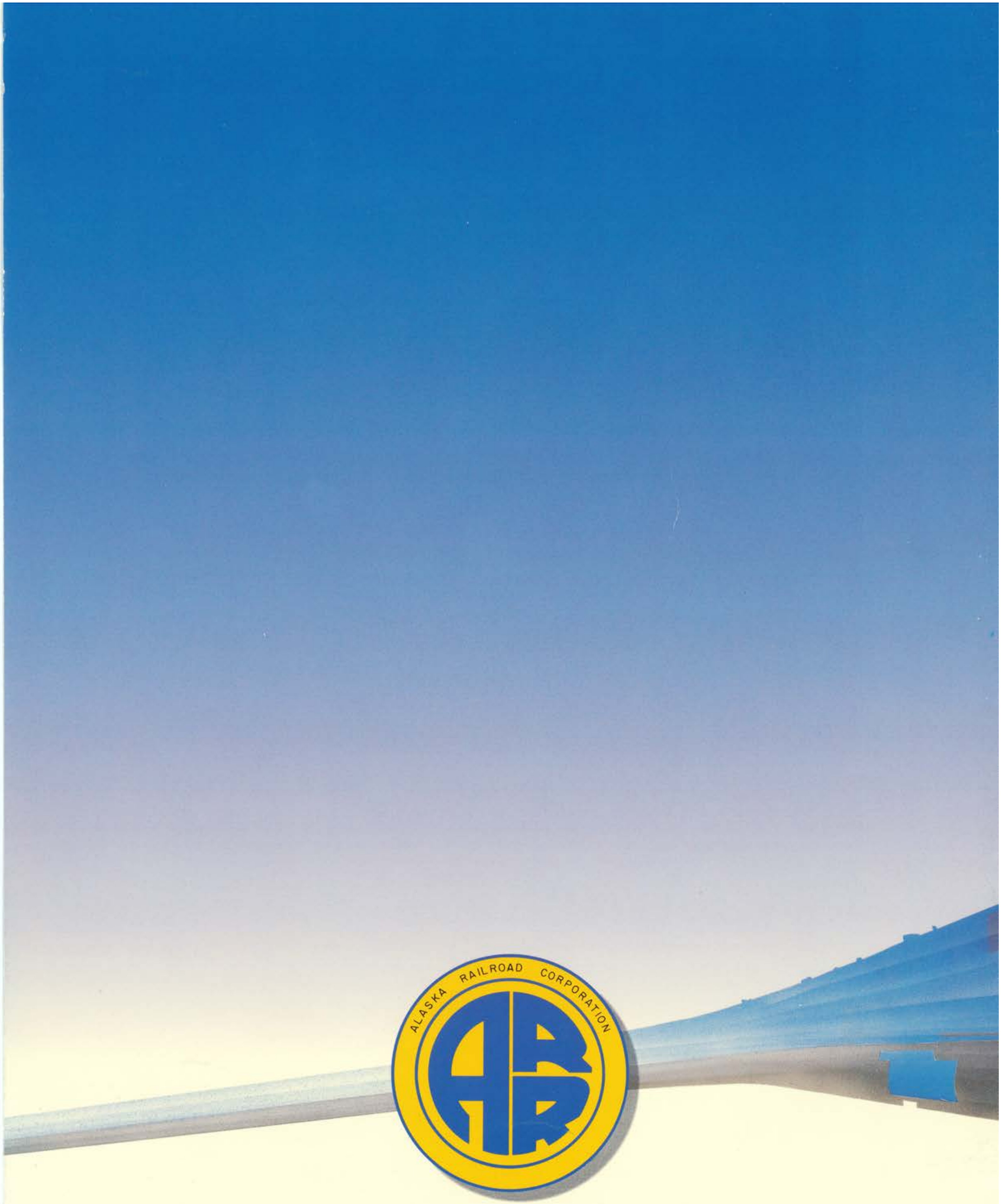
Third Eye Photography: Pages 4, 7, 10
Jack Wolff, Milkie Studio: Pages 8, 12, 15

This locomotive is one of five purchased by the railroad in 1985.



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