CONTINUOUS RAIL

Alaska Railroad 2010 Annual Report

March 30, 2011

In accordance with Alaska Statute (AS) 42.40.260, it is our pleasure to present the financial section of the Alaska Railroad Corporation's (ARRC) Annual Report for the fiscal year ending December 31, 2010.

The financial section of the Annual Report is presented in three parts:

- Management's Discussion and Analysis (MD&A) – provides an introduction, overview, and analysis of the basic financial statements
- The independent auditor's report on the basic financial statements
- The basic financial statements and accompanying notes

Whether an ARRC customer, creditor, or other resident of the State of Alaska, we hope you find this section of the Annual Report useful.

Sincerely,

Bill O'Leary, CPA
Vice President Finance and
Chief Financial Officer

Wendy Richerson, CPA
Controller

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MANAGEMENT'S DISCUSSION AND ANALYSIS

December 31, 2010 and 2009

This section of the Alaska Railroad Corporation's (ARRC's) annual financial report presents the discussion and analysis of the ARRC's financial performance during the fiscal years that ended on December 31, 2010 and 2009. Please read it in conjunction with the ARRC's financial statements, which follow this section.

Financial Highlights

- The ARRC's total fund equity increased 9% during the course of this year's operations and increased 19% over the course of 2009 operations.
- During 2010, the ARRC's operating revenues exceeded operating expenses by $5.6 million, yielding an operating ratio of 0.96. Last year, operating revenues exceeded operating expenses by $5.6 million and yielded an operating ratio of 0.96.
- The total 2010 operating costs of the ARRC's programs were $140.6 million, an increase of 2% compared to last year. The total 2009 operating costs of the ARRC's programs were $138.0 million, a decrease of 11% compared to 2008.
- Expenditures on capital assets totaled $73.1 million during 2010, a decrease of 9% compared to last year. Expenditures on capital assets totaled $80.4 million during 2009, a decrease of 13% compared to 2008.
- Federal grant funding was used for $36.3 million, or 50%, of the 2010 capital expenditures. Federal grant funding was used for $28.8 million, or 36%, of the 2009 capital expenditures. These amounts were recorded as deferred revenue in the regulatory liabilities section of the balance sheet. Revenue associated with capital grants is recognized when the assets are depreciated. Grant revenue for capital assets equals grant depreciation expense in operations and real estate. More detailed information can be found in note 8 to the financial statements.

Overview of the Financial Statements

The ARRC is a component unit of the State of Alaska and operates like a stand-alone business. The ARRC is subject to the jurisdiction of the Surface Transportation Board (STB) and the ARRC's rates for services are established by its board of directors and designed to recover the cost of providing the service. The financial statements report information about the ARRC using accounting methods similar to those used by private sector companies. This annual report consists of two parts – *management's discussion and analysis* (this section) and the *basic financial statements*. The basic financial statements consist of three statements that present information about the ARRC's overall financial status:

- Balance sheet – the balance sheets report assets, liabilities, and fund equity of the ARRC. Assets and liabilities are segregated into current and noncurrent; that is, assets and liabilities that are expected to be received or liquidated within one year (current), and those that are not expected to be received or liquidated within one year (noncurrent). Fund equity, the difference between the ARRC's assets and its liabilities, is one way to measure the ARRC's financial health. Over time, increases or decreases in the ARRC's fund equity are an indicator of whether its financial health is improving or deteriorating, respectively.
- Statement of revenues, expenses, and changes in fund equity – this statement reflects revenues earned from services and expenses incurred to operate the ARRC, as well as the activities of the ARRC not

considered to be operations. All of the current year's revenues and expenses are accounted for in this statement regardless of when cash is received or paid.

- Statement of cash flows – this statement reports activities of the ARRC as they affect cash balances.

The financial statements also include notes that explain some of the information in the financial statements and provide more detailed data.

Financial Analysis of the Alaska Railroad Corporation

Fund equity – ARRC's fund equity increased 9% between fiscal years 2009 and 2010 to approximately $232.6 million. ARRC's fund equity increased 19% between fiscal years 2008 and 2009 to approximately $213.8 million.

(in thousands)		2010	2009	2008
Assets:				
Current assets	$	97,910	73,928	76,867
Capital assets		761,002	741,154	709,213
Other noncurrent assets		27,105	46,173	68,042
Total assets	$	886,017	861,255	854,122
Liabilities:				
Current liabilities	$	43,863	40,768	44,464
Notes payable outstanding, less current installments		24,028	24,537	27,436
Revenue bonds payable, net of unamortized premiums and deferred amounts		135,133	145,315	155,066
Other liabilities		1,434	1,484	1,908
Payable from restricted assets		757	619	410
Regulatory liabilities:				
Pension and postretirement		832	6,258	29,225
Deferred grant revenue		447,341	428,501	415,882
Total liabilities	$	653,388	647,482	674,391
Fund equity:				
Invested in capital assets, net of related debt	$	166,416	174,564	160,612
Restricted for reinvestment in infrastructure		66,213	39,209	19,119
Total fund equity	$	232,629	213,773	179,731

Capital assets – Capital assets, net of accumulated depreciation increased $19.8 million in 2010 and $31.9 million in 2009. During 2010 and 2009, the ARRC continued an extensive capital improvement plan, including bridge replacements, siding extensions, track refurbishing, straightening of curves, and welding rail to allow faster train speed and reduce wear. Also during this time period, ARRC continued developing a collision avoidance system, and acquired right of way in anticipation of future rail realignments.

MANAGEMENT'S DISCUSSION AND ANALYSIS

December 31, 2010 and 2009

Long-term debt – Notes payable decreased $0.5 million and $2.9 million in 2010 and 2009, respectively. During 2010, ARRC refinanced 12 locomotives to provide security interest in a new long-term loan of $2.8 million to fund tenant improvements in Anchorage and fund a property acquisition in Whittier. During 2009, the ARRC executed no new long-term loans.

Regulatory assets and liabilities – The STB regulates the ARRC's operations and has specific accounting requirements. The ARRC's board of directors establishes rates for services that are designed to recover the cost of providing the services. The ARRC records regulatory assets and liabilities as required by provisions of Financial Accounting Standards Board (FASB) Accounting Standards Codification (ASC) 980, *Regulated Operations*, formerly, FASB Statement No. 71, *Accounting for the Effects of Certain Types of Regulation*.

A description of each of the regulatory assets and liabilities is as follows:

- Deferred grant revenue relates to capital assets funded with federal grants. Deferred grant revenue increased $18.8 million in 2010 and $12.6 million in 2009. This increase reflects the amount of capital assets constructed with grant funding. Generally deferred grant revenue will be recognized as income as the related capital assets are depreciated.
- The accrued pension and postretirement benefits liability decreased $5.4 million during 2010, due primarily to market performances of the assets invested. The accrued pension and postretirement benefits liability decreased $23.0 million during 2009 primarily due to the change in asset valuation methods and market performance of the assets invested.

Revenue – The ARRC's total revenues increased less than 1% and totaled $167.1 million in 2010. The ARRC's total revenues decreased 7% and totaled $166.7 million in 2009. Approximately 50% and 51% of the ARRC's revenue comes from freight revenue during 2010 and 2009, respectively, and 12% and 13% of the revenue comes from passenger services during 2010 and 2009, respectively. The majority of the remaining income is related to real estate activities and federal grant revenue. Generally, federal grant revenue is recognized as the capital assets funded by the grants are depreciated.

Real estate expenses were $11.5 million in 2010, $13.1 million in 2009, and $9.9 million in 2008, a decrease of 12% from 2009 to 2010 and an increase of 32% from 2008 to 2009. The decrease in real estate expense in 2010 results from restructuring certain facilities to operating facilities.

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MANAGEMENT'S DISCUSSION AND ANALYSIS

December 31, 2010 and 2009

(in thousands)		2010	2009	2008
Operating revenue:				
Freight	$	84,328	84,939	96,337
Passenger		20,783	21,455	24,550
Other		772	704	895
Total transportation revenue		105,883	107,098	121,782
Grant revenue		40,225	36,515	37,013
Total		146,108	143,613	158,795
Operating expense:				
Transportation		41,591	40,716	48,846
Passenger operations		4,880	5,365	6,209
Passenger services		4,607	4,241	5,191
Business development		16,916	16,941	20,264
Mechanical		21,432	21,700	22,295
Maintenance		31,553	31,254	33,002
Facilities		9,383	7,453	6,828
Engineering services		1,451	1,129	777
Signals		2,856	2,719	3,083
General and administrative		5,887	6,475	8,995
Total		140,556	137,993	155,490
Operating income		5,552	5,620	3,305
Nonoperating revenues (expenses):				
Real estate and facilities income, net of expenses		9,378	9,365	10,407
Gain (loss) on sale of capital assets		—	517	(13)
Investment income		78	115	377
Interest expense, net of grant revenue		(1,561)	(1,715)	(1,519)
Net income		13,447	13,902	12,557
Other changes in fund equity		5,409	20,140	(30,882)
Change in fund equity	$	18,856	34,042	(18,325)

Several events occurred during 2010 that significantly impacted the change in fund equity:

- ARRC's indirect cost rate agreements allowed ARRC to allocate eligible general and administrative expenses to capital projects. A total of $2.2 million was allocated to capital projects during 2010, reducing general and administrative expenses. The overall indirect cost recovery was $160,000 less than 2009.

MANAGEMENT'S DISCUSSION AND ANALYSIS

December 31, 2010 and 2009

- Total transportation revenue was $1.2 million less than 2009. The decrease in transportation revenue is attributed to the global recession, which impacted freight shipments and passenger services.
- ARRC used $472,000 of federal grant funding to acquire right of way in anticipation of future rail realignments.
- During 2010, ARRC entered into an agreement with one customer under the Internal Revenue Code (IRC) §45G. Under the agreement, ARRC received $4.8 million for qualified track maintenance expense and gave the customer a shipping credit of $2.7 million.
- ARRC records costs and accrued benefits under its defined benefit and postretirement plans. The other changes in fund equity of $5.4 million represent the change from the prior year in the unfunded actuarial accrued liability of the defined benefit pension and postretirement plans.

Several events occurred during 2009 that significantly impacted the change in fund equity:

- ARRC's indirect cost rate agreements allowed ARRC to allocate eligible general and administrative expenses to capital projects. A total of $2.3 million was allocated to capital projects during 2009, reducing general and administrative expenses. The overall indirect cost recovery was $506,000 greater than 2008.
- Total transportation revenue was $14.7 million less than 2008. The decrease in transportation revenue is attributed to the overall global recession, which significantly reduced freight shipments and passenger services.
- ARRC used $477,000 of federal grant funding to acquire right of way in anticipation of future rail realignments.
- During 2009, ARRC entered into an agreement with one customer under the IRC §45G. Under the agreement, ARRC received $4.6 million for qualified track maintenance expense and gave the customer a shipping credit of $2.6 million.
- ARRC records costs and accrued benefits under its defined benefit and postretirement plans, and effective January 1, 2009, changed valuation methods under the plans. The cumulative effect of the change in accounting principle, reported as a change in fund equity of $25.0 million, represents the decreased unfunded actuarial accrued liabilities for the defined pension plan of $16.6 million and the postretirement plan of $8.4 million.

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December 31, 2010 and 2009

Capital Asset and Debt Administration

Capital Assets

At the end of 2010, the ARRC had invested $761.0 million in a broad range of capital assets including land, road and roadway structures, equipment, and leasehold improvements. This amount represents a net increase (including additions and deductions) of $19.8 million, or 3%, over last year. Grants have funded $464.7 million of the assets, net of accumulated depreciation.

(in thousands)		2010	2009	2008
Land and improvements	$	29,288	26,292	24,769
Road materials and supplies		6,684	8,959	9,038
Road and roadway structures		558,876	489,152	472,204
Equipment		146,372	144,017	134,910
Leasehold improvements		415	542	667
Quarry improvements		3,801	3,801	3,742
Construction in progress		15,566	68,391	63,883
Total capital assets, net of accumulated depreciation	$	761,002	741,154	709,213

The ARRC's fiscal year 2011 capital budget approved spending another $63.4 million for capital projects, principally for continued track and bridge rehabilitation and other infrastructure improvements. The ARRC intends to use federal grant funding to provide $24.8 million of the capital additions. The remaining capital projects will be funded out of the FTA Capital Receipts Bonds, Series 2007, current year earnings and cash flow. More detailed information about the ARRC's capital assets is presented in note 4 to the financial statements.

Long-Term Debt

At the end of 2010, the ARRC had $27.3 million in notes payable outstanding, a decrease of less than 1% from 2009, and $145.3 million in revenue bonds payable outstanding, a decrease of 6%. At the end of 2009, the ARRC had $27.4 million in notes payable outstanding, a decrease of 9% from 2008, and $155.1 million in revenue bonds payable outstanding, a decrease of 6%. Bond issuance costs from FTA Capital Grants Receipts, Series 2007 of $1.2 million and Series 2006 of $1.4 million are being amortized over the life of the bonds. More detailed information about the ARRC's long-term debt is presented in note 6 to the financial statements.

Bond Rating

In August 2007, Standard & Poor's Ratings Services, Fitch Ratings, and Moody's Investor Services assigned "A+", "A" and "A1" ratings to the approximately $88.6 million of Capital Grant Receipts Bonds, Series 2007 (FTA Section 5307 Urbanized Area Formula Funds and Section 5309 Fixed Guideway Modernization Formula Funds). These ratings were used to determine the ARRC's financial strength for the bond issuance, insured under a policy issued by Financial Guaranty Insurance Company. More detailed information about the ARRC's bond funded activities is presented in note 6 to the financial statements.

MANAGEMENT'S DISCUSSION AND ANALYSIS

December 31, 2010 and 2009

In July 2006, Standard & Poor's Ratings Services and Fitch Ratings assigned "A+" and "A" ratings, respectively, to the approximately $76.4 million of Capital Grant Receipts Bonds, Series 2006 (FTA Section 5307 Urbanized Area Formula Funds and Section 5309 Fixed Guideway Modernization Formula Funds). These ratings were used to determine the ARRC's financial strength for the bond issuance, insured under a policy issued by Financial Guaranty Insurance Company. Fitch Ratings affirmed the "A" rating and stable outlook on Alaska Railroad Corporation's Capital Grant Receipts Bonds in September 2010. Moody's Investors Service affirmed the "Aa3" rating and stable outlook on Alaska Railroad Corporation's Capital Grant Receipts Bonds in December 2010. March 2011 Fitch Ratings changed the outlook from stable to negative. More detailed information about ARRC's bond funded activities is presented in note 6 to the financial statements.

Next Year's Budget

Freight and passenger revenues are budgeted at $101.3 million and $21.5 million, respectively. As a result, the ARRC's fund equity is expected to increase $18.2 million or 8% by the close of 2011.

Contacting the ARRC's Financial Management

This financial report is designed to provide residents of the State of Alaska and customers and creditors with a general overview of the ARRC's finances and to demonstrate accountability for the money it receives. If you have questions about this report or need additional financial information, contact the Alaska Railroad Corporation, P.O. Box 107500, Anchorage, Alaska 99510-7500, 907-265-2300 or visit the website at www.alaskarailroad.com.

KPMG LLP
Suite 600
701 West Eighth Avenue
Anchorage, AK 99501

Independent Auditors' Report

The Board of Directors
Alaska Railroad Corporation:

We have audited the accompanying balance sheets of the Alaska Railroad Corporation (the Corporation), a component unit of the State of Alaska, as of December 31, 2010 and 2009, and the related statements of revenues, expenses, and changes in fund equity, and cash flows for the years then ended. These financial statements are the responsibility of the Corporation's management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with auditing standards generally accepted in the United States of America and the standards applicable to financial audits contained in *Government Auditing Standards*, issued by the Comptroller General of the United States. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes consideration of internal control over financial reporting as a basis for designing audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the Corporation's internal control over financial reporting. Accordingly, we express no such opinion. An audit also includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements, assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of the Alaska Railroad Corporation as of December 31, 2010 and 2009, and the changes in its financial position and its cash flows for the years then ended, in conformity with U.S. generally accepted accounting principles.

As discussed in note 7 to the financial statements, effective January 1, 2009, the Corporation changed its method of accounting for its defined benefit pension and postretirement plans.

In accordance with *Government Auditing Standards*, we have also issued our report dated March 30, 2011 on our consideration of the Alaska Railroad Corporation's internal control over financial reporting and on our tests of its compliance with certain provisions of laws, regulations, contracts, grants agreements, and other matters. The purpose of that report is to describe the scope of our testing of internal control over financial reporting and compliance and the results of that testing, and not to provide an opinion on the internal control over financial reporting or on compliance. That report is an integral part of an audit performed in accordance with *Government Auditing Standards* and should be considered in assessing the results of our audit.

KPMG

The management's discussion and analysis on pages 1 through 7 is not a required part of the basic financial statements but is supplementary information required by U.S. generally accepted accounting principles. We have applied certain limited procedures, which consisted principally of inquires of management regarding the methods of measurement and presentation of the required supplementary information. However, we did not audit the information and express no opinion on it.

KPMG LLP

March 30, 2011

BALANCE SHEETS

December 31, 2010 and 2009

(In thousands)

Assets		**2010**	**2009**
Current assets:			
Cash and cash equivalents (note 3)	$	33,488	18,267
Accounts receivable, net of allowance for doubtful accounts of $452 in 2010 and $381 in 2009		21,573	19,176
Grants receivable (note 8)		11,676	4,960
Materials and supplies		9,223	9,675
Prepaid expenses and other current assets		1,064	1,188
Under recovery of vehicle and equipment allocated costs (note 2(k))		785	—
Restricted assets (note 3)		20,101	20,662
Total current assets		97,910	73,928
Capital assets (notes 4 and 8):			
Land and improvements and quarry improvements (note 11)		33,402	30,406
Road materials and supplies		6,684	8,959
Road and roadway structures		797,677	693,482
Equipment		279,317	261,091
Leasehold improvements (note 11)		1,650	1,650
Accumulated depreciation, depletion and amortization		(373,294)	(322,825)
Construction in progress		15,566	68,391
Total capital assets, net		761,002	741,154
Restricted assets (note 3)		27,087	46,155
Other assets		18	18
	$	886,017	861,255
Liabilities and Fund Equity			
Current liabilities:			
Current portion of notes payable (notes 5 and 6)	$	3,309	2,898
Accounts payable and accrued liabilities (notes 5, 13, and 16)		13,184	10,235
Environmental remediation reserve (notes 5 and 15)		1,059	1,050
Interest payable		2,852	3,034
Payroll liabilities		9,563	9,495
Over recovery of vehicle and equipment allocated costs (note 2(k))		—	121
Unearned revenues (note 11)		3,701	4,150
Current portion of revenue bonds payable (notes 5 and 6)		10,195	9,785
Total current liabilities		43,863	40,768
Notes payable, less current portion (notes 5 and 6)		24,028	24,537
Revenue bonds payable (net of unamortized premiums and deferred amounts), less current portion (notes 5 and 6)		135,133	145,315
Environmental remediation reserve (notes 5 and 15)		1,257	1,303
State of Alaska advances (notes 3, 5, and 8)		177	181
Payable from restricted assets (note 5)		757	619
Regulatory liabilities:			
Accrued pension and postretirement benefits (notes 5 and 7)		832	6,258
Deferred grant revenue (notes 5 and 8)		447,341	428,501
Total liabilities		653,388	647,482
Fund equity (note 9):			
Investment in capital assets, net of related debt and deferred grant revenue (note 4)		166,416	174,564
Restricted for reinvestment in infrastructure (notes 2(a) and 2(l))		66,213	39,209
Total fund equity		232,629	213,773
Commitments and contingencies (notes 5, 7, 10, 12, 13, 15 and 16)			
	$	886,017	861,255

See accompanying notes to financial statements.

STATEMENTS OF REVENUES, EXPENSES, AND CHANGES IN FUND EQUITY

Years ended December 31, 2010 and 2009

(In thousands)

	2010	2009
Operating revenues:		
Freight (note 10)	$ 84,328	84,939
Passenger	20,783	21,455
Other	772	704
	105,883	107,098
Grant revenue (note 8)	40,225	36,515
	146,108	143,613
Operating expenses:		
Transportation	41,591	40,716
Passenger operations	4,880	5,365
Passenger services	4,607	4,241
Business development	16,916	16,941
Mechanical	21,432	21,700
Maintenance	31,553	31,254
Facilities	9,383	7,453
Engineering services	1,451	1,129
Signals	2,856	2,719
General and administrative, net of indirect cost recovery of $2,169 in 2010 and $2,329 in 2009	5,887	6,475
	140,556	137,993
Operating income	5,552	5,620
Nonoperating revenues (expenses):		
Real estate and facilities income, less direct expenses of $11,494 in 2010 and $13,055 in 2009 (notes 8 and 11)	9,378	9,365
Gain on sale of capital assets	—	517
Investment income	78	115
Interest expense, net of grant revenue of $2,603 in 2010 and $2,768 in 2009 (note 8)	(1,561)	(1,715)
Total nonoperating revenues	7,895	8,282
Net income (note 2(a))	13,447	13,902
Other change in fund equity:		
Change in pension and postretirement funding status (note 7)	5,409	(4,893)
Cumulative effect of change in accounting principle (note 7)	—	25,033
Change in fund equity	18,856	34,042
Fund equity, beginning of year	213,773	179,731
Fund equity, end of year	$ 232,629	213,773

See accompanying notes to financial statements.

STATEMENTS OF CASH FLOWS

Years ended December 31, 2010 and 2009

(In thousands)

		2010	2009
Cash flows from operating activities:			
Receipts from customers	$	103,487	111,247
Operating grants received		7,479	6,706
Payments to suppliers		(34,404)	(34,826)
Payments to employees		(56,130)	(64,994)
Net cash provided by operating activities		20,432	18,133
Cash flows from capital and related financing activities:			
Principal payments on long-term debt		(2,898)	(2,785)
Interest payments on long-term debt		(8,328)	(8,966)
Proceeds from long-term debt		2,800	—
Purchases and construction of capital assets		(68,666)	(78,748)
Proceeds from sales of capital assets		31	1,289
Increase in deferred revenues, net of advances		45,454	43,634
Net cash used by capital and related financing activities		(31,607)	(45,576)
Cash flows from investing activities:			
Real estate income and related cash flows		24,187	26,423
Real estate direct expenses paid		(11,494)	(13,055)
Grant received for interest expense		2,191	2,662
Interest received		1,693	2,567
Purchase of restricted investments		(9,948)	(9,537)
Proceeds from sale of restricted investments		19,767	19,555
Net cash provided by investing activities		26,396	28,615
Net increase in cash and cash equivalents		15,221	1,172
Cash and cash equivalents at beginning of year		18,267	17,095
Cash and cash equivalents at end of year	$	33,488	18,267
Reconciliation of operating income to net cash provided by operating activities:			
Operating income	$	5,552	5,620
Adjustments to reconcile operating income to net cash provided by operating activities:			
Depreciation and amortization		47,223	42,193
Bond issuance cost amortization		176	176
Grant revenue on capital assets		(32,922)	(29,985)
Changes in operating assets and liabilities:			
Materials and supplies		452	(191)
Accounts receivable		(2,397)	4,149
Prepaid expenses and other assets		124	641
Accounts payable and accrued liabilities		2,949	(136)
Interest payable		167	279
Over (under) recovery of vehicle and equipment allocated costs		(906)	1,227
Payroll liabilities		68	(3,205)
Environmental reserve		(37)	104
Accrued postretirement and pension benefits		(17)	(2,739)
Total adjustments		14,880	12,513
Net cash provided by operating activities	$	20,432	18,133
Supplemental disclosure of noncash activity:			
Depreciation included in real estate activity	$	3,764	5,434
Notes payable refinanced		13,874	—

See accompanying notes to financial statements.

NOTES TO FINANCIAL STATEMENTS

December 31, 2010 and 2009

(1) Organization and Operations

The United States Congress authorized construction of the Alaska Railroad (ARR) in 1914 and operations began in 1923. The federal government operated the railroad until its sale to the State of Alaska in January 1985. The sale of the ARR to the State of Alaska was authorized under the Alaska Railroad Transfer Act of 1982, which was signed into law on January 14, 1983. The State of Alaska legislature created the Alaska Railroad Corporation (ARRC), a component unit of the State of Alaska, to own and operate the railroad and manage the railroad's rail, industrial, port and other properties. The ARRC commenced operations on January 6, 1985.

The ARRC operates 685 track miles, providing both freight and passenger services. The ARRC serves the cities of Anchorage and Fairbanks, the ports of Whittier, Seward, and Anchorage as well as Denali National Park and military installations. Vessel and rail barge connections are provided from Seattle, Washington, and Prince Rupert, British Columbia.

(2) Summary of Significant Accounting Policies

In preparing the financial statements in accordance with accounting principles generally accepted in the United States of America, management is required to make a number of estimates and assumptions relating to the reporting of assets and liabilities and the disclosure of contingent assets and liabilities as of the date of the financial statements and revenue and expenses for the reporting period. Actual results could differ from these estimates. The more significant accounting and reporting policies and estimates applied in the preparation of the accompanying financial statements are discussed below:

(a) Basis of Accounting

As a component unit of the State of Alaska and for the purpose of preparing financial statements in accordance with accounting principles generally accepted in the United States of America, the ARRC is subject to the accounting requirements as set forth by the Governmental Accounting Standards Board (GASB).

The ARRC is an enterprise fund of the State of Alaska. Accordingly, the financial activities of the ARRC are reported using the economic resources measurement focus and the accrual basis of accounting, whereby revenues are recorded when earned and expenses are recorded when a liability is incurred, regardless of the timing of related cash flows.

The ARRC has elected to apply all applicable private sector standards of accounting and financial reporting issued by the Financial Accounting Standards Board (FASB) that do not conflict with or contradict GASB pronouncements, under the option allowed by GASB Statement No. 20, *Accounting and Financial Reporting for Proprietary Funds and Other Governmental Entities That Use Proprietary Fund Accounting*.

The ARRC is subject to the jurisdiction of the Surface Transportation Board (STB) and the ARRC's rates for services are established by the board of directors and designed to recover the cost of providing the service. Accordingly, the ARRC follows the provisions of FASB Accounting Standards Codification (ASC) 980, *Regulated Operations*, formerly, FASB Statement No. 71, *Accounting for the Effects of Certain Types of Regulation*.

NOTES TO FINANCIAL STATEMENTS

December 31, 2010 and 2009

The ARRC's board of directors has adopted a resolution requiring a measure of net income in the statement of revenues, expenses and changes in fund equity. The ARRC's board of directors has also adopted a resolution restricting fund equity for reinvestment in infrastructure.

(b) Cash and Cash Equivalents

For purposes of the statements of cash flows, cash and cash equivalents include time deposits, money market accounts and repurchase agreements with original maturities of three months or less.

(c) Materials and Supplies

Materials and supplies inventories are carried at the lower of average cost or market. Road materials and supplies include rail, ties, ballast, and other track materials. These items will generally be capitalized when placed into service, and accordingly are included in capital assets.

(d) Capital Assets

Capital assets are stated at cost. Costs of normal maintenance and repairs that do not add to the value of the asset or materially extend asset lives are not capitalized. Depreciation and amortization are computed on the straight-line basis over the estimated useful lives of the related assets, ranging from 3 to 32 years.

(e) Restricted Assets

The ARRC's restricted assets consist of money market accounts, investments in commercial paper, U.S. Treasury notes, and guaranteed investment contracts (GICs). Money market accounts, investments in commercial paper and U.S. Treasury notes are reported at cost. GICs are reported at amortized cost because they cannot be negotiated or transferred to a third party.

(f) Regulatory Assets and Liabilities

The ARRC's rates for services are established by the board of directors and are designed to recover the cost of providing the service. For purposes of establishing rates, the ARRC defers the recognition of grant revenues relating to depreciable capital assets funded with federal grants, and amortizes the deferred amounts over the life of the related capital assets. Additionally, ARRC records the funded status of its defined pension and postretirement plans as regulatory assets and liabilities.

(g) Operations

The ARRC considers all revenues and expenses related to the transportation of freight and passengers, including general and administrative costs, to be operating revenues and expenses. Revenues and expenses associated with leasing and permitting ARRC property are not considered a part of the ARRC's primary operations and are reported as non operating activities.

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(h) ***Grants***

Grants are recognized as earned when all eligibility requirements have been met; however, recognition of revenue for grants expended for depreciable capital assets is deferred and recognized over the period in which the asset is depreciated as described in note 2(f). Grant funds received but not yet expended are recorded as advance grant funding.

(i) ***Income Taxes***

As a corporation owned by the State of Alaska, the ARRC is exempt from federal and state income taxes.

(j) ***Environmental Remediation Costs***

The ARRC accrues for losses, including legal fees, associated with environmental remediation obligations based on obligating events as defined under GASB Statement No. 49, *Accounting and Financial Reporting for Pollution Remediation Obligations*. Costs of future expenditures for environmental remediation liabilities are not discounted to their present value.

(k) ***Vehicle and Equipment Allocated Costs***

The ARRC's vehicle and equipment costs for maintenance, fuel, depreciation, and leases are recorded in the vehicle and equipment cost pool. These costs are recovered through various responsibility centers through a fixed charge rate based on usage of vehicles and equipment. Any over or under recovery of actual vehicle and equipment cost is applied against fixed charge rates in subsequent years. Accordingly, the ARRC has recorded an under recovery of $785,000 and an over recovery of $121,000 as of December 31, 2010 and 2009, respectively.

(l) ***Equity***

During 2010 and 2009, the ARRC's board of directors restricted $66,213,000 and $39,209,000, respectively, of fund equity for reinvestment in infrastructure.

(m) ***Reclassifications***

Certain reclassifications not affecting net income have been made to the 2009 financial statements to conform to the current presentation.

(n) ***Subsequent Events***

The ARRC has evaluated subsequent events from the balance sheet date through March 30, 2011, the date at which the financial statements were available to be issued, and determined there are no other items requiring disclosure.

(3) Deposits and Investments

(a) ***Custodial Credit Risk***

In the case of deposits, custodial credit is the risk that in the event of a bank failure, the ARRC's deposits may not be returned to it. For an investment, custodial credit risk is a risk that, in the event of the failure of the counterparty, the ARRC will not be able to recover the value of its investments or collateral securities that are in the possession of an outside party. The ARRC's Investment Policy requires that all investments be collateralized and/or insured.

At December 31, 2010, the ARRC's carrying amount of cash and cash equivalents was $33,488,000 and the bank balance was $34,423,000. Of the bank balance, $5,400,000 was covered by federal depository insurance, and $29,273,000 represents money market funds held by the ARRC's agent in the ARRC's name.

At December 31, 2009, the ARRC's carrying amount of cash and cash equivalents was $18,267,000 and the bank balance was $19,457,000. Of the bank balance, $250,000 was covered by federal depository insurance; $3,244,000 was collateralized with securities held by the pledging financial institution's trust department or agent, but not in the ARRC's name; none of the balances were uncollateralized; and $15,963,000 represents money market funds held by the ARRC's agent in the ARRC's name.

(b) Interest Rate Risk

The ARRC has a formal investment policy that limits investment maturities to five years or less as a means of managing its exposure to fair value losses arising from increasing interest rates. The ARRC uses the specific identification method to report maturities of investments.

(c) Credit Risk

The ARRC's Investment Policy authorizes the ARRC to invest in U.S. Treasury and agency obligations, state and local government obligations, corporate bonds, certificates of deposit, bankers acceptances, commercial paper, asset-backed securities and money market funds.

(d) Concentration of Credit Risk

The ARRC investment policy places no limit on the amount the ARRC may invest in any one issuer.

The carrying value and maturities of the investments consist of the following at December 31, 2010 and 2009:

(in thousands)

Investment Type	Maturities		2010	2009
Commercial Paper	1/4/2011	$	1,016	1,021
Guaranteed Investment Contracts	6/30/2012		25,313	44,263
U.S. Treasury Notes	1/15/2011		3,238	—
	Total investments		29,567	45,284
Money Market			17,621	21,533
	Total	$	47,188	66,817

NOTES TO FINANCIAL STATEMENTS

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These investments are restricted by the terms of grant or other agreements or by the ARRC's board of directors and the fair value is summarized as follows at December 31, 2010 and 2009:

(in thousands)

Description of Restriction		2010	2009
Capital assets as authorized by the			
Department of Natural Resources	$	177	187
Advance grant funding,			
other federal grants		460	497
Project Fund			
Guaranteed Investment			
Contract (GIC)		25,313	44,263
Money Market		107	182
Debt Service Reserve			
U.S. Treasury Notes		3,238	—
Money Market		16,863	20,662
Forward Sale Agreement:			
2006A Reserve Account		440	438
2006B Reserve Account		590	588
	$	47,188	66,817

Foreign Currency Risk

Foreign currency risk arises when changes in foreign exchange rates will adversely affect the fair value of an investment. ARRC does not have a policy to limit foreign currency risk associated with investment funds. ARRC does not have exposure to foreign currency risk in its investment funds at December 31, 2010 and 2009.

Other Restricted Assets

ARRC has received grants from various agencies. The amounts received in excess of the amounts spent on the grant programs are reported as advance grant funding (note 8).

(4) Capital Assets

During 2002, the ARRC received initial approval from its federal cognizant agency, which was updated in 2005, of its indirect cost rate agreement. In compliance with Federal Transit Authority (FTA) Circular 5010.1C, ARRC will continue to update its indirect cost rate proposal but will retain it onsite and make it available for review during its annual financial audit. This agreement allows ARRC to allocate certain general and administrative expenses to grant projects. Indirect costs allocated to capital projects under this agreement totaled $2,169,000 and $2,329,000 during the years ended December 31, 2010 and 2009, respectively.

(Continued)

December 31, 2010 and 2009

The following tables summarize activity in the capital assets accounts during the years ended December 31, 2010 and 2009:

(in thousands)		Balance at December 31, 2009	Additions	Reductions	Reclasses	Balance at December 31, 2010
Capital assets not being depreciated:						
Land and improvements	$	26,292	2,996	—	—	29,288
Road materials and supplies		8,959	—	(2,275)	—	6,684
Construction in progress		68,391	73,140	(125,965)	—	15,566
Total capital assets not being depreciated		103,642	76,136	(128,240)	—	51,538
Capital assets being depreciated:						
Road and roadway structures		693,482	104,195	—	—	797,677
Equipment		261,091	18,775	(549)	—	279,317
Leasehold improvements		1,650	—	—	—	1,650
Total capital assets being depreciated		956,223	122,970	(549)	—	1,078,644
Capital assets being depleted:						
Quarry improvements		4,114	—	—	—	4,114
Less accumulated depreciation for:						
Road and roadway structures		204,330	34,471	—	—	238,801
Equipment		117,074	16,389	(518)	—	132,945
Leasehold improvements		1,108	127	—	—	1,235
Total accumulated depreciation		322,512	50,987	(518)	—	372,981
Less accumulated depletion for:						
Quarry improvements		313	—	—	—	313
Capital assets being depreciated and depleted, net		637,512	71,983	(31)	—	709,464
Net capital assets	$	741,154	148,119	(128,271)	—	761,002

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December 31, 2010 and 2009

(in thousands)		Balance at December 31, 2008	Additions	Reductions	Reclasses	Balance at December 31, 2009
Capital assets not being depreciated:						
Land and improvements	$	24,769	1,523	—	—	26,292
Road materials and supplies		9,038	—	(79)	—	8,959
Construction in progress		63,883	80,420	(75,912)	—	68,391
Total capital assets not being depreciated		97,690	81,943	(75,991)	—	103,642
Capital assets being depreciated:						
Road and roadway structures		644,890	48,528	(340)	404	693,482
Equipment		241,532	25,689	(5,726)	(404)	261,091
Leasehold improvements		1,650	—	—	—	1,650
Total capital assets being depreciated		888,072	74,217	(6,066)	—	956,223
Capital assets being depleted:						
Quarry improvements		3,943	171	—	—	4,114
Less accumulated depreciation for:						
Road and roadway structures		172,686	31,765	(307)	186	204,330
Equipment		106,622	15,625	(4,987)	(186)	117,074
Leasehold improvements		983	125	—	—	1,108
Total accumulated depreciation		280,291	47,515	(5,294)	—	322,512
Less accumulated depletion for:						
Quarry improvements		201	112	—	—	313
Capital assets being depreciated and depleted, net		611,523	26,761	(772)	—	637,512
Net capital assets	$	709,213	108,704	(76,763)	—	741,154

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Depreciation expenses were charged to the following departments during the years ending December 31, 2010 and 2009:

(in thousands)		2010 Grant Funded Depreciation	2010 Non-Grant Funded Depreciation	2009 Grant Funded Depreciation	2009 Non-Grant Funded Depreciation
Transportation	$	5,096	620	4,635	645
Passenger operations		1,204	272	1,302	279
Passenger services		139	254	139	38
Business development		118	1,177	118	1,043
Mechanical		3,173	5,583	3,193	5,817
Maintenance		16,178	5,020	13,995	5,477
Facilities		3,207	944	979	284
Engineering services		—	27	—	12
Signals		1,078	—	1,078	239
General and administrative		503	2,630	353	2,455
Real estate and facilities		2,226	1,538	4,193	1,241
	$	32,922	18,065	29,985	17,530

Fund equity invested in capital assets, net of related debt and deferred grant revenue is as follows at December 31, 2010 and 2009:

(in thousands)		2010	2009
Net capital assets (note 4)	$	761,002	741,154
Notes payable (note 6)		(27,337)	(27,435)
Proceeds of revenue bonds expended on capital assets (note 6)		(119,908)	(110,654)
Deferred grant revenue (note 8)		(447,341)	(428,501)
	$	166,416	174,564

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(5) Long-Term Liabilities

Long-term liability activity is summarized as follows during the years ended December 31, 2010 and 2009:

(in thousands)		Balance at December 31, 2009	Additions	Reductions	Balance at December 31, 2010	Due within one year
Long-term debt:						
Notes payable	$	27,435	16,674	(16,772)	27,337	3,309
Revenue bonds payable		155,100	13	(9,785)	145,328	10,195
Environmental remediation reserve		2,353	1,500	(1,537)	2,316	1,059
Other claims		1,274	72	(1,196)	150	150
State of Alaska advances		181	—	(4)	177	—
Payable from restricted assets		619	138	—	757	—
Regulatory liabilities:						
Accrued pension and postretirement benefits		6,258	745	(6,171)	832	—
Deferred grant revenue		428,501	51,145	(32,305)	447,341	—
Total long-term liabilities	$	621,721	70,287	(67,770)	624,238	14,713

(in thousands)		Balance at December 31, 2008	Additions	Reductions	Balance at December 31, 2009	Due within one year
Long-term debt:						
Notes payable	$	30,220	—	(2,785)	27,435	2,898
Revenue bonds payable		164,461	34	(9,395)	155,100	9,785
Environmental remediation reserve		2,161	459	(267)	2,353	1,050
Other claims		978	852	(556)	1,274	1,274
State of Alaska advances		186	1	(6)	181	—
Payable from restricted assets		410	209	—	619	—
Regulatory liabilities:						
Accrued pension and postretirement benefits		29,225	2,066	(25,033)	6,258	—
Deferred grant revenue		415,882	42,760	(30,141)	428,501	—
Total long-term liabilities	$	643,523	46,381	(68,183)	621,721	15,007

The ARRC has arrangements for three short-term unsecured lines of credit. The general purpose lines of credit allow borrowing up to $20,000,000, at a rate of 55% of the prime rate of a major bank. The self-insurance line of credit allows borrowing up to $10,000,000 at a rate of 55% of the prime rate of a major bank. None of the lines of credit had an outstanding balance at December 31, 2010 or 2009.

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(6) Long-Term Debt

Long-term debt at December 31, 2010 and 2009 consists of the following:

(in thousands)		2010	2009
Notes payable:			
Notes payable, refinanced December 31, 2010	$	—	16,344
Note payable, secured by equipment, due in monthly payments of $285,842 including interest at 3.73%, matures March 2019		16,674	—
Note payable, secured by real estate revenue, due in monthly payments of $36,211, including interest at 5.40%, matures June 2026		4,556	4,739
Note payable, secured by real estate revenue, due in monthly payments of $48,539, including interest at 5.40%, matures June 2026		6,107	6,352
		27,337	27,435
Less current portion		3,309	2,898
	$	24,028	24,537
Revenue bonds:			
Revenue Bonds – Series 2006 and 2007, (interest at 3.625% – 5.25%) interest payable semi annually February 1 and August 1, secured by 5307 and 5309 FTA Formula Funds, matures August 2021, including premiums of $5,447,000 and unamortized issuance costs of $1,874,000 for the year ended December 31, 2010	$	145,328	155,100
Less current portion		10,195	9,785
	$	135,133	145,315

NOTES TO FINANCIAL STATEMENTS

December 31, 2010 and 2009

Annual payments on debt are scheduled as follows at December 31, 2010:

(in thousands)	Notes Payable		Revenue Bonds Payable		
	Principal	**Interest**	**Principal**	**Interest**	**Total**
Year ending December 31:					
2011	$ 3,309	1,138	10,195	6,741	21,383
2012	3,442	1,005	10,635	6,301	21,383
2013	3,581	866	11,120	5,820	21,387
2014	2,171	742	11,620	5,319	19,852
2015	1,919	662	12,095	4,841	19,517
2016 – 2020	8,085	2,081	69,950	14,742	94,858
2021 – 2026	4,830	763	16,140	798	22,531
	27,337	7,257	141,755	44,562	220,911
Current portion of principal	(3,309)		(10,195)		(13,504)
Unamortized premium			5,447		5,447
Unamortized issuance cost			(1,874)		(1,874)
Total long-term portion	$ 24,028		135,133		210,980

Notes Payable

The real estate lease revenue debt service reserves balances, associated with the 2006A and 2006B term loans used to acquire its general office building and other properties located in the Anchorage Terminal Reserve, at December 31, 2010 were $440,000 and $590,000, respectively. The debt service reserves balances for December 31, 2009 were $438,000 and $588,000, respectively.

Bonds Payable

In August 2007, the ARRC issued $88.6 million in Capital Grant Receipts Bonds, Series 2007 FTA Section 5307 Urbanized Area Formula Funds and Section 5309 Fixed Guideway Modernization Formula Funds, to provide funds to finance various capital improvement projects. The 2007 Revenue Bonds are limited obligations of the ARRC payable solely from and secured solely by amounts received by the ARRC from its share of FTA Section 5307 Urbanized Area Formula Funds and Section 5309 Fixed Guideway Modernization Formula Funds. The bonds bear fixed interest rates from 4.0% to 5.0%, mature at various dates through 2021, are insured by the Financial Guaranty Insurance Company (FGIC), and were initially assigned ratings by Standard & Poor’s Ratings Service, Fitch Ratings, and Moody’s Investors Service of “A+”, “A” and “A1”, respectively. Bond issuance costs of $1.2 million and bond premium of $2.4 million will be amortized over the life of the bonds.

In August 2006, the ARRC issued $76.4 million in Capital Grant Receipts Bonds, Series 2006 FTA Section 5307 Urbanized Area Formula Funds and Section 5309 Fixed Guideway Modernization Formula Funds, to provide funds to finance various capital improvement projects. The 2006 Revenue Bonds are limited obligations of the ARRC payable solely from and secured solely by amounts received by the ARRC from its share of FTA Section 5307 Urbanized Area Formula Funds and Section 5309 Fixed Guideway Modernization Formula Funds. The bonds bear fixed interest rates from 3.625% to 5.250%, mature at various dates through 2021, are insured by the FGIC, and were initially assigned ratings by

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Standard & Poor's Ratings Service and Fitch Ratings of "A+" and "A", respectively. Bond issuance costs of $1.4 million and bond premium of $3.4 million will be amortized over the life of the bonds.

Fitch Ratings affirmed the "A" rating and stable outlook on ARRC's Capital Grant Receipts Bonds in September 2010. Moody's Investors Service affirmed the "Aa3" rating and stable outlook on ARRC's Capital Grant Receipts Bonds in December 2010. March 2011 Fitch Ratings changed the outlook from stable to negative.

The following table sets forth the authorized funding allocation of the Federal Transit Administration (FTA) Section 5307 Formula Program Funds and Section 5309 Formula Program Funds to ARRC in Federal Fiscal Years (FFY) 2010 and 2011:

FFY		Formula Program	Formula Program	Total
2010	$	18,981,806	17,766,261	36,748,067
2011*		19,445,525	18,200,710	37,646,235

*FFY 2011 estimates are based on formula program growth rates contained in the Continuing Appropriations and Surface Transportation Extensions Act, 2011 (Public Law 111-322).

The ARRC expended $23.7 million during 2010 and $23.5 million during 2009 of the bond proceeds on eligible capital costs related to the capital improvement program.

The following table sets forth the interest capitalized during the years ended December 31, 2010 and 2009:

(in thousands)		2010	2009
Capitalized interest			
Interest expense	$	3,815	4,044
Less interest income		1,615	2,452
	$	2,200	1,592

State of Alaska Authorizations

Chapter 65, SLA 2007 authorized the ARRC to issue up to $2.9 billion in revenue bonds to finance all or a portion of the Kenai gasification project and Port MacKenzie rail spur project, subject to an agreement with a third party to pay the debt service and other costs of the bonds. To date, no bonds have been issued.

Chapter 28, SLA 2006 authorized the ARRC to issue up to $165 million in revenue bonds to finance rail transportation projects that qualify for federal financial participation and associated costs. To date, $165 million in bonds have been issued with a premium of $5.8 million.

Chapter 46, SLA 2004 authorized the ARRC to issue up to $500 million in revenue bonds, subject to an agreement with a third party to pay the debt service and other related bond costs, to finance the cost of extending its rail line to Fort Greely, Alaska. To date, no bonds have been issued.

Chapter 71, SLA 2003 authorized the ARRC to issue up to $17 billion in revenue bonds to finance the construction of a natural gas pipeline and related facilities, subject to an agreement with a third party to pay the debt service and other costs of the bonds. To date, no bonds have been issued.

Chapter 77, SLA 1994, authorized the ARRC to issue up to $55 million in revenue bonds to finance the construction and acquisition of the Alaska Discovery Center for the Ship Creek Project in Anchorage. To date, no bonds have been issued.

(7) Employee Benefits

The ARRC's board of directors has established a method of accounting for pension and postretirement cost, which is designed to recover the full costs of these benefits. As a result, the unfunded actuarial accrued liabilities associated with these benefits are reported as regulatory liabilities in the balance sheets. Periodic benefit costs related to these plans are included in operating expenses and capital additions. Pension costs and accrued benefits under the defined benefit pension and postretirement plans (Plans) are calculated under the provisions of GASB Statements No. 27, *Accounting for Pensions by State and Local Government Employers*, and No. 45, *Accounting and Financial Reporting by Employers for Postemployment Benefits Other Than Pensions*.

The unfunded actuarial accrued liability, which is the difference between the actuarial value of the assets and the actuarial accrued liability of the plans, is reported as a regulatory liability of $832,000 and $6,258,000 at December 31, 2010 and 2009, respectively. The change in pension and postretirement funding status presented as other changes in fund equity of an increase of $5,409,000 and decrease $4,893,000 in 2010 and 2009, respectively, represents the prior year change in the unfunded actuarial accrued liability for the plans.

Actuarial valuations of an ongoing plan involve estimates of the value of reported amounts and assumptions about the probability of occurrence of events far into the future. Examples include assumptions about future employment, mortality, and the healthcare cost trend. Amounts determined regarding the funded status of the plan and the annual required contributions of the employer are subject to continual revision as actual results are compared with past expectations and new estimates are made about the future.

Projections of benefits for financial reporting purposes are based on the substantive plan (the plan as understood by the employer and the plan members) and include the types of benefits provided at the time of each valuation and the historical pattern of sharing of benefit costs between the employer and plan members to that point. The actuarial methods and assumptions used include techniques that are designed to reduce the effects of short-term volatility in actuarial accrued liabilities and the actuarial value of assets, consistent with the long-term perspective of the calculations.

Effective January 1, 2009, the defined benefit pension and postretirement plans changed valuation methods. The plans changed from valuing assets at fair value to an actuarial value of assets method. Using the actuarial value of the assets for this calculation, rather than the fair value of the assets, results in lower volatility of the annual required contribution and associated expense. The new valuation method was considered preferable because the goal of an asset valuation method is to produce a relatively stable asset value thereby reducing year-to-year volatility in annual required contribution (ARC). The actuarial value of the assets avoids fluctuating gains and losses, which have no long-term significance on the annual valuations. The new valuation method is consistent with GASB Statements No. 27 and No. 45.

This change in accounting principle decreased the unfunded actuarial accrued liability for the defined pension plan by $16,618,000 and the postretirement plan by $8,415,000 as of January 1, 2009, which is reflected as an other change in fund equity. It was impracticable for the ARRC to determine the effect of the change in accounting principle prior to January 1, 2009, because the ARRC has changed consulting actuaries and unreasonable efforts would be necessary to determine the impact of the change in accounting principle for any prior period.

(a) Alaska Railroad Corporation Pension Plan

The ARRC has a defined benefit pension plan (Plan) covering all regular represented and non represented employees who are not covered by the Civil Service Retirement System. Benefits under this Plan are based upon the employee's years of service and final average compensation. The ARRC's funding policy is to contribute each year an amount equal to the ARC. Employees contribute an amount equal to 9% of eligible compensation. Contributions are made continuously throughout the year. Plan assets comprise fixed income securities, common stocks, real estate investment trusts, and real estate separate accounts.

Assumptions used to determine annual pension cost (APC) and related information for the years ended December 31, 2010 and 2009 are as follows:

	2010	2009
Actuarial assumptions compounded annually:		
Inflation rate	2.80%	2.80%
Discount rate	7.50	7.50
Investment return for funding purposes	7.50	7.50
Expected investment return	7.50	7.50
Investment return on employee accounts	4.50	4.50
Projected salary increase	4.00	4.00
Cost of living allowance	1.40	1.40

All valuations are as of January 1st of each year. The actuarial cost method used was the projected unit credit. The unfunded accrued liability is amortized over an open 30-year period as a level dollar amount.

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The following table presents activity of the Plan's assets during the years ended December 31, 2010 and 2009:

(in thousands)

		2010	2009
Income:			
Contributions received:			
Employee	$	3,773	4,126
Employer		2,254	1,857
Investment earnings		10,525	12,532
Total income		16,552	18,515
Disbursements:			
Benefit payments		2,475	1,854
Administrative and investment consulting expenses		573	298
Total disbursements		3,048	2,152
Net income		13,504	16,363
Fair value of assets at beginning of year		75,520	59,157
Fair value of assets at end of year	$	89,024	75,520

The following table reconciles the Plan's fair value of the assets to the actuarial value of the assets based on valuation dates of January 1st of each year and presents the funding status at December 31, 2010, 2009 and 2008:

(in thousands)

		2010	2009	2008
Fair value of assets at end of year	$	89,024	75,520	59,157
Unamortized actuarial losses		588	6,905	—
Actuarial value of assets at the end of year		89,612	82,425	59,157
Actuarial accrued liability (AAL)		92,545	84,614	74,274
Unfunded AAL (UAAL)	$	2,933	2,189	15,117
Funded ratio (actuarial value of plan assets/AAL)		96.8%	97.4%	79.6%
Covered payroll (active plan members)	$	45,048	47,426	46,950
UAAL as a percentage of covered payroll		6.5%	4.6%	32.2%

The ARC of $2,254,000 and $1,857,000 and the associated expenses of $1,816,000 and $1,509,000 were included in the accompanying financial statements for the years ended December 31, 2010 and 2009, respectively. The ARRC's APC, which is the periodic cost of the plan, the percentage of APC contributed to the plan, and the net pension obligation for 2010 and the two preceding years were as follows:

(in thousands)

		2010	2009	2008
Annual pension cost	$	2,254	1,857	1,019
Contributed		100%	100%	100%
Net pension obligation	$	—	—	—

(b) *Alaska Railroad Postretirement Health Care Trust*

The ARRC sponsors a retiree health care plan (Plan) that provides postretirement medical benefits to employees receiving retirement under the pension plan and retired CSRS employees who do not qualify for the federal medical insurance, and who move directly from active coverage to retiree coverage. The Plan is contributory with retiree contributions adjusted annually, and contains other cost-sharing features such as deductibles and coinsurance.

Assumptions used to determine annual postemployment benefit cost and related information for the years ended December 31, 2010 and 2009 are as follows:

	2010	2009
Discount rate	7.50%	7.50%
Investment return for funding purposes	7.50	7.50
Expected investment return	7.50	7.50
Health cost trend:		
Medical	4.5 to 9.9	4.5 to 10.5
Prescription	4.5 to 9.9	4.5 to 10.5

All valuations are as of January 1st of each year. The actuarial cost method used was the projected unit credit. The unfunded accrued liability is amortized over an open 30-year period as a level dollar amount.

The ARRC is in the process of evaluating the Patient Protection and Affordable Care Act (PPACA) or "Health Care Reform" impact on actuarial accrued liability, and does not expect the impact to be material.

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The following table represents activity of the Plan's assets during the years ended December 31, 2010 and 2009:

(in thousands)

		2010	2009
Income:			
Contributions received – employer	$	2,099	5,219
Investment earnings		3,663	4,755
Net accrued		—	—
Total income		5,762	9,974
Disbursements:			
Benefit payments		352	231
Administrative and investment consulting expenses		45	54
Total disbursements		397	285
Net income		5,365	9,689
Fair value of assets at beginning of year		26,130	16,441
Fair value of assets at the end of year	$	31,495	26,130

The following table reconciles the Plan's fair value of the assets to the actuarial value of the assets based on valuation dates of January 1st of each year and presents the funding status at December 31, 2010, 2009 and 2008:

(in thousands)

		2010	2009	2008
Fair value of assets at end of year	$	31,495	26,130	16,441
Unamortized actuarial (gains) losses		(580)	1,400	—
Actuarial value of assets at end of year		30,915	27,530	16,441
Actuarial accrued liability (AAL)		27,113	31,600	30,549
Unfunded (overfunded) AAL	$	(3,802)	4,070	14,108
Funded ratio (actuarial value of plan assets/AAL)		114.0%	87.1%	53.8%
Covered payroll (active plan members)	$	45,048	47,426	46,950
UAAL as a percentage of covered payroll		(8.4)%	8.6%	30.0%

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The ARC of $2,099,000 and $2,719,000 and the associated expenses of $1,676,000 and $1,942,000 were included in the accompanying financial statements for the years ended December 31, 2010 and 2009, respectively. The periodic cost of ARRC's annual other postemployment benefit (OPEB), the percentage of annual OPEB cost contributed to the plan and the net OPEB obligation for 2010 and the two preceding years were as follows:

(in thousands)

		2010	2009	2008
Annual OPEB cost	$	2,083	2,393	2,476
Annual OPEB cost contributed		101%	218%	113%
Net OPEB obligation	$	1,702	1,718	4,544

(c) Civil Service Retirement System (CSRS)

Federal employees who transferred to the ARRC continue to participate in the CSRS, a multi-employer defined benefit plan. ARRC is required to contribute 7% of the transferred employees' eligible compensation. Benefit expense related to CSRS was $212,000 and $274,000 for the years ended December 31, 2010 and 2009, respectively.

(d) Alaska Railroad Corporation 401(k) Tax Deferred Savings Plan

The ARRC sponsors a defined contribution plan (Plan) under Section 401(k) of the Internal Revenue Code (IRC) for employees. All regular employees are eligible to contribute to the Plan. Under the terms of certain collective bargaining agreements, representing 55% of employees, the ARRC will match a portion of employee contributions. The maximum amount of matching required under the agreements is 66% of employee contributions for the first 9% of salary. Benefit expense related to the Plan was $529,000 and $538,000 for the years ended December 31, 2010 and 2009, respectively.

(e) Alaska Railroad Corporation 457 Deferred Compensation Plan

ARRC sponsors a Section 457 deferred compensation plan under Section 457(b) of the IRC for non represented employees. There are no benefit expenses related to the Plan for the years ended December 31, 2010 and 2009, respectively.

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(8) Grants

The ARRC has spent grant funding on a variety of operating property, right of way acquisition and equipment. Generally, grant revenue will be recognized equal to depreciation on these assets each year.

The original cost of assets constructed or acquired with grant funding as of December 31, 2010 and 2009 consists of the following:

(in thousands)

			2010	2009
Land and improvements		$	7,541	7,030
Road and roadway structures	15 – 32 year life		469,757	422,929
Equipment	5 – 25 year life		99,810	88,001
Construction in process			5,726	28,622
		$	582,834	546,582

The original cost of assets constructed or acquired with Capital Grant Receipts Bonds, Series 2006 and 2007 funding at December 31, 2010 and 2009 consists of the following:

(in thousands)

			2010	2009
Road and roadway structures	15 – 32 year life	$	128,154	82,205
Equipment	5 – 25 year life		18,960	18,960
Construction in process			7,514	29,765
		$	154,628	130,930

Deferred grant revenue consists of grant funding received for capital assets and is equal to the net book value of assets constructed with that funding. It will generally be amortized over the life of the related capital assets. The ARRC had receivable balances of $11,676,000 and $4,960,000 for the years ended December 21, 2010 and 2009, respectively. Deferred grant balances as of December 31, 2010 and 2009 were $447,341,000 and $428,501,000, respectively.

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December 31, 2010 and 2009

The ARRC recognized the following grant revenue during the years ended December 31, 2010 and 2009:

(in thousands)

		2010	2009
Alaska State Fair:			
Depreciation on assets constructed	$	12	12
Capital Grant Receipts Bonds, Series 2006 and 2007:			
Depreciation on assets constructed		7,682	6,749
Grant funded principal, interest and issuance costs		156	156
Department of Agriculture:			
Depreciation on assets constructed		182	180
Department of Interior:			
Grant funding of accrued derailment expense		30	—
Derailment expense paid in current year		(30)	—
Federal Emergency Management Agency:			
Depreciation on assets constructed		255	197
Grant funded disaster recovery expense		—	7
Federal Railroad Administration:			
Depreciation on assets constructed		16,443	16,231
Right of way acquisition		511	51
Federal Transit Administration:			
Depreciation on assets purchased and constructed		8,382	7,514
Grant funded maintenance and transit security expense		9,660	10,083
Right of way acquisition		(39)	427
Homeland Security:			
Depreciation on assets purchased and constructed		94	88
Grant funded port security expense		14	—
Municipality of Anchorage Ship Creek Economic Development:			
Depreciation on assets constructed		10	10
Rasmuson Foundation:			
Depreciation on assets purchased		80	80
State of Alaska:			
Depreciation on assets purchased		50	48
State of Alaska Wishbone Hill Coal:			
Depreciation on assets purchased and constructed		354	354
Taxpayer Relief Act:			
Depreciation on assets purchased and constructed		1,178	1,259
US Fish and Wildlife:			
Depreciation on assets purchased and constructed		30	30
		45,054	43,476
Less grant revenue included in real estate nonoperating revenues		(2,226)	(4,193)
Less grant revenue reported as a reduction of interest expense		(2,603)	(2,768)
	$	40,225	36,515

December 31, 2010 and 2009

(9) Fund Equity

Fund equity consists of the following major items as of December 31, 2010 and 2009:

(in thousands)		Investment by the State of Alaska	Cumulative net income	Cumulative other changes in fund equity	Total fund equity
Balance at December 31, 2008	$	34,174	170,235	(24,678)	179,731
Net income		—	13,902	—	13,902
Other changes in fund equity		—	—	20,140	20,140
Total changes in fund equity					34,042
Balance at December 31, 2009		34,174	184,137	(4,538)	213,773
Net income		—	13,447	—	13,447
Other changes in fund equity		—	—	5,409	5,409
Total changes in fund equity					18,856
Balance at December 31, 2010	$	34,174	197,584	871	232,629

(10) Major Customer

One ARRC customer accounted for 29% and 42% of freight revenue in 2010 and 2009, respectively. During 2010 and 2009, ARRC entered into agreements with the same customer under the IRC §45G. Under the agreements, ARRC received $4.8 and $4.6 million for qualified track maintenance expenses and gave the customer a shipping credit of $2.7 and $2.6 million in 2010 and 2009, respectively. The qualified track maintenance expenses and the shipping credit are recorded as reductions in operating expenses and freight revenue.

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December 31, 2010 and 2009

(11) Land

The ARRC leases a significant portion of its land to various parties under long-term agreements. Rental income on these leases, which is included in real estate income, was $12,948,000 and $12,491,000 in 2010 and 2009, respectively. The following table summarizes future minimum lease payments as of December 31, 2010:

(in thousands)		Amount
Year ending December 31:		
2011	$	10,915
2012		10,313
2013		9,888
2014		9,386
2015		8,977
Thereafter		130,922
	$	180,401

The ARRC has $737,000 in rent credits outstanding on these leases at December 31, 2010. The assets provided by tenants in exchange for the rent credits are included in property and equipment and are depreciated over their useful lives. The balance of the rent credits is included in unearned revenue.

(12) Operating Leases and Agreements

The ARRC leases certain operating equipment and barge services under operating leases and agreements. Payments under the leases and agreements totaled $10,536,000 and $12,511,000 in 2010 and 2009, respectively. Future minimum lease payments as of December 31, 2010 are summarized as follows:

(in thousands)		Amount
Year ending December 31:		
2011	$	9,583
2012		8,368
2013		7,957
2014		7,951
2015		7,884
Thereafter		1,213
	$	42,956

(13) Insurance

The ARRC is self-insured to certain limits for employee health benefits, personal injury, property and casualty damage claims, and workers' compensation claims, and establishes reserves for the estimated losses of such claims. The ARRC uses third-party administrators that process claims based on the provisions of the employee health plan, or for on-the-job injuries, in compliance with the State of Alaska

December 31, 2010 and 2009

Workers' Compensation Act. ARRC's commercial insurance policies with self-insured retention limits are summarized as follows at December 31, 2010:

(in thousands)		Policy Limit	Retention Limit
Casualty/liability	$	50,000	5,000
Property damage		65,000	10,000

Self-insurance activity is summarized as follows during the years ended December 31, 2010 and 2009:

(in thousands)		Balance at December 31, 2009	Incurred claims	Claim payments	Balance at December 31, 2010
Employee health benefits	$	1,995	10,414	(10,341)	2,068
Workers' compensation		1,575	1,714	(1,422)	1,867
	$	3,570	12,128	(11,763)	3,935

(in thousands)		Balance at December 31, 2008	Incurred claims	Claim payments	Balance at December 31, 2009
Employee health benefits	$	2,296	9,741	(10,042)	1,995
Workers' compensation		2,411	1,570	(2,406)	1,575
	$	4,707	11,311	(12,448)	3,570

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(14) Fair Value of Financial Instruments

At December 31, 2010 and 2009, the fair values of cash and cash equivalents, net receivables, accounts payable and accrued liabilities, including payroll and interest payable, approximate their carrying value due to the short-term nature of these financial instruments.

The carrying amounts and estimated fair values of ARRC's restricted assets, notes payable and revenue bonds payable are summarized as follows for the years ended December 31, 2010 and 2009:

(in thousands)

		2010		2009	
		Carrying amount	**Fair value**	**Carrying amount**	**Fair value**
Financial assets:					
Derivative	$	—	—	109	109
Restricted assets		47,188	47,188	66,817	66,817
Financial liabilities:					
Notes payable	$	27,337	27,337	27,435	27,435
Revenue bonds payable		145,328	153,668	155,100	162,109

On October 1, 2009, ARRC entered into a commodity swap agreement to hedge cash flows against market price fluctuations related to the purchase of diesel fuel. The notional amount was 1,008,000 gallons of diesel fuel, settled at 84,000 gallons monthly from January 1, 2010 through December 31, 2010. ARRC paid or received cash at each monthly settlement period for the net of variable receipts for the floating rate, which was based on the price of Diesel Fuel-Gulf Coast Ultra Low Sulfur (Pipeline) published by Platts U.S., and fixed payments of $2.05 per U.S. gallon. The fair value of the derivative was measured using quoted futures rates discounted based on ARRC's short-term line of credit rate.

Restricted assets, which consist of investments in GICs, commercial paper and money market accounts, are measured using quoted market prices at the reporting date multiplied by the quantity held for investments traded in an active market (money market funds and commercial paper) or using contractual cash flows discounted using current market rates for investments with comparable terms for those investments that are not traded in an active market (GIC).

The estimated fair value of notes payable is measured using contractual cash flows discounted using quoted interest rates adjusted for ARRC's credit standing and interest rates currently offered to the ARRC for similar debt instruments of comparable maturities by the ARRC's bankers.

The estimated fair value of revenue bonds payable is measured using contractual cash flows discounted using bond yields quoted from brokered markets and other long-term debt offered to the ARRC.

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(15) Environmental Remediation Reserve

The ARRC has accrued certain environmental pollution remediation liabilities for its properties. The accrual for the Anchorage Terminal Reserve is based on an on going investigation described below. As to all other locations, ARRC has estimated the liability for pollution remediation by estimating a reasonable range of potential outlays and multiplying those outlays by the probability of occurrence, reduced by the allocation of liability to other potentially responsible parties where applicable. The liabilities associated with these sites could change over time due to changes in costs of goods and services, changes in remediation technology, or changes in laws and regulations governing the remediation efforts.

During 2004, the ARRC commenced investigation of the nature and extent of certain environmental conditions at the Anchorage Terminal Reserve (the Site), which includes the Anchorage rail yard and properties the ARRC owns and leases to third parties. The work is being done under an administrative settlement agreement negotiated with the United States Environmental Protection Agency (EPA). Management has accrued a reasonable estimate of its obligations, as the current owner of the Site, for the activities required under the order, which are a remedial investigation and a feasibility study. These activities were completed in 2010. ARRC has also reflected an anticipated settlement with the United States for a share of costs to date based on the United States' ownership of the Site before 1985. Payment on this settlement was received on February 17, 2010. ARRC is waiting for EPA to determine what, if any, future remediation is required for the Site and what parties will be required to perform the work. This will be subject to negotiations with third parties in addition to ARRC. ARRC has accrued a reasonable estimate of its potential obligation for such future work by estimating a reasonable range of potential outlays and multiplying those outlays by the probability of occurring, reduced by the allocation of liability to other potentially responsible parties. If other responsible parties do not contribute or pay their fair share of the liability, or if remedial requirements are more stringent than currently anticipated, the ARRC will revise its estimate. It is the opinion of ARRC's management that the ultimate outcome will not have a material adverse impact on the ARRC's financial position, but may have significant impact on the change in fund equity in a given year.

(16) Commitments and Contingencies

Approximately 76% of the ARRC's labor force is subject to one of five collective bargaining agreements. The labor agreement with the United Transportation Union (UTU) expired in September 2008 and negotiations continue in 2011. The labor agreement with American Train Dispatchers Department (ATDD) expired June 2009 and negotiations continue in 2011. The labor agreement with the Carmen's Division of Transportation Communication International Union (TCU) expired January 2010 and negotiations commenced in December 2009 and continue in 2011. The labor agreement with the Alaska Railroad Workers (ARW) expired August 2010 and a new agreement was ratified in September 2010. The labor agreement with the International Association of Machinists and Aerospace Workers (IAM) expired December 2010. Coincident with the IAM negotiations, Teamsters Local 959 made a bid to decertify and replace the IAM as the representative union. Effective March 2011, Teamsters replaced IAM as the representative union.

The ARRC has certain other contingent liabilities resulting from lawsuits, contract disputes and claims incident to the ordinary course of business. Provision has been made in the financial statements for probable losses, if any, from such contingencies. In the opinion of management, the resolution of such contingencies will not have a material effect on the financial position of the ARRC.

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ALASKA RAILROAD CORPORATION

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Passenger Service		1-800-544-0552	
Seattle Office		1-800-843-2772	

The Alaska Railroad Corporation has not received any bona-fide offers of a sale arrangement within the calendar year of 2010, nor is the Corporation aware of any potential sales that require analysis under AS 42.40.260.

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