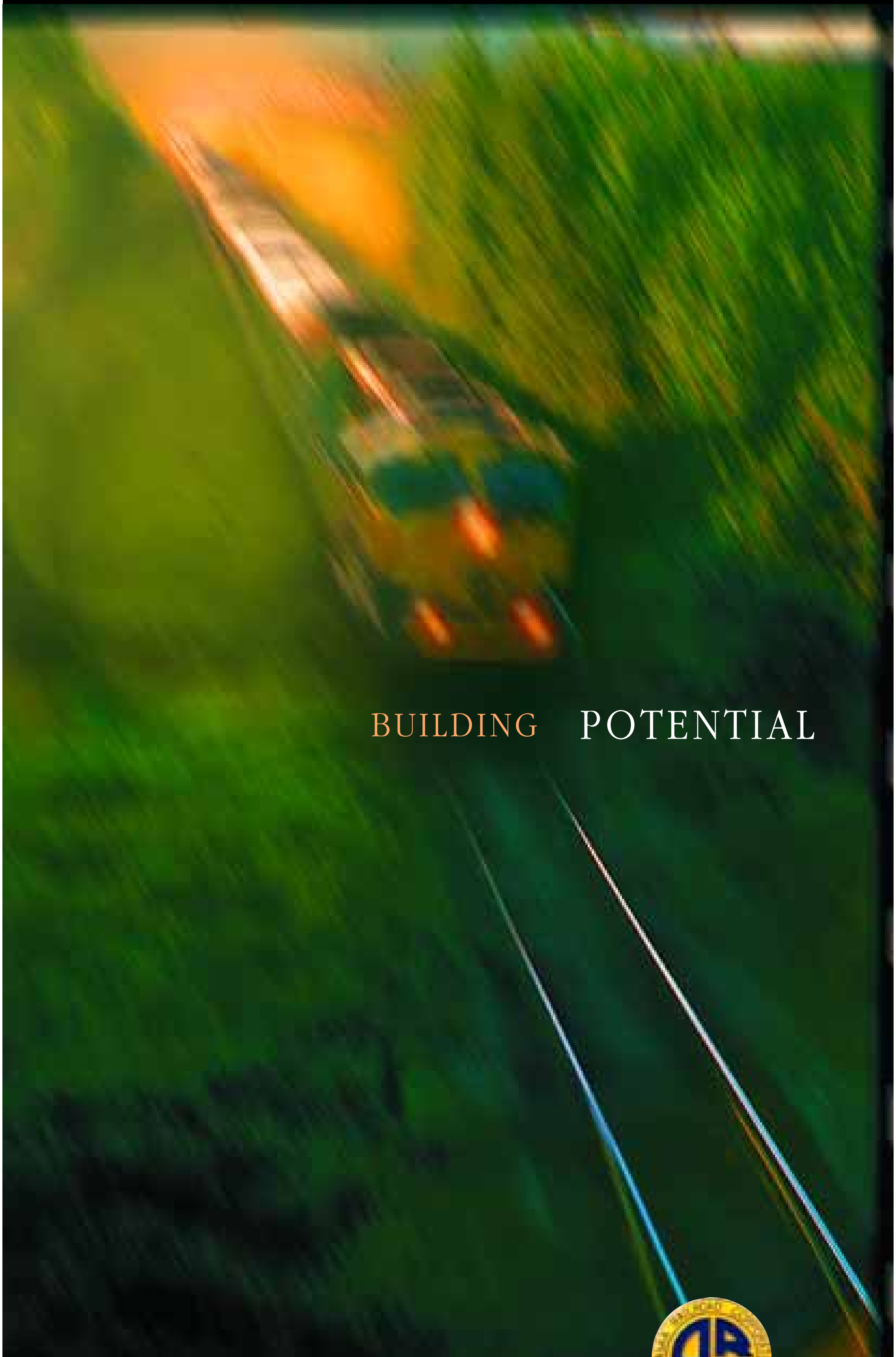
ALASKA RAILROAD CORPORATION

2002 ANNUAL REPORT



BUILDING POTENTIAL

OUR MISSION

BUILDING A GREAT RAILROAD
IN A GREAT LAND

To be profitable by focusing on safe, high quality service to our freight, passenger, and real estate customers. To foster the development of Alaska's economy by integrating railroad and railbelt community development plans.

A MESSAGE FROM JOHNE BINKLEY
CHAIRMAN OF THE BOARD

2002 marked the railroad's first full year with Pat Gamble at the helm as President & CEO. Retiring the four stars of his U.S. Air Force career, his transition to the civilian business world has met with outstanding results. Under Pat's leadership the railroad team met with tremendous success, exceeding goals of increased safety, outstanding customer service, and improved profitability.

On the safety front, I'm proud to report that the Alaska Railroad achieved its lowest injury rate ever and now ranks among the safest railroads in North America. The employees' commitment to safety proved instrumental in attaining this remarkable achievement.

The railroad's customer service success – demonstrated by award-winning passenger services, on-time freight performance, and increased real estate revenue – goes beyond railroad operations. Expanded efforts to work with communities and local planning organizations have not only helped improve coordination, but also strengthened the railroad's relationships with those it serves.

Improving the bottom line was a challenge. We faced an economic downturn and a flat year in tourism, and we lost our export coal contract. We also operated the railroad in one of the world's toughest climates. Despite these obstacles, the railroad's hard work resulted in net earnings of almost \$9 million on revenues of \$105.7 million.

The past year also saw two long-serving, dedicated members leave our board of directors. Joe Perkins, as Commissioner of Alaska's Department of Transportation & Public Facilities (DOT&PF), gave eight years of service to the railroad. His efforts were instrumental in forging stronger bonds between the railroad and DOT&PF, and his expertise in managing large construction projects proved invaluable in our expansion efforts. Debbie Sedwick, as Commissioner of Community & Economic Development (DCED), also provided strong leadership on the railroad's board. Her insistence on the Alaska Railroad's not losing sight of our role in economic development, as well as her expertise in real estate matters, proved invaluable to the railroad. We are thankful for both of these members' contributions to the success of the railroad.

With Governor Murkowski dedicated to expanding the development of our resources, the railroad is optimistic about being a part of that future. I am excited to welcome two new members to our board of directors: Mike Barton, Commissioner of DOT&PF, and Edgar Blatchford, Commissioner of DCED. Both bring a wealth of experience to the board and will contribute greatly to the railroad's achievements in years to come.

The Alaska Railroad's board of directors appreciates the dedication and accomplishments of the railroad's employees and customers. As good as 2002 was, 2003 promises to be even better.

BUILDING

A MESSAGE FROM PATRICK K. GAMBLE
PRESIDENT & CEO

The Alaska Railroad shared in the country's economic roller coaster ride during 2002. Like so many businesses in nearly every sector, we experienced a reduction in operating revenues coupled with a steep rise in certain costs of doing business. Throughout a particularly rigorous budget process we had anticipated most of these fiscal impacts. But then came a few sobering surprises. As a result, the second half of the year became a time of regrouping and strategizing. We cut expenses and introduced new operating efficiencies.

Our board of directors gave management unqualified support for a matrix of initiatives put into place to reduce costs and secure potential revenue opportunities not apparent at budget time. And I certainly want to credit the heavy lifting done by our Washington legislative team and their staffs on behalf of the Alaska Railroad as well. Adding to the positive financial picture that developed was the railroad's marked safety improvement in 2002; we bested our workers compensation forecast by over half a million dollars.

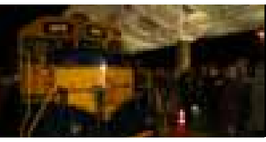
In short, we offset a flat revenue year by the collective successes of deliberate efforts on several fronts. As a result, we more than doubled our budgeted net earnings for the year. Our employees in every department stepped up to the task, and they made it happen.

Throughout the year and into 2003 we remained on course in the areas of technology introduction and training. We are in the early stages of a railroad-wide business software upgrade. We have just begun the launch of a major new employee training initiative. We have also taken significant steps to better our position with regard to the railroad's environmental responsibilities.

We ended 2002 on a high note. Not just at the bottom line, but where it really counts – all along the rail line – in the shops, in the yards, and at the desks.

In 2003, our plan is to continue the strategy of steady, measurable operational improvement. We will continue to make important enhancements to our infrastructure and our work areas. We will continue to leverage our real estate holdings as we pursue new business. We will take full advantage of cutting edge technology to ensure train safety. And we will continue our commitment to work proactively with our partners – communities, agencies, organizations, and leaders who have Alaska's developmental interests at heart.

POTENTIAL



THE YEAR IN REVIEW

Even as Alaska's economic climate flattened, and key revenue sources declined, the Alaska Railroad Corporation (ARRC) contained expenses and remained steadily on track in terms of safe day-to-day operations, embedding efficiency and productivity in our train operations, and upholding our commitment to investing for the future. In other words, we stuck to our strategy of continuous, steady improvement.

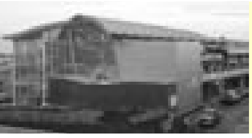
Financial Picture

Similar to the economic landscape across Alaska, many segments of ARRC's business remained flat. In addition to the cancellation of Korean export coal, unexpected maintenance reduced fuel shipments from the North Pole Refinery. At the same time, market downturns meant the ARRC saw a significant increase in retirement benefit costs. Unexpected expenses also came in the spring when severe flooding caused track damage and resulted in several days of costly service delays. Even so, ARRC went to work quickly to offset what could have been a marginal financial year with substantial reductions in corporate expenses, still preserving wage and benefit increases agreed to during labor negotiations.

Safety & Environmental

Our employees made admirable strides in the area of safety. This year, ARRC reduced its injury frequency rate by 63 percent from 1997, marking our lowest corporate injury frequency rate to date. In 2002, ARRC's Mechanical and Transportation departments had injury rates that rank them among the safest in the country. ARRC's 2002 derailment record also bettered the national average.

During the year, ARRC developed and completed both our spill contingency plan (C-plan) and an



environmental management system that goes beyond regulatory requirements. The C-plan is filed with the Alaska Department of Environmental Conservation and has been tested through a number of spill response drills that have actively engaged state and federal regulatory agencies, as well as the Department of Defense.

With regard to equipment upgrades, the railroad initiated a program in 2002 to install auxiliary power units and software technology on locomotives that will reduce diesel emissions and noise. The railroad worked with petroleum customers to repair fuel tank car wheel assemblies as part of a preemptive program to enhance safety by reducing derailment risk.

Customers & Revenues

Freight: 2002 saw overall freight revenue below last year's level. Helping to offset coal revenue loss, gravel came on strong in the latter part of the year, surpassing 2001 levels. Petroleum shipments from North Pole Refinery were very strong in the last quarter, but still came in under the expected annual volume.

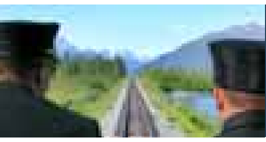
Passenger: Early predictions that September 11 would have a negative impact on tourism activity in Alaska were incorrect with regard to our passenger business. Rail passenger revenue grew more than 4 percent over last year. Passenger purchases reflected changing economic factors, however, as shorter, less expensive packages were most popular.

Real Estate: This important segment continues to perform well, with revenues exceeding $11 million for the first time. During its first full year of operation, the new Seward freight dock generated promising new business. Continued development of railroad reserve lands also contributed to revenue increases.

Capital Projects

Infrastructure improvements continued at an accelerated pace throughout the year. Construction on the rail depot at Ted Stevens Anchorage International Airport was completed in November, on time and on budget. Ribbon cutting occurred in December.

A tunnel (left) links the new rail depot to Ted Stevens Anchorage International Airport, one of many improvements to railroad facilities.



Ground was broken on both the Fairbanks and Denali Depot projects this fall. Several miles of new track alignment came on-line from the Anchorage yard onto Elmendorf and Fort Richardson this year. The environmental process to gain approval for curve-straightening efforts between Eagle River and Knik River was also completed in 2002. To date, about one-fourth of the 70 curves to be straightened through the Anchorage-to-Wasilla track realignment projects have been accomplished.

Construction of a new bridge over Campbell Creek during the winter is the final step to finishing the South Anchorage Double Track and Signalization Project, which will ease congestion along this busy 5-mile stretch.

In Whittier, the Railroad constructed a new side-unloading barge dock that is allowing more efficient transfer operations for this growing segment of ARRC's freight business. The Pedestrian Underpass, traversing the rail yard underground, opened last summer to provide safe passage for residents and visitors who want to travel between the harbor and town site. The Railroad also continued work on the DeLong Dock's electrical system and installed a water line to provide fresh water to ships and fishing boats. The DeLong Dock was put into operation at railroad

expense to temporarily offset the loss of the 1,100-foot Marginal Wharf, which had reached the end of its useful life. The railroad has plans to rebuild the Marginal Wharf.

Pedestrians near the Anchorage rail yard saw improvements this year. The plaza at the corner of North C Street and Ship Creek Avenue was completed and landscaped. Sidewalk and lighting projects around the

plaza area continued through the summer, complementing construction of the new Ulu Factory by a railroad tenant, which is going up adjacent to the plaza. Assisted by the new Ship Creek Shuttle bus service, we are seeing greater public interest in visiting Ship Creek as it becomes more pedestrian friendly.

Community Cooperation

As a busy partner in the economic well-being of railbelt communities, ARRC coordinated future transit plans and facilitated an improved regional transportation planning process. The railroad became an official member of the Anchorage Metropolitan Area Transportation System (AMATS) technical committee, Fairbanks Metropolitan Area Transportation System (FMATS) technical committee, Fairbanks Rail Task Force Committee, Palmer Urban Revitalization Steering Committee, and the Anchorage-Mat-Su Regional Transportation Steering Committee. Additionally, ARRC officials sit on the State Chamber of Commerce Board, the Anchorage Chamber of Commerce Board, Anchorage Economic Development Corporation, Resource Development Council, and Vision Anchorage, adding to the numerous community-based groups our employees participate in each year.

ARRC continued to support local school business partnership programs and non-profit efforts through a generous corporate giving program. In addition, many parks and public use areas are located on ARRC lands – leased to communities well below market value.

Looking Ahead

Although ARRC has significantly improved its personnel safety record, safety improvements will remain the top priority. The ARRC will continue to invest heavily in safety training in 2003, having set ambitious goals to achieve a 20 percent decrease in both lost time and derailments.

We expect ARRC's freight business to decrease slightly in 2003. The railroad's focus will be on customer service, velocity, and on-time performance. On the passenger side, ARRC will introduce a new day trip service to Southcentral Alaska's Spencer Glacier and Grandview Pass, actually a continuation of the Glacier Discovery currently serving Whittier. Beginning in May 2003, the new airport rail depot will serve cruise ship customers traveling between Anchorage and Seward.

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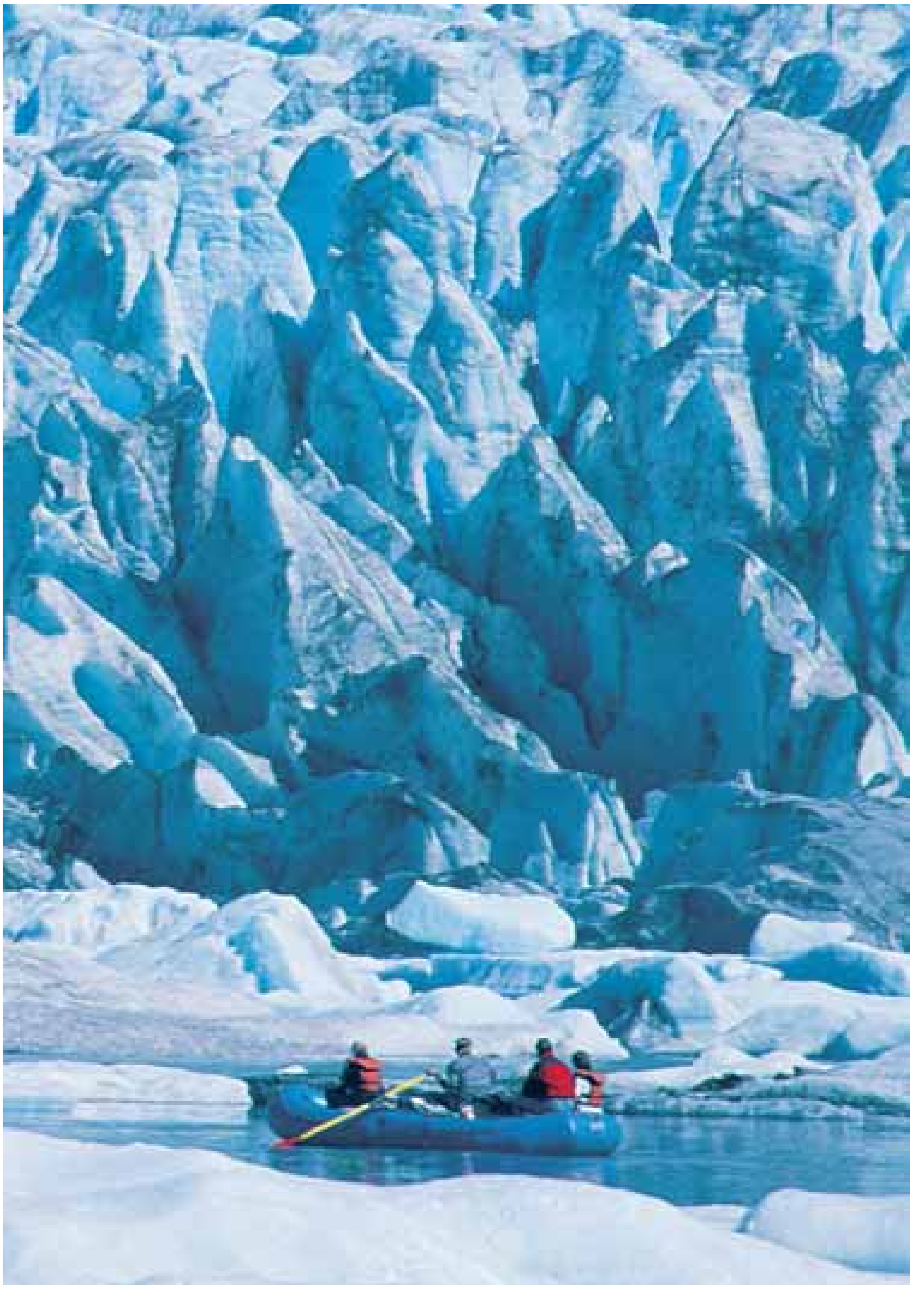
THE POTENTIAL OF



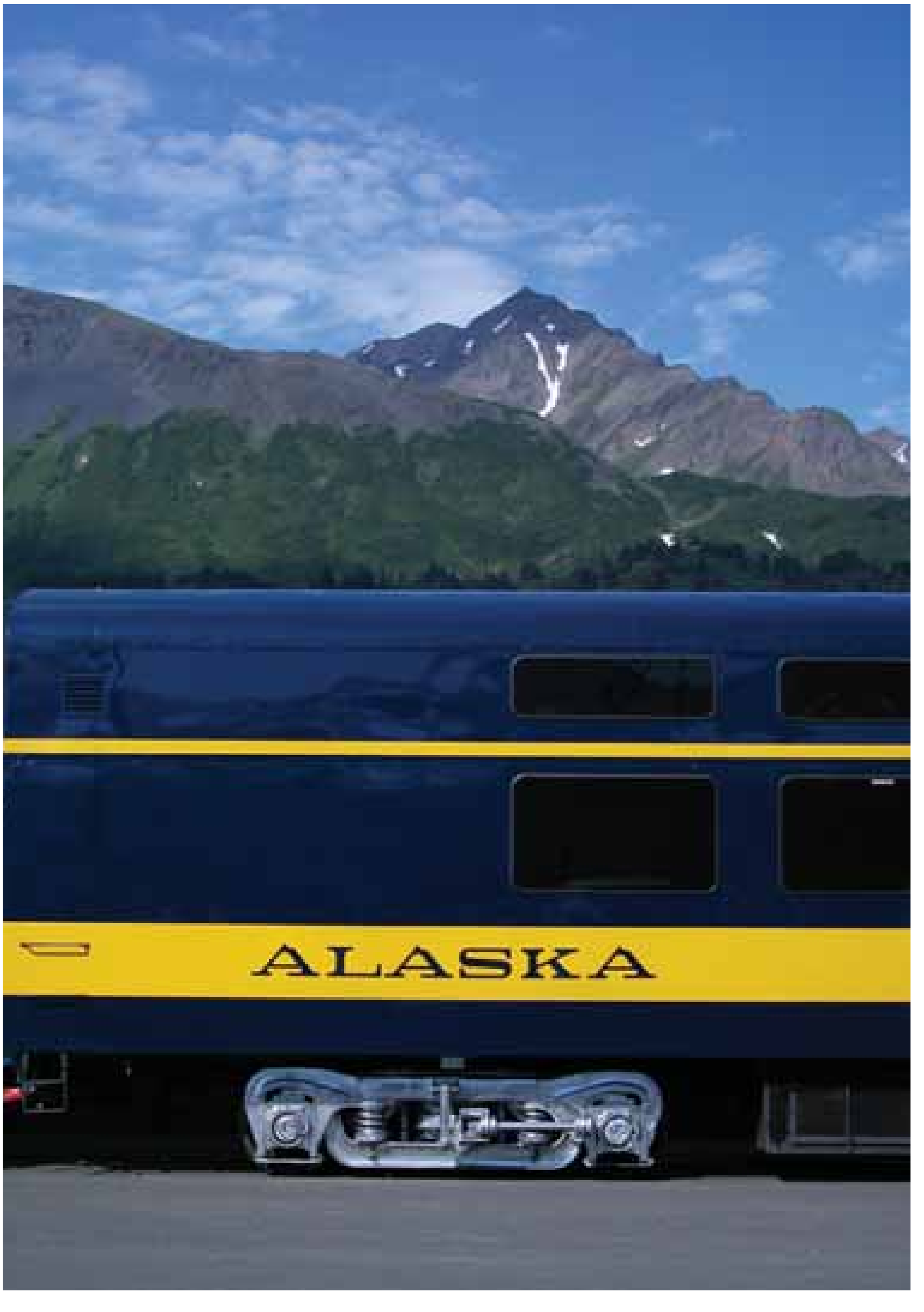
INNOVATION

Our passenger services department developed plans to offer a new service in 2003. Our new day trip service will tour south to Spencer Glacier and Grandview Pass providing beautiful sightseeing and the option of an exciting raft trip on the Placer River.

Shorter segments like Anchorage – Seward saw ridership increases in 2002.

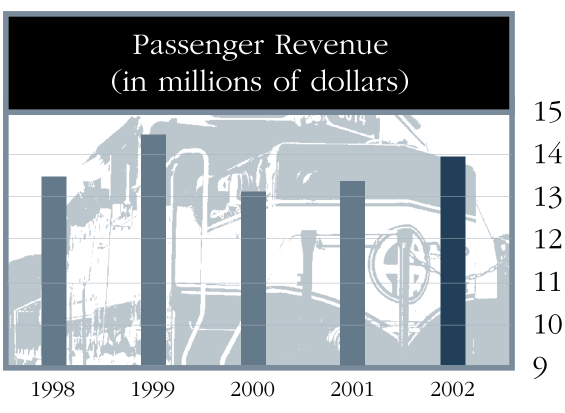
2002 brought new capability for on-line booking of rail transportation – improving and streamlining our customer service. The new system can accommodate current and projected needs, and capitalizes on customer demand for Internet information and transaction capability.

BUILDING BUSINESS



The Alaska Railroad's award-winning tour guide program trains young Alaskans to work on passenger trains. Many go on to careers in tourism.

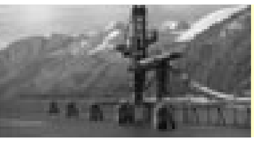
Outstanding work throughout the railroad earned us Overall Best Railroad, five first-place and one second-place Onboard Services Magazine *awards for 2002. We enjoyed growth in both passenger ridership and revenue, despite a soft year in the tourism sector.*

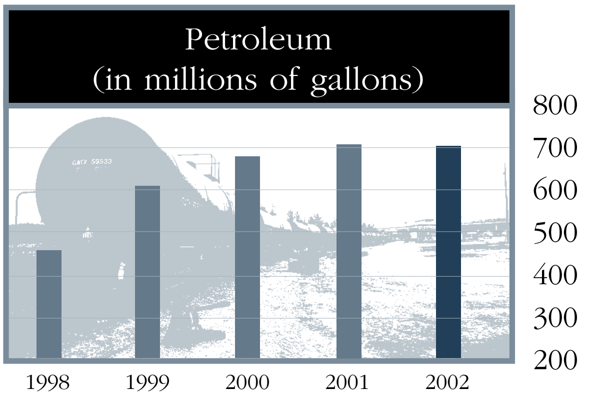


Rail passenger revenue grew slightly over 2001.

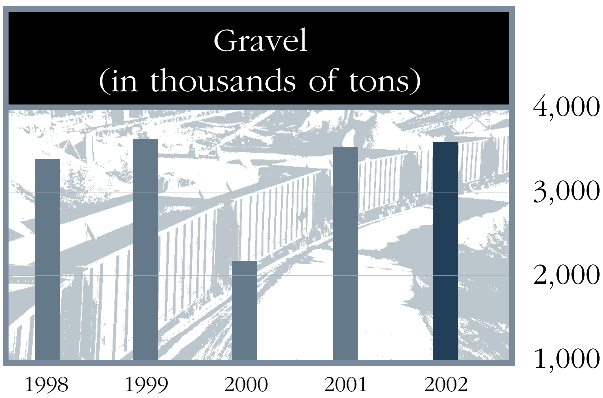
Gravel came on strong in the latter part of the year, surpassing 2001 levels.

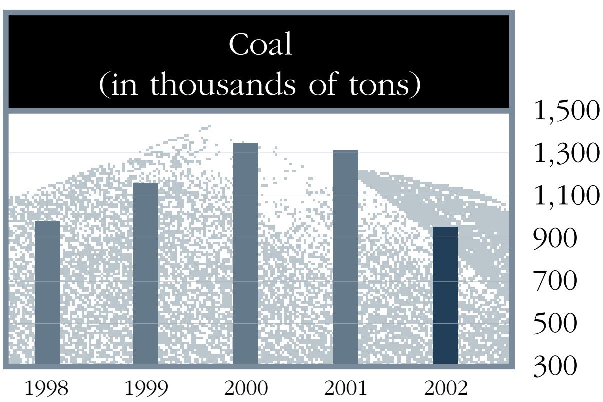
Cessation of coal shipments to South Korea, coupled with lower than expected fuel movements, diminished overall freight tonnage and revenues from 2001 levels.





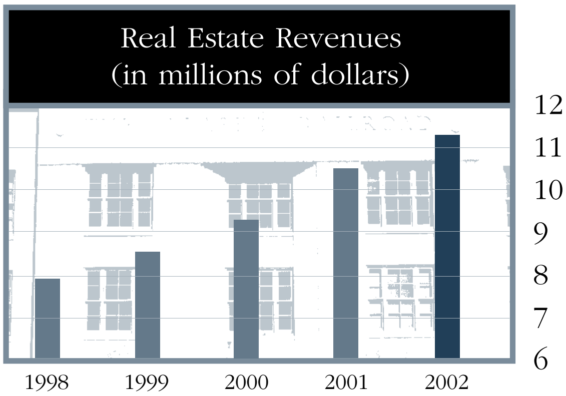
Efficiencies associated with rail-barge service, fuel hauling and capital improvements, along with operational streamlining, continue to improve freight service's operating ratios and bottom line.





BUILDING BUSINESS

Improvements like the Ship Creek Plaza (below) add to the attractiveness of railbelt communities, while increasing the value of ARRC real estate and attracting new tenants. Due to these and other improvements, revenues from real estate exceeded $11 million – reaching a corporate goal as well as setting a new record.



The railroad's experienced real estate staff includes railroader Karen Morrissey, seen here receiving her 35-year service award from Chairman Johne Binkley. Real estate generates important revenue while helping railbelt businesses meet their land use needs.

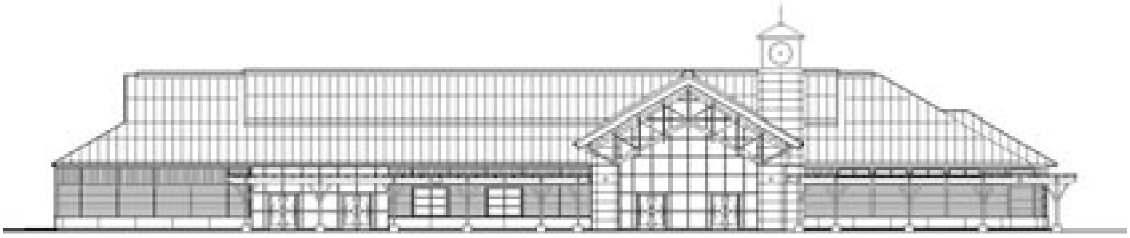
The railroad partnered with area businesses to create the Ship Creek Shuttle, improving transportation between Ship Creek and downtown.

Aaron Pascar (above right), an ARRC Carman, works with kids on a charter train to teach them about rail safety and introduce them to the excitement of rail travel.

An example of the railroad's community planning efforts is the joint effort with state and local agencies to permit a trail along untracked miles of right-of-way in the Palmer area.

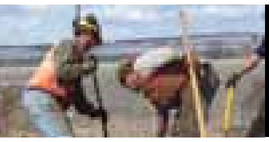
A new depot at Ted Stevens Anchorage International Airport is one of many additions to the railroad's facilities. New depots are also under construction in Fairbanks and Denali National Park. These projects provide better service to our customers as well as attractive venues for the communities we serve.

New "pass-pass" side unloading facilities in Whittier will move containerized cargo more efficiently from rail barges to land transportation.



North elevation of Fairbanks Intermodal Facility.

Further improvements to Seward dock facilities enhance intermodal connectivity.

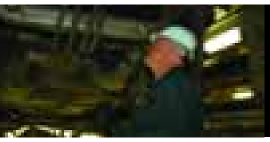


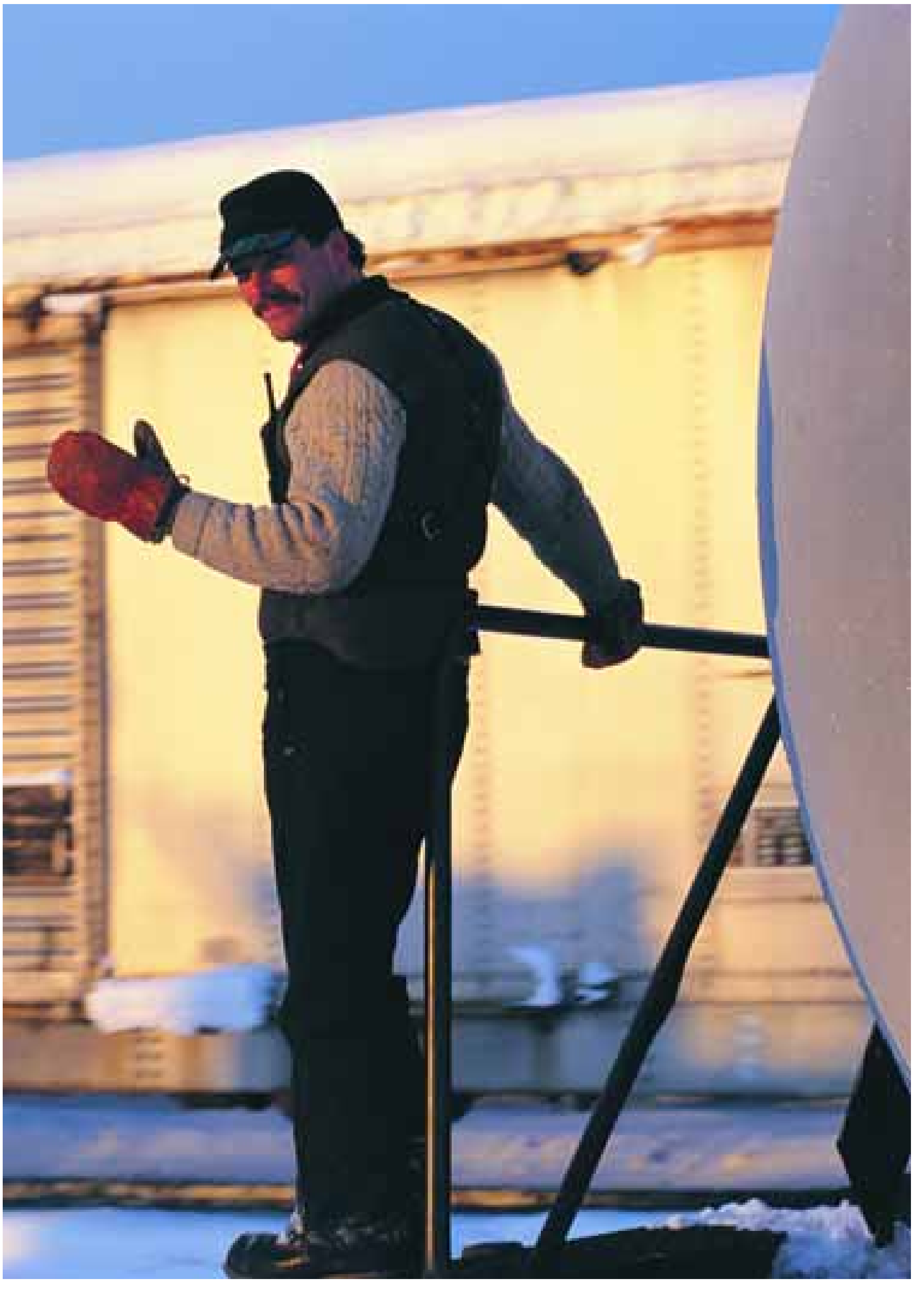
Track straightening between Anchorage and Wasilla continues, offering improved safety and reduced transit times. Truck rehabilitation of tank cars used on the railroad wrapped up in Spring 2002, resulting in improved safety in fuel transport. Maintenance of Way teams step up efforts during the busy summer construction season.

Installation of Ecotrans® and Smart Start technology reduces the amount of time locomotives spend idling, thus improving air quality.

New and improved sidings along with track and roadbed upgrades continue to improve safety, velocity, and reliability along the railroad.

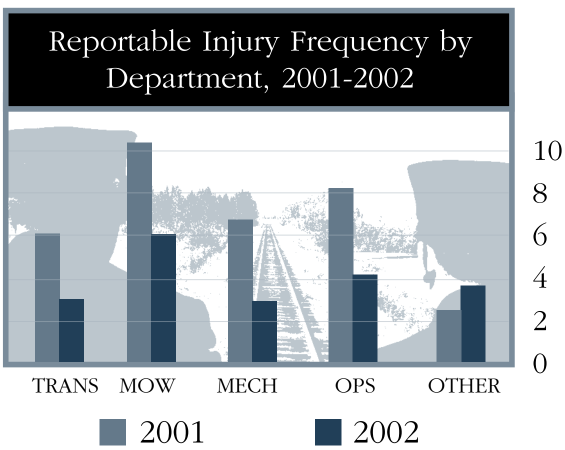
PREPARATION



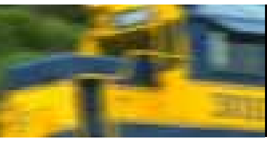


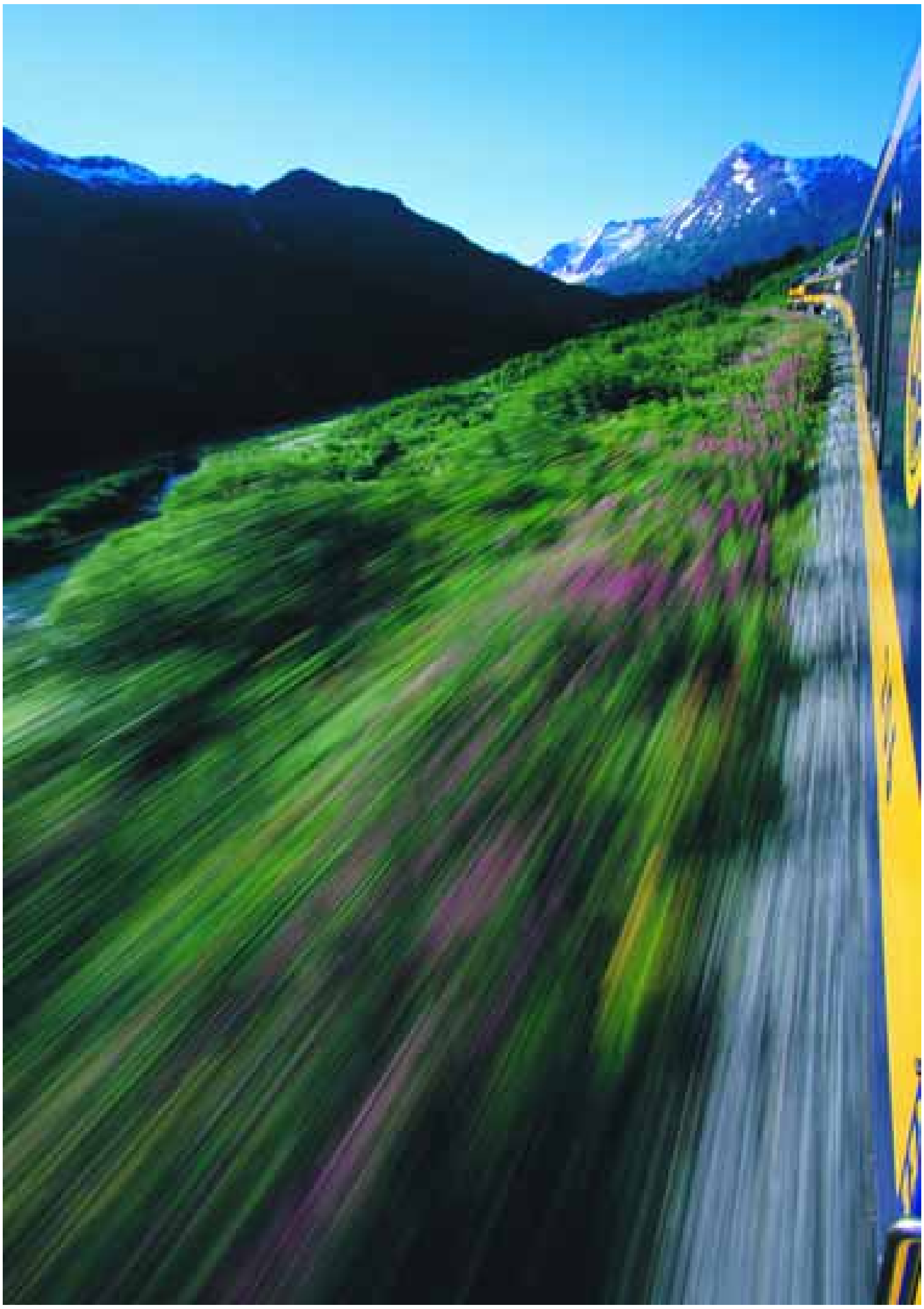
THE POTENTIAL OF

Continued efforts by railroad employees to improve safety paid big dividends in 2002. Jennifer Verley (left), Ray Sechser, Lloyd Tesch, and Ed Rivera formed a Maintenance of Way (MOW) Safety Coordinator team that helped reduce MOW injuries by almost 50 percent.



In 2002 the railroad provided more and better technical training to new hires and to railroaders assuming new responsibilities, or using new equipment, in order to increase safety and efficiency.





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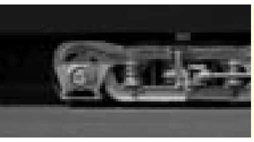
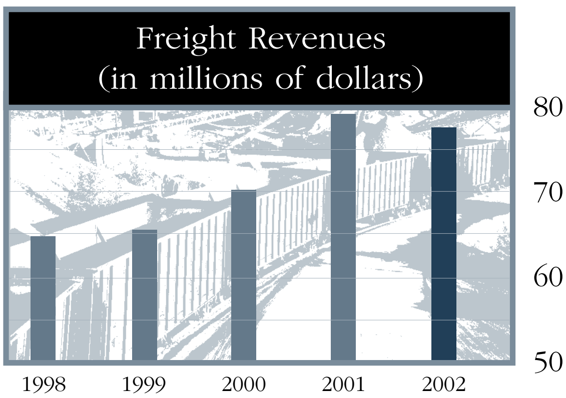
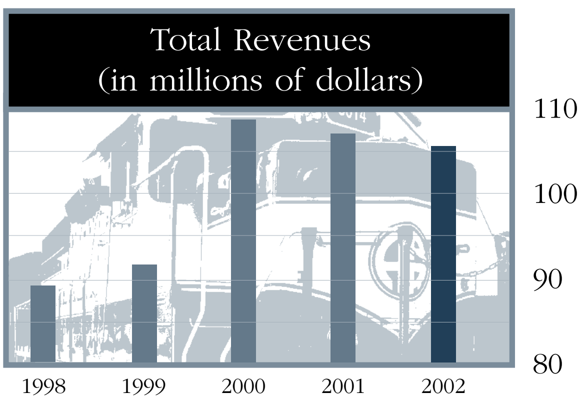


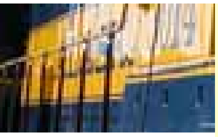
The railroad's continued improvements, aimed at building a safer and more efficient transportation system, will pay future dividends to both the corporation and the communities we serve.



After a sustained period of growth, freight revenues, and consequently overall revenues, dipped in 2002.



The Alaska Railroad Corporation continues to work with customers and communities to meet the needs of Alaska's future.



February 28, 2003

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, 2002. This year's Annual Report is the first to be issued since ARRC was required to adopt three new accounting statements issued by the Governmental Accounting Standards Board and the provisions of Financial Accounting Standards Board Statement No. 71. By adopting these statements, the reporting model used by the ARRC has changed slightly.

These overall changes include minor modifications to the basic financial statements, accompanying footnotes, and independent auditor's opinion; additionally, a Management's Discussion and Analysis (MD&A) section has been added.

The financial section of the annual report is presented in three parts:

- MD&A – provides an introduction, overview, and analysis to the basic financial statements.
- The independent auditor's report on the basic financial statements.
- The basic financial statements and accompanying notes.

We hope the changes to the corporation's financial reporting enhance the users' understanding of the Alaska Railroad Corporation's financial statements.

Sincerely,

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

Wendy Richerson, CPA
Controller

This section of the Alaska Railroad Corporation's (ARRC's) annual financial report presents our discussion and analysis of the ARRC's financial performance during the fiscal year that ended on December 31, 2002. Please read it in conjunction with the ARRC's financial statements, which follow this section.

FINANCIAL HIGHLIGHTS

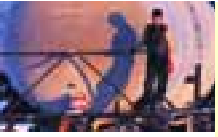
- The ARRC's total fund equity increased 5% over the course of this year's operations.
- During the year, the ARRC's operating revenues exceeded operating expenses by $2.1 million, yielding an operating ratio of .98. This is an improvement over last year, when operating revenues were approximately equal to operating expenses with an operating ratio of 1.0.
- The ARRC's transportation revenues decreased 3% to $90.5 million. Total operating revenues decreased 2% to $94.5 million.
- The total operating costs of the ARRC's programs were approximately $92.3 million, a decrease of 4% compared to last year.
- Expenditures on capital assets totaled $66.5 million during the year ended December 31, 2002, a decrease of 5% from the $70.1 million expended during 2001.
- Federal grant funding was used for $57 million, or 86% of the 2002 capital expenditures. In 2001, federal grant funding was $52 million, or 74% of 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. More detailed information can be found in Note 8.

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 non-current; 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 (non-current). 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. This statement replaces the previously reported Statement of Income.
- 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 (in thousands)

Fund equity. ARRC's fund equity increased 5% between fiscal years 2001 and 2002—increasing to approximately $119.4 million. In comparison, 2001 fund equity increased 6.1%.

		2002	2001	Percentage Change
Assets				
Current assets	$	44,983	32,316	39%
Capital assets		320,052	266,931	20%
Other non-current assets		1,603	7,132	-78%
Total assets		**366,638**	**306,379**	**20%**
Liabilities				
Current liabilities		18,376	19,714	-7%
Long-term debt outstanding		16,466	18,600	-11%
Other liabilities		6,302	6,385	-1%
Regulatory liabilities:				
Postretirement and pension		14,599	10,121	44%
Deferred grant revenue		191,468	137,789	39%
Total liabilities		**247,211**	**192,609**	**28%**
Fund Equity				
Invested in capital assets, net of related debt		110,003	108,300	2%
Restricted for reinvestment in infrastructure		9,424	5,470	72%
Total fund equity	$	**119,427**	**113,770**	**5%**

Capital assets. Capital assets, net of accumulated depreciation, increased $53.1 million in 2002. The ARRC is continuing an extensive capital improvement plan, including track refurbishing, straightening of curves in the track to allow faster train speed, and building new passenger depots. The majority of capital assets are funded through federal grants.

Regulatory liabilities. The Surface Transportation Board 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 liabilities as required by Statement of Financial Accounting Standards No. 71, Accounting for the Effects of Certain Types of Regulations. A description of each of the regulatory liabilities follows.

- Deferred grant revenue relates to capital assets funded with federal grants. Deferred grant revenue increased $53.7 million in 2002. This increase reflects the increased amount of capital assets constructed with grant funding. This deferred grant revenue will be recognized as operating income as the related capital assets are depreciated.
- The postretirement and pension liability increased $4.5 million during 2002. This increase includes a $3.3 million increase relating to an additional minimum pension liability resulting primarily from poor performance in the investment markets.

Changes in fund equity. The ARRC's total revenues decreased 1.5% and totaled $105.7 million in 2002. Approximately 72% of the ARRC's revenue comes from freight revenue, and 13% of the revenue comes from passenger services. The majority of the remaining income is related to real estate activities and federal grant revenue recognized as capital assets funded by the grants are depreciated.

ARRC's total expenses decreased 4% compared to 2001. Expenses cover a range of services, with approximately half directly related to transportation activities.

		2002	2001	Percentage Change
Operating revenue				
Freight	$	76,021	79,868	-5%
Passenger		13,980	13,389	4%
Other		544	239	128%
Total transportation revenue		90,545	93,496	-3%
Grant revenue		3,906	2,687	45%
Total		**94,451**	**96,183**	**-2%**
Operating expense				
Transportation		45,616	46,320	-2%
Maintenance		24,796	24,574	1%
Mechanical		13,019	13,433	-3%
General and administrative		8,913	11,819	-25%
Total		**92,344**	**96,146**	**-4%**
Operating income		2,107	37	5595%
Non-operating revenues and expenses				
Real estate income, net of expense		7,830	7,150	10%
Investment income (loss)		(28)	555	-105%
Interest expense		(1,000)	(1,129)	-11%
Net income		**8,909**	**6,613**	**35%**
Other changes in fund equity		(3,252)	-	
Total changes in fund equity	$	**5,657**	**6,613**	**-14%**

Several events occurred during 2002 that significantly impacted the change in fund equity:

• Two primary events caused a decrease in freight revenue during 2002. Due to a Korean company's cancellation of a contract with its Alaskan supplier, the ARRC ceased transport of coal to Seward via railcar for further shipment to Korea. Additionally, the slow down in oil exploration and the general economy led to decreases in the amount of freight shipped from Seattle to Whittier via the ARRC's barge service.

• The Federal Railroad Administration approved ARRC's indirect cost rate agreements. The plans allow ARRC to allocate eligible general and administrative expenses to federal grant projects. A total of $2.4 million was allocated to capital projects during 2002, reducing general and administrative expenses.

• Market conditions led to pension investments being inadequate to cover the accumulated pension benefit obligation. This was the primary reason for a $3.3 million additional minimum pension liability recorded as an "other change in fund equity" during 2002.

CAPITAL ASSET AND DEBT ADMINISTRATION

Capital Assets

At the end of 2002, the ARRC had invested $320.1 million in a broad range of capital assets, including road and roadway structures, equipment, and leasehold improvements. This amount represents a net increase (including additions and deductions) of $53.1 million, or 20%, over last year. Federal grants have funded $191.5 million of the assets.

		2002	2001	Percentage Change
Land and improvements	$	17,644	17,644	0%
Road materials and supplies		3,491	5,772	-40%
Road and roadway structures		80,393	75,086	7%
Equipment		62,283	66,214	-6%
Leasehold improvements		1,668	1,676	0%
Construction in progress		154,573	100,539	54%
Total capital assets, net of accumulated depreciation	**$**	**320,052**	**266,931**	**20%**

The ARRC's fiscal year 2003 capital budget projects spending another $68.6 million for capital projects, principally for continued track straightening and depot construction and improvements. The ARRC plans to issue additional debt of $4.75 million to finance some of the projects. The ARRC intends to use federal grant funding to provide $50.3 million of the capital additions. More detailed information about the ARRC's capital assets is presented in Note 4 to the financial statements.

Long-term Debt

At year-end the ARRC had $18.6 million in long-term notes outstanding—a decrease of 11% from last year. During 2002 the ARRC refinanced an equipment loan to obtain more favorable loan terms. No new debt was issued during 2002. More detailed information about the ARRC's long-term liabilities is presented in Note 6 to the financial statements.

NEXT YEAR'S BUDGETS

- Total revenues are expected to decrease by approximately 3% for 2003. Passenger service revenues are expected to increase 7%, freight revenues are expected to decrease 1% and real estate will decrease by approximately 3%.
- Total expenses are not expected to change for 2003.

If these estimates are realized, the ARRC's fund equity is expected to increase modestly by the close of 2003.

CONTACTING THE ARRC'S FINANCIAL MANAGEMENT

This financial report is designed to provide residents of the State of Alaska and our 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, or visit us on the Internet at www.AlaskaRailroad.com.

INDEPENDENT AUDITOR'S REPORT

We have audited the accompanying balance sheets of the Alaska Railroad Corporation, a component unit of the State of Alaska, as of and for the years ended December 31, 2002 and 2001, 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 examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes 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, 2002 and 2001, and the changes in its financial position and its cash flows for the years then ended in conformity with accounting principles generally accepted in the United States of America.

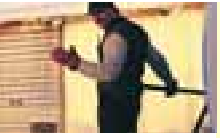
As discussed in note 2, the Alaska Railroad Corporation adopted Governmental Accounting Standards Board (GASB) Statement No. 34, Basic Financial Statements—and Management's Discussion and Analysis—for State and Local Governments; GASB Statement No. 37, Basic Financial Statements—and Management's Discussion and Analysis—for State and Local Governments: Omnibus; and GASB Statement No. 38, Certain Financial Statement Disclosures; effective January 1, 2001.

In accordance with Government Auditing Standards, we have also issued our report dated February 28, 2003 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 and grants. That report is an integral part of an audit performed in accordance with Government Auditing Standards and should be read in conjunction with this report in considering the results of our audit.

The management's discussion and analysis on pages 27 through 30 is not a required part of the basic financial statements but is supplementary information required by the Governmental Accounting Standards Board. We have applied certain limited procedures, which consisted principally of inquiries 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.

February 28, 2003
Anchorage, Alaska

KPMG LLP



ALASKA RAILROAD CORPORATION BALANCE SHEETS

December 31, 2002 and 2001
(In thousands)

Assets	**2002**	**2001**
Current assets:		
Cash and cash equivalents	$ 18,638	7,279
Accounts receivable, net of allowance for doubtful accounts of $199 in 2002 and $586 in 2001	9,688	10,167
Materials and supplies	5,299	5,013
Restricted assets (note 3)	9,866	9,531
Prepaid expenses and other current assets	1,492	326
Total current assets	44,983	32,316
Capital assets (note 4):		
Land and improvements (note 11)	17,644	17,644
Road materials and supplies	3,491	5,772
Road and roadway structures	134,000	122,432
Equipment	110,050	107,666
Leasehold improvements (note 11)	1,848	1,728
Accumulated depreciation and amortization	(101,554)	(88,850)
Construction in progress	154,573	100,539
Total capital assets, net	320,052	266,931
Restricted assets (note 3)	647	5,921
Investments (note 3)	652	1,017
Other assets	304	194
	$ 366,638	306,379
Liabilities and Fund Equity		
Current liabilities:		
Current portion of long-term debt (note 6)	$ 2,115	2,242
Accounts payable and accrued liabilities (note 14)	5,330	6,443
Payroll liabilities	7,331	7,734
Unearned revenues (note 11)	3,600	3,295
Total current liabilities	18,376	19,714
Long-term debt, less current portion (note 6)	16,466	18,600
Environmental remediation reserve (note 14)	579	1,341
Advance grant funding (notes 3 and 8)	4,782	3,313
State of Alaska advances (notes 3 and 8)	941	1,731
Regulatory liabilities:		
Accrued postretirement and pension benefits (note 7)	14,599	10,121
Deferred grant revenue (note 8)	191,468	137,789
Total liabilities	247,211	192,609
Fund equity (note 9)		
Investment in capital assets, net of related debt and deferred grant revenue (note 4)	110,003	108,300
Restricted for reinvestment in infrastructure (note 2(a))	9,424	5,470
Total fund equity	119,427	113,770
Commitments and contingencies (notes 7, 10, 12, 13 and 14)	$ 366,638	306,379

See accompanying notes to basic financial statements.

STATEMENTS OF REVENUES, EXPENSES, AND CHANGES IN FUND EQUITY

Years ended December 31, 2002 and 2001

(In thousands)

	2002	2001
Operating revenues:		
Freight (note 10)	$ 76,021	79,868
Passenger	13,980	13,389
Other	544	239
	90,545	93,496
Grant revenue (note 8)	3,906	2,687
	94,451	96,183
Operating expenses (note 8):		
Transportation	45,616	46,320
Maintenance	24,796	24,574
Mechanical	13,019	13,433
General and administrative, net of indirect cost recovery of $2,362 in 2002 and $462 in 2001	8,913	11,819
	92,344	96,146
Operating income	2,107	37
Nonoperating revenues (expenses):		
Real estate income, less direct expenses of $3,477 in 2002 and $3,421 in 2001 (note 11)	7,830	7,150
Investment income (loss)	(28)	555
Interest expense	(1,000)	(1,129)
Total nonoperating revenues	6,802	6,576
Net income (note 2 (a))	8,909	6,613
Other change in fund equity - additional minimum pension liability (note 7)	(3,252)	–
Change in fund equity	5,657	6,613
Fund equity, beginning of year	113,770	107,157
Fund equity, end of year	$ 119,427	113,770

See accompanying notes to basic financial statements.

ALASKA RAILROAD CORPORATION STATEMENTS OF CASH FLOWS

Years ended December 31, 2002 and 2001
(In thousands)

	2002	2001
Cash flows from operating activities:		
Receipts from customers	$ 90,109	93,510
Operating grants received	959	4
Payments to suppliers	(40,844)	(43,700)
Payments to employees	(41,821)	(41,508)
Net cash provided by operating activities	8,403	8,306
Cash flows from capital and related financing activities:		
Principal payments on long-term debt	(2,261)	(2,209)
Interest payments on long-term debt	(1,000)	(1,129)
Proceeds from long-term debt	–	1,000
Purchases of capital assets	(66,356)	(69,345)
Proceeds from sales of capital assets	612	74
Increase in deferred revenues, net of advances	57,305	51,276
Net cash used in capital and related financing activities	(11,700)	(20,333)
Cash flows from investing activities:		
Real estate income received, net of direct expenses	9,380	8,926
Proceeds from sale of investments	247	818
Interest received on investments	274	555
Purchase of restricted investments	–	(10,093)
Proceeds from sale of restricted investments	4,755	11,433
Net cash provided by investing activities	14,656	11,639
Net increase (decrease) in cash and cash equivalents	11,359	(388)
Cash and cash equivalents at beginning of year	7,279	7,667
Cash and cash equivalents at end of year	$ 18,638	7,279
Reconciliation of operating income to net cash provided by operating activities:		
Operating income	2,107	37
Adjustments to reconcile operating income to net cash provided by operating activities:		
Deprecation and amortization	12,293	11,313
Grant revenue on capital assets	(2,947)	(2,703)
(Gain) loss on disposal of capital assets	(436)	14
Changes in assets and liabilities:		
Decrease in operating advance grant funding	–	20
Increase in materials and supplies	(286)	(466)
(Increase) decrease in prepaid expenses and other assets	(1,276)	21
Decrease in accounts payable and accrued liabilities	(1,113)	(1,850)
Increase (decrease) in payroll liabilities	(403)	2,149
Decrease in environmental reserve	(762)	(1,317)
Increase in accrued postretirement and pension benefits	1,226	1,088
Total adjustments	6,296	8,269
Net cash provided by operating activities	$ 8,403	8,306
Supplemental disclosure of noncash activity:		
Leasehold improvements provided through rent credits	$ 120	765
Additional minimum pension liability recognized	$ 3,252	–

See accompanying notes to basic financial statements.

(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 525 route 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). Effective January 1, 2001, the ARRC adopted three new accounting statements issued by the GASB:

- Statement No. 34, Basic Financial Statements and Management Discussion and Analysis for State and Local Governments;
- Statement No. 37, Basic Financial Statements and Management Discussion and Analysis for State and Local Governments: Omnibus; and
- Statement No. 38, Certain Financial Statement Disclosures

Adoption of these statements resulted in modifications in the financial reporting model used by the ARRC. Modifications include presentation of management's discussion and analysis (as required supplementary information), cash flow statement using the direct method, reclassification of fund equity according to certain criteria, and addition and revision of certain note disclosures. The adoption of these statements increased fund equity at January 1, 2001 by $24,000.

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 has implemented the provisions of FASB Statement No. 71, Accounting for the Effects of Certain Types of Regulation.

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. This statement replaces the previously reported statement of income. 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 operating property and equipment.

(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 is computed on the straight-line basis over the estimated useful lives of the related assets, ranging from 3 to 32 years.

(e) Restricted Assets and Investments

The ARRC's marketable equity and debt securities are reported at fair value on the balance sheet. Unrealized gains and losses are reported as a component of investment income. Fair values are based on quoted market prices.

(f) Regulatory 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 capital assets funded with federal grants, and amortizes the deferred amounts over the life of the related capital assets. Additionally, costs relating to pension and postretirement benefits are calculated in accordance with FASB Statements No. 87, Employers' Accounting for Pensions, and No. 106, Employers' Accounting for Postretirement Benefits Other Than Pensions. Accordingly, the ARRC has recorded regulatory liabilities in the aggregate amount of $206,067,000 and $147,910,000 at December 31, 2002 and 2001, respectively. Regulatory liabilities at December 31, 2002 include $3,252,000 of additional minimum pension liability included as an other change in fund equity during the year ended December 31, 2002.

(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 is not considered a part of the ARRC's primary operations and are reported as nonoperating activities.

(h) Grants

Grants are recognized as earned when all eligibility requirements have been met; however, recognition of revenue for grants expended for 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 associated with environmental remediation obligations when such losses are probable and reasonably estimable. Costs of future expenditures for environmental remediation liabilities are not discounted to their present value.

(k) Fair Value of Financial Instruments

Fair values of financial instruments, as defined under SFAS No. 107, Disclosures About Fair Value of Financial Instruments, are estimated by the ARRC's management. Fair values of restricted assets and investments are based on quoted market prices. Fair values for accounts receivable are estimated using cash flows in comparison to assets with similar estimated average lives but bearing current market interest rates. Fair values of long-term debt are based on the discounted value of contractual cash flows and interest rates being offered for similar debt. ARRC has determined the fair values of financial instruments do not differ significantly from their carrying amounts with the exception of debt, which is estimated to have a fair value of $19,849,000 at December 31, 2002.

(l) Reclassifications

Certain reclassifications not affecting net income have been made to the 2001 financial statements to conform with current presentation.

(3) Deposits and Investments

At December 31, 2002, the ARRC's carrying amount of cash and cash equivalents was $18,638,000 and the bank balance was $20,018,000. Of the bank balance, $162,000 was covered by federal depository insurance; $3,832,000 was collateralized with securities held by the pledging financial institution's trust department or agent, but not in the ARRC's name; $638,000 was uncollateralized; and $15,386,000 represents money market funds held by the ARRC's agent in the ARRC's name.

All restricted assets and investments are insured or registered, or held by the ARRC's agent in the ARRC's name. The ARRC's investment policy allows for investments 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.

(a) Restricted Assets

The market value of restricted assets consists of the following at December 31, 2002 and 2001 (in thousands):

Description of Security	2002	2001
Money market accounts	$ 9,866	4,296
U.S. Agency notes (maturing in 1-5 years)	–	5,235
Corporate notes (maturing in 1-5 years)	–	5,090
Equity mutual funds	647	831
Total	$ 10,513	15,452

These investments are restricted by the terms of grant or other agreements or by the ARRC's board of directors and are summarized as follows at December 31, 2002 and 2001 (in thousands):

Description of Restrictions	2002	2001
Capital assets as authorized by the State of Alaska	$ 686	1,495
Capital assets as authorized by the Department of Natural Resources	262	259
Advance grant funding, Taxpayer Relief Act	7,697	10,616
Advance grant funding, other federal grants	1,221	2,251
Postretirement benefits	647	831
Total	$ 10,513	15,452

The ARRC received $9,000,000 from the State of Alaska in 1990 for the purchase of locomotives and coal hopper cars for the Wishbone Hill Coal project. An agreement reached in 2000 reduced the amount to $5,489,000 authorized for the purchase of equipment. Interest earned on these funds is remitted to the State of Alaska. The unspent balance and interest thereon is reported as restricted assets and State of Alaska advances.

The ARRC also received funding in 1990 from the State of Alaska Department of Natural Resources. These funds are being managed by the ARRC in anticipation of future capital projects. If no capital projects are undertaken, the funds, including accrued interest, will be returned to the Department of Natural Resources. The unspent balance and interest thereon is reported as restricted assets and State of Alaska advances.

As part of the 1997 Taxpayer Relief Act passed by the U.S. Congress, states without Amtrak service are due a benefit in lieu of the tax benefits received through Amtrak subsidies over the years. The ARRC received Alaska's $23,230,000 share of this benefit. The amount received, along with investment income earned thereon, is required to be spent on passenger service improvements. The unspent portion of the amount received and related investment income is reported as advance grant funding (note 8).

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

The ARRC's board of directors has restricted investments in anticipation of funding future postretirement benefits (note 7).

(b) Investments

The market value of investments consists of the following at December 31, 2002 and 2001 (in thousands):

Description of Security	2002	2001
U.S. Agency notes (maturing in 1-5 years)	$ 652	652
Corporate notes (maturing in 1-5 years)	–	365
Total	$ 652	1,017

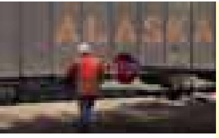
(4) Capital Assets

During 2002 the ARRC received approval of their indirect cost rate agreement from their federal cognizant agency. This agreement allows ARRC to allocate certain general and administrative expenses to grant projects. Indirect costs allocated to capital projects under this agreement totaled $2,362,000 during the year ended December 31, 2002.

The following summarizes activity in the capital assets accounts during the years ended December 31, 2002 and 2001 (in thousands):

	Balance at Dec. 31, 2001	Additions	Reclassifications	Reductions	Balance at Dec. 31 2002
Capital assets not being depreciated:					
Land	$ 17,644	–	–	–	17,644
Road materials and supplies	5,772	–	(2,281)	–	3,491
Construction in progress	100,539	66,356	(12,322)	–	154,573
Total capital assets not being depreciated	123,955	66,356	(14,603)	–	175,708
Capital assets being depreciated					
Road and roadway structures	122,432	–	11,587	(19)	134,000
Equipment	107,666	–	3,016	(632)	110,050
Leasehold improvements	1,728	120	–	–	1,848
Total capital assets being depreciated	231,826	120	14,603	(651)	245,898
Less accumulated depreciation for:					
Roadway and roadway structures	47,346	6,266	–	(5)	53,607
Equipment	41,452	6,785	–	(470)	47,767
Leasehold improvements	52	128	–	–	180
Total accumulated depreciation	88,850	13,179	–	(475)	101,554
Capital assets being depreciated, net	142,976	(13,059)	14,603	(176)	144,344
Net capital assets	$ 266,931	53,297	–	(176)	320,052

	Balance at Dec. 31, 2000	Additions	Reclassifications	Reductions	Balance at Dec. 31 2001
Capital assets not being depreciated:					
Land	$ 17,644	–	–	–	17,644
Road materials and supplies	4,486	1,286	–	–	5,772
Construction in progress	56,269	68,059	(23,789)	–	100,539
Total capital assets not being depreciated	78,399	69,345	(23,789)	–	123,955
Capital assets being depreciated					
Road and roadway structures	113,837	–	8,677	(82)	122,432
Equipment	92,726	–	15,112	(172)	107,666
Leasehold improvements	963	765	–	–	1,728
Total capital assets being depreciated	207,526	765	23,789	(254)	231,826
Less accumulated depreciation for:					
Roadway and roadway structures	41,153	6,214	–	(21)	47,346
Equipment	35,812	5,785	–	(145)	41,452
Leasehold improvements	–	52	–	–	52
Total accumulated depreciation	76,965	12,051	–	(166)	88,850
Capital assets being depreciated, net	130,561	(11,286)	23,789	(88)	142,976
Net capital assets	$ 208,960	58,059	–	(88)	266,931



Depreciation expense was charged to the following departments during the years ending December 31 (in thousands):

		2002	2001
Transportation	$	2,151	1,811
Maintenance		6,664	6,214
Mechanical		2,986	2,852
General and administration		492	436
Real estate		886	738
Total	$	13,179	12,051

Fund equity invested in capital assets, net of related debt and deferred grant revenue, is as follows at December 31, 2002 and 2001 (in thousands):

		2002	2001
Net capital assets	$	320,052	266,931
Long-term debt		(18,581)	(20,842)
Deferred grant revenue		(191,468)	(137,789)
Total	$	110,003	108,300

(5) Long-term Liabilities

Long-term liability activity is summarized as follows during the years ended December 31, 2002 and 2001 (in thousands):

		Balance at Dec. 31, 2001	Additions	Reductions	Balance at Dec. 31, 2002	Due Within One Year
Long-term debt	$	20,842	–	(2,261)	18,581	2,115
Environmental remediation reserve		2,104	–	(790)	1,314	735
Advance grant funding		3,313	58,780	(57,311)	4,782	–
State of Alaska advances		1,731	–	(790)	941	–
Regulatory liabilities:						
Accrued postretirement and pension benefits		10,121	6,241	(1,763)	14,599	–
Deferred grant revenue		137,789	56,626	(2,947)	191,468	–
Total long-term liabilities	$	175,900	121,647	(65,862)	231,685	2,850

		Balance at Dec. 31, 2000	Additions	Reductions	Balance at Dec. 31, 2001	Due Within One Year
Long-term debt	$	22,051	1,000	(2,209)	20,842	2,242
Environmental remediation reserve		5,067	–	(2,963)	2,104	763
Advance grant funding		3,976	51,655	(52,318)	3,313	–
State of Alaska advances		2,136	–	(405)	1,731	–
Regulatory liabilities:						
Accrued postretirement and pension benefits		9,033	1,287	(199)	10,121	–
Deferred grant revenue		88,128	52,344	(2,683)	137,789	–
Total long-term liabilities	$	130,391	106,286	(60,777)	175,900	3,005

(6) Long-Term Debt

Long-term debt at December 31, 2002 and 2001 consists of the following (in thousands):

	2002	2001
Note payable, secured by equipment, due in monthly payments of $162,945, including interest at 5.19%, matures September 2014	$ 17,088	18,123
Note payable, secured by equipment, due in monthly payments of $74,173, including interest at 4.28%, matures September 2003	656	1,498
Note payable, secured by equipment, due in monthly payments of $16,225, including interest at 4.28%, matures October 2003	159	343
Note payable, secured by vehicles and equipment, due in monthly payments of $18,415, including variable interest at 56% of prime rate, adjusted monthly, matures April 2006	678	878
	18,581	20,842
Less current portion	2,115	2,242
	$ 16,466	18,600

ARRC has met all debt covenants at December 31, 2002.

Annual payments on debt are scheduled as follows at December 31, 2002 (in thousands):

	Principal	Interest
Year ending December 31:		
2003	$ 2,115	891
2004	1,364	812
2005	1,431	745
2006	1,324	677
2007	1,346	609
2008-2012	7,885	1,891
2013 and beyond	3,116	143
	$ 18,581	5,768

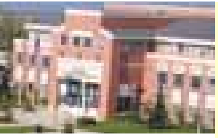
The ARRC has arrangements for three short-term unsecured lines of credit. The general purpose line of credit allows borrowing up to $10,000,000 at a rate of 56% of the prime rate of a major bank. The self-insurance line of credit allows borrowing up to $10,000,000 at a rate of 56% of the prime rate of a major bank. The nonrevolving equipment line of credit allows borrowing up to $5,000,000, limited to $1,000,000 annually, at a rate of 56% of the prime rate of a major bank. None of the lines of credit had an outstanding balance as of December 31, 2002 or 2001.

(7) Employee Benefits

Accrued benefits under employee benefit plans are calculated under the provisions of SFAS No. 87, Employers' Accounting for Pensions, and SFAS No. 106, Employers' Accounting for Postretirement Benefits Other Than Pensions and are reported as regulatory liabilities in the balance sheets. Periodic benefit costs related to these plans are included in operating expenses. The additional minimum pension liability of $3,252,000 at December 31, 2002 is reported as an other change in fund equity and as a regulatory liability.

(a) Defined Benefit Plan

The ARRC has a defined benefit pension plan (Plan) covering all regular represented and nonrepresented 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 net periodic pension cost. In 2001, the ARRC contributed an amount for the periodic pension cost which was net of a prepaid pension amount. Employees contribute an amount equal to 9% of compensation. Contributions are made continuously throughout the year. Plan assets are comprised of fixed income securities and common stocks.

The following table sets forth the Plan's funded status at December 31 (in thousands):

	2002	2001
Change in benefit obligation:		
Benefit obligation at beginning of year	$ 32,993	28,558
Service cost	1,042	722
Interest cost	2,430	2,054
Participant contributions	2,480	2,175
Actuarial (gain) loss	(776)	418
Benefits paid	(628)	(934)
Benefit obligation at end of year	37,541	32,993
Change in plan assets:		
Fair value of plan assets at beginning of year	33,236	33,924
Actual return on plan asset	(4,279)	(1,929)
Employer contributions	1,427	–
Participant contributions	2,480	2,175
Benefits paid	(628)	(934)
Fair value of plan assets at end of year	32,236	33,236
Funded status	(5,305)	243
Unrecognized net actuarial (gain) loss	4,536	(1,687)
Unrecognized prior service cost	769	808
Other change in fund equity:		
Adjustment to recognize minimum liability	(3,252)	–
Accrued benefit cost	$ (3,252)	(636)

The following table sets forth the Plan's weighted average assumptions used in determining the actuarial present value of the projected benefit obligation at December 31 (in thousands):

	2002	2001
Discount rate	6.75%	7.25%
Expected return on plan assets	8.00%	8.00%
Rate of compensation increase	4.00%	4.00%

Components of net pension costs are as follows (in thousands):

	2002	2001
Service cost	$ 1,042	722
Interest cost	2,430	2,054
Expected return on plan assets	(2,756)	(2,758)
Amortization of prior service costs	75	73
Amortization of unrecognized transition obligation	–	61
Recognized net actuarial gain	–	(300)
Net periodic benefit cost	$ 791	(148)

(b) Postretirement Benefits Other Than Pension

The ARRC sponsors a defined benefit health care plan (Plan) that provides postretirement medical benefits to employees receiving retirement under the corporate retirement plan and retired CSRS employees who do not qualify for the federal medical insurance. The Plan is contributory, with retiree contributions adjusted annually, and contains other cost-sharing features such as deductibles and coinsurance. The accounting for the Plan anticipates future cost-sharing changes to the written plan that are consistent with ARRC's expressed intent to increase the retiree contribution rate by the amount of that year's premium increase. ARRC's policy is to fund the cost of medical benefits in amounts determined at the discretion of management. At December 31, 2002 and 2001, the ARRC has designated assets with a market value of $647,000 and $831,000, respectively, for the funding of these benefits (note 3).

The ARRC accounts for postretirement health care by accruing these benefits over the period in which active employees become eligible for such postretirement benefits. The following table sets forth the Plan's funded status at December 31 (in thousands):

		2002	2001
Change in benefit obligation			
Benefit obligation at beginning of year	$	9,136	7,055
Service cost		1,392	912
Interest cost		795	550
Actuarial loss		3,341	819
Benefits paid		(365)	(200)
Benefit obligation at end of year		14,299	9,136
Funded status		(14,299)	(9,136)
Unamortized prior service costs		(191)	(218)
Unrecognized net actuarial (gain) loss		3,143	(131)
Accrued benefit cost	$	(11,347)	(9,485)

The components of net periodic cost for these postretirement benefits are as follows (in thousands):

		2002	2001
Service costs	$	1,392	912
Interest costs		795	550
Recognized prior service costs		(27)	(27)
Recognized net actuarial gains		38	–
Net periodic benefit cost	$	2,198	1,435

For measuring the 2002 expected postretirement benefit obligation, an 11% annual rate of increase in the per capita claims cost was utilized. This rate was assumed to decrease by 1.1% per year over a four-year period to an ultimate rate of 5.50% in 2007.

For measuring the 2001 expected postretirement benefit obligation, a 9.25% annual rate of increase in the per capita claims cost was utilized. This rate was assumed to decrease over a three-year period to an ultimate rate of 5.50% in 2004.

Assumed health care cost trend rates have a significant effect on the amounts reported for the health care plans. A one-percentage-point change in assumed health care cost trend rates would have the following effects (in thousands):

	2002		2001	
	One percentage point increase	One percentage point decrease	One percentage point increase	One percentage point decrease
Effect on total service and interest cost component	$ 689	(510)	411	(308)
Effect on postretirement benefit obligation	$ 3,718	(2,806)	2,227	(1,698)

(c) Civil Service Retirement System

Federal employees who transferred to the ARRC continue to participate in the Civil Service Retirement System (CSRS), a multi-employer defined benefit plan. ARRC is required to contribute 8.5% of the transferred employees' base pay. Benefits expense related to CSRS was $615,000 and $729,000 for the years ended December 31, 2002 and 2001, respectively.

(d) Defined Contribution Plan

The ARRC sponsors a defined contribution plan (Plan) for employees. All employees are eligible to contribute to the Plan. Under the terms of certain collective bargaining agreements, representing 67% of employees, the ARRC will match a portion of employee contributions. The maximum amount of matching required under the agreement is 50% of employee contributions for the first 5% of salary. Benefits expense related to the Plan was $92,000 and $0 for the years ended December 31, 2002 and 2001, respectively.

(8) Grants

The ARRC has spent grant funding on a variety of operating property and equipment. Grant revenue will be recognized equal to depreciation on these assets each year. The original cost of assets constructed with grant funding as of December 31 consists of the following (in thousands):

		2002	2001
Road and roadway structures	15-32 year life	$ 30,815	30,261
Equipment	5-25 year life	22,451	21,936
Construction in progress		148,062	92,144
		$ 201,328	144,341

Deferred grant revenue consists of grant funding received in advance (receivable from grantor). Deferred items relating to grants consist of the net book value of assets constructed with grant funding. Deferred grant balances as of December 31 consist of the following (in thousands):

	2002		2001	
	Advance grant funding	Deferred grant revenue	Advance grant funding	Deferred grant revenue
Federal Railroad Administation:				
Net book value of assets constructed	$ –	23,591	–	25,062
Construction in process	–	106,899	–	70,610
Grant funding received in advance	536	–	–	–
Amount receivable from grantor	–	–	(5,300)	–
Taxpayer Relief Act:				
Net book value of assets purchased and constructed		6,422	–	6,830
Construction in process	–	11,592	–	8,368
Grant funding received in advance	4,303	–	7,496	–
Investment earnings on funding	2,991	–	2,729	–
Federal Transit Administation:				
Net book value of assets purchased and constructed	–	8,125	–	8,412
Construction in process	–	26,693	–	10,627
Amount receivable from grantor	(2,515)	–	(1,691)	–
Federal Emergency Management Agency:				
Net book value of assets constructed	–	214	–	222
Grant funding received in advance	–	–	31	–
Amount receivable from grantor	(471)	–	–	–
Department of Interior:				
Grant funding received in advance	1,204	–	1,569	–
Accrued derailment expense (note 14)	(1,204)	–	(1,569)	–
Department of Agriculture:				
Construction in process	–	1,676	–	1,492
Grant funding received in advance	–	–	504	–
State of Alaska Wishbone Hill Coal Project:				
Net book value of assets purchased	–	4,861	–	5,119
Construction in process	–	1,202	–	853
Amount receivable from grantor	(62)	–	(456)	–
Municipality of Anchorage Ship Creek Economic Development:				
Net book value of assets constructed	–	193	–	–
Construction in process	–	–	–	194
	$ 4,782	191,468	3,313	137,789

The ARRC recognized the following grant revenue during the years ended December 31 (in thousands):

	2002	2001
Federal Railroad Administration:		
Depreciation on assets constructed	$ 1,471	1,471
Taxpayer Relief Act:		
Depreciation on assets purchased and constructed	408	364
Grant funded project planning expense	–	4
Federal Transit Administration:		
Depreciation on assets purchased and constructed	802	603
Grant funded maintenance expense	457	–
Federal Emergency Management Agency:		
Depreciation on assets constructed	8	8
Grant funded disaster recovery expense	502	–
Department of Interior:		
Grant reduction	–	(20)
Grant funding of accrued derailment expense (note 14)	545	(724)
Derailment expense paid in current year	(545)	724
Municipality of Anchorage Ship Creek Economic Development:		
Depreciation on assets constructed	1	–
State of Alaska Wishbone Hill Coal Project:		
Depreciation on assets purchased	257	257
	$ 3,906	2,687

(9) Fund Equity

Fund equity consists of the following major items as of December 31 (in thousands):

	Investment by the state of Alaska	Cumulative net income	Cumulative other changes in fund equity	Total fund equity
Balance at December 31, 2000	$ 34,174	72,983	–	107,157
Net income	–	6,613	–	6,613
Balance at December 31, 2001	34,174	79,596	–	113,770
Net income	–	8,909	–	8,909
Other changes in fund equity	–	–	(3,252)	(3,252)
Total changes in fund equity				5,657
Balance at December 31, 2002	$ 34,174	88,505	(3,252)	119,427

(10) Major Customer

One ARRC customer accounted for 46% and 48% of freight revenue in 2002 and 2001 respectively.

(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 $8,948,000 and $8,553,000 in 2002 and 2001, respectively. The following table summarizes future minimum lease payments as of December 31, 2002 (in thousands):

	Amount
Year ending December 31:	
2003	$ 7,574
2004	7,177
2005	6,950
2006	6,866
2007	6,501
Thereafter	119,951
	$ 155,019

The ARRC has $1,669,000 in rent credits outstanding on these leases at December 31, 2002. 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 its headquarters, certain operating equipment, and barge services under operating leases and agreements. Payments under the leases and agreements totaled $11,800,000 and $12,629,000 in 2002 and 2001, respectively. Future minimum lease payments as of December 31, 2002 are summarized as follows (in thousands):

	Amount
Year ending December 31:	
2003	$ 11,841
2004	10,760
2005	10,502
2006	10,357
2007	10,316
2008-2012	32,937
	$ 86,713
Amounts to be received under noncancelable sub-leases	(2,574)
	$ 84,139

(13) Insurance

The ARRC is self-insured to certain limits for employee health benefits, personal injury, property and casualty damage claims and establishes reserves for the estimated losses of such claims. The ARRC is also self-insured against worker's compensation claims. The ARRC carries commercial insurance policies limiting ARRC's exposure for health benefits to $5.3 million, for casualty/liability to $5 million and for property to $10 million at December 31, 2002. Self-insurance activity is summarized as follows during the years ended December 31, 2002 and 2001 (in thousands).

	Balance at Dec. 31, 2001	Incurred Claims	Claim Payments	Balance at Dec. 31, 2002
Employee health benefits	$ 1,219	4,541	(4,438)	1,322
Casualty and liability	340	1,117	(68)	1,389
Worker's compensation	1,143	936	(1,297)	782
	$ 2,702	6,594	(5,803)	3,493

		Balance at Dec. 31, 2000	Incurred Claims	Claim Payments	Balance at Dec. 31, 2001
Employee health benefits	$	878	4,123	(3,782)	1,219
Casualty and liability		497	5	(162)	340
Worker's compensation		419	1,694	(970)	1,143
	$	1,794	5,822	(4,914)	2,702

(14) Commitments and Contingencies

During 2002, the EPA completed a Resource Conservation and Recovery Act Facility Assessment (RFA) regarding ARRC's Anchorage rail yard and contiguous properties ARRC owns and leases to third parties. In February 2003, EPA notified ARRC that a number of solid waste management units within the RFA area require further investigation [called a RCRA Facility Investigation (RFI) and Corrective Measures Study (CMS)] to determine if any contaminants from the units pose a risk to human health or the environment. Management has accrued an estimate of costs to perform the RFI/CMS. The ARRC believes most, if not all, contamination in this area would have occurred prior to the transfer of the ARRC from the federal government to the State of Alaska or as a result of actions by third party tenants. The liability for contamination that occurred prior to the transfer will be ultimately imposed on the federal government under the Alaska Railroad Transfer Act and a 1990 agreement between the federal government and the ARRC. The ARRC will attempt to bring all potentially liable parties into the current action and, failing that, would seek restitution from the United States and from third party tenants for any contamination resulting from their actions. Although the eventual disposition of this claim and ultimate collectibility of any restitution cannot be predicted with certainty, 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 could potentially have a significant impact on the change in fund equity in a given year.

During 1999, two derailments resulted in fuel spills along the ARRC tracks at Canyon and at Gold Creek. The ARRC is responsible for the remediation, restoration and monitoring of environmental contamination at these sites. The ARRC has accrued its best estimate of its remaining obligation with respect to the sites, which was $1,314,000 and $2,104,000 at December 31, 2002 and 2001, respectively. The amount expected to be paid within the next year, $735,000 and $763,000 at December 31, 2002 and 2001, respectively, is included in accounts payable and accrued liabilities. The remaining amount is expected to be incurred through 2008 and is reported as environmental remediation reserve. ARRC received grants to cover the costs associated with the Gold Creek derailment and the 1999/2000 winter storm disaster. The grants are expected to cover $1,024,000 of the ARRC's remaining obligation. The aggregate undiscounted amount has been recorded since it represents management's best estimate of the cost, but the payments are not considered to be fixed and reliably determinable. The estimate of costs and their timing of payment could change as a result of changes to the remediation plan, changes in technology available to treat the site and unforeseen circumstances existing at the site. It is not possible to estimate the amount losses may exceed amounts accrued at this time as a result of these factors.

Approximately 76% of the ARRC's labor force is subject to one of five collective bargaining agreements. One of the agreements, representing 2% of the labor force, expired in 2002 and is being renegotiated. Another of the agreements, representing 10% of the labor force, expires in 2003.

The ARRC has certain other contingent liabilities resulting from lawsuits, environmental issues, 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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(L to R back row)

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Ed Bauer	Professional Railway Consultant

(L to R front row)

Johne Binkley, Chairman	Chairman and CEO, Alaska Riverways, Inc.
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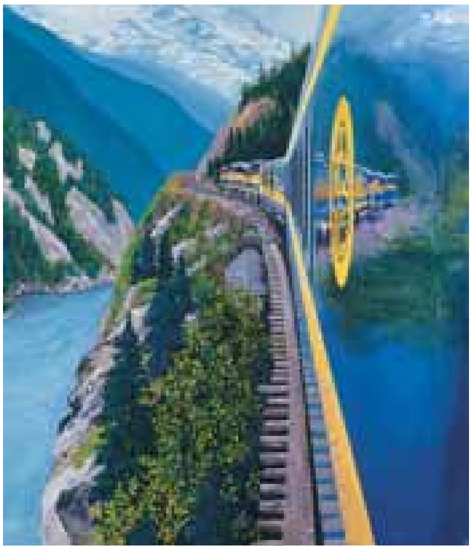

Sue Dranchak, a Fairbanks Mechanical Laborer, became the first railroad employee ever selected to produce the railroad's annual print (left).

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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 2002, nor is the Corporation aware of any potential sales that require analysis under AS 42.40.260

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