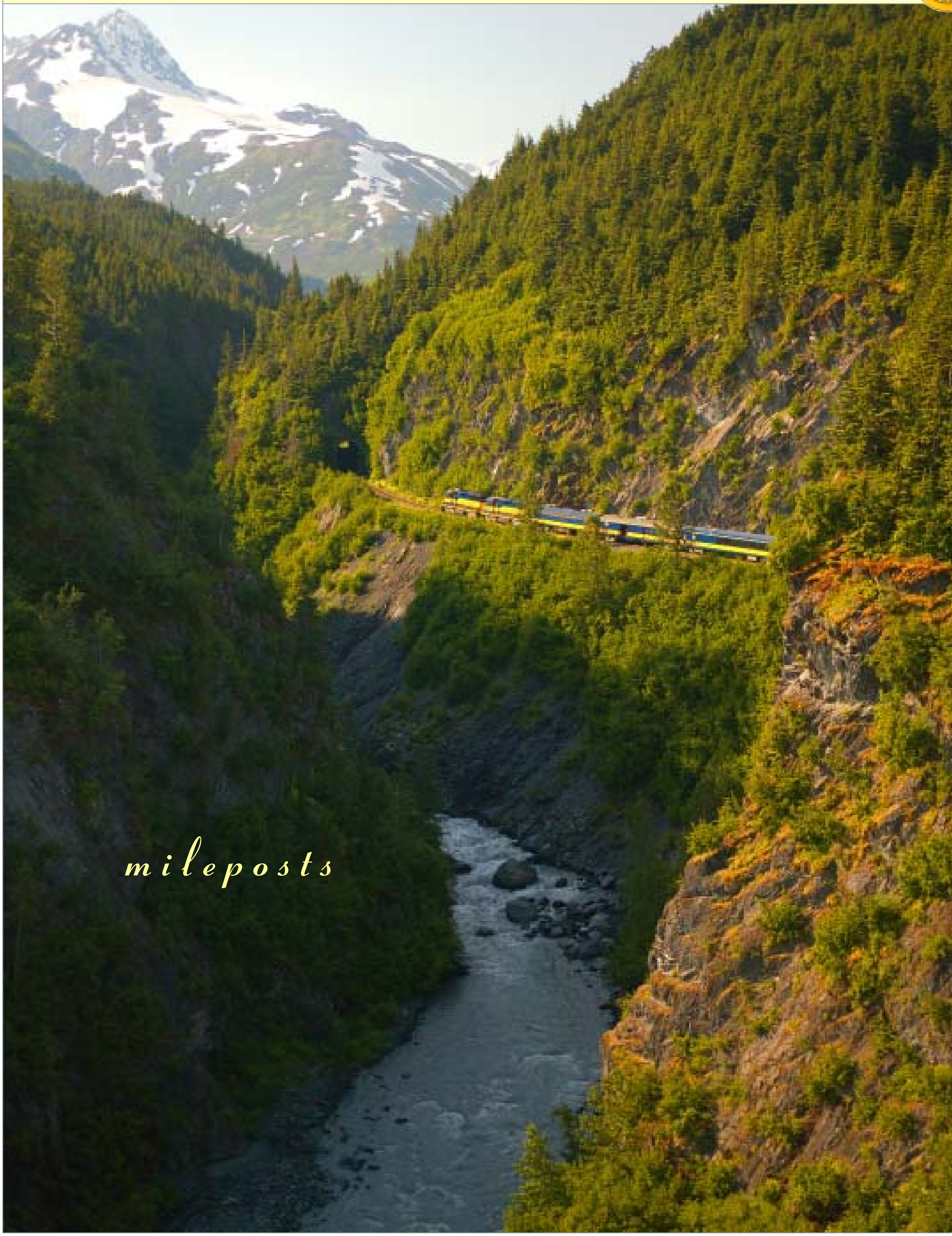
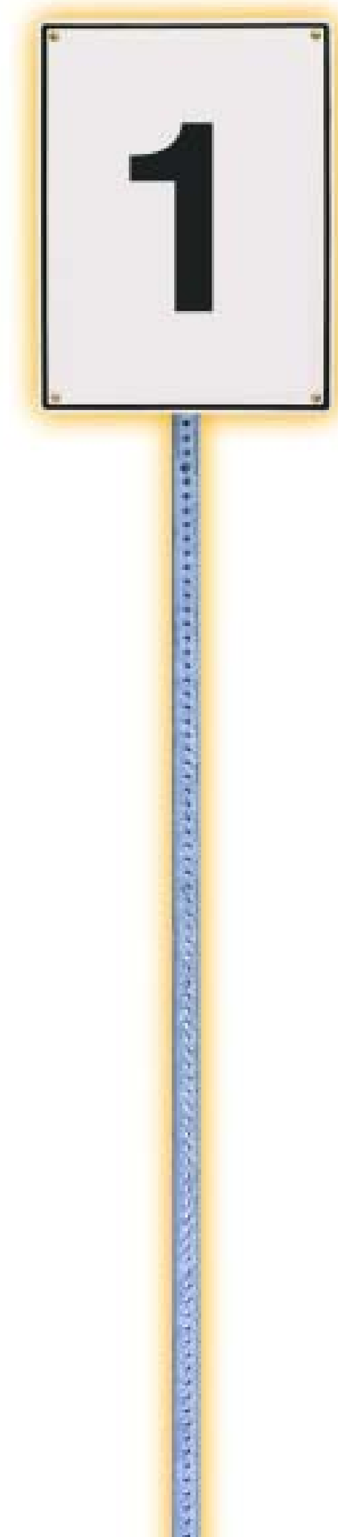
Alaska Railroad Annual Report 2003



mission



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 John E. Binkley, Chairman of the Board

Our theme for the Alaska Railroad's 2003 annual report is "Reaching new mileposts." In railroad terminology, "milepost" refers to a measure of distance. But in a broader sense, it also speaks to reaching a destination, achieving a goal, and making progress.

It is my pleasure to report that the Alaska Railroad has made this theme a reality. Our mission focuses on increasing safety, providing exceptional customer service, and improving profitability. We set challenging short-term goals for 2003 and long-term goals for the next five years. From safety and operations to technology and workforce development, Pat Gamble and his Alaska Railroad team surpassed the Board of Directors' expectations on every front. I am proud to share the results of what I consider the most successful year in Railroad history.

In 2003, the Alaska Railroad had one of its best years ever in terms of national safety standards. Our train incident rate fell below the national average, and fewer employees were injured on the job. We improved customer service through an enhanced Internet service, new passenger day trips, and flexibility in handling opportunities suggested by our customers. Our exceptional employee performance translated into the strongest bottom line we have ever had — well beyond our short and long-term objectives.

Our success did not happen in a vacuum. It began at the top with Governor Murkowski's vision for developing the resources of the State. Thanks to his efforts and those of the Legislature, we have the authority to sell tax-free bonds and participate in the financing of a Trans-Alaska Gas Pipeline. The relationship between the Administration, the Legislature, and the Alaska Railroad Board has never been more important to the future of the State than it is now.

In furthering this vision, we have been fortunate in having the outstanding leadership of two Commissioners on our Board: Mike Barton of the Department of Transportation and Public Facilities, and Edgar Blatchford of the Department of Community and Economic Development. Both Commissioners have contributed significantly to shaping the Governor's vision and making it a reality.

In 2003 we bid farewell to Board member Ed Bauer, a nationally recognized railroad expert who provided seven years of valuable service to the Alaska Railroad Corporation. Ed focused on safety and was instrumental in turning around our safety record. He also played a key role in modernizing our locomotive fleet. In turn, we welcomed back to the Alaska Railroad Board former Governor Bill Sheffield, whose long-term support and tireless work over so many years contributed to getting the Alaska Railroad to where it is today.

Critical to all of our efforts was Pat Gamble, President and CEO of the Alaska Railroad. Pat has done a phenomenal job, and he has literally changed the culture of the Railroad. Along with a tremendously talented and dedicated crew, he is poised to accomplish even greater goals in the future.

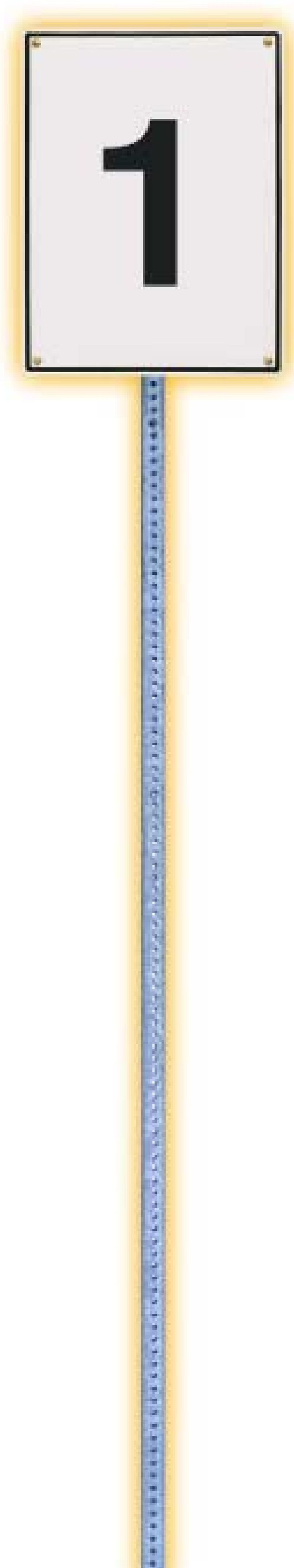
With appreciation for the support given to us by our friends and customers, the Alaska Railroad Board of Directors is pleased to present this 2003 annual report to the people of Alaska. Together we have passed many mileposts and made remarkable progress toward goals that will ensure continued success.

A message from Patrick K. Gamble, President & CEO

The winds of change are blowing over the Alaska Railroad, heralding a transformation that's every bit as dramatic as the changing of the seasons. Development is in the air. Prospects in Alaska are improving for a natural gas pipeline, a rail extension through Delta Junction to the border, commuter service, Anchorage's Port Expansion, the Ship Creek Intermodal/E-Street proposal...any one of which will likely place significant support demands on Alaska's railroad. Additionally, increased demand will compete head-on with our efforts to satisfy core customers' needs. Our challenge is to accommodate both. When calculating how to do that, one quickly senses that the correct solution lies in transitioning to a new operational phase — one that incorporates designs to mature the capacity and tempo of the Railroad.

While it is true that the Railroad has historically been integral to Alaska's development... instrumental in resource extraction, port development, passenger service, and community development...it is readily apparent that this time simply adhering to the traditional ways of the old days isn't good enough. To address the foreseeable future, we have had to integrate the very latest in locomotive technology, global positioning system applications, redundant railbelt data communications, and computer based simulation and training. Straightening out the original winding track has allowed us to accelerate from steam engine speed to commuter speed. Infrastructure upgrades and sophisticated geotechnical sensors placed in slide zones are contributing to a safer ride throughout our railbelt, year round. Soon, we will employ a real-time satellite tracking system to effect a true collision avoidance operating environment. Smart circuitry will automate the essential function of deconflicting approaching vehicles on a single track, even stopping a train automatically if necessary. We continue the quest to move more trains, faster.

In short, the strategic goal I articulated for the company 3 years ago — that the Alaska Railroad must be robust and well postured to meet a dynamic future — is working. Now approaching a half billion dollars in assets, the Alaska Railroad is safer and more productive than ever. The fact that our employees are very proud of their collective accomplishments on this journey towards increased excellence, goes without saying. This year, 2003, was an affirmation that the Alaska Railroad Board-Management-Employee team is focused, able, and increasingly ready to meet any challenge. We have our eyes on the next milepost and the signals say, "All clear ahead."



Tunnel. Indian. Hurricane.

There are more than 500 mileposts on the Alaska Railroad. To a passenger riding the rail, these landmarks are mere flashes of black and white; blurred steel scattered like birch branches from the emerald tidewater of Seward to the amber fields of Fairbanks.

It's different for a railroader.

Every milepost tells a story.
These are signs of progress.
Reminders of distance spanned.
Accomplishments logged.
Challenges ahead.

Gazing back down the road, the mileposts stand out like the echoes of a 4000-horse-power locomotive pulling hard through an alpine valley. Energy. True blue and gold. 2003 was a remarkable journey for the Alaska Railroad.

The best train ride in the world.

Mīle′pōst′, n.

One in a series of posts set up to indicate distance in miles from a given place.

Denotes reaching an identifiable stage in completion of something other than a physical journey.

Noteworthy accomplishment.

A pivotal event in history, life.

A turning point.

Bruce Gough, Seward to Anchorage Roadmaster

1 *"Our aim is for everyone to go home at night with everything they went to work with. There is a lot of pride and our numbers reflect it. People are proud to come to work."*

The goal of the Alaska Railroad Corporation (ARRC) is the same as it has always been—to operate a safe railroad. Sounds simple until you set over 8,000 tons of steel and freight in motion. Surprising what ingenuity, a committed team, modern equipment, and a little track straightening can do for a corporation's safety record.

Safe production

2003 turned out to be the safest year in the Alaska Railroad's history — with the lowest number and severity of injuries ever. The injury/severity reductions were primarily due to new mechanical lifting and maintenance equipment, and improved training.

This milepost was achieved during a time when Railroad employees worked nearly one-and-a-half million man-hours. There was a 54 percent reduction in days lost to injury over last year. In addition, the first phases of new safety technology were brought on-line.

ARRC met its goal to reduce train derailments by 20 percent. Train incidents measured well under the national average.

Quite impressive accomplishments when you consider the Alaska Railroad has about 725 year-round employees (nearly 900 in peak season) and runs 500 miles of mainline track from the Gulf of Alaska to Fairbanks, crosses two mountain ranges, and rolls through some of North America's most challenging conditions.

In 2003, the Railroad employees introduced Safe Zone, a program to heighten employee safety awareness.

FIVE-YEAR SAFETY OBJECTIVE: Reduce employee injuries to achieve an average of no more than 2.0 injuries per 200,000 man-hours.

tracks on Fort Richardson lose curves

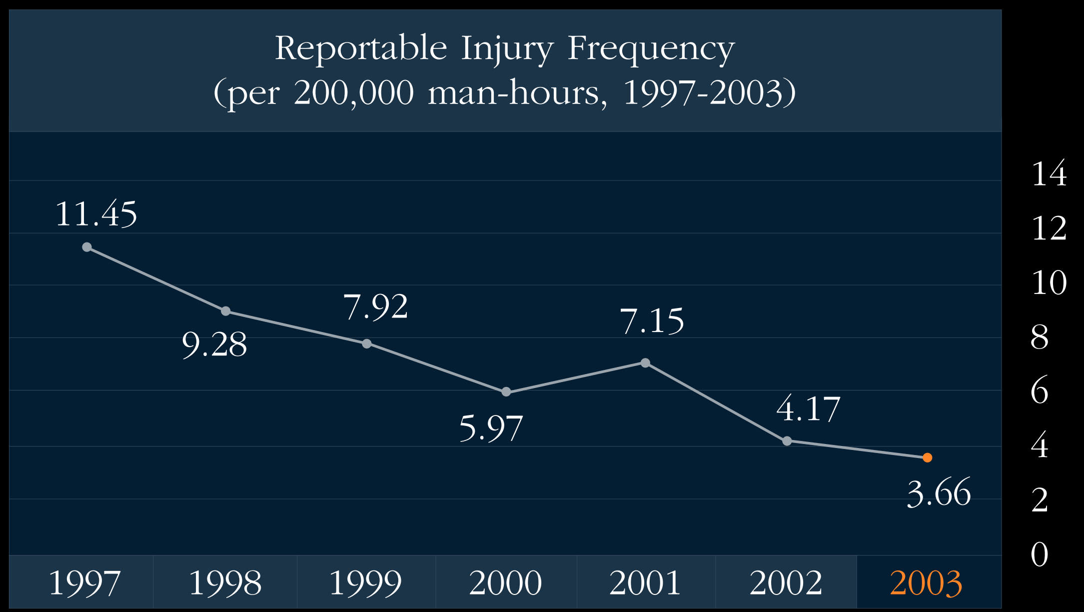
road assistant vice president of operating safety, told the Alaska Journal of Commerce.

Work began last summer and required moving about 1.2 million cubic yards of earth to level the rail bed. The railroad then laid the sections of track that did not interfere with the operational rail.

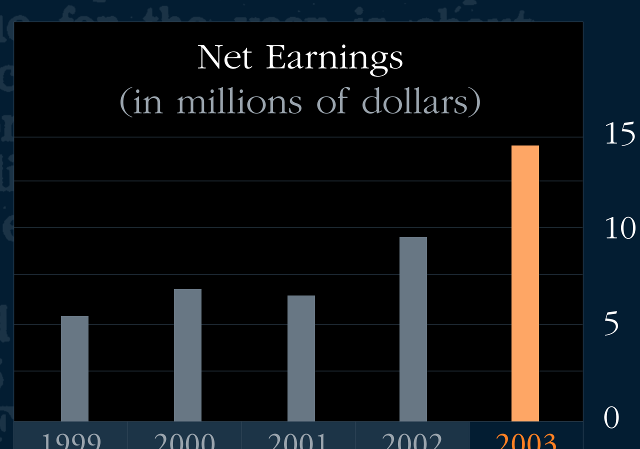
The straightening is part of an ongoing track rehabilitation project from Wasilla to Anchorage. Through the corridor, the railroad will implement a new method of rail construction whereby rail is welded rather than bolted together. Bolt holes have been a source of weakness. Pressure causes fractures in the joints and can lead to misalignment in the rail, derailing trains in extreme cases.

Curves are another problem. Weight leaning to the inside creates pressure on rail.

"The wear on the rail is tremendous," Piper said.



FIVE-YEAR FINANCIAL OBJECTIVE: Grow overall revenue two to four percent per year.



Note: 1999 and 2000 are presented net of derailment expenses and related federal disaster revenues.

2 2003 was the most prosperous year in the history of the Alaska Railroad. Revenues were up, the cost of train operations were down, and corporation assets grew by 20 percent. Not bad, seeing that the original economic forecast called for a marginal, if not below average, business year.

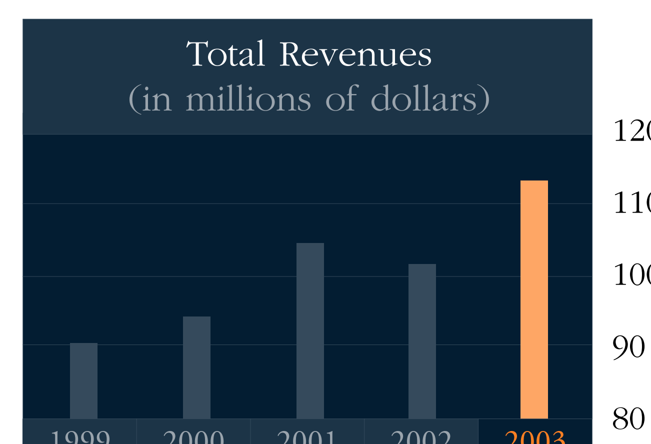
Financial mileposts

Improved efficiency, increased employee productivity, a surprisingly strong Alaska economy, and several unplanned business opportunities contributed to an excellent operating ratio — a measure of operating costs versus operating revenue. The Railroad well surpassed its budget estimate and earned a net income of $14.5 million, the result of its best performance ever.

An unexpected revenue opportunity arose from the Alaska State Department of Transportation (DOT) construction project at Bird Creek. Hauling 22,000 carloads of rock for this Turnagain Arm highway project, along with growth in petroleum, gravel, coal, and real estate revenue, combined to bolster the bottom line.

True to its priorities, ARRC remained committed to its number one asset — our employees. Railroad salaries, benefits, and retirement plans remained healthy and intact.

Not many Fortune 500 companies can say that.



Note: Does not include grant revenues.

Erik Forland, Conductor

3 The Alaska Railroad enjoyed seven percent growth in overall ridership over last year. This occurred while most of the tourism industry continued to struggle with the fallout of September 11 and an uncertain economy. The Passenger Services division worked hard at making the Railroad a preferred means of travel in Alaska — a destination for adventure.

Passenger Services

New sightseeing service to Grandview and Spencer Glacier proved to be popular travel choices in 2003, as well as our day trips to Seward, which recorded the largest jump in ridership — 17 percent. Shorter, less expensive packages continue to be a trend. This is a niche market that we address for travelers with time constraints. Our crews placed greater emphasis on giving the customer a top Alaskan experience. They accomplished this through intensified training, making the booking process more convenient through the Internet, delivering excursion variety, focusing on individual passenger comfort, and upgrading food service.

As a means to that end, ARRC plans to retire four diner cars and replace them with two new first-class double-decker passenger/ dining coaches due for delivery in 2005.

These passenger service mileposts led to *Onboard Services Magazine* naming the Alaska Railroad the best passenger railroad in 2003.

"We set high standards for taking care of customers, and met them. The fact that our standards are of international award-winning caliber is a great tribute to our railroaders."
— Pat Gamble, President and CEO

2003 PASSENGER SERVICES GOAL: Enhance customer service and place more emphasis on "the business" of the Railroad.

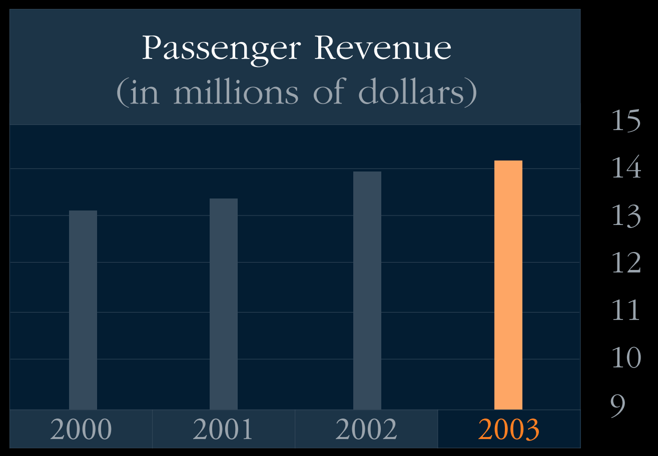
Alaska Railroad named best railroad

Onboard Services magazine, an international publication focusing on passenger services in the airline, cruise line, railroad, and duty-free markets, announced their annual awards Jan. 14 and the A... ...ilroad Corporation received honors in seven ca...ies, including overall best rail... ...y also received five first place ...equipment, entertainment, uni... ...services, and second place for ...s. The awards involve competition agai... ...rak, other ARRC industry partners, and a ...ber of tourist operations around the world... ...ss release said.

...wards acknowledge our shops, our crews, our safety programs as well as our tour guides and our food service contractor," said Steve Silverstein, ARRC vice-president of markets, sales and service.

The Alaska Railroad is the United States' la... full-service railroad. It provides passenger services to Seward, Whittier, Anchorage, Talkeetna, Denali National Park, and Fairbanks and also provides a unique flagstop service between Talkeetna and Hurricane.

For more information about the magazine Onboard Services, call Cathie Dakel or Ch... Mayer at 1-800-525-2015 or visit perf... plans@yahoo.com.



4 The Alaska Railroad was born to move freight across the Last Frontier. Gravel, coal, pipe, and petroleum make up the backbone of this business.

Freight Services

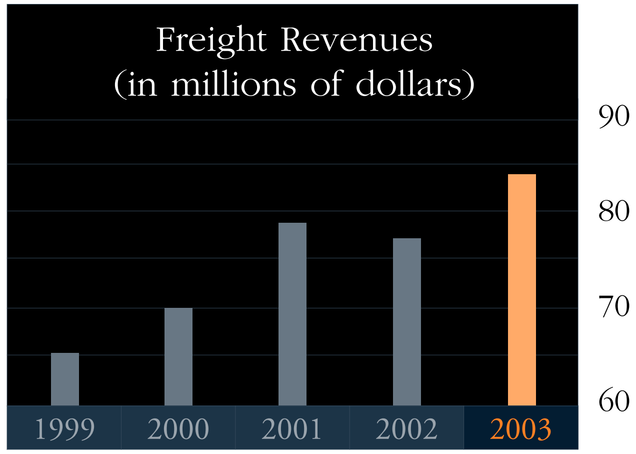
ARRC started out 2003 fully expecting slight decreases in the freight business. But freight came on strong. Operating expenses were decreased substantially, while the number of freight carloads increased by 26 percent.

Fuel transported from Williams Refinery, the Railroad's largest customer, exceeded budget estimates. ARRC moved 16 percent more petroleum product carloads over last year, and set records in the process.

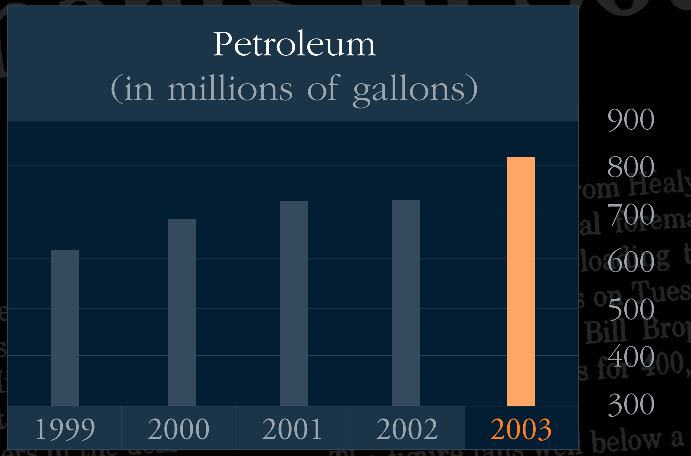
Southcentral construction projects drove a high demand for gravel. The 5.3 percent increase made 2003 the second highest year for gravel tonnage in the history of the line.

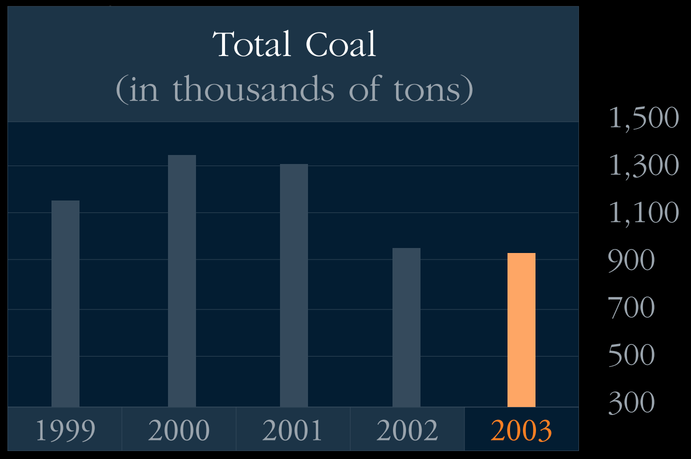
Usibelli Coal Mine resumed shipping export coal to South Korea, and the Railroad added back our southbound coal train operations in mid-year.

The Alaska DOT unexpectedly called on ARRC to move 22,000 carloads of granite for a highway expansion project south of Anchorage at Bird Creek. Using rail avoided highway congestion and pavement wear and tear.



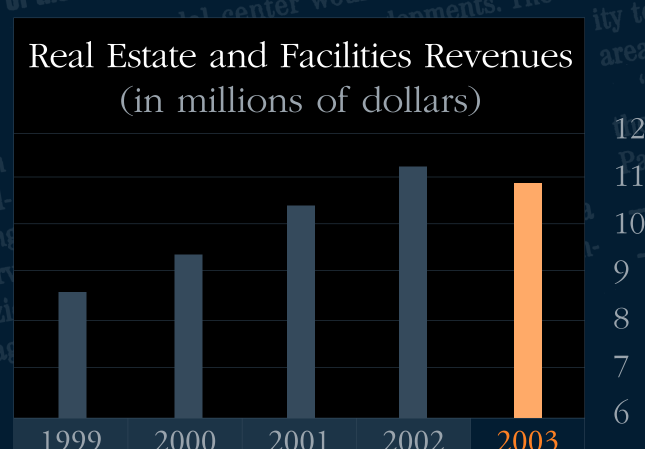
2003 FREIGHT SERVICES GOAL: Place more emphasis on "the business" of the Railroad.





FIVE-YEAR REAL ESTATE OBJECTIVE: Achieve and sustain an annual real estate income of at least $10 million per year.

The Railroad's new passenger shelters at Denali National Park, part of the new Denali Park Depot complex.



Note: Does not include grant revenues.

5 Many people perceive the Railroad as only offering freight and passenger services. They are familiar with engineers, conductors, brakemen, crossings, hornblasts, and bridges. But there is another essential business dimension that is not as visible.

Real Estate & Facilities

Never underestimate the value of real estate. This robust division continued to be one of the Railroad's most consistent sources of income. Exceeding corporate expectations, Real Estate earned $10.9 million in 2003, plus an additional $3.1 million in grant revenue. Profits generated from leases and permits were fed right back into equipment, property upgrades and safety improvements.

The Seward and Whittier docks, in addition to a variety of other leased holdings, once again contributed to a healthy increase in revenues.

Closer to headquarters, the Alaska Railroad welcomed its first upscale retail neighbor at Ship Creek — The Ulu Factory opened the doors of its new showroom last summer.

In 2003, the Railroad also proposed the idea for the E Street Corridor community project to the Municipality of Anchorage. The concept is to eventually link downtown Anchorage with the ARRC's future intermodal center — that will combine pedestrian, bus, train, commuter rail, and access to air traffic together in one location.

2003 also signaled the beginning of a new Real Estate division called Facilities. This reorganization will centralize planning, budgeting, and property management of all ARRC public and internal facilities including the Bill Sheffield Depot and the new Fairbanks Depot.

6 A committed team, careful planning, and a targeted investment strategy allowed ARRC to exceed most of its operating goals in 2003. The corporation made great strides in modernization, cost-reduction, safety improvements, and productivity.

Operations & Maintenance

New track, equipment, facilities, and technology were added to the line. Accordingly, trains picked up average speed on the 358-mile Anchorage-to-Fairbanks run. Through improvements in scheduling and maintenance, and a resulting sharp reduction in delays, ARRC advanced its objective of running this core route in under 12 hours — achieving a 75 percent success rate in the winter months.

An efficient and productive workforce held expenses down in 2003. Overtime was significantly reduced in Anchorage, ARRC's busiest terminal. Railroad operations notched a .89 operating ratio — a measure of operating costs versus operating revenues. This accomplishment surpassed the Railroad's five-year operating ratio objective in the first year.

The Railroad successfully introduced distributed power, a technology that allows multiple locomotives placed throughout the train to work in concert for improved performance, more power, higher fuel economy, better braking ability, and lower potential for derailments.

ARRC invested in eight new SD70MAC locomotives, which will reduce emissions and increase fuel efficiency and economy, upon their arrival in spring of 2004.

All these improvements add up to what we call operational excellence.

Sandy Wanner, Transportation Support Tech II

FIVE-YEAR OPERATIONS & MAINTENANCE OBJECTIVE: Achieve and sustain an operating ratio of 0.95 by 2005. Consistently run trains between Anchorage and Fairbanks in under 12 hours.

An aerial view of the rail straightening program on Fort Richardson which has helped ARRC increase safety, efficiency, and speed.

FIVE-YEAR CAPITAL PROJECTS OBJECTIVE: Invest an average of 20 percent of annual revenue in infrastructure maintenance. Successfully complete the federally funded capital construction program. Fund and apply technology to train dispatching, signals, and switching.

Alaska Railroad gears for $70 million in capital projects

The Associated Press

TRANSPORTATION

FAIRBANKS — The Alaska Railroad will hold a public hearing next month to help alleviate an annoyance in Nenana: Waiting for freight trains to pass.

The plan, while still in the initial phases, calls for straightening the line around Nenana and bypassing intersections with roads. Now, freight trains travel through the middle of the community at all hours.

Meanwhile, construction likely will begin this summer in Fairbanks on a $22 million project that includes a new depot off the Johansen Expressway.

The railroad also will begin work on a Denali National Park depot renovation, and is planning other rail work in the Interior.

The railroad typically spends about $70 million to $80 million a year on capital construction, and plans for 2003 will meet that average.

Railroad officials plan to have the Fairbanks depot project plans ready to bid on by May, with a groundbreaking this summer and tentative completion by fall of 2004.

"The whole project is about $22 million, of which only about $5 million is for the depot itself. So the rest of the expense is really in the tracks and the switch and the improvement that we're making to the yard in order to make our operation more efficient," said Johne Binkley, railroad board chairman.

That work includes creating a looping track that allows trains to turn around, and a new inspection pit enabling workers to inspect the undercarriage of the train without sending it into a shop.

Also in the works is a roughly $6 million effort to renovate the railroad's Denali depot, located about 10 miles south of Healy.

The project includes improving the loading and unloading facilities and expanding the parking and "siding" areas, Binkley said.

Siding is a length of rail that runs connected and parallel to the main line and allows one train to pass another.

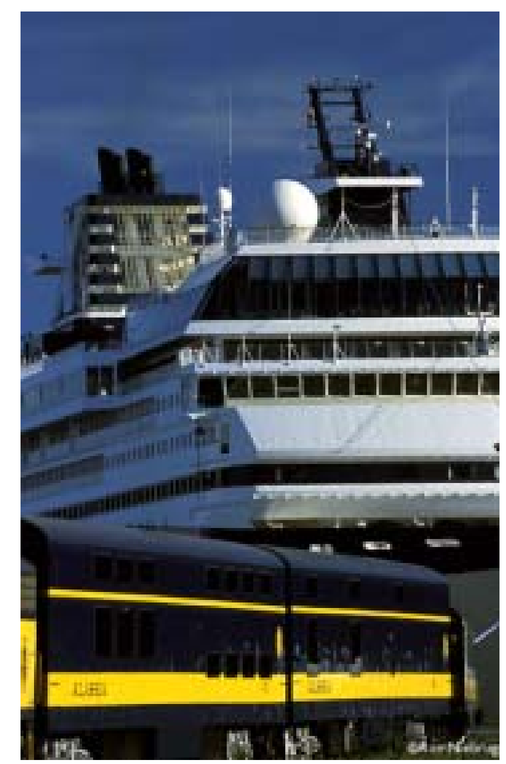
The National Park Service is planning a new Visitors Service Center north of the depot.

The Denali project, handled by Fairbanks contractor Great Northwest Inc., is expected to be finished by fall, said Pat Flynn, Alaska Railroad public affairs officer.

7 This is a much improved rail line since the State of Alaska took the reins from the federal government in 1985. Today the Railroad is a model of safety and efficiency, thanks in part to a dedicated workforce, sound investment strategies, and an annual federal grant program which underwrites an ambitious capital project effort.

Capital Projects

ARRC continued to invest heavily in system-wide infrastructure improvements. In 2003, the Railroad also worked hard to improve its federal funding status in order to secure a higher degree of predictable financial health.



The Seward passenger dock and terminal improvements were finalized in May 2003 in time for the season's first cruise ship docking.

On the northern front, passenger access enhancements were completed at the Talkeetna Depot. The Railroad built new passenger shelters and restrooms at Denali Park, finishing a two-year site upgrade project. And construction shifted into high gear at the Fairbanks Intermodal project when ARRC broke ground on a multi-million dollar passenger rail/depot project.

ARRC improved and expanded signal control of trains in the high traffic Anchorage-to-Wasilla corridor, realizing significant safety and efficiency gains. ARRC installed and tested the initial phase of its state-of-the-art collision avoidance system, one of the very first in the country. Once completed, this technology will go a long way toward preventing track equipment collisions and will increase protection for maintenance crews.

The South Anchorage Double Track Project was completed, greatly reducing train congestion and improving freight operations along this busy five-mile corridor.

Substantial progress was made on mainline track straightening between Anchorage and Wasilla — 25 percent complete to date.

In Whittier, the Railroad invested several million dollars in infrastructure upgrades, including a new heavy equipment maintenance facility and improvements for small boat access at the DeLong Dock.

8 The Alaska Railroad owes much of its 81-year success to community support all along the railbelt. Each year it is important to acknowledge how essential this support is to our operation.

Katie Thomas, Tour Guide

Community cooperation

In 2003, the Railroad participated in a number of community events and planning activities to celebrate our shared history and to map out plans for future economic development.

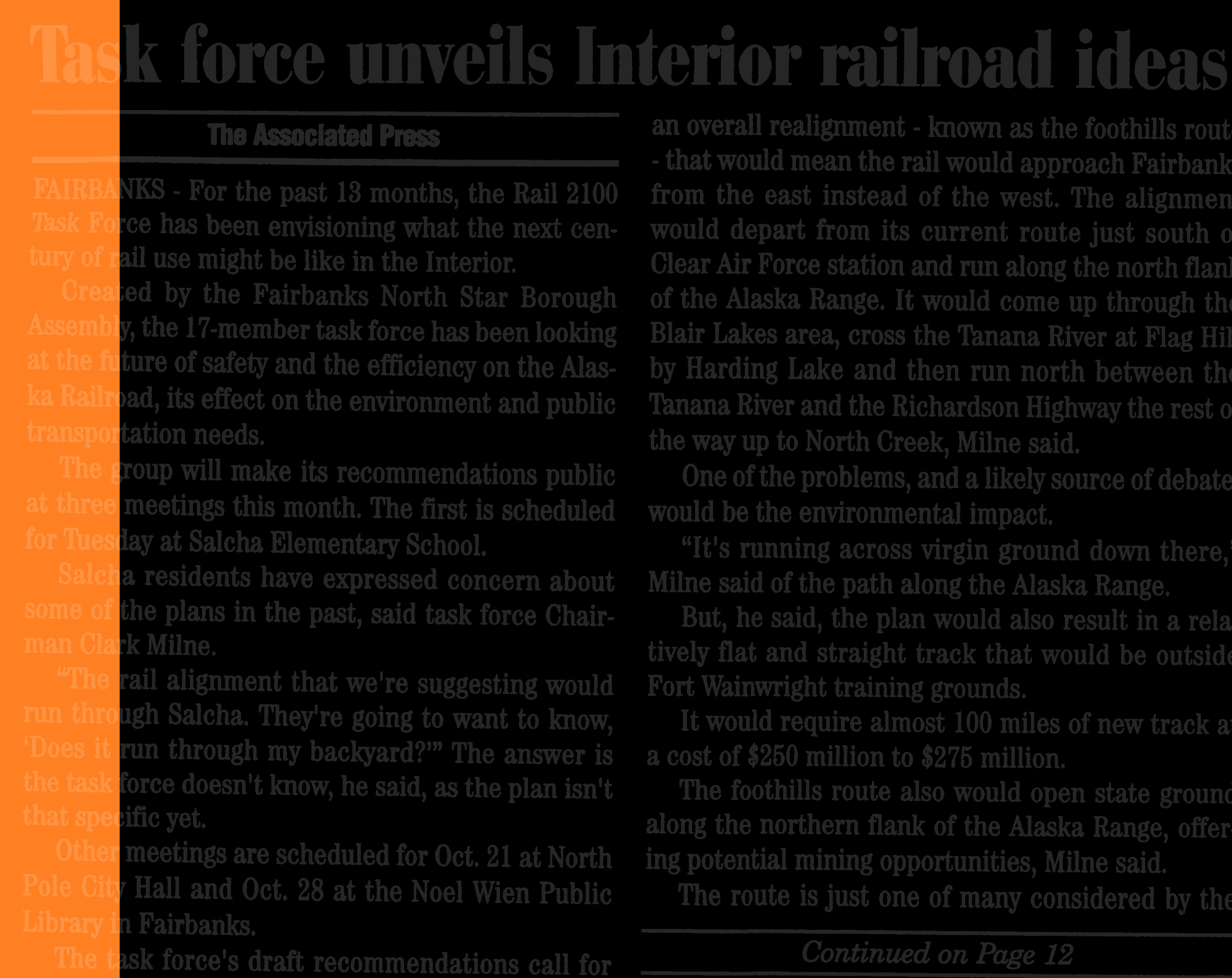
The Railroad maintained an active membership in numerous local and statewide civic groups. Hundreds of hours were devoted to transportation planning efforts such as the Fairbanks Rail Task Force, the Anchorage/Mat-Su Regional Transportation Planning Organization, and the Anchorage and Fairbanks Metropolitan Transportation Planning organizations.

2003 was a year of celebration. ARRC participated in the 50-year anniversary of North Pole and the Seward Centennial ceremony. The Railroad grew up with these communities and was honored to be part of the festivities.

The Tour Guide Program is one of the Railroad's flagship success stories in community involvement. For more than 20 years, high school juniors and seniors from Anchorage, Fairbanks, and Seward have endeared themselves to passengers from around the world with their stories about Alaska's wonders. Students at Government Hill Elementary School in Anchorage have enjoyed a partnership with the Railroad for more than 10 years with joint activities ranging from holiday train rides and spelling bees to the great back-to-school picnic.

The Railroad sponsored a demonstration of a state-of-the-art commuter rail car along the railbelt giving the communities a taste of possible things to come.

2003 COMMUNITY COOPERATION GOAL: Continue to participate in community planning and development organizations.



Task force unveils Interior railroad ideas

The Associated Press

FAIRBANKS - For the past 13 months, the Rail 2100 Task Force has been envisioning what the next century of rail use might be like in the Interior.

Created by the Fairbanks North Star Borough Assembly, the 17-member task force has been looking at the future of safety and the efficiency on the Alaska Railroad, its effect on the environment and public transportation needs.

The group will make its recommendations public at three meetings this month. The first is scheduled for Tuesday at Salcha Elementary School.

Salcha residents have expressed concern about some of the plans in the past, said task force Chairman Clark Milne.

"The rail alignment that we're suggesting would run through Salcha. They're going to want to know, 'Does it run through my backyard?'" The answer is the task force doesn't know, he said, as the plan isn't that specific yet.

Other meetings are scheduled for Oct. 21 at North Pole City Hall and Oct. 28 at the Noel Wien Public Library in Fairbanks.

The task force's draft recommendations call for an overall realignment - known as the foothills route - that would mean the rail would approach Fairbanks from the east instead of the west. The alignment would depart from its current route just south of Clear Air Force station and run along the north flank of the Alaska Range. It would come up through the Blair Lakes area, cross the Tanana River at Flag Hill by Harding Lake and then run north between the Tanana River and the Richardson Highway the rest of the way up to North Creek, Milne said.

One of the problems, and a likely source of debate, would be the environmental impact.

"It's running across virgin ground down there," Milne said of the path along the Alaska Range.

But, he said, the plan would also result in a relatively flat and straight track that would be outside Fort Wainwright training grounds.

It would require almost 100 miles of new track at a cost of $250 million to $275 million.

The foothills route also would open state ground along the northern flank of the Alaska Range, offering potential mining opportunities, Milne said.

The route is just one of many considered by the

Continued on Page 12

FIVE-YEAR EMPLOYEE OBJECTIVE: Establish formal railroad recruitment and training program.

Charles Jones, Engineer and Michael Alfaro, Conductor.

Without question, Alaska Railroad employees are the reason behind its continuous improvement. Investing in their professional welfare makes good business sense. In 2003, the Railroad invested $1.8 million to enhance corporation-wide employee training and education programs.

Employees & Labor

The Railroad averages over 90 percent Alaska hire, exceeding the governor's stated goal.

Last year, ARRC introduced the National Academy of Railroad Sciences' industry standard training curriculum. The program was brought on-line to better educate the Railroad's new train service personnel and student engineers.

With the goal of improving performance across the board, Railroad transportation department employees logged a significant number of hours on everything from our state-of-the-art locomotive simulator to new computer-based training courses.

ARRC introduced employee courses designed to teach practical leadership and management. Discipline and grievance training was also added to the mix. Several more advanced and truly comprehensive employee education and training programs are currently in the development stage.

The Railroad is well on its way toward fulfilling a five-year objective of establishing a comprehensive recruitment and training system.

"I'm seeing a lot of results that I've been dreaming about for the past 30 years. We've seen such a tremendous improvement in the reduction of accidents and incidents. That's made a big difference in employee morale."

Steve Love, District 3 Roadmaster
Alaska Railroad employee — 45 years

Borrowing a tenet from the Boy Scouts of America, the Alaska Railroad is working toward always being prepared. With the prospect of major projects like the natural gas pipeline and extending the rail line to Canada on the horizon, the Railroad is committed to accomplishing mainline improvements in order to meet the development challenge without cutting back service to its traditional customers.

Forward thinking

Gas pipeline construction plans include possible use of the Railroad's tax-exempt bonding authority to help finance the project costs. In addition, when construction begins, the Railroad infrastructure must be ready to add on capacity to haul pipe and other equipment for the project. Meeting those needs is why accelerating the five-year Capital Improvement Plan is taking on a sense of urgency.

The military and Alaska's congressional delegation are considering the benefits of extending the rail line from North Pole to Delta Junction. The new line would open up underutilized military training grounds, create better access for business opportunities, and set the stage for potential commuter service along the route.

Safety is enhanced any time you grade-separate a road and rail crossing. Three proposed rail realignments would eliminate 36 road crossings — four in south Wasilla, six at Nenana, and 28 between Fort Wainwright and North Pole. The ARRC will continue to work with the Alaska DOT on grade-separated crossings.

The Alaska Railroad remains on-track to make the most of opportunities we see coming in 2004 and beyond.

The signals are green, we're clear ahead for the future.

The rails near Bird Point glisten in the golden rays of the setting sun on Turnagain Arm.

Alaska Governor, Yukon Premier discuss mutual interests: railroad, highways, tourism

Governor Frank H. Murkowski recently had a series of meetings with Yukon Premier Dennis Fentie and other Yukon government officials and business leaders in Whitehorse.

Following the signing of an agreement to work on issues of mutual concern to Alaska and Yukon, Murkowski and Fentie immediately got busy on those issues which include reviving the White Pass & Yukon Route rail service all the way to Whitehorse, maintenance on the Taylor Highway, construction of a bridge across the Yukon at Dawson, and other tourism-related issues.

"Both governments would like to see the White Pass operating to Whitehorse," Murkowski said. "There is a big potential for expanding tourism, and I will be contacting the major tour companies about how they can help make that happen."

In addition to the WP&YRR, Murkowski and Fentie discussed the possibility of connecting the Alaska Railroad through Yukon and British Columbia to existing rail lines into the Lower 48. Such a railway would serve to transport Alaska minerals to market; as well as moving goods northward and opening new tourism markets.

Fentie discussed the goal of the Yukon Government to build a bridge over the Yukon River at Dawson City. Both leaders agreed that the Taylor Highway needs improvement, and they plan to continue their support of obtaining federal highway funds for the upgrades.

Governor Murkowski and Premier Fentie agreed to hold a summit in Juneau this winter with the provinces of British Columbia, Alberta, Northwest Territories and Yukon to discuss emerging developments in the north.

February 27, 2004

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, 2003.

This year's Annual Report is the second to be issued since ARRC adopted three new accounting statements issued by the Governmental Accounting Standards Board and the provisions of Financial Accounting Standards Board Statement No. 71. With the adoption of these statements in 2002, the reporting model used by the ARRC changed slightly.

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 auditors' 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

ALASKA RAILROAD CORPORATION MANAGEMENT'S DISCUSSION AND ANALYSIS

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 years that ended on December 31, 2003 and 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 15% over the course of this year's operations and 5% over the course of 2002 operations.
- During the year, the ARRC's operating revenues exceeded operating expenses by $11.9 million, yielding an operating ratio of .89. This is an improvement over last year, when operating revenues exceeded operating expenses by $2.1 million, yielding an operating ratio of .98.
- The ARRC's transportation revenues increased 9% to $98.5 million. Total operating revenues increased 20% to $113.2 million. Transportation revenues had decreased 3% to $90.5 million from 2001 to 2002. Total operating revenues had decreased 2% to $94.5 million from 2001 to 2002.
- The total operating costs of the ARRC's programs were $101.2 million, an increase of 10% compared to last year. Total operating costs were $92.3 million during 2002, a decrease of 4% over 2001.
- Expenditures on capital assets totaled $81.4 million during the year ended December 31, 2003, an increase of 23% compared to last year. During 2002, expenditures on capital assets totaled $66.5 million, a decrease of 5% from the $70.1 million expended during 2001.
- Federal grant funding was used for $63 million, or 77%, of the 2003 capital expenditures. In 2002, federal grant funding was $57 million, or 86%, 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 and real estate. 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 consists 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. 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

Fund equity — ARRC's fund equity increased 15% between fiscal years 2002 and 2003 — increasing to approximately $137.2 million. In comparison the 2002 fund equity increased 5% (in thousands):

		2003	2002	2001
ASSETS:				
Current assets	$	60,348	44,983	32,316
Capital assets		378,792	320,052	266,931
Other noncurrent assets		982	1,603	7,132
Total assets	$	440,122	366,638	306,379
LIABILITIES:				
Current liabilities	$	26,129	18,376	19,714
Long-term debt outstanding		17,874	16,466	18,600
Other liabilities		3,397	6,302	6,385
Regulatory liabilities:				
Postretirement and pension		13,495	14,599	10,121
Deferred grant revenue		242,014	191,468	137,789
Total liabilities	$	302,909	247,211	192,609
FUND EQUITY:				
Invested in capital assets, net of related debt	$	116,728	110,003	108,300
Restricted for reinvestment in infrastructure		20,485	9,424	5,470
Total fund equity	$	137,213	119,427	113,770

Capital assets — Capital assets, net of accumulated depreciation, increased $58.7 million in 2003 and $53.1 million in 2002. During 2003 and 2002, the ARRC continued 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 $50.5 million in 2003 and $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 decreased $1.1 million during 2003, primarily due to good market performance during 2003. It had increased $4.5 million during 2002. The increase during 2002 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 increased 21% and totaled $127.6 million in 2003. During 2002, the ARRC's total revenues decreased 1.5% and totaled $105.7 million. Approximately 66% and 72% of the ARRC's revenue comes from freight revenue during 2003 and 2002, respectively, and 11% and 13% of the revenue comes from passenger services during 2003 and 2002, respectively. The majority of the remaining income is related to real estate activities and federal grant revenue. Federal grant revenue is recognized as the capital assets funded by the grants are depreciated.

ARRC's total expenses increased 17% from 2002 to 2003 and decreased 4% from 2001 to 2002 (in thousands):

		2003	2002	2001
OPERATING REVENUE:				
Freight	$	84,074	76,021	79,868
Passenger		14,174	13,980	13,389
Other		245	544	239
Total transportation revenue		98,493	90,545	93,496
Grant revenue		14,665	3,905	2,687
Total		113,158	94,450	96,183
OPERATING EXPENSE:				
Transportation		24,344	22,839	24,107
Maintenance		24,767	22,197	20,100
Mechanical		14,346	13,019	13,433
Markets, sales and service		16,639	16,737	18,077
Passenger services		6,387	6,040	5,592
Engineering and signals		1,945	1,535	1,830
Health, safety and environment		1,522	1,285	2,071
General and administrative		11,277	8,692	10,936
Total		101,227	92,344	96,146
Operating income		11,931	2,106	37
NONOPERATING REVENUES (EXPENSES):				
Real estate income, net of expense		3,055	7,831	7,150
Investment income (loss)		385	(28)	555
Interest expense		(837)	(1,000)	(1,129)
Net income		14,534	8,909	6.613
Other changes in fund equity		3,252	(3,252)	—
Change in fund equity	$	17,786	5,657	6,613

Several events occurred during 2003 that significantly impacted the change in fund equity:

- The Federal Railroad Administration approval of ARRC's indirect cost rate agreements allowed ARRC to allocate eligible general and administrative expenses to federal grant projects. A total of $1.5 million was allocated to capital projects during 2003, reducing general and administrative expenses. The overall indirect cost recovery was $900,000 less than 2002.
- Total transportation revenue was $7.9 million greater than 2002. These revenues increased as a result of the return of export coal shipments, a large Alaska DOT construction project that generated unbudgeted gravel shipments and additional petroleum shipments.
- During 2003, ARRC accrued expenses relating to possible environmental impacts attributable to ARRC. More detailed information about the accrued expenses is presented in note 14 to the financial statements.
- Market conditions led to pension investments being adequate to cover the accumulated pension benefit obligation. This was the primary reason for the decrease in the $3.3 million additional minimum pension liability recorded as an "other change in fund equity" during 2003.

During 2002, the following events occurred that significantly impacted the change in fund equity:

- 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.
- Total freight revenue dropped by $3.8 million in 2002. However, the approval of the indirect cost recovery plans, operational efficiencies, and an increase in grant revenue helped offset the decrease in revenue.

CAPITAL ASSET AND DEBT ADMINISTRATION

Capital Assets

At the end of 2003, the ARRC had invested $378.8 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 $58.7 million, or 18.4%, over last year. Federal grants have funded $242 million of the assets, net of accumulated depreciation (in thousands):

		2003	2002	2001
Land and improvements	$	18,991	17,644	17,644
Road materials and supplies		3,724	3,491	5,772
Road and roadway structures		159,849	80,393	75,086
Equipment		72,440	62,283	66,214
Leasehold improvements		1,528	1,668	1,676
Construction in progress		122,260	154,573	100,539
Total capital assets, net of accumluated depreciation	$	378,792	320,052	266,931

The ARRC's fiscal year 2004 capital budget approved spending another $82.1 million for capital projects, principally for continued track straightening and depot construction and improvements. The ARRC plans to issue additional debt of $13.3 million to finance new locomotives. The ARRC intends to use federal grant funding to provide $45.6 million of the capital additions. The remaining capital projects will be funded out of 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 year-end the ARRC had $20.1 million in long-term notes outstanding — an increase of 8% from last year. During 2003 the ARRC refinanced twelve locomotives. New debt totaling $4 million was issued during 2003. More detailed information about the ARRC's long-term liabilities is presented in note 6 to the financial statements.

Next Year's Budget

Operating revenue is projected to decrease by 3.8% in 2004. However, management initiatives to reduce operating expenses were implemented during the 2004 budget process. As a result, the ARRC's fund equity is expected to increase $9.5 million or 6.9% by the close of 2004.

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 AUDITORS' REPORT

The Board of Directors
Alaska Railroad Corporation:

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, 2003 and 2002, 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, 2003 and 2002, 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.

In accordance with *Government Auditing Standards*, we have also issued our report dated February 27, 2004 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 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 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.

February 27, 2004
Anchorage, Alaska

KPMG LLP

ALASKA RAILROAD CORPORATION BALANCE SHEETS

December 31, 2003 and 2002

(In thousands)

ASSETS	2003	2002
Current assets:		
Cash and cash equivalents (note 3)	$ 26,092	18,638
Accounts receivable, net of allowance for doubtful accounts of $160 in 2003 and $199 in 2002	9,382	9,688
Grants receivable (note 8)	6,162	—
Materials and supplies	5,760	5,299
Restricted assets (note 3)	10,652	9,866
Prepaid expenses and other current assets	2,300	1,492
Total current assets	60,348	44,983
Capital assets (note 4):		
Land and improvements (note 11)	18,991	17,644
Road materials and supplies	3,724	3,491
Road and roadway structures	228,231	134,000
Equipment	127,703	110,050
Leasehold improvements (note 11)	1,848	1,848
Accumulated depreciation and amortization	(123,965)	(101,554)
Construction in progress	122,260	154,573
Total capital assets, net	378,792	320,052
Restricted assets (note 3)	831	647
Investments (note 3)	—	652
Other assets	151	304
	$ 440,122	366,638
LIABILITIES AND FUND EQUITY		
Current liabilities:		
Current portion of long-term debt (notes 5 and 6)	$ 2,176	2,115
Accounts payable and accrued liabilities (notes 5 and 14)	10,092	5,330
Payroll liabilities	8,435	7,331
Over recovery of vehicle & equipment allocated costs (note (2k))	1,509	—
Unearned revenues (note 11)	3,917	3,600
Total current liabilities	26,129	18,376
Long-term debt, less current portion (notes 5 and 6)	17,874	16,466
Environmental remediation reserve (notes 5 and 14)	2,567	579
Advance grant funding (notes 3, 5, and 8)	—	4,782
State of Alaska advances (notes 3, 5, and 8)	830	941
Regulatory liabilities:		
Accrued postretirement and pension benefits (notes 5 and 7)	13,495	14,599
Deferred grant revenue (notes 5 and 8)	242,014	191,468
Total liabilities	302,909	247,211
Fund equity (notes 7 and 9):		
Investment in capital assets, net of related debt and deferred grant revenue (note 4)	116,728	110,003
Restricted for reinvestment in infrastructure (notes 2(a) and 3)	20,485	9,424
Total fund equity	137,213	119,427
Commitments and contingencies (notes 6, 7, 10, 12, 13, and 14)		
	$ 440,122	366,638

See accompanying notes to basic financial statements.

ALASKA RAILROAD CORPORATION
STATEMENTS OF REVENUES, EXPENSES AND CHANGES IN FUND EQUITY

Years ended December 31, 2003 and 2002

(In thousands)

	2003	2002
OPERATING REVENUES:		
Freight (note 10)	$ 84,074	76,021
Passenger	14,174	13,980
Other	245	544
	98,493	90,545
Grant revenue (note 8)	14,665	3,905
	113,158	94,450
OPERATING EXPENSES (note 8):		
Transportation	24,344	22,839
Maintenance	24,767	22,197
Mechanical	14,346	13,019
Markets, sales and service	16,639	16,737
Passenger services	6,387	6,040
Engineering and signals	1,945	1,535
Health, safety and environment	1,522	1,285
General and administrative, net of indirect cost recovery of $1,459 in 2003 and $2,362 in 2002	11,277	8,692
	101,227	92,344
Operating income	11,931	2,106
NONOPERATING REVENUES (EXPENSES):		
Real estate income, less direct expenses of $10,957 in 2003 and $3,477 in 2002 (notes 8 and 11)	3,055	7,831
Investment income (loss)	385	(28)
Interest expense	(837)	(1,000)
Total nonoperating revenues	2,603	6,803
Net income (note 2(a))	14,534	8,909
Other change in fund equity:		
Reduction (additional) minimum pension liability (note 7)	3,252	(3,252)
Change in fund equity	17,786	5,657
Fund equity, beginning of year	119,427	113,770
Fund equity, end of year	$ 137,213	119,427

See accompanying notes to basic financial statements.

ALASKA RAILROAD CORPORATION STATEMENTS OF CASH FLOWS

Years ended December 31, 2003 and 2002
(In thousands)

		2003	2002
CASH FLOWS FROM OPERATING ACTIVITIES:			
Receipts from customers	$	98,338	90,109
Operating grants received		5,781	959
Payments to suppliers		(24,827)	(40,844)
Payments to employees		(47,469)	(41,821)
Net cash provided by operating activities		31,823	8,403
CASH FLOWS FROM CAPITAL AND RELATED FINANCING ACTIVITIES:			
Principal payments on long-term debt		(2,540)	(2,261)
Interest payments on long-term debt		(836)	(1,000)
Proceeds from long-term debt		4,009	—
Purchases of capital assets		(81,399)	(66,356)
Proceeds from sales of capital assets		344	612
Increase in deferred revenues, net of advances		51,520	57,305
Net cash used in capital and related financing activities		(28,902)	(11,700)
CASH FLOWS FROM INVESTING ACTIVITIES:			
Real estate income received, net of direct expenses		4,466	9,380
Proceeds from sale of investments		652	247
Interest received on investments		201	274
Purchase of restricted investments		(786)	—
Proceeds from sale of restricted investments		—	4,755
Net cash provided by investing activities		4,533	14,656
Net increase in cash and cash equivalents		7,454	11,359
Cash and cash equivalents at beginning of year		18,638	7,279
Cash and cash equivalents at end of year	$	26,092	18,638
RECONCILIATION OF OPERATING INCOME TO NET CASH PROVIDED BY OPERATING ACTIVITIES:			
Operating income	$	15,076	2,107
Adjustments to reconcile operating income to net cash provided by operating activities:			
Depreciation and amortization		18,535	12,293
Grant revenue on capital assets		(12,029)	(2,947)
Gain on disposal of capital assets		(155)	(436)
Changes in assets and liabilities:			
Increase in materials and supplies		(461)	(286)
Increase in prepaid expenses and other assets		(655)	(1,276)
Increase (decrease) in accounts payable and accrued liabilities		4,763	(1,113)
Increase in over recovery of vehicle and equipment allocated costs		1,509	—
Increase (decrease) in payroll liabilities		1,104	(403)
Increase (decrease) in environmental reserve		1,988	(762)
Increase in accrued postretirement and pension benefits		2,148	1,226
Total adjustments		16,747	6,296
Net cash provided by operating activities	$	31,823	8,403
Supplemental disclosure of noncash activity:			
Leasehold improvements provided through rent credits	$	—	120
Reduction (additional) minimum pension liability recognized		3,252	(3,252)

See accompanying notes to basic financial statements.

NOTES TO FINANCIAL STATEMENTS

December 31, 2003 and 2002

(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).

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 $255,509,000 and $206,067,000 at December 31, 2003 and 2002, respectively. Regulatory liabilities at December 31, 2003 and 2002 include $0 and $3,252,000 of additional minimum pension liability respectively. This additional minimum pension reduction (liability) was included as an other change in fund equity during the years ended December 31, 2003 and 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 are 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) Vehicle & 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 costs is applied against fixed charge rates in subsequent years. Accordingly, the ARRC has recorded an over recovery of $1,509,000 at December 31, 2003.

(l) Fair Value of Financial Instruments

Fair values of financial instruments, as defined under FASB Statement 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 $22,703,000 at December 31, 2003.

(m) Reclassifications

Certain reclassifications not affecting net income have been made to the 2002 financial statements to conform with current presentation.

(3) Deposits and Investments

At December 31, 2003, the ARRC's carrying amount of cash and cash equivalents was $26,092,000 and the bank balance was $28,953,000. Of the bank balance, $100,000 was covered by federal depository insurance; $5,856,000 was collateralized with securities held by the pledging financial institution's trust department or agent, but not in the ARRC's name; $501,000 was uncollateralized; and $22,496,000 represents money market funds held by the ARRC's agent in the ARRC's name.

NOTES TO FINANCIAL STATEMENTS
December 31, 2003 and 2002

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, 2003 and 2002 (in thousands):

Description of Security	2003	2002
Money market accounts	$ 10,652	9,866
Equity mutual funds	831	647
Total	$ 11,483	10,513

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, 2003 and 2002 (in thousands):

Description of Restriction	2003	2002
Capital assets as authorized by the State of Alaska	$ 570	686
Capital assets as authorized by the Department of Natural Resources	265	262
Advance grant funding, Taxpayer Relief Act	3,231	7,697
Advance grant funding, other federal grants	776	1,221
Postretirement benefits	831	647
Locomotive purchase	5,810	—
Total	$ 11,483	10,513

During 2003 the ARRC's Board of Directors restricted $20,485,000 of fund equity for reinvestment in infrastructure.

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 or capital expenses related to State owned rail operations. 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).

The ARRC's Board of Directors has restricted investments for the purchase of locomotives.

(b) ***Investments***

The market value of investments consists of the following at December 31, 2003 and 2002 (in thousands):

Description of Security	2003	2002
U.S. Agency notes (maturing in 1-5 years)	$ —	652
Total	$ —	652

(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 $1,459,000 and $2,362,000 during the years ended December 31, 2003 and 2002 respectively.

The following summarizes activity in the capital assets accounts during the years ended December 31, 2003 and 2002 (in thousands):

	Balance at December 31, 2002	Additions	Reclassifications	Reductions	Balance at December 31, 2003
Capital assets not being depreciated:					
Land	$ 17,644	—	1,347	—	18,991
Road materials and supplies	3,491	233	—	—	3,724
Construction in progress	154,573	81,166	(113,479)	—	122,260
Total capital assets not being depreciated	175,708	81,399	(112,132)	—	144,975
Capital assets being depreciated:					
Road and roadway structures	134,000	—	94,244	(13)	228,231
Equipment	110,050	—	17,888	(235)	127,703
Leasehold improvements	1,848	—	—	—	1,848
Total capital assets being depreciated	245,898	—	112,132	(248)	357,782
Less accumulated depreciation for:					
Road and roadway structures	53,607	14,779	—	(4)	68,382
Equipment	47,767	7,550	—	(54)	55,263
Leasehold improvements	180	140	—	—	320
Total accumulated depreciation	101,554	22,469	—	(58)	123,965
Capital assets being depreciated, net	144,344	(22,469)	112,132	(190)	233,817
Net capital assets	$ 320,052	58,930	—	(190)	378,792

	Balance at December 31, 2001	Additions	Reclassifications	Reductions	Balance at December 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:					
Road 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

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

	2003	2002
Transportation	$ 3,152	2,152
Maintenance	11,667	6,664
Mechanical	3,212	2,986
General and administrative	505	491
Real estate	3,933	886
	$ 22,469	13,179

Fund equity invested in capital assets, net of related debt and deferred grant revenue, is as follows at December 31, 2003 and 2002 (in thousands):

	2003	2002
Net capital assets	$ 378,792	320,052
Long-term debt (note 6)	(20,050)	(18,581)
Deferred grant revenue (note 8)	(242,014)	(191,468)
	$ 116,728	110,003

(5) Long-term Liabilities

Long-term liability activity is summarized as follows during the years ended December 31, 2003 and 2002 (in thousands):

	Balance at December 31, 2002	Additions	Reductions	Balance at December 31, 2003	Due within one year
Long-term debt	$ 18,581	4,009	(2,540)	20,050	2,176
Environmental remediation reserve	1,314	4,977	—	6,291	3,724
Advance grant funding	4,782	57,321	(62,103)	—	—
State of Alaska advances	941	—	(111)	830	—
Regulatory liabilities:					
Accrued postretirement and pension benefits	14,599	3,070	(4,174)	13,495	—
Deferred grant revenue	191,468	62,575	(12,029)	242,014	—
Total long-term liabilities	$ 231,685	131,952	(80,957)	282,680	5,900

	Balance at December 31, 2001	Additions	Reductions	Balance at December 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

(6) Long-term Debt

Long-term debt at December 31, 2003 and 2002 consists of the following (in thousands):

	2003	2002
Note payable, secured by equipment, due in monthly payments of $156,933, including interest at 4.47%, matures September 2014.	$ 15,954	17,088
Note payable, secured by equipment, due in monthly payments of $74,173, including interest at 4.28%, matures September 2003.	—	656
Note payable, secured by equipment, due in monthly payments of $16,225, including interest at 4.28%, matures October 2003.	—	159
Note payable, secured by equipment, due in monthly payments of $44,226, including interest at 2.55%, matures July 2008.	2,293	—
Note payable, secured by equipment, due in monthly payments of $27,557, including interest at 3.35%, matures April 2008.	1,332	—
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.	471	678
	20,050	18,581
Less current portion	2,176	2,115
	$ 17,874	16,466

Annual payments on debt are scheduled as follows at December 31, 2003 (in thousands):

	Principal	Interest
Year ending December 31:		
2004	$ 2,176	794
2005	2,252	709
2006	2,164	626
2007	2,202	542
2008	1,844	503
2009 – 2013	8,177	1,239
2014	1,235	21
	$ 20,050	4,434

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 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. 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, 2003 or 2002.

Chapter 71, SLA 2003 authorized the ARRC to issue up to $17,000,000,000 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.

(7) Employee Benefits

Accrued benefits under employee benefit plans are calculated under the provisions of FASB Statement No. 87, *Employers' Accounting for Pensions*, and FASB Statement 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. There was no additional minimum pension liability at December 31, 2003. The change in the minimum pension liability is reported as an other change in fund equity, increasing fund equity $3,252,000 during 2003 and decreasing fund equity $3,252,000 during 2002.

(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. 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):

	2003	2002
Change in benefit obligation:		
Benefit obligation at beginning of year	$ 37,541	32,993
Service cost	1,792	1,042
Interest cost	2,471	2,430
Participant contributions	2,728	2,480
Actuarial (gain) loss	1,236	(776)
Benefits paid	(1,011)	(628)
Benefit obligation at end of year	44,757	37,541
Change in plan assets:		
Fair value of plan assets at beginning of year	32,236	33,236
Actual return on plan assets	7,978	(4,279)
Employer contributions	1,637	1,427
Participant contributions	2,728	2,480
Benefits paid	(1,011)	(628)
Fair value of plan assets at end of year	43,568	32,236
Funded status	(1,189)	(5,305)
Unrecognized net actuarial loss	495	4,536
Unrecognized prior service cost	694	769
Other change in fund equity:		
Adjustment to recognize minimum liability	—	(3,252)
Accrued benefit cost	$ —	(3,252)

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:

	2003	2002
Discount rate	6.50%	6.75%
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):

	2003	2002
Service cost	$ 1,792	1,042
Interest cost	2,471	2,430
Expected return on plan assets	(2,719)	(2,756)
Amortization of prior service costs	75	75
Recognized net actuarial gain	18	—
Net periodic benefit cost	$ 1,637	791

(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. ARRC's policy is to pre-fund the cost of medical benefits in amounts determined at the discretion of management. At December 31, 2003 and 2002, the ARRC has designated assets with a market value of $831,000 and $647,000, 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):

	2003	2002
Change in benefit obligation:		
Benefit obligation at beginning of year	$ 14,299	9,136
Service cost	1,709	1,392
Interest cost	751	795
Actuarial (gain) loss	(2,380)	3,341
Benefits paid	(287)	(365)
Benefit obligation at end of year	14,092	14,299
Funded status	(14,092)	(14,299)
Unamortized prior service costs	(166)	(191)
Unrecognized net actuarial loss	763	3,143
Accrued benefit cost	$ (13,495)	(11,347)

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

	2003	2002
Service costs	$ 1,709	1,392
Interest costs	751	795
Recognized prior service costs	(27)	(27)
Recognized net actuarial gains	—	38
Net periodic cost	$ 2,433	2,198

For measuring the 2003 expected postretirement benefit obligation, a 9.9% 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 3-year period to an ultimate rate of 5.50% in 2007.

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.

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):

	2003		2002	
	One percentage point increase	One percentage point decrease	One percentage point increase	One percentage point decrease
Effect on total service and interest cost components	$ 746	(552)	689	(510)
Effect on postretirement benefit obligation	3,746	(2,819)	3,718	(2,806)

(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 7% of the transferred employees' base pay. Benefit expense related to CSRS was $495,000 and $615,000 for the years ended December 31, 2003 and 2002, respectively.

(d) Defined Contribution Plan

The ARRC sponsors a defined contribution plan (Plan) for employees. All regular employees are eligible to contribute to the Plan. Under the terms of certain collective bargaining agreements, representing 62% of employees, the ARRC will match a portion of employee contributions. The maximum amount of matching required under the agreements is

50% of employee contributions for the first 8% of salary. Benefit expense related to the Plan was $78,000 and $92,000 for the years ended December 31, 2003 and 2002, respectively.

Subsequent to year end, ARRC Board of Directors approved a Section 457 deferred compensation plan for non-representative employees, subject to final review of the plan document by legal counsel.

(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):

		2003	2002
Road and roadway structures	15 – 32 year life	$ 87,918	30,815
Equipment	5 – 25 year life	62,322	22,451
Construction in process		111,006	148,062
		$ 261,246	201,328

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):

	2003		2002	
	Advance grant funding (receivable)	Deferred grant revenue	Advance grant funding (receivable)	Deferred grant revenue
Federal Railroad Administration:				
Net book value of assets constructed	$ —	93,875	—	23,591
Construction in process	—	68,412	—	106,899
Grant funding received in advance	—	—	536	—
Amount receivable from grantor	(1,659)	—	—	—
Taxpayer Relief Act:				
Net book value of assets purchased and constructed	—	12,307	—	6,422
Construction in process	—	7,618	—	11,592
Grant funding received in advance	—	—	4,303	—
Investment earnings on funding	2,895	—	2,991	—
Federal Transit Administration:				
Net book value of assets purchased and constructed	—	17,187	—	8,125
Construction in process	—	33,716	—	26,693
Amount receivable from grantor	(5,834)	—	(2,515)	—
Federal Emergency Management Agency:				
Net book value of assets constructed	—	1,566	—	214
Amount receivable from grantor	(1,556)	—	(471)	—
Department of Interior:				
Grant funding received in advance	775	—	1,024	—
Accrued derailment expense (note 14)	(775)	—	(1,024)	—
Department of Agriculture:				
Net book value of assets constructed	—	1,300	—	—
Construction in process	—	—	—	1,676
State of Alaska Wishbone Hill Coal Project:				
Net book value of assets purchased	—	4,591	—	4,861
Construction in process	—	1,260	—	1,202
Amount receivable from grantor	(8)	—	(62)	—
Municipality of Anchorage Ship Creek Economic Development:				
Net book value of assets constructed	—	182	—	193
	$ (6,162)	242,014	4,782	191,468

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

	2003	2002
Federal Railroad Administration:		
Depreciation on assets constructed	$ 9,034	1,471
Taxpayer Relief Act:		
Depreciation on assets purchased and constructed	1,245	408
Grant funded project planning expense	1,303	—
Federal Transit Administration:		
Depreciation on assets purchased and constructed	1,139	802
Grant funded maintenance expense	4,422	457
Federal Emergency Management Agency:		
Depreciation on assets constructed	9	8
Grant funded disaster recovery expense	1	502
Department of Agriculture:		
Depreciation on assets constructed	321	—
Grant funded project expense	55	—
Department of Interior:		
Grant reduction	—	—
Grant funding of accrued derailment expense (note 14)	249	545
Derailment expense paid in current year	(249)	(545)
Municipality of Anchorage Ship Creek Economic Development:		
Depreciation on assets constructed	10	1
State of Alaska Wishbone Hill Coal Project:		
Depreciation on assets purchased	271	257
	17,810	3,906
Less grant revenue included in real estate nonoperating revenues	(3,145)	(1)
	$ 14,665	3,905

(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, 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
Net income	—	14,534	—	14,534
Other changes in fund equity	—	—	3,252	3,252
Total changes in fund equity				17,786
Balance at December 31, 2003	$ 34,174	103,039	—	137,213

(10) Major Customer

One ARRC customer accounted for 48% and 46% of freight revenue in 2003 and 2002 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 $8,557,000 and $8,948,000 in 2003 and 2002, respectively. The following table summarizes future minimum lease payments as of December 31, 2003 (in thousands):

		Amount
Year ending December 31:		
2004	$	7,892
2005		7,373
2006		7,162
2007		6,865
2008		6,865
Thereafter		119,965
	$	156,122

The ARRC has $1,530,000 in rent credits outstanding on these leases at December 31, 2003. 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 $11,855,000 and $11,800,000 in 2003 and 2002, respectively. Future minimum lease payments as of December 31, 2003 are summarized as follows (in thousands):

		Amount
Year ending December 31:		
2004	$	10,952
2005		10,715
2006		10,650
2007		10,326
2008		10,181
2009-2013		23,054
	$	75,878

(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 workers' compensation claims. The ARRC carries commercial insurance policies limiting ARRC's exposure for health benefits to $5.8 million, for casualty/liability to $5 million and for property to $10 million at December 31, 2003. Self-insurance activity is summarized as follows during the years ended December 31, 2003 and 2002 (in thousands):

		Balance at December 31, 2002	Incurred claims	Claim payments	Balance at December 31, 2003
Employee health benefits	$	1,322	4,064	(4,111)	1,275
Casualty and liability		1,389	2,523	(732)	3,180
Workers' compensation		782	1,778	(1,538)	1,022
	$	3,493	8,365	(6,381)	5,477

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

(14) Commitments and Contingencies

During 2004, the ARRC expects to commence 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 will be done under a consent order currently being negotiated with the U.S. EPA. Management has accrued its best estimate of its obligations, as the current owner of the Site, for the activities required under the order. However, it is not possible at this time to reasonably estimate the ARRC's ultimate liability associated with the Site because the extent of environmental impacts attributable to the ARRC, the allocation of liability to other potentially responsible parties, the potential cleanup alternatives and the concurrence of regulatory authorities have not yet advanced to the stage where reasonable estimates of liability can be made. The ARRC management believes most, if not all, contamination 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. If this is the case, the liability for contamination that occurred prior to the transfer ultimately may be imposed on the federal government under terms of the transfer act and a 1990 agreement between the federal government and the ARRC. The ARRC also will seek cost recovery and contribution from third-party former and current tenants for contamination as a result of their actions on leased portions of the Site. The eventual disposition of such cost-recovery and contribution claims and the ultimate realization of any judgments or allocations awards, however, cannot be predicted with certainty at this time. 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.

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 $775,000 and $1,314,000 at December 31, 2003 and 2002, respectively. The amount expected to be paid within the next year, $490,000 and $735,000 at December 31, 2003 and 2002, 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 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 9% of the labor force, is currently being renegotiated.

The ARRC has certain other contingent liabilities resulting from lawsuits, environmental issues, 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.

2003 Board of Directors

Board of Directors pictured in the Train Dispatch control room, the nerve center of the Railroad.

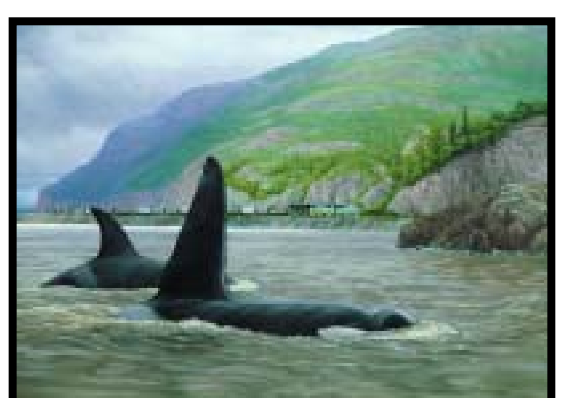
(L to R back row)

Jack Burton	Track Inspector, Alaska Railroad Corporation
Jacob Adams	President and CEO, Arctic Slope Regional Corporation
Edgar Blatchford	Commissioner, Department of Community and Economic Development
Governor Bill Sheffield	Port Director, Municipality of Anchorage

(L to R front row)

Carl Marrs, Vice-Chair	President and CEO, Cook Inlet Region, Inc.
John E. Binkley, Chairman	President and CEO, Alaska Riverways, Inc.
Mike Barton	Commissioner, Department of Transportation and Public Facilities

Each year the Alaska Railroad commissions artwork for a limited edition print, poster and lapel pin. This year's print, by Anchorage artist James Havens, depicts a southbound freight train along Turnagain Arm.



Contact Information

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Anchorage, Alaska

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Yard Office	1201 Whitney Road	(907) 265-2434	(907) 265-2643

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	Freight Marketing	1-800-321-6518
	Passenger Service	1-800-544-0552
	Seattle Office	1-800-843-2772

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The Alaska Railroad Corporation has not received any bona-fide offers of a sale arrangement within the calendar year of 2003, nor is the Corporation aware of any potential sales that require analysis under AS 42.40.260.

The 2003 Team

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