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1997 Annual Report

# 75TH ANNIVERSARY

Alaska Railroad Corporation

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# The Golden Spike

The “experts” about the wild territory of Alaska had recommended warm leggings and long underwear for the special ceremony to mark the completion of the new Alaska Railroad at Nenana. But July 15, 1923, was a perfect Interior Alaska midsummer day: hot, sunny, still and bright.

With the Tanana River flowing by, and many onlookers sweltering in their warm clothing, U.S. President Warren G. Harding tapped a golden spike with a maul, after which the golden one was withdrawn and an iron one put in its place. The President missed twice, then connected to drive the final spike. The Alaska Railroad – running more than 500 miles across the Alaska wilderness from the port of Seward to the mining town of Fairbanks – was officially complete.

It was the trans-Alaska pipeline of its time, worthy of the personal attention of the President of the United States. Private interests had attempted to build a railroad into Alaska’s Interior from Seward as early as 1903, but they had run out of money and luck. The U.S. government picked up the job in 1914, and on the way to completion, helped found what is now Alaska’s largest city, Anchorage, now the headquarters of the Alaska Railroad Corporation.

In 1998 the Railroad and its citizen owners celebrate the 75th anniversary of the completion of the line. Many of the same kind of Alaska “experts” who suggested long underwear for the Interior in July also suggested the wilderness Railroad and the empty territory would never amount to much.

But since 1923 the Alaska Railroad has played a central role in Alaska’s growth – supplying the Fairbanks gold fields, settling the Matanuska Valley, helping build the Alaska Highway, supporting the war effort, hauling pipe and supplies for the construction of the Trans-Alaska Pipeline System, and now, hauling the coal, refined petroleum products and passengers that are all part of the state’s thriving economy.

The Alaska Railroad is still in public ownership, now owned by the State of Alaska, which bought the line from the U.S. government in 1985. Since then, the Railroad has become consistently profitable and self-supporting through its revenues, and it still serves the public and economic interests of Alaska businesses and citizens. The 600 employees of the Alaska Railroad proudly invite you to celebrate this milestone with them this year.

*Message from the Chairman and the President*

When someone asks any of the 600 employees of the Alaska Railroad and the Board of Directors what this Railroad is all about, you'll hear one simple statement: We aim to run a safe, service-driven, self-supporting rail line to help Alaska's economy grow, and to provide vital public transportation.

For most of this century, the Alaska Railroad has served Alaskans and the nation in a variety of critical roles. In 1998, we remain the backbone of the state's overland transportation system and a key link in the state's economy, moving export coal from a mine as old as the Railroad itself, refined petroleum products for ooming air transport industry, gravel for key construction projects, freight for nearly every type of Alaska business, l passengers who flock to the Last Frontier to see the wilderness from the comfort of a rail car.

*Johne Binkley*

In 1997, the Alaska Railroad had a banner year in a number of significant ways, including a third consecutive year of record earnings.

The bottom line for 1997 looks impressive, but it's important to look past the numbers and see what the numbers really mean. We are proud to say that the Alaska Railroad is professionally run, taking the best from private-sector management and business strategies and turning them into a self-supporting public corporation.

But our profit isn't quite like the profit earned by a privately-held company. There are no stock options for management and no dividend checks sent out to shareholders. All our net earnings are, by law, plowed back into the line, so that this vital public institution can continue to operate to the highest standards of safety and service, without depending on government subsidies.

The Alaska Legislature wisely established the Alaska Railroad Corporation under these terms, and we work hard every day to fulfill those tasks of safety, service, and self-support.

In 1997, our strong earnings allowed us to pay down long-term debt, which set the stage for phasing in a fleet of brand new, 4,000-horsepower General Motors SD70MAC locomotives. Delivery of the first eight units is expected for 1999, with six of the eight dedicated to the rapidly increasing output from MAPCO Alaska Petroleum's North Pole refinery.

*Bill Sheffield*

The Alaska Railroad's status as a full-service line providing intercity passenger rail service also holds great opportunities for speedy and sophisticated capital improvements and investments in the railbed, communications system, bridges, track and other equipment. With the guidance of Alaska's Congressional delegation, Sens. Ted Stevens and Frank Murkowski and Rep. Don Young, the Alaska Railroad will receive $23 million in additional federal rail appropriations for passenger service capital improvements split over 1998 and 1999.

And ultimately all this investment and improvement helps us run more safely and efficiently. However, we continue to cultivate a culture of personal responsibility and professional attention to safety by every one of our Alaska Railroad team members. A safe operation protects our employees, and it shows our customers that we take seriously our business of getting people and goods safely and efficiently from one place to another.

Bill Sheffield

We're proud of what our employees and customers achieved in 1997, and we are eagerly looking forward to doing even better in our Diamond Anniversary year of 1998.

ANNIVERSARY

# Year in Review

The Alaska Railroad Corporation's 1997 net earnings of $10.6 million on $83.7 million gross revenues were the best in the 13 years under state ownership.

Gross revenues rose by 4 percent over 1996, while net earnings were 30 percent over 1996. It was the third consecutive year of record revenue and profit for the Corporation. Operating revenues were nearly $1.6 million over projections, while operating expenses were $2.4 million under projections.

The record performance was largely attributable to five major factors: continued strong demand for refined petroleum products from MAPCO Alaska Petroleum in North Pole and shipped on the railroad; several major Anchorage construction projects, raising demand for gravel; freight revenues of $64.0 million, $1.8 million over 1996; significant reductions in budgeted operating expenses; and a record 612,000 passengers carried, representing an increase of more than 20 percent from 1996.

The Corporation was also able to pay down $1.5 million in debt before it was due, set aside cash to put towards the purchase of new locomotives, and reduce its future exposure on post-retirement medical liability.

Other indicators further buttress the Railroad's financial good standing: increase in cash balances for the last four years; decrease in current liabilities due to improved cash flow; no short-term borrowing in 1996 or 1997; since January 1996, long term debt has been reduced from $14.1 million to $1.9 million; improved equity position through improved earnings; and significant increases in fixed assets through an aggressive capital improvement program.

Intermodal transport rebounded in 1997 with a 12 percent increase in units moved.

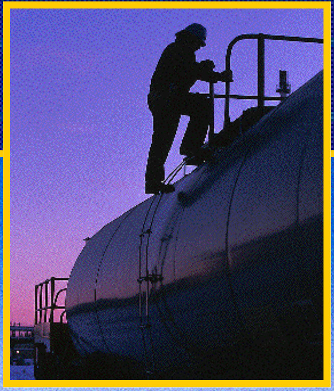
In 1997, the Alaska Railroad transported 1.2 million tons of coal and 412.5 million gallons of petroleum product; improved on-time service performance (90 percent on time, passenger services); began and successfully operated the first new scheduled train service since 1985 (Anchorage-Whittier); opened new passenger depots in Talkeetna, Seward and Girdwood; upgraded passenger equipment; reduced mainline incidents 71 percent from 1990-96 levels; reduced hazardous material use and waste generation; installed 100,000 new ties; and upgraded bridges and railroad crossings.

Johne Binkley of Fairbanks was elected chairman of the Alaska Railroad Board of Directors in 1997. Binkley, 44, has served on the Board since 1995. He served in the Alaska State House of Representatives and the Alaska State Senate, and operates a tour company in Fairbanks.

Dale Lindsey of Seward continues as vice chair. Ed Bauer was appointed to fill the seat on the Board reserved for a professional railroader.

Former Alaska Governor Bill Sheffield was appointed President and Chief Executive Officer of the Corporation. He remains on the Board. Sheffield served as governor at transfer of the Alaska Railroad to the State of Alaska, and has more than 40 years of experience in Alaska business.

The Alaska Railroad provides important freight and cargo services that bring goods into the state. It also is the primary transportation for Alaska products, including raw logs (shown here at the Port of Seward) and refined petroleum products (below).



The Railroad began hauling fuel in 1977 for the company that would become MAPCO Alaska Petroleum, starting with a short haul from the North Pole refinery to Fairbanks International Airport. Since then, the business with MAPCO has blossomed into a thriving transportation partnership now framed by a 20-year contract. MAPCO fuel hauling is the backbone of the Alaska Railroad's freight operations.

# Commodities

## Overall rail operations

In 1997 the Corporation was able to narrow the ratio between the contributions of real estate and rail operations to the bottom line. After a management restructuring in 1993, when the Corporation absorbed one-time charges for personnel reductions, the Corporation for several years depended heavily on real estate leases and rents to buttress the bottom line.

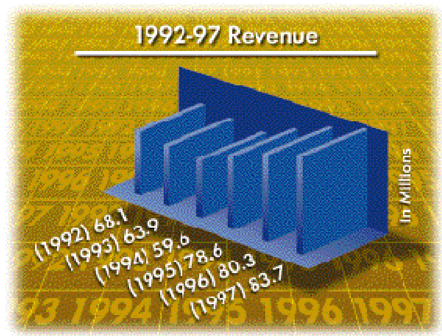
By the end of 1997, rail operations had regained much ground not only by carrying more freight and passengers, but by reducing expenses as well. Rail operations contributed $5.6 million to the $10.6 million profit, or 53 percent of the total, up from $3.2 million or 40 percent of the 1996 profit and $3 million or 39 percent of the 1995 profit.

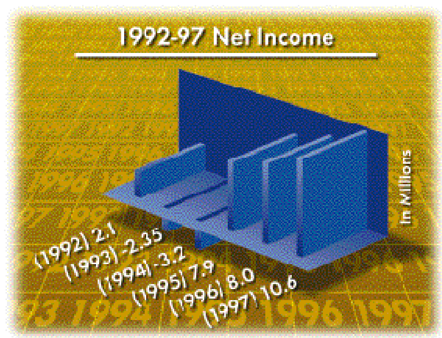
## New locomotives

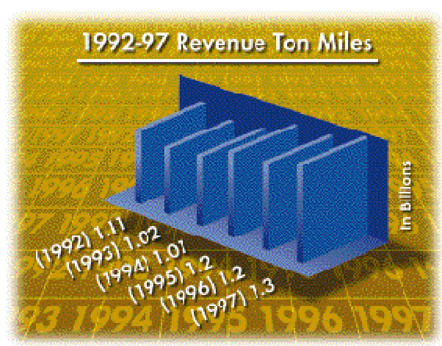
It has been clear for some time that to meet increasing service demands and lower operating costs, the Alaska Railroad's aging locomotive fleet needs to be overhauled or replaced.

After construction of a cost model and testing of two General Motors EMD SD70MAC units in the summer of 1997, management recommended the Board replace the locomotive fleet rather than overhaul it. Cost savings in favor of purchase were estimated by the model to be $66.7 million over 20 years. The on-the-rail tests of running times, pulling capacity, and other operating factors of the SD70MACs matched very closely the models constructed earlier, confirming the expected performance improvements.

The Board approved the upgrade plan, under which the Railroad will invest $33 million over the next four years to purchase 16 new SD70MAC units. The first eight units are scheduled to be delivered in the fourth quarter of 1999. These new locomotives use AC technology and generate 4,000 horsepower. Of the initial eight delivered, six are expected to be dedicated to MAPCO Alaska Petroleum service and two to gravel hauling.



The Railroad moved more than 1.2 million tons of coal from the Usibelli mine in Healy in 1997, with almost 700,000 tons shipped through the Alaska Railroad facility at the Port of Seward (top, center photos).

Interline traffic continues to be a mainstay, accounting for more than a third of freight revenue in 1997. Two barges call at Whittier, one from Alaska Rail Marine Service in Seattle, the other from Canadian National in Prince Rupert, B.C.

# Commodities

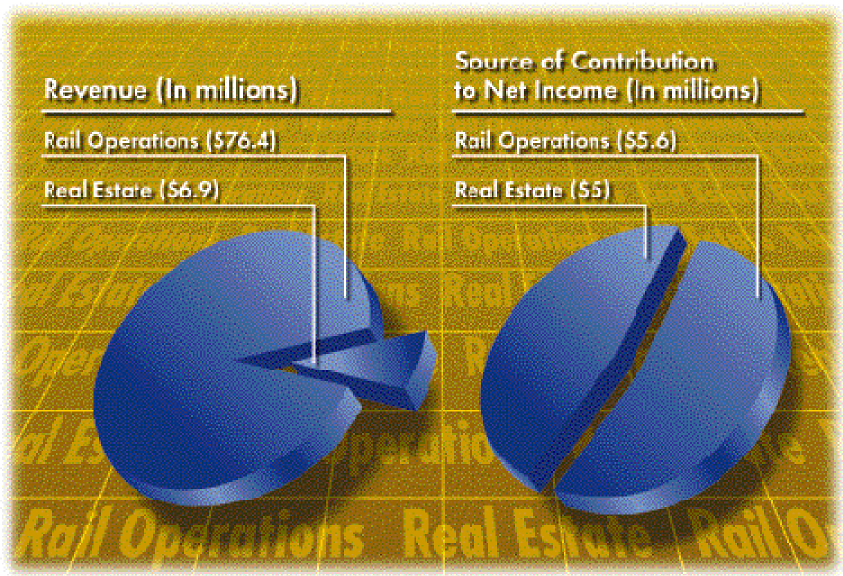
Over the long term, the locomotive plan will achieve the following:

- reduce the fleet from 50 to 30 units, while increasing pulling capacity, allowing for future growth;
- standardize the fleet from the current seven different types of units to three, making maintenance, operation, training, and planning more accurate and efficient;
- reduce maintenance and operating expenses;
- reduce air emissions and fuel use;
- open up new opportunities for employees and for use of yard facilities and other Railroad land; and
- improve service overall.

### Federal intercity rail grants

The Alaska Congressional delegation has for many years supported infrastructure and safety improvements for passenger rail lines. Beginning in 1996, the Alaska Railroad became a part of these Federal Railroad Administration programs, and now will receive $10 million in 1998, in addition to $20 million from previous years.

The federal money is being invested in a variety of improvements for intercity rail service in Alaska.




### Freight

Alaska's steady economy was reflected in the strength of freight operations for the Alaska Railroad in 1997. Slight drops in petroleum shipments from 1996 were more than balanced by increases in coal hauling, interline freight, and a banner year in gravel.

Shipments from the MAPCO Alaska Petroleum Refinery in North Pole were less in both volume and number of rail cars than in 1996. Total gallons shipped dropped 12 percent, from 417.2 million gallons to 412.5 million gallons in 1997, following a 7.4 percent increase in 1996. Still, MAPCO remains the Alaska Railroad's single largest customer, accounting in 1997 for $21.2 million in gross revenues, or just more than one-third of total freight revenue. In the past five years, MAPCO revenues have made up from 33 percent to 44 percent of freight revenues.

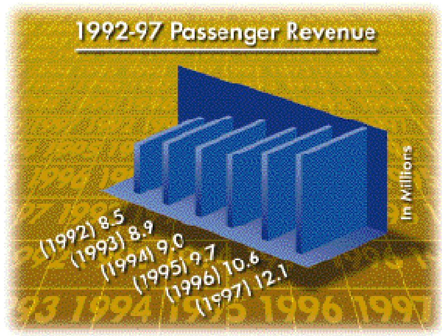
The Alaska Railroad's team of professional railroaders is one of the few in North America to serve a diverse range of passenger needs, from the "flag stop" local service year-round on the northbound run, to the full-service summer trains to Seward, Whittier, Talkeetna, Denali National Park and Fairbanks.


Photo by Charlie Shugart, courtesy of Kenai Fjords Tours

Intercity rail has been an integral part of the Alaska Railroad's service since 1923, and has adapted to changing markets and public service needs. The booming Alaska visitor industry has provided much of the impetus for recent growth.

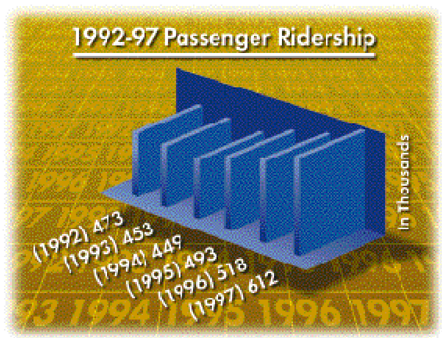
# Commodities

Interline freight accounted for $21.8 million, or 34 percent of freight gross revenues.




After a slump in production due to drops in demand overseas in 1996, coal shipments bounced back from 763,000 tons to more than 1.2 million tons in 1997, accounting for just more than $10 million, or nearly 16 percent of freight revenues.

The 1997 gravel season was the best for the Alaska Railroad since the mid-1980s construction boom in Alaska. The original budget for 1997 called for shipping 2 million tons of gravel, but actual shipments were almost 50 percent higher than projections at 2.9 million tons. Trains were running 24 hours a day, and for a while, two train sets were running 24 hours a day. Gravel business is tied directly to construction activity, and two major construction projects in the Anchorage area helped boost the business well beyond projections.




## Passenger services

The Alaska Railroad set another record for ridership in 1997, with 612,000 total passenger segments traveled, an increase of 17.6 percent. Two major factors contributed to the increase:

- the successful start-up of the Alaska Railroad's Anchorage-Whittier "Glacier Discovery," which carried 33,000 passengers; and
- addition of a Talkeetna segment to the Princess Tours pull contract service.

Tour-related business with the Railroad continues to grow, even though dips in the Asian economy had an impact on winter- and "shoulder-season" passenger travel. Tour company numbers in 1997 were up by about 25 percent. There was an 18 percent increase in express traffic between Anchorage and Fairbanks and a 13 percent increase in Anchorage-Seward traffic.

## Real estate and land management

Real estate continued to be a significant contributor to the Alaska Railroad Corporation bottom line in 1997, with $5.0 million in net income of the Corporation's $10.6 million total net.

The emphasis in 1997, however, was on settling a long-standing development dispute with LoPatin Associates for prime Corporation land in the Ship Creek basin, and setting the stage for development of a land use master plan.

In addition, the Alaska Railroad sold an exclusive right-of-way use to Alaska Fiberstar that will bring the Corporation $6.5 million over the next few years. AFS in 1997 nearly completed the laying of fiberoptic data and voice transmission cable that will significantly improve transmission capabilities throughout the railbelt area.

# Community Service

The Alaska Railroad made roughly half a million dollars in major cash and in-kind contributions to organizations and communities along the railbelt.

The Corporation also continued an active outreach program to local governments, through quarterly meetings of the Community Briefing Council, which consists of elected officials and chamber of commerce leaders from railbelt communities.

Among the major recipients of cash contributions in 1997 was the Seward SeaLife Center, a public-private partnership that combines marine research and public education facilities, and will be a major visitor attraction in Seward after opening in May, 1998. The Railroad also contributed to the United Way and the Food Bank of Alaska.

Alaska Railroad employees and the Corporation continued their active association with Government Hill Elementary School in Anchorage, through the School-Business Partnership program. It was the fifth year of participation for the Alaska Railroad.


In a few short years, Ship Creek — where the city of Anchorage was born during construction of the Alaska Railroad from 1914-23 — has gone from a forgotten industrial waterway to a vital part of Anchorage's recreational experience.

The Railroad also continued its highly successful tour guide program, which provides training and job opportunities to a select group of Alaska teenagers. Working with the Anchorage and Fairbanks North Star Borough school districts, the Railroad competitively selects and trains young Alaskans to work the summer passenger season providing timely information and assistance to visitors. The program is credited with helping young people develop strong communications skills, confidence and work habits, and is nationally recognized.

Among other service highlights in 1997 was the railroad's participation in the Ship Creek Task Force, a group of 16 citizens who worked with the community, the Railroad, the Municipality of Anchorage, and state and federal agencies to develop a vision for uses and development of the Ship Creek Basin. The railroad, as principal landowner in the region, and the Municipality, through Mayor Rick Mystrom, were interested in coordinating on land use planning to bring the highest benefit to the community, while maintaining the railroad's ability to develop properties and generate operating revenue.

# Board of Directors

## Board of Directors

Jack Burton, Track Inspector, Alaska Railroad Corporation.
Johne Binkley, Chairman & Chief Executive Officer, Alaska Riverways, Inc.
Ed Bauer, Professional Railway Consultant.
Debby Sedwick, Commissioner of Commerce and Economic Development.
Joe Perkins, Commissioner of Transportation and Public Facilities.
Governor Bill Sheffield, President & Chief Executive Officer.
Dale R. Lindsey, Vice Chairman, President and CEO, Harbor Enterprises, Inc.

## Officers

Governor Bill Sheffield, President & Chief Executive Officer.
James B. Blasingame, Vice President, Corporate Affairs.
George L. Erickson, Vice President, Transportation Services.
Phyllis C. Johnson, Vice President, General Counsel.
Jerry Anderson, Vice President, Finance & Administration.
J. David Eagle, Vice President, Real Estate & Facilities.
Thomas E. Brooks, Acting Vice President, Maintenance & Engineering.
Eileen M. Reilly, Chief Information Officer.

## Management Statement: Alaska Railroad Corporation

The management of the Alaska Railroad Corporation is responsible for the fair statement of the accompanying financial statements and all other information contained in the annual report. The financial statements were prepared in conformity with generally accepted accounting principles and prevailing railroad industry practices and reflect Management's judgments and estimates concerning effects of events and transactions that are accounted for or disclosed. The financial information contained elsewhere in the annual report is consistent with that in the financial statements.

The Alaska Railroad Corporation maintains accounting systems that are supported by internal accounting controls. These systems and controls provide reasonable assurance that assets are safeguarded and that transactions are executed in accordance with Management's authorization and recorded properly to permit the preparation of financial statements in accordance with generally accepted accounting principles. The concept of reasonable assurance is based on the recognition that the cost of a system of internal control should not exceed the related benefits. Management believes the company's system provides this appropriate balance in all material respects.

The financial statements have been audited by KPMG Peat Marwick LLP, independent certified public accountants, who are appointed by the Board of Directors. Their audit is conducted in accordance with generally accepted auditing standards which include an objective, outside review of operating results, financial condition, and the Corporation's system of internal controls. The opinion of the independent auditors is contained in this annual report.

The audit committee of the board of directors, composed solely of outside directors, meets with the independent auditors and management periodically to discuss audit findings and other accounting and financial matters. The committee reviews the scope and results of the audit effort with the independent auditors as well as the annual financial statements and recommends their approval by the board of directors.

Jerry Anderson

Jerry Anderson
Vice President, Finance and Administration

## The Board of Directors Alaska Railroad Corporation:

We have audited the accompanying balance sheets of the Alaska Railroad Corporation as of December 31, 1997 and 1996, and the related statements of income, 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 generally accepted auditing standards. 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, 1997 and 1996, and the results of its operations and its cash flows for the years then ended in conformity with generally accepted accounting principles.

KPMG Peat Marwick LLP

February 20, 1998

# Alaska Railroad Corporation Balance Sheets

| | 1997 | December 31, (In Thousands) 1996 |
|---|---|---|
| ***Assets*** | | |
| Current assets: | | |
| Cash and cash equivalents | $ 5,918 | $ 4,814 |
| Accounts receivable, net of allowance for doubtful accounts of $524,000 in 1997 and $573,000 in 1996 | 11,536 | 11,160 |
| Materials and supplies | 3,180 | 3,346 |
| Prepaid expenses and other current assets | 967 | 317 |
| *Total current assets* | *21,601* | *19,637* |
| Operating property and equipment | | |
| Road and roadway structures | 83,549 | 72,979 |
| Equipment | 43,921 | 41,863 |
| Road materials and supplies | 1,357 | 1,269 |
| Construction in progress | 5,276 | 3,138 |
| Accumulated depreciation and amortization | (52,433) | (46,131) |
| *Total operating property and equipment, net* | *81,670* | *73,118* |
| Land (note 10) | 13,850 | 13,850 |
| Board designated assets (note 3) | 3,210 | – |
| Restricted assets (note 4) | 13,857 | 13,066 |
| Other assets (note 5) | 367 | 251 |
| *Total Assets* | *$134,555* | *$119,922* |
| ***Liabilities and Equity*** | | |
| Current liabilities: | | |
| Current portion of long-term debt (note 6) | 1,954 | 3,598 |
| Accounts payable and accrued liabilities | 4,073 | 5,500 |
| Payroll liabilities | 6,759 | 5,523 |
| Unearned revenues | 2,250 | 1,455 |
| *Total current liabilities* | *15,036* | *16,076* |
| Long-term debt, less current portion (note 6) | 37 | 3,514 |
| Accrued postretirement and pension benefits (note 7) | 6,881 | 5,997 |
| Deferred grant revenue (note 8) | 14,704 | 7,819 |
| Deferred revenue (note 4) | 13,857 | 13,066 |
| *Total liabilities* | *50,515* | *46,472* |
| Equity: | | |
| Investment by the State of Alaska | 34,174 | 34,174 |
| Retained earnings | 49,866 | 39,276 |
| *Total equity* | *84,040* | *73,450* |
| Commitments and contingencies (notes 6, 7, 9, 10, 11, 12 and 13) | | |
| *Total Liabilities and Equity* | *$134,555* | *$119,922* |

See accompanying notes to financial statements.

# Alaska Railroad Corporation Statements of Income

| | Years ended December 31, 1997 (In Thousands) | 1996 |
|---|---|---|
| Operating revenue: | | |
| Freight (note 9) | $ 64,029 | $ 62,248 |
| Passenger | 12,119 | 10,594 |
| Other | 238 | 500 |
| | *76,386* | *73,342* |
| Grant revenue (note 8) | 1,230 | 1,791 |
| | *77,616* | *75,133* |
| Operating expense: | | |
| Transportation | 37,076 | 35,945 |
| Engineering (note 8) | 16,622 | 19,417 |
| Mechanical | 11,388 | 9,864 |
| General and administrative | 6,927 | 6,729 |
| | *72,013* | *71,955* |
| *Income from operations* | *5,603* | *3,178* |
| Other income (expense): | | |
| Real estate income, less direct expenses of $2,031,000 in 1997 and $1,309,000 in 1996 (note 10) | 4,903 | 5,264 |
| Interest income | 352 | 430 |
| Interest expense | (268) | (863) |
| | *4,987* | *4,831* |
| *Net income* | *$ 10,590* | *$ 8,009* |

See accompanying notes to financial statements.

# Statements of Equity

| | *Investment by the State of Alaska* | *Retained Earnings* | *Total Equity* |
|---|---|---|---|
| | | *(In Thousands)* | |
| Balance at December 31, 1995 | $34,174 | $31,267 | $65,441 |
| Net income | – | 8,009 | 8,009 |
| *Balance at December 31, 1996* | *34,174* | *39,276* | *73,450* |
| Net income | – | 10,590 | 10,590 |
| *Balance at December 31, 1997* | *$34,174* | *$49,866* | *$84,040* |

See accompanying notes to financial statements.

# *Alaska Railroad Corporation Statements of Cash Flows*

| | *Years ended December 31,* 1997 (In Thousands) | 1996 |
|---|---|---|
| Operating activities: | | |
| Net income | $ 10,590 | $ 8,009 |
| Adjustments to reconcile net income to net cash provided by operating activities: | | |
| Depreciation and amortization | 6,758 | 6,178 |
| Gain on disposal of assets | – | (376) |
| Changes in assets and liabilities: | | |
| (Increase) decrease in accounts receivable, net of allowance for doubtful accounts | (376) | 920 |
| (Increase) decrease in materials and supplies | 166 | (75) |
| (Increase) decrease in other assets | (766) | 2,973 |
| Decrease in accounts payable and accrued liabilities | (1,427) | (433) |
| Increase in payroll liabilities | 1,236 | 1,043 |
| Increase in unearned revenues | 795 | 235 |
| Increase in accrued postretirement and pension benefits | 884 | 1,134 |
| *Net cash provided by operating activities* | *17,860* | *19,608* |
| Investing activities: | | |
| Purchases of operating property and equipment | (15,310) | (15,740) |
| Proceeds from sales of fixed assets | – | 477 |
| Increase in board designated assets | (3,210) | – |
| Increase in deferred grant revenue | 6,885 | 8,529 |
| *Net cash used in investing activities* | *(11,635)* | *(6,734)* |
| Financing activities: | | |
| Payments on long-term debt | (5,121) | (11,956) |
| *Net cash used in financing activities* | *(5,121)* | *(11,956)* |
| *Net increase in cash and cash equivalents* | *1,104* | *918* |
| *Cash and cash equivalents at beginning of year* | *4,814* | *3,896* |
| *Cash and cash equivalents at end of year* | *$ 5,918* | *$ 4,814* |
| *Interest paid* | *$ 277* | *$ 932* |

See accompanying notes to financial statements.

*December 31, 1997 and 1996*

## (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 Alaska Railroad Corporation (the ARRC) is a corporation created by the State of Alaska legislature 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 Generally Accepted Accounting Principles 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.

### Basis of Accounting

The ARRC is subject to the jurisdiction of the Surface Transportation Board (STB). Accordingly, the ARRC has prepared the accompanying financial statements in accordance with the STB rules and regulations (US CFR Title 49), which are generally consistent with generally accepted accounting principles as promulgated by the Financial Accounting Standards Board.

### 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.

### Materials and Supplies

Materials and supplies inventories are carried at the lower of average cost (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.

### Operating Property and Equipment

Operating property and equipment are stated at cost. Depreciation and amortization is computed on the straight-line basis over the estimated useful lives of the related assets, ranging from 5 to 32 years.

### Board Designated Assets

Board designated assets represent investment securities held by the ARRC in anticipation of funding future postretirement benefits and equipment purchases. Management has both the ability and intent to hold the investment securities to maturity, and accordingly, has elected to account for them at amortized cost under Statement of Financial Accounting Standards (SFAS) No. 115, Accounting for Certain Investments in Debt and Equity Securities.

*Restricted Assets*

Restricted assets represent investment securities held by the ARRC in anticipation of the approval of future capital projects. Management has both the ability and intent to hold the investment securities to maturity, and accordingly has elected to account for them at amortized cost under SFAS No. 115. Funds received but not yet expended are recorded as deferred revenue.

*Grants*

Grant revenue is recorded in the same period as expenses related to the grant. Grant funds received but not yet expensed are recorded as deferred grant revenue.

*Income Taxes*

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

*Environmental Remediation Costs*

The Corporation 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.

*Fair Value of Financial Instruments*

Fair values of financial instruments, as defined under Statement of Financial Accounting Standards No. 107, Disclosures About Fair Value of Financial Instruments, are estimated by the ARRC's management. Fair values of restricted assets and related deferred revenue are based on quoted market prices, when available, and quoted market prices of comparable instruments, when not available. 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 investments which are discussed in note 4.

*Reclassifications*

Certain reclassifications have been made to the prior year balances in order to conform to the current year presentation.

## *(3) Board Designated Assets*

In 1997, the ARRC Board of Directors designated $2,500,000 for the purchase of locomotives (note 12) and $700,000 for postretirement benefits (note 7). These amounts are invested primarily in U.S. Agency Discount Notes with a carrying value and market value of $3,210,000 at December 31, 1997.

## *(4) Restricted Assets*

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. Any remaining funds, along with interest earned on the $9,000,000 while in the possession of the ARRC, may be used to purchase other equipment and improvements related to the project. This contribution from the State of Alaska is accounted for as deferred revenue, which will be amortized over the life of the project. Since 1991, the funds have been invested in U.S. Government securities, corporate notes and money market accounts. At December 31, 1997 and 1996, these investments had a carrying value, including accrued interest, of $13,610,000 and $12,832,000, respectively, at amortized cost and a market value of $13,624,000 and $12,827,000, respectively. According to the current agreement, the ARRC is to refund the $9,000,000 plus interest earned less administrative fees during the holding period if the Wishbone Hill Coal Project is canceled.

Also included in restricted assets is $247,000 received in 1990 from the 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, would be returned to the Department of Natural Resources. At December 31, 1997 and 1996, these investments had a carrying value, including accrued interest, of $247,000 and $234,000, respectively, at amortized cost and a market value of $247,000 and $234,000, respectively.

Securities at December 31, 1997 consisted of the following (in thousands):

| *Description of Security* | *Estimated market value* | *Gross unrealized gains* | *Gross unrealized losses* | *Amortized cost* |
|---|---|---|---|---|
| Corporate Notes | $ 1,838 | (2) | – | $ 1,836 |
| U.S. Agency Notes | 8,771 | (24) | 11 | 8,758 |
| U.S. Treasury Strips | 2,911 | – | 1 | 2,912 |
| Money Market Accounts | 351 | – | – | 351 |
| *Total* | *$13,871* | *(26)* | *12* | *$13,857* |

Securities at December 31, 1996 consisted of the following (in thousands):

| *Description of Security* | *Estimated market value* | *Gross unrealized gains* | *Gross unrealized losses* | *Amortized cost* |
|---|---|---|---|---|
| U.S. Agency Notes | $ 3,143 | (5) | 1 | $ 3,139 |
| U.S. Treasury Strips | 2,744 | (3) | 12 | 2,753 |
| Money Market Accounts | 7,174 | – | – | 7,174 |
| *Total* | *$13,061* | *(8)* | *13* | *$13,066* |

## *(5) Investment in Partnership*

During 1992, the ARRC entered into a general partnership agreement to develop and operate a hotel complex in the Ship Creek area. The ARRC entered into a 35 year lease with the partnership for the land on which the hotel is located for $1 per year. In return, the ARRC received a 40% interest in the partnership, which is accounted for using the equity method. The ARRC has no cash investment in the partnership. The ARRC's equity in the earnings of the partnership totaled $191,000 and $53,000 at December 31, 1997 and 1996, respectively.

## *(6) Long-Term Debt and Notes Payable*

Long-term debt at December 31, 1997 and 1996 consists of the following (in thousands):

| | 1997 | 1996 |
|---|---|---|
| Note payable, secured by equipment, due in monthly payments of $132,699 including interest at 4.6%, matures August, 1998. | $ 521 | $ 2,051 |
| Note payable, secured by equipment, due in monthly payments of $82,066 including interest at 4.50%, matures October, 1998. | 804 | 1,730 |
| Note payable, secured by equipment, due in monthly payments of $88,066 including interest at 5.8125%, matures November 1999. | 412 | 2,828 |
| Note payable, secured by equipment, due in monthly payments of $18,616 including interest at 4.44%, matures February 1999. | 254 | 461 |
| Other note payable, secured by equipment, due in annual payments of $20,965, matured August, 1997. | – | 42 |
| | 1,991 | 7,112 |
| Less current portion | 1,954 | 3,598 |
| | *$ 37* | *$ 3,514* |

ARRC has met all debt covenants at December 31, 1997.

Long-term debt maturities are as follows at December 31, 1997 (in thousands):

| | | |
|---|---|---|
| Year ending December 31, | 1998 | $1,954 |
| | 1997 | 37 |
| | | *$1,991* |

The ARRC has arrangements for short-term unsecured lines of credit of up to $10,000,000 each with two banks. The general purpose line of credit allows borrowing up to $10,000,000 at a rate of 65% of the prime rate of a major bank. The self-insurance line of credit allows borrowing up to $10,000,000 at a rate of 56% of the prime rate of a major bank. ARRC has met the debt covenants of both lines of credit, which have due dates of August 1, 1998. The ARRC believes these lines will be renewed when they mature or additional commitments will be obtained on similar terms.

## *(7) Employee Benefits*

The ARRC has a defined benefit pension plan (Plan) covering all regular represented and nonrepresented employees who are not covered by the Civil Service Retirement System. Benefits under this Plan are based upon the employee's years of service and final average compensation. The ARRC's funding policy is to contribute each year an amount equal to the net periodic pension cost. In 1997 and 1996, the ARRC contributed an amount for the periodic pension cost which was net of a prepaid pension amount. Contributions are made continuously throughout the year. Plan assets are comprised of fixed income securities and common stocks. Effective January 1, 1997, the Plan was amended to provide unreduced retirement benefits at age 58 rather than age 62.

The following table sets forth the Plan's status at December 31, 1997 and 1996 (in thousands):

| | *1997* | *1996* |
|---|---|---|
| Actuarial present value of benefit obligations: | | |
| Accumulated benefit obligation - vested | $ 13,635 | $ 10,161 |
| Accumulated benefit obligation - nonvested | 4,433 | 3,395 |
| | *$ 18,068* | *$ 13,556* |
| Projected benefit obligation for service rendered to date | 20,349 | 15,944 |
| Plan assets at fair value | (22,332) | (18,882) |
| Projected benefit obligation less than Plan assets | (1,983) | (2,938) |
| Unrecognized prior service cost | (1,100) | (223) |
| Unrecognized net transition obligation | (243) | (304) |
| Unrecognized net gain | 3,701 | 3,421 |
| *Pension accrual (prepayment)* | *$ 375* | *$ (44)* |

The weighted average discount rate and rate of increase in future compensation levels used in determining the actuarial present value of the projected benefit obligation were 7.0% and 4.75% at December 31, 1997 and 7.25% and 4.75% at December 31, 1996.

The components of 1997 and 1996 net pension costs are as follows (in thousands):

| | 1997 | 1996 |
|---|---|---|
| Service cost-benefits earned during the period | $ 698 | $ 529 |
| Interest cost on projected benefit obligation | 1,215 | 985 |
| Return on Plan assets | (2,598) | (1,260) |
| Net amortization and deferral | 1,104 | (159) |
| *Net periodic pension costs* | *$ 419* | *$ 95* |

The weighted average discount rate and rate of increase in future compensation levels used in determining the net pension cost were 7.25% and 4.75%, in 1997 and 1996. The expected long-term rate of return on assets was 8.0% in 1997 and 1996.

Federal employees who transferred to the ARRC continue to participate in the Civil Service Retirement System (CSRS). ARRC is required to contribute 8.5% of the transferred employees' base pay. Pension expense related to CSRS was $687,000 and $672,000 for the years ended December 31, 1997 and 1996, respectively.

In addition to the defined benefit pension plan, the ARRC sponsors a defined benefit health care plan (Plan) that provides postretirement medical benefits to employees receiving retirement under the corporate retirement plan and retired CSRS employees who do not qualify for the federal medical insurance. The Plan is contributory, with retiree contributions adjusted annually, and contains other cost-sharing features such as deductibles and coinsurance. The accounting for the Plan anticipates future cost-sharing changes to the written plan that are consistent with ARRC's expressed intent to increase the retiree contribution rate by the amount of that year's premium increase. Effective January 1, 1997, the Plan was amended to increase the employee annual deductible. ARRC's policy is to fund the cost of medical benefits in amounts determined at the discretion of management. At December 31, 1997, the ARRC has designated $700,000 for the funding of these benefit costs (note 3).

The following table presents the Plan's funded status, at December 31, 1997 and 1996 (in thousands):

| | 1997 | 1996 |
|---|---|---|
| Accumulated postretirement benefit obligation: | | |
| Retirees | $ 1,276 | $ 1,209 |
| Fully eligible active plan participants | 218 | 339 |
| Other active employees | 3,778 | 5,889 |
| Total accumulated postretirement benefit obligation | 5,272 | 7,437 |
| Unrecognized transition obligation | – | (2,901) |
| Unrecognized net gain | 910 | 1,505 |
| Unrecognized prior service cost | 324 | – |
| *Accrued postretirement benefit cost* | *$ 6,506* | *$ 6,041* |

The weighted average discount rate used in determining the actuarial present value of the accumulated postretirement benefit obligation was 7.0% and 7.25% at December 31, 1997 and 1996.

The components of 1997 and 1996 net postretirement benefit costs are as follows (in thousands):

| | 1997 | 1996 |
|---|---|---|
| Net periodic postretirement benefit cost includes the following components: | | |
| Service cost | $ 416 | $ 725 |
| Interest cost | 317 | 460 |
| Amortization of net gains over average future service expected to retirement date | (42) | (51) |
| Amortization of transition obligation over 20 years | – | 193 |
| Amortization of prior service cost over average future service expected to eligibility date | (26) | – |
| *Net periodic postretirement benefit cost* | *$ 665* | *$ 1,327* |

The weighted average discount rate used in determining the net postretirement benefit cost was 7.25% in 1997 and 1996.

For measuring the 1997 expected postretirement benefit obligation, a 10% annual rate of increase in the per capita claims cost was utilized for all participants. This rate was assumed to decrease over a five-year period to an ultimate rate of 5.25% in 2002. The effect of a 1% increase in the health care cost trend rate would increase the accumulated postretirement benefit obligation by $1,039,000 and increase the aggregated service and interest cost components by $206,000.

For measuring the 1996 expected postretirement benefit obligation, an 11% annual rate of increase in the per capita claims cost was utilized for all participants. This rate was assumed to decrease over a six-year period to an ultimate rate of 5.25% in 2002. The effect of a 1% increase in the health care cost trend rate would increase the accumulated postretirement benefit obligation by $1,556,000 and increase the aggregated service and interest cost components by $382,000.

## (8) Federal Grant

The ARRC received $10,000,000 grants in 1997 and 1996 from the Federal Railroad Administration for capital rehabilitation and improvements benefiting passenger operations. In 1997, the ARRC spent $9,201,000 of the 1996 and 1997 grants including proceeds from tie disposal of $116,000. In 1996, the ARRC spent $9,056,000 of the 1996 grant including proceeds from tie disposal of $41,000. Spending on road and roadway structures, which have a 15 to 25 year life, has totaled $13,545,000 through December 31, 1997, and spending on a collision avoidance system, which has a 10 to 15 year life, totaled $2,211,000 in 1997. The ARRC will recognize grant revenue equal to depreciation on these assets each year. During 1997, the ARRC recognized grant revenue equal to the $432,000 depreciation on the assets constructed and $798,000 of engineering expense funded by the grant. During 1996, the ARRC recognized grant revenue equal to the $88,000 depreciation on the assets constructed and $1,703,000 of engineering expense funded by the grant.

Deferred revenue as of December 31, 1997 represents the $15,230,000 net book value of assets constructed under the grants less $526,000 receivable from the Federal Railroad Administration. Included in accounts payable is $118,000 due to the Federal Railroad Administration for interest earned on grant advances.

The ARRC was awarded another $10,000,000 grant from the Federal Railroad Administration for 1998. Additionally in 1998, the ARRC was awarded $23,000,000 under the Taxpayer Relief Act of 1997 for improvements to intercity rail passenger services. These funds will be received in 1998 and 1999.

## (9) Major Customers

Two ARRC customers accounted for 34% and 8% of freight revenue in 1997 and 37% and 11% of freight revenue in 1996.

## (10) 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 $5,460,000 and $5,306,000 in 1997 and 1996, respectively.

The following table summarizes future minimum lease payments receivable as of December 31, 1997 (in thousands):

| | | |
|---|---|---|
| Year ending December 31, | 1998 | $ 5,741 |
| | 1999 | 5,989 |
| | 2000 | 6,406 |
| | 2001 | 6,741 |
| | 2002 | 6,668 |
| | Thereafter | 144,730 |
| | | *$ 176,275* |

The ARRC has $1,100,000 in rent credits outstanding on these leases at December 31, 1997.

## *(11) 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 $13,630,000 and $13,776,000 in 1997 and 1996, respectively. Future minimum lease payments as of December 31, 1997 are summarized as follows (in thousands):

| | | |
|---|---|---|
| Year ending December 31, | 1998 | $ 13,524 |
| | 1999 | 13,151 |
| | 2000 | 12,961 |
| | 2001 | 2,510 |
| | 2002 | 818 |
| | Thereafter | 6,933 |
| | | *$ 49,897* |

## *(12) Commitments and Contingencies*

The ARRC has entered into an agreement with another entity for rail barge services between Washington and Alaska and related administrative responsibilities. The agreement expires in February 2001. The rail barge operation, which is a significant portion of the ARRC's interline traffic, requires a substantial minimum annual level of utilization before it becomes profitable for the ARRC.

During 1997, the ARRC entered into an agreement to purchase eight locomotives for approximately $15,700,000. The locomotives are scheduled for delivery in the last half of 1999.

During 1992, the EPA filed a complaint seeking to fine the ARRC for alleged violations of the Resource Conservation and Recovery Act in relation to storing hazardous wastes at the Anchorage rail yard. A consent agreement was executed during 1994 settling the alleged violations. The accrual included in the financial statements does not reflect any costs to clean up any contamination in the area covered by the settlement. No contamination has been discovered, but the ARRC believes most, if not all, contamination in this area would have occurred prior to the transfer of the ARRC from the federal government to the State of Alaska. That liability for contamination will be ultimately imposed on the federal government under the transfer act and a 1990 agreement between the federal government and the ARRC.

The ARRC is a defendant in various legal proceedings related to the conduct of its business. Provision has been made in the financial statements for probable losses, if any, from such litigation. In the opinion of management, the outcome of the litigation will not have a material effect on the financial position of the ARRC.

## *(13) Insurance*

The ARRC is self-insured to certain limits for employee health benefits, personal injury, property and casualty damage claims which are funded by a line of credit (note 6). The ARRC is also self-insured against workers' compensation claims. The limit at December 31, 1997 for health benefits is $2.4 million, for casualty/liability is $5 million and for property is $10 million.

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# *Alaska Railroad Corporation Offices*

P.O. Box 107500, Anchorage, Alaska 99510-7500

## *Anchorage, Alaska*

| *Offices* | *Physical Address* | *Telephone* | *Fax* |
|---|---|---|---|
| Headquarters Offices | 327 W Ship Creek Avenue | (907) 265-2300 | (907) 265-2312 |
| Ticket Office | 411 W 1st Avenue | (907) 265-2494 | (907) 265-2509 |
| Yard Office | 1221 Whitney Road | (907) 265-2434 | (907) 265-2698 |

## Fairbanks, Alaska

| *Offices* | *Physical Address* | *Telephone* | *Fax* |
|---|---|---|---|
| Passenger Depot | 280 North Cushman | (907) 458-6025 | (907) 452-5582 |
| Yard Office | 1888 Fox Avenue | (907) 458-6022 | (907) 458-6052 |
| Freight House | 1888 Fox Avenue | (907) 458-6048 | (907) 458-6061 |

## *Seward, Alaska*

P.O. Box 95, Seward, Alaska 99664
Telephone: (907) 224-5550/5552
Fax: (907) 265-2660

## *Seattle, Washington*

Suite 215, 2203 Airport Way S, Seattle, WA 98134
Telephone: (206) 624-4234
Fax; (206) 624-9677

## *800 Numbers*

| | *Within Alaska (Outside Anchorage)* | *From Lower 48* |
|---|---|---|
| Customer Service | 1-800-478-2442 | 1-800-247-3153 |
| Marketing | 1-800-321-6518 | 1-800-321-6518 |
| Passenger Service | 1-800-544-0552 | 1-800-544-0552 |
| Seattle Office | 1-800-843-2772 | 1-800-843-2772 |

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