Blue & Gold Make Green

April 1, 2009

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, 2008.

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

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

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

Sincerely,

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

Wendy Richerson, CPA
Controller

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MANAGEMENT'S DISCUSSION AND ANALYSIS

December 31, 2008 and 2007

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, 2008 and 2007. Please read it in conjunction with the ARRC's financial statements, which follow this section.

Financial Highlights

- The ARRC's total fund equity decreased 9% during the course of this year's operations and increased 8% over the course of 2007 operations.
- During 2008, the ARRC's operating revenues exceeded operating expenses by $3.3 million, yielding an operating ratio of 0.98. Last year, operating revenues exceeded operating expenses by $9.7 million and yielded an operating ratio of 0.93.
- The total 2008 operating costs of the ARRC's programs were $155.5 million, an increase of 12% compared to last year. Total operating costs were $138.9 million, an increase of 8% during 2007.
- Expenditures on capital assets totaled $92.7 million during 2008, a decrease of 13% compared to last year. Expenditures on capital assets totaled $106.4 million during 2007, a decrease of 2% compared to last year.
- Federal grant funding was used for $33.2 million, or 36%, of the 2008 capital expenditures. In 2007 federal grant funding was $39.4 million, or 37%, 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 consist of three statements that present information about the ARRC's overall financial status:

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

statement regardless of when cash is received or paid. 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 decreased 9% between fiscal years 2007 and 2008 to approximately $179.7 million. ARRC's fund equity increased 8% between fiscal years 2006 and 2007 – increasing to approximately $198.1 million.

(in thousands)		2008	2007	2006
Assets:				
Current assets	$	76,867	59,702	53,896
Capital assets		709,213	664,608	599,708
Other noncurrent assets		68,042	110,204	60,642
Total assets	$	854,122	834,514	714,246
Liabilities:				
Current liabilities	$	44,464	38,140	34,322
Notes payable outstanding, less current installments		27,436	30,219	33,310
Revenue bonds payable, net of unamortized premiums and deferred amounts		155,066	164,314	78,403
Other liabilities		1,908	1,095	1,208
Payable from restricted assets		410	109	—
Regulatory liabilities:				
Postretirement and pension		29,225	—	—
Deferred grant revenue		415,882	402,581	383,435
Total liabilities	$	674,391	636,458	530,678
Fund equity:				
Invested in capital assets, net of related debt	$	160,612	165,215	157,685
Restricted for reinvestment in infrastructure		19,119	32,841	25,883
Total fund equity	$	179,731	198,056	183,568

Capital assets – Capital assets, net of accumulated depreciation, increased $44.6 million in 2008 and $64.9 million in 2007. During 2008 and 2007, the ARRC continued an extensive capital improvement plan, including bridge replacements, siding extensions, track refurbishing, straightening of curves, and welding rail to allow faster train speed and reduce wear. Also during this time period, ARRC increased its passenger fleet by five cars and acquired right of way in anticipation of future rail realignments.

December 31, 2008 and 2007

Long-term debt – Notes payable decreased $3.1 million and $3.1 million in 2008 and 2007, respectively. During 2008 and 2007, the ARRC executed no new long term loans.

Regulatory assets and 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 assets and 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 $13.3 million in 2008 and $19.1 million in 2007. This increase reflects the increased amount of capital assets constructed with grant funding. Generally deferred grant revenue will be recognized as income as the related capital assets are depreciated.
- The net postretirement and pension liability increased $29.2 million and the net postretirement and pension asset decreased $1.3 million during 2008, primarily due to poor market performance of the assets invested. The net postretirement and pension asset increased $1.2 million during 2007, primarily due to a strong market performance of the assets invested and a $2.5 million postretirement contribution.

Changes in fund equity – The ARRC's total revenues increased 6% and totaled $179.4 million in 2008. The ARRC's total revenues increased 14% and totaled $169.3 million in 2007. Approximately 54% and 54% of the ARRC's revenue comes from freight revenue during 2008 and 2007, respectively, and 14% and 14% of the revenue comes from passenger services during 2008 and 2007, respectively. The majority of the remaining income is related to real estate activities and federal grant revenue. Generally, federal grant revenue is recognized as the capital assets funded by the grants are depreciated.

Real estate expenses were $9.9 million in 2008, $12.6 million in 2007, and $8.5 million in 2006, a decrease of 21% from 2007 to 2008 and an increase of 48% from 2006 to 2007. The significant decrease in expense in 2008 is associated with a one time adjustment for a potential recovery from a third party.

MANAGEMENT'S DISCUSSION AND ANALYSIS

December 31, 2008 and 2007

(in thousands)		2008	2007	2006
Operating revenue:				
Freight	$	96,337	91,783	89,623
Passenger		24,550	23,304	21,292
Other		895	526	456
Total transportation revenue		121,782	115,613	111,371
Grant revenue		37,013	32,949	21,299
Total		158,795	148,562	132,670
Operating expense:				
Transportation		47,794	43,001	40,322
Passenger services		11,400	10,706	10,040
Business development		20,264	18,203	20,052
Mechanical		22,295	19,509	18,391
Maintenance		33,002	27,590	24,002
Facilities		6,828	6,111	3,271
Engineering services		511	317	447
Signals		3,083	2,536	1,530
General and administrative		10,313	10,905	10,364
Total		155,490	138,878	128,419
Operating income		3,305	9,684	4,251
Nonoperating revenues (expenses):				
Real estate income, net of expenses		10,407	6,670	6,510
Gain (loss) on sale of capital assets		(13)	478	616
Investment income		377	945	572
Interest expense		(1,519)	(1,527)	(1,504)
Net income		12,557	16,250	10,445
Other changes in fund equity		(30,882)	(1,762)	1,944
Change in fund equity	$	(18,325)	14,488	12,389

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December 31, 2008 and 2007

Several events occurred during 2008 that significantly impacted the change in fund equity:

- ARRC's indirect cost rate agreements allowed ARRC to allocate eligible general and administrative expenses to federal grant projects. A total of $1.8 million was allocated to capital projects during 2008, reducing general and administrative expenses. The overall indirect cost recovery was $254,000 greater than 2007.
- Total transportation revenue was $6.2 million greater than 2007. The increase in transportation revenue is attributed to barge freight, gravel, fuel surcharges, export coal shipments and passenger services.
- ARRC implemented GASB Statement No. 49, *Accounting and Financial Reporting for Pollution Remediation Obligations* and has estimated the liability for pollution remediation by estimating a reasonable range of potential outlays. The ranges of outlays have been reduced by allocation of liability to other potentially responsible parties where applicable, and in certain instances have included estimated recoveries for costs that were incurred in the past. As a result, net earnings in 2008 were increased by $2.9 million.
- ARRC used $651,000 of federal grant funding to acquire right of way in anticipation of future rail realignments.
- During 2008, ARRC entered into an agreement with one customer under the Internal Revenue Code (IRC) §45G. Under the agreement ARRC received $4.6 million for qualified track maintenance expense and gave the customer a shipping credit of $2.6 million.
- Beginning in 2005, ARRC changed methods for recording costs and accrued benefits under its defined benefit and postretirement plans to be calculated under the provisions of GASB Statements No. 27, *Accounting for Pensions by State and Local Government Employers*, and No. 45, *Accounting and Financial Reporting by Employers for Postemployment Benefits Other Than Pensions.* The ARRC's annual required contributions of $1,019,000 for its defined benefit plan and $2,805,000 for its postretirement plan were made during the year and are included in the accompanying financial statements. The other changes in fund equity of $30,882,000 and $1,675,000 represents the change from the prior year in the unfunded accrued actuarial liability of the defined benefit and post retirement plans at December 31, 2008 and 2007, respectively.

Several events occurred during 2007 that significantly impacted the change in fund equity:

- ARRC's indirect cost rate agreements allowed ARRC to allocate eligible general and administrative expenses to federal grant projects. A total of $1.6 million was allocated to capital projects during 2007, reducing general and administrative expenses. The overall indirect cost recovery was $21,000 less than 2006.
- Total transportation revenue was $4.2 million greater than 2006. The increase in transportation revenue is attributed to an increase in petroleum shipments and a record year in passenger services.
- ARRC used $4,137,000 of federal grant funding to acquire right of way in anticipation of future rail realignments.

- During 2007, ARRC entered into an agreement with one customer under the Internal Revenue Code (IRC) §45G. Under the agreement ARRC received $4.6 million for qualified track maintenance expense and gave the customer a shipping credit of $2.6 million.
- Beginning in 2005, ARRC changed methods for recording costs and accrued benefits under its defined benefit and postretirement plans to be calculated under the provisions of GASB Statements No. 27, *Accounting for Pensions by State and Local Government Employers*, and No. 45, *Accounting and Financial Reporting by Employers for Postemployment Benefits Other Than Pensions*. A $2.5 million postretirement contribution decreased the postretirement liabilities. The ARRC's annual required contributions of $872,000 for its defined benefit plan and $2,286,000 for its postretirement plan were made during the year and are included in the accompanying financial statements. The other changes in fund equity of $1,675,000 and $1,945,000 represents the change from the prior year in the unfunded accrued actuarial liability of the defined benefit and post retirement plans at December 31, 2007 and 2006, respectively.

Capital Asset and Debt Administration

Capital Assets

At the end of 2008, the ARRC had invested $709.2 million in a broad range of capital assets including land, road and roadway structures, equipment, and leasehold improvements. This amount represents a net increase (including additions and deductions) of $44.6 million, or 7%, over last year. Grants have funded $426.1 million of the assets, net of accumulated depreciation.

(in thousands)		2008	2007	2006
Land and improvements	$	24,769	24,056	19,599
Road materials and supplies		9,038	8,483	7,680
Road and roadway structures		472,204	328,986	245,358
Equipment		134,910	96,594	86,958
Leasehold improvements		667	797	2,022
Quarry Improvements		3,742	3,892	—
Construction in progress		63,883	201,800	238,091
Total capital assets, net of accumulated depreciation	$	709,213	664,608	599,708

The ARRC's fiscal year 2009 capital budget approved spending another $138.5 million for capital projects, principally for continued track and bridge rehabilitation and other infrastructure improvements. The ARRC intends to use federal grant funding to provide $78.1 million of the capital additions. The remaining capital projects will be funded out of the FTA Capital Receipts Bonds, Series 2007, current year earnings and cash flow. More detailed information about the ARRC's capital assets is presented in note 4 to the financial statements.

December 31, 2008 and 2007

Long-Term Debt

At the end of 2008, the ARRC had $30.2 million in notes payable outstanding, a decrease of 9% from last year and $164.5 million in bonds payable outstanding a decrease of 2%. At the end of 2007, the ARRC had $33.3 million in notes payable outstanding, a decrease of 10% from last year and $168.5 million in bonds payable outstanding an increase of 115%. Bond issuance costs from FTA Capital Grants Receipts, Series 2007 of $1.1 million and Series 2006 of $1.4 million are being amortized over the life of the bonds. More detailed information about the ARRC's long-term liabilities is presented in note 6 to the financial statements.

Bond Rating

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

In July 2006, Standard & Poor's Ratings Services and Fitch Ratings assigned "A+" and "A" ratings, respectively to the approximately $76.4 million of Capital Grant Receipts Bonds, Series 2006 (FTA Section 5307 Urbanized Area Formula Funds and Section 5309 Fixed Guideway Modernization Formula Funds). These ratings were used to determine the ARRC's financial strength for the bond issuance, insured under a policy issued by Financial Guaranty Insurance Company. More detailed information about ARRC's bond funded activities is presented in note 6 to the financial statements.

Next Year's Budget

Freight and passenger revenues are projected at $97.3 million and $27.4 million, respectively. As a result, the ARRC's fund equity is expected to increase $16.8 million or 9% by the close of 2009.

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, 907-265-2300 or visit us on the Internet at www.alaskarailroad.com.

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KPMG

KPMG LLP
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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 December 31, 2008 and 2007, 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. Our audit included consideration of internal control over financial reporting as a basis for designing audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the Corporation's internal control over financial reporting. Accordingly, we express no such opinion. An audit also includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements, assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of the Alaska Railroad Corporation as of December 31, 2008 and 2007, and the changes in its financial position and its cash flows for the years then ended in conformity with U.S. generally accepted accounting principles.

As discussed in Note 1 to the financial statements, effective January 1, 2008, the Company adopted the provisions of Governmental Accounting Standards Board Statement (GASB) No. 49, *Accounting and Financial Reporting for Pollution Remediation Obligations.*

In accordance with *Government Auditing Standards*, we have also issued our report dated April 1, 2009 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 agreements, and other matters. The purpose of that report is to describe the scope of our testing of internal control over financial reporting and compliance and the results of that testing, and not to provide an opinion on the internal control over financial reporting or on compliance. That report is an integral part of an audit performed in accordance with *Government Auditing Standards* and should be considered in assessing the results of our audit.

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

KPMG LLP

April 1, 2009

BALANCE SHEETS

December 31, 2008 and 2007

(In thousands)

Assets		2008	2007
Current assets:			
Cash and cash equivalents (note 3 and 14)	$	17,095	15,332
Accounts receivable, net of allowance for doubtful accounts of $376 in 2008 and $442 in 2007 (note 14)		23,325	17,890
Grants receivable (note 8)		5,889	8,177
Materials and supplies		9,484	8,450
Prepaid expenses and other current assets		1,829	1,834
Under recovery of vehicle and equipment allocated costs (note (2k))		1,106	439
Restricted assets (note 5, 6 and 14)		18,139	7,580
Total current assets		76,867	59,702
Capital assets (note 4):			
Land and improvements (note 11)		28,712	27,999
Road materials and supplies		9,038	8,483
Road and roadway structures		644,890	468,994
Equipment		241,532	189,339
Leasehold improvements (note 11)		1,650	1,650
Accumulated depreciation and amortization		(280,492)	(233,657)
Construction in progress		63,883	201,800
Total capital assets, net		709,213	664,608
Restricted assets (note 3 and 14)		68,024	108,863
Regulatory assets:			
Accrued postretirement and pension benefits (notes 5 and 7)		—	1,324
Other assets		18	17
	$	854,122	834,514
Liabilities and Fund Equity			
Current liabilities:			
Current portion of long-term debt (notes 5, 6 and 14)	$	2,784	3,090
Accounts payable and accrued liabilities (notes 5, 13, 14 and 16)		10,371	10,990
Environmental remediation (note 15)		439	32
Interest payable (note 14)		3,194	2,947
Payroll liabilities (note 14)		12,700	11,148
Unearned revenues (note 11)		5,581	5,868
Current portion of revenue bonds payable (note 5, 6 and 14)		9,395	4,065
Total current liabilities		44,464	38,140
Notes payable, less current portion (notes 5, 6 and 14)		27,436	30,219
Revenue bonds payable (net of unamortized premiums and deferred amounts (notes 5, 6 and 14))		155,066	164,314
Environmental remediation reserve (notes 5, 13, and 15)		1,722	543
State of Alaska advances (notes 3, 5, and 8)		186	552
Payable from restricted assets		410	109
Regulatory liabilities:			
Accrued postretirement and pension benefits (notes 5 and 7)		29,225	—
Deferred grant revenue (notes 5 and 8)		415,882	402,581
Total liabilities		674,391	636,458
Fund equity (notes 7 and 9):			
Investment in capital assets, net of related debt and deferred grant revenue (note 4)		160,612	165,215
Restricted for reinvestment in infrastructure (notes 2(a) and 2(m))		19,119	32,841
Total fund equity		179,731	198,056
Commitments and contingencies (notes 5, 7, 10, 12, 13, 15 and 16)			
	$	854,122	834,514

See accompanying notes to basic financial statements.

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STATEMENTS OF REVENUES, EXPENSES, AND CHANGES IN FUND EQUITY

Years ended December 31, 2008 and 2007

(In thousands)

		2008	2007
Operating revenues:			
Freight (note 10)	$	96,337	91,783
Passenger		24,550	23,304
Other		895	526
		121,782	115,613
Grant revenue (note 8)		37,013	32,949
		158,795	148,562
Operating expenses (note 8):			
Transportation		47,794	43,001
Passenger services		11,400	10,706
Business development		20,264	18,203
Mechanical		22,295	19,509
Maintenance		33,002	27,590
Facilities		6,828	6,111
Engineering services		511	317
Signals		3,083	2,536
General and administrative, net of indirect cost recovery of $1,823 in 2008 and $1,569 in 2007		10,313	10,905
		155,490	138,878
Operating income		3,305	9,684
Nonoperating revenues (expenses):			
Real estate income, less direct expenses of $9,878 in 2008 and $12,626 in 2007 (notes 8 and 11)		10,407	6,670
Gain (loss) on sale of capital assets		(13)	478
Investment income		377	945
Interest expense, net of grant revenue of $984 in 2008		(1,519)	(1,527)
Total nonoperating revenues		9,252	6,566
Net income (note 2(a))		12,557	16,250
Other change in fund equity:			
Change in pension and postretirement funding status (note 7)		(30,882)	(1,675)
Environmental remediation liability (note 15)		—	(87)
Change in fund equity		(18,325)	14,488
Fund equity, beginning of year		198,056	183,568
Fund equity, end of year	$	179,731	198,056

See accompanying notes to basic financial statements.

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STATEMENTS OF CASH FLOWS

Years ended December 31, 2008 and 2007

(In thousands)

		2008	2007
Cash flows from operating activities:			
Receipts from customers	$	116,347	119,282
Operating grants received		5,928	8,002
Payments to suppliers		(49,963)	(48,046)
Payments to employees		(62,542)	(61,747)
Net cash provided by operating activities		9,770	17,491
Cash flows from capital and related financing activities:			
Principal payments on long-term debt		(3,089)	(3,585)
Interest payments on long-term debt		(8,906)	(5,139)
Revenue bond proceeds, net of bond issuance costs of $1,149 in 2007		—	89,855
Purchases and construction of capital assets		(93,826)	(104,869)
Proceeds from sales of capital assets		—	799
Increase in deferred revenues, net of advances		46,484	45,134
Net cash provided (used) by capital and related financing activities		(59,337)	22,195
Cash flows from investing activities:			
Real estate income and related cash flows		25,626	26,422
Real estate direct expenses paid		(9,878)	(12,626)
Interest received		377	945
Purchase of restricted investments		(4,094)	(96,608)
Proceeds from sale of restricted investments		39,299	44,250
Net cash provided (used) by investing activities		51,330	(37,617)
Net increase in cash and cash equivalents		1,763	2,069
Cash and cash equivalents at beginning of year		15,332	13,263
Cash and cash equivalents at end of year	$	17,095	15,332
Reconciliation of operating income to net cash provided by operating activities:			
Operating income	$	3,305	9,684
Adjustments to reconcile operating income to net cash provided by operating activities:			
Depreciation and amortization		42,496	33,977
Bond issuance cost amortization		176	121
Grant revenue on capital assets		(31,261)	(24,947)
Changes in operating assets and liabilities:			
Materials and supplies		(1,034)	(539)
Accounts receivable		(5,435)	3,548
Prepaid expenses and other assets		4	305
Accounts payable and accrued liabilities		(619)	(453)
Under recovery of vehicle and equipment allocated costs		(667)	(996)
Payroll liabilities		1,552	(199)
Environmental reserve		1,586	(158)
Accrued postretirement and pension benefits		(333)	(2,852)
Total adjustments		6,465	7,807
Net cash provided by operating activities	$	9,770	17,491
Supplemental disclosure of noncash activity:			
Depreciation included in real estate activity	$	5,628	6,033

See accompanying notes to basic financial statements.

NOTES TO FINANCIAL STATEMENTS

December 31, 2008 and 2007

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

(2) Summary of Significant Accounting Policies

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

(a) Basis of Accounting

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

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

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

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

December 31, 2008 and 2007

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

The ARRC's restricted assets consist of money market accounts and investments in commercial paper and guaranteed investment contracts (GICs), which are reported at fair value on the balance sheet. Fair values are based on quoted market prices.

(f) Regulatory Assets and Liabilities

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

(g) Operations

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

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NOTES TO FINANCIAL STATEMENTS

December 31, 2008 and 2007

(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 based on obligating events as defined under GASB Statement No. 49, *Accounting and Financial Reporting for Pollution Remediation Obligations*. Costs of future expenditures for environmental remediation liabilities are not discounted to their present value.

(k) Vehicle and Equipment Allocated Costs

The ARRC's vehicle and equipment costs for maintenance, fuel, depreciation, and leases are recorded in the vehicle and equipment cost pool. These costs are recovered through various responsibility centers through a fixed charge rate based on usage of vehicles and equipment. Any over or under recovery of actual vehicle and equipment costs is applied against fixed charge rates in subsequent years. Accordingly, the ARRC has recorded an under recovery of $1,106,000 and $439,000 during the years ended December 31, 2008 and 2007, respectively.

(l) Fair Value of Financial Insutrments

Fair values of financial instruments, as defined under FASB Statement No. 107, *Disclosures about Fair Value of Financial Instruments*, are estimated by ARRC's management.

(m) Equity

During 2008 and 2007, the ARRC's board of directors restricted $19,119,000 and $32,841,000, respectively, of fund equity for reinvestment in infrastructure.

(n) Recently Issued Accounting Standards

On January 1, 2008 the ARRC adopted Statement of Governmental Accounting Standards No. 49, *Accounting and Financial Reporting for Pollution Remediation Obligations*. GASB 49 requires all governments and their component units to account for pollution remediation obligations in the same manner, including required reporting of pollution remediation obligations that previously may not have been reported. The ARRC adopted this statement and has recorded the impact on its financial condition, results of operations and cash flows.

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December 31, 2008 and 2007

(o) Reclassifications

Certain reclassifications not affecting net income have been made to the 2007 financial statements to conform to the current presentation.

(3) Deposits and Investments

(a) Custodial Credit Risk

In the case of deposits, this is the risk that in the event of a bank failure, the ARRC's deposits may not be returned to it. The ARRC's Investment Policy requires that all investments be collateralized and/or insured.

At December 31, 2008, the ARRC's carrying amount of cash and cash equivalents was $17,095,000 and the bank balance was $17,901,000. Of the bank balance, $250,000 was covered by federal depository insurance; $3,396,000 was collateralized with securities held by the pledging financial institution's trust department or agent, but not in the ARRC's name; none of the balances were uncollateralized; and $14,255,000 represents money market funds held by the ARRC's agent in the ARRC's name.

At December 31, 2007, the ARRC's carrying amount of cash and cash equivalents was $15,332,000 and the bank balance was $17,569,000. Of the bank balance, $100,000 was covered by federal depository insurance; $6,809,000 was collateralized with securities held by the pledging financial institution's trust department or agent, but not in the ARRC's name; none of the balances were uncollateralized; and $10,660,000 represents money market funds held by the ARRC's agent in the ARRC's name.

For an investment, custodial credit risk is a risk that, in the event of the failure of the counterparty, the ARRC will not be able to recover the value of its investments or collateral securities that are in the possession of an outside party. The ARRC had no debt securities exposed to custodial credit risk at December 31, 2008.

(b) Interest Rate Risk

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

(c) Credit Risk

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

(d) Concentration of Credit Risk

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

NOTES TO FINANCIAL STATEMENTS

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The fair value and maturities of the investments consists of the following at December 31, 2008 and 2007 (in thousands):

Investment Type	Maturities		2008	2007
Commercial Paper	01/04/08	$	1,019	1,016
Guaranteed Investment Contracts (GICs)	12/31/2008 - 6/30/2012		65,960	106,188
	Total Investments	$	66,979	107,204
Money Market			19,184	9,239
	Total	$	86,163	116,443

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, 2008 and 2007:

(in thousands)		Fair Value 2008			
Description of Restriction		Money Market	Commercial Paper	Investment Contract	Total
Capital assets as authorized by the State of Alaska	$	—	—	—	—
Capital assets as authorized by the Department of Natural Resources		191	—	—	191
Advance grant funding, other federal grants		547	—	—	547
Guaranteed Investment Contract (GIC):					
Capital Interest		9	—	2,076	2,085
Project Fund		284	—	63,884	64,168
Debt Service Reserve		18,139	—	—	18,139
Forward Sale Agreement:					
2006A Reserve Account		6	435	—	441
2006B Reserve Account		8	584	—	592
	$	19,184	1,019	65,960	86,163

December 31, 2008 and 2007

		Fair Value			
		2007			
Description of Restriction		Money Market	Commercial Paper	Investment Contract	Total
Capital assets as authorized by the State of Alaska	$	373	—	—	373
Capital assets as authorized by the Department of Natural Resources		193	—	—	193
Advance grant funding, other federal grants		558	—	—	558
Guaranteed Investment Contract (GIC):					
Capital Interest		62	—	7,506	7,568
Project Fund		426	—	98,682	99,108
Debt Service Reserve		7,580	—	—	7,580
Forward Sale Agreement:					
2006A Reserve Account		28	434	—	462
2006B Reserve Account		19	582	—	601
	$	9,239	1,016	106,188	116,443

Foreign Currency Risk

Foreign currency risk arises when changes in interest rates will adversely affect the fair value of an investment. ARRC does not have a policy to limit foreign currency risk associated with investment funds. ARRC does not have exposure to foreign currency risk in its investment funds at December 31, 2008 and 2007.

Other Restricted Assets

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

(4) Capital Assets

During 2002, the ARRC received initial approval from its Federal cognizant agency, which was updated in 2005, of its indirect cost rate agreement. In compliance with FTA Circular 5010.1C, ARRC will continue to update its indirect cost rate proposal but will retain it onsite and make it available for review during its annual financial audit. This agreement allows ARRC to allocate certain general and administrative expenses to grant projects. Indirect costs allocated to capital projects under this agreement totaled $1,823,000 and $1,569,000 during the years ended December 31, 2008 and 2007, respectively.

December 31, 2008 and 2007

The following summarizes activity in the capital assets accounts during the years ended December 31, 2008 and 2007:

(in thousands)	Balance at December 31, 2007	Additions	Reductions	Reclasses	Balance at December 31, 2008
Capital assets not being depreciated:					
Land and improvements	$ 24,056	713	—	—	24,769
Road materials and supplies	8,483	555	—	—	9,038
Construction in progress	201,800	92,179	(230,096)	—	63,883
Total capital assets not being depreciated	234,339	93,447	(230,096)	—	97,690
Capital assets being depreciated:					
Road and roadway structures	468,994	175,896	—	—	644,890
Equipment	189,339	53,487	(1,294)	—	241,532
Leasehold improvements	1,650	—	—	—	1,650
Total capital assets being depreciated	659,983	229,383	(1,294)	—	888,072
Capital assets being depleted:					
Quarry improvements	3,943	—	—	—	3,943
Less accumulated depreciation for:					
Road and roadway structures	140,008	32,717	—	(39)	172,686
Equipment	92,745	15,127	(1,289)	39	106,622
Leasehold improvements	853	130	—	—	983
Total accumulated depreciation	233,606	47,974	(1,289)	—	280,291
Less accumulated depletion for:					
Quarry improvements	51	150	—	—	201
Capital assets being depreciated and depleted, net	430,269	181,259	(5)	—	611,523
Net capital assets	$ 664,608	274,706	(230,101)	—	709,213

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		Balance at December 31, 2006	Additions	Reductions	Reclasses	Balance at December 31, 2007
Capital assets not being depreciated:						
Land and improvements	$	19,599	4,457	—	—	24,056
Road materials and supplies		7,680	803	—	—	8,483
Construction in progress		238,091	105,642	(141,933)	—	201,800
Total capital assets not being depreciated		265,370	110,902	(141,933)	—	234,339
Capital assets being depreciated:						
Road and roadway structures		358,114	112,808	—	(1,928)	468,994
Equipment		172,259	22,333	(5,565)	312	189,339
Leasehold improvements		2,738	—	(1,088)	—	1,650
Total capital assets being depreciated		533,111	135,141	(6,653)	(1,616)	659,983
Capital assets being depleted:						
Quarry improvements		—	2,334	(7)	1,616	3,943
Less accumulated depreciation for:						
Road and roadway structures		112,757	27,301	(50)	—	140,008
Equipment		85,300	12,449	(5,004)	—	92,745
Leasehold improvements		716	209	(72)	—	853
Total accumulated depreciation		198,773	39,959	(5,126)	—	233,606
Less accumulated depletion for:						
Quarry improvements		—	51	—	—	51
Capital assets being depreciated and depleted, net		334,338	97,465	(1,534)	—	430,269
Net capital assets	$	599,708	208,367	(143,467)	—	664,608

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Depreciation expenses were charged to the following departments during the years ending December 31, 2008 and 2007:

(in thousands)	2008 Grant Funded Depreciation	2008 Non-Grant Funded Depreciation	2007 Grant Funded Depreciation	2007 Non-Grant Funded Depreciation
Transportation	$ 3,798	391	3,716	186
Passenger services	1,465	316	1,470	449
Business development	118	997	94	762
Mechanical	3,743	3,645	1,812	3,157
Maintenance	15,542	7,608	11,147	7,336
Facilities	—	107	—	31
Engineering services	—	9	1,166	118
Signals	1,435	200	—	10
General and administrative	535	2,437	364	2,108
Real estate	4,468	1,160	5,178	855
	$ 31,104	16,870	24,947	15,012

Fund equity invested in capital assets, net of related debt and deferred grant revenue, is as follows at December 31, 2008 and 2007:

(in thousands)	2008	2007
Net capital assets (note 4)	$ 709,213	664,608
Notes payable including current portion (note 6)	(30,220)	(33,309)
Proceeds of revenue bonds expended on capital assets (note 6)	(102,499)	(63,503)
Deferred grant revenue (note 8)	(415,882)	(402,581)
	$ 160,612	165,215

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December 31, 2008 and 2007

(5) Long-Term Liabilities

Long-term liability activity is summarized as follows during the years ended December 31, 2008 and 2007:

(in thousands)		Balance at December 31, 2007	Additions	Reductions	Balance at December 31, 2008	Due within one year
Long-term debt:						
Notes payable	$	33,310	—	(3,090)	30,220	2,784
Revenue bonds payable		168,379	147	(4,065)	164,461	9,395
Environmental remediation reserve		1,011	1,948	(798)	2,161	439
Other claims		537	584	(143)	978	978
State of Alaska advances		552	2	(368)	186	—
Payable from restricted assets		108	302	—	410	—
Regulatory liabilities:						
Accrued PRM & Pension Benefits		—	29,225	—	29,225	—
Deferred grant revenue		402,581	44,562	(31,261)	415,882	—
Total long-term liabilities	$	606,478	76,770	(39,725)	643,523	13,596

		Balance at December 31, 2006	Additions	Reductions	Balance at December 31, 2007	Due within one year
Long-term debt:						
Notes payable	$	36,895	—	(3,585)	33,310	3,090
Revenue bonds payable		78,403	89,976	—	168,379	4,065
Environmental remediation reserve		2,111	928	(2,028)	1,011	32
Other claims		1,331	311	(1,105)	537	537
State of Alaska advances		562	—	(10)	552	—
Payable from restricted assets		—	108	—	108	—
Regulatory liabilities:						
Deferred grant revenue		383,435	44,093	(24,947)	402,581	—
Total long-term liabilities	$	502,737	135,416	(31,675)	606,478	7,724

The ARRC has arrangements for three short-term unsecured lines of credit. The two general purpose lines of credit allow borrowing up to $20,000,000 at a rate of 55% of the prime rate of a major bank. The self-insurance line of credit allows borrowing up to $10,000,000 at a rate of 55% of the prime rate of a major bank. On November 21, 2007, an irrevocable letter of credit in the amount of $432,000 was issued, which expired December 31, 2007. None of the lines of credit had an outstanding balance as of December 31, 2008 or 2007.

December 31, 2008 and 2007

(6) Long-Term Debt

Long-term debt at December 31, 2008 and 2007 consists of the following:

(in thousands)		2008	2007
Notes payable:			
Note payable, secured by equipment, due in monthly payments of $156,934, including interest at 3.79%, matures March 2014.	$	8,842	10,359
Note payable, secured by equipment, due in monthly payments of $97,249, including interest at 3.83%, matures March 2019.		9,880	10,652
Note payable, secured by equipment, due in monthly payments of $44,226, including interest at 2.55%, matured July 2008.		—	307
Note payable, secured by equipment, due in monthly payments of $27,557, including interest at 3.35%, matured April 2008.		—	109
Note payable, secured by real estate revenue, due in monthly payments of $36,211, including interest at 5.40%, matures June 2026.		4,913	5,077
Note payable, secured by real estate revenue, due in monthly payments of $48,539, including interest at 5.40%, matures June 2026.		6,585	6,805
		30,220	33,309
Less current portion		2,784	3,090
	$	27,436	30,219
Revenue bonds:			
Revenue Bonds-Series 2006 and 2007, (interest at 3.625% – 5.25%) interest payable semi-annually Feb 1, and Aug 1, secured by 5307 and 5309 FTA Formula Funds, maturing August 2021, including premiums of $5,753,000 and unamortized issuance costs of $2,227,000 for the year ended December 31, 2008.	$	164,461	168,379
Less current portion		9,395	4,065
	$	155,066	164,314

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NOTES TO FINANCIAL STATEMENTS

December 31, 2008 and 2007

Annual payments on debt are scheduled as follows at December 31, 2008:

(in thousands)		Notes Payable		Revenue Bonds Payable		
		Principal	Interest	Principal	Interest	Total
Year ending December 31:						
2009	$	2,784	1,283	9,395	7,546	21,008
2010		2,898	1,169	9,785	7,153	21,005
2011		3,018	1,049	10,195	6,741	21,003
2012		3,142	925	10,635	6,301	21,003
2013		3,272	796	11,120	5,820	21,008
2014 – 2018		8,555	2,700	63,650	21,040	95,945
2019 – 2026		6,551	1,369	46,155	4,659	58,734
		30,220	9,291	160,935	59,260	259,706
Current portion of principal		(2,784)		(9,395)		(12,179)
Unamortized premium				5,753		5,753
Unamortized issuance cost				(2,227)		(2,227)
Total long-term portion	$	27,436		155,066		251,053

Notes Payable

There were no additional notes executed in 2008 or 2007. The real estate lease revenue debt service reserves balances, associated with the 2006 term loans used to acquire its general office building and other properties located in the Anchorage Terminal Reserve, at December 31, 2008 and 2007 were $441,000 and $592,000, and $462,000 and $601,000, respectively.

Bonds Payable

In August 2007, the ARRC issued $88.6 million in Capital Grant Receipts Bonds, Series 2007 FTA Section 5307 Urbanized Area Formula Funds and Section 5309 Fixed Guideway Modernization Formula Funds, to provide funds to finance various capital improvement projects. The 2007 Revenue Bonds are limited obligations of the ARRC payable solely from and secured solely by amounts received by the ARRC from its share of FTA Section 5307 Urbanized Area Formula Funds and Section 5309 Fixed Guideway Modernization Formula Funds. The bonds bear fixed interest rates from 4.0% to 5.0% and mature at various dates through 2021 and are insured by Financial Guaranty Insurance Company (FGIC) and were assigned ratings by Standard & Poor's Ratings Service, Fitch Ratings, and Moody's Investors Service of "A+", "A" and "A1", respectively. Bond issuance costs of $1.1 million and bond premium of $2.4 million will be amortized over the life of the bonds.

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

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NOTES TO FINANCIAL STATEMENTS

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

The following table sets forth the authorized funding allocation of the Federal Transit Administration (FTA) Section 5307 Formula Program Funds and Section 5309 Formula Program Funds to ARRC in Federal Fiscal Years (FFY) 2008 and 2009:

(in thousands) FFY		Section 5307 Formula Program	Section 5309 Formula Program	Total
2008	$	18,912,352	17,181,327	36,093,679
2009*		18,971,386	17,122,418	36,093,804

*Source: FFY 2009 FTA apportionments published in Federal Register December 18, 2008. House Resolution (H.R.) 1105 Omnibus Appropriations Act 2009 for fiscal year ending September 30, 2009 was signed by the President on March 11, 2009.

During 2008, the ARRC expended $41.8 million of the bond proceeds on eligible capital costs related to the capital improvement program. Of these costs, $2.6 million was capitalized interest, which is calculated from the interest earnings of $3.9 million and the accrued interest expense of $6.5 million.

State of Alaska Authorizations

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

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

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

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

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(7) Employee Benefits

The ARRC's board of directors has established a method of accounting for pension and postretirement costs which are designed to recover the full costs of these benefit costs. As a result, all accrued liabilities net of accrued assets are reported as regulatory assets and liabilities in the balance sheets. Periodic benefit costs related to these plans are included in operating expenses and capital additions. Pension costs and accrued benefits under the defined benefit and postretirement plans are calculated under the provisions of GASB Statements No. 27, *Accounting for Pensions by State and Local Government Employers*, and No. 45, *Accounting and Financial Reporting by Employers for Postemployment Benefits Other Than Pensions*. The funded status of the defined benefit plan is reported as regulatory liability of $15,117,000 and asset of $9,162,000 at December 31, 2008 and 2007, respectively. The funded status of the postretirement benefit plan is reported as a regulatory liability of $14,108,000 and $7,838,000 at December 31, 2008 and 2007, respectively. The change in pension and postretirement funding status presented as other changes in fund equity of $30,882,000 and $1,675,000 in 2008 and 2007, respectively, represents the change from the prior year in the unfunded accrued actuarial liability for the defined benefit and post retirement plans.

(a) Defined Benefit Plan

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

The annual pension cost for the year ended December 31, 2008 and 2007, and related information is as follows:

	2008	2007
Actuarial assumptions compounded annually:		
Inflation rate	2.50%	2.50%
Investment return for funding purposes	7.50	7.50
Investment return on employee accounts	4.50	4.50
Projected salary increase	4.00	4.00
Cost of living allowance	1.25	1.25

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The following table sets forth the Plan's assets and funded status at December 31, 2008 and 2007:

(in thousands)

		2008	2007
Income:			
Contributions received:			
Employee	$	4,060	3,864
Employer		1,019	872
Investment earnings (loss)		(17,435)	5,468
Net accrued		(81)	18
Total income (loss)		(12,437)	10,222
Disbursements:			
Benefit payments:			
Periodic		879	757
Nonperiodic:			
Termination		854	919
Retirement		23	—
Disability		27	43
Death		41	6
Total benefit payments		1,824	1,725
Administrative and investment consulting expenses		300	361
Total disbursements		2,124	2,086
Net income (loss)		(14,561)	8,136
Net assets at beginning of year		73,718	65,582
Net assets at the end of year		59,157	73,718
Actuarial accrued liability (AAL)		74,274	64,556
Underfunded\(Overfunded) AAL	$	15,117	(9,162)

The annual required contribution of $1,019,000 and $872,000 and the associated expenses of $819,000 and $681,000 were included in the accompanying financial statements for the years ended December 31, 2008 and 2007, respectively.

(b) Postretirement Benefits Other Than Pension

The ARRC sponsors a retiree 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, and who move directly from active coverage to retiree coverage. The Plan is contributory with retiree contributions adjusted annually, and contains other cost-sharing features such as deductibles and coinsurance.

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The annual post employment benefit cost for the years ended December 31, 2008 and 2007, and related information is as follows:

Actuarial assumptions used in valuing the liabilities and benefits under the plan:

	2008	2007
Discount rate	7.50%	7.50%
Investment return for funding purposes	7.50	7.50

The following table sets forth the Plan's assets and funded status for other postemployment benefit obligations (OPEB) at December 31, 2008 and 2007:

(in thousands)

		2008	2007
Income:			
Contributions received – employer	$	2,805	5,138
Investment earnings (loss)		(5,245)	996
Net accrued		(24)	9
Total income (loss)		(2,464)	6,143
Disbursements:			
Benefit payments paid		38	202
Benefit payments payable		39	112
Administrative and investment consulting expenses		46	36
Total disbursements		123	350
Net income (loss)		(2,587)	5,793
Net assets at beginning of year		19,028	13,235
Net assets at the end of year		16,441	19,028
Actuarial accrued liability (AAL)		30,549	26,866
Unfunded AAL	$	14,108	7,838

The annual other postemployment benefit (OPEB) contribution of $2,805,000 and $2,638,000 and the associated expenses of $1,999,000 and $1,839,000 were included in the accompanying financial statements for the years ended December 31, 2008 and 2007, respectively.

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December 31, 2008 and 2007

(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' eligible compensation. Benefit expense related to CSRS was $333,000 and $373,000 for the years ended December 31, 2008 and 2007, respectively.

(d) Defined Contribution Plan

The ARRC sponsors a defined contribution plan (Plan) under Section 401(k) of the IRS Code for employees. All regular employees are eligible to contribute to the Plan. Under the terms of certain collective bargaining agreements, representing 55% of employees, the ARRC will match a portion of employee contributions. The maximum amount of matching required under the agreements is 66% of employee contributions for the first 9% of salary. Benefit expense related to the Plan was $556,000 and $481,000 for the years ended December 31, 2008 and 2007, respectively.

ARRC also sponsors a Section 457 deferred compensation plan under Section 457(b) of the IRS Code for non-represented employees. There are no benefit expenses related to the Plan for the years ended December 31, 2008 and 2007, respectively.

(8) Grants

The ARRC has spent grant funding on a variety of operating property, right of way acquisition and equipment. Generally, grant revenue will be recognized equal to depreciation on these assets each year. The original cost of assets constructed or acquired with grant funding as of December 31, 2008 and 2007 consists of the following:

(in thousands)

			2008	2007
Land and improvements		$	6,592	5,941
Road and roadway structures	15 – 32 year life		406,349	295,142
Equipment	5 – 25 year life		79,794	47,767
Construction in process			25,049	135,759
		$	517,784	484,609

Grant Receipts Bonds, Series 2006 and 2007 FTA

			2008	2007
Land and improvements		$	—	—
Road and roadway structures	15 – 32 year life		67,921	16,008
Equipment	5 – 25 year life		17,974	7,772
Construction in process			21,584	41,886
		$	107,479	65,666

Deferred grant revenue consists of grant funding received for capital assets and is equal to the net book value of assets constructed with that funding. It will generally be amortized over the life of the related capital assets. Deferred grant balances as of December 31, 2008 and 2007 consist of the following:

(in thousands)	2008		2007	
	Advance grant funding (receivable)	**Deferred grant revenue**	**Advance grant funding (receivable)**	**Deferred grant revenue**
Federal Railroad Administration:				
Net book value of assets constructed	$ —	234,437	—	165,815
Construction in process	—	5,291	—	87,603
Amount receivable from grantor	(519)	—	(1,180)	—
Taxpayer Relief Act:				
Net book value of assets purchased and constructed	—	18,321	—	19,541
Construction in process	—	(15)	—	—
Nondepreciable asset	—	(1,549)	—	(1,549)
Federal Transit Administration:				
Net book value of assets purchased and constructed	—	93,251	—	37,180
Construction in process	—	60,976	—	87,528
Nondepreciable asset	—	(5,043)	—	(4,392)
Amortize Bond Issuance Costs	—	(177)	—	(160)
Interest Expense Debt Service	—	(984)	—	—
Amount receivable from grantor	(4,388)	—	(6,138)	—
Federal Emergency Management Agency:				
Net book value of assets constructed	—	2,108	—	977
Construction in process	—	1,147	—	1,624
Amount receivable from grantor	(954)	—	(859)	—
Department of Interior:				
Grant funding received in advance	490	—	528	—
Accrued derailment expense (note 14)	(490)	—	(528)	—
Department of Agriculture:				
Net book value of assets constructed	—	1,300	—	659
Construction in process	—	(12)	—	764
Amount receivable from grantor	—	—	—	—

NOTES TO FINANCIAL STATEMENTS

December 31, 2008 and 2007

	2008		2007	
	Advance grant funding (receivable)	Deferred grant revenue	Advance grant funding (receivable)	Deferred grant revenue
U.S. Fish and Wildlife:				
Net book value of assets constructed	$ —	362	—	334
Construction in process	—	1	—	29
Amount receivable from grantor	(2)	—	—	—
Department of Homeland Security:				
Net book value of assets constructed	—	320	—	408
Construction in process	—	—	—	—
State of Alaska Wishbone Hill Coal Project:				
Grant funding commitments	—	4,840	(363)	4,830
Construction in process	—	—	—	—
Grant funding received in advance	—	—	363	—
Municipality of Anchorage Ship Creek Economic Development:				
Net book value of assets constructed	—	135	—	145
Alaska State Fair:				
Net book value of assets constructed	—	313	—	325
Construction in process	—	—	—	—
Rasmuson Foundation:				
Net book value of assets constructed	—	633	—	713
Construction in process	—	—	—	—
State of Alaska Other:				
Net book value of assets constructed	—	108	—	110
Construction in process	—	47	—	97
MOU-DOT Fairbanks Freight Intermodal				
Construction in process	—	72	—	—
Amount receivable from grantor	(26)	—	—	—
	$ (5,889)	415,882	(8,177)	402,581

(Continued)

NOTES TO FINANCIAL STATEMENTS

December 31, 2008 and 2007

The ARRC recognized the following grant revenue during the years ended December 31, 2008 and 2007:

(in thousands)

		2008	2007
Alaska State Fair			
Depreciation on assets constructed	$	12	11
Capital Grant Receipts Bonds, Series 2006 and 2007			
Depreciation on assets constructed		3,477	1,261
Grant funded principal, interest and issuance costs		157	97
Department of Agriculture:			
Depreciation on assets constructed		191	180
Department of Interior:			
Grant funding of accrued derailment expense (note 15)		37	3
Derailment expense paid in current year		(37)	(3)
Federal Emergency Management Agency:			
Depreciation on assets constructed		238	107
Grant funded disaster recovery expense		117	35
Federal Railroad Administration:			
Depreciation on assets constructed		19,390	15,833
Federal Transit Administration:			
Depreciation on assets purchased and constructed		6,899	5,529
Grant funded maintenance and transit security expense		9,483	8,982
Right of way acquisition		651	3,937
Homeland Security:			
Depreciation on assets purchased and constructed		88	88
Municipality of Anchorage Ship Creek			
Economic Development:			
Depreciation on assets constructed		10	10
Rasmuson Foundation:			
Depreciation on assets purchased		80	86
State of Alaska:			
Depreciation on assets purchased		53	37
State of Alaska Wishbone Hill Coal Project:			
Depreciation on assets purchased		354	330
Taxpayer Relief Act:			
Depreciation on assets purchased and constructed		1,235	1,404
Right of way acquisition		—	200
US Fish and Wildlife:			
Depreciation on assets purchased and constructed		30	—
		42,465	38,127
Less grant revenue included in real estate nonoperating revenues		(4,468)	(5,178)
Less grant funded interest included in Series 2006 Bond revenues		(984)	—
	$	37,013	32,949

NOTES TO FINANCIAL STATEMENTS

December 31, 2008 and 2007

(9) Fund Equity

Fund equity consists of the following major items as of December 31, 2008 and 2007:

(in thousands)	Investment by the State of Alaska	Cumulative net income	Cumulative other changes in fund equity	Total fund equity
Balance at January 1, 2007	$ 34,174	141,516	7,878	183,568
Net income	—	16,250	—	16,250
Other changes in fund equity	—	—	(1,762)	(1,762)
Total changes in fund equity				14,488
Balance at December 31, 2007	34,174	157,766	6,116	198,056
Net income	—	12,557	—	12,557
Other changes in fund equity	—	—	(30,882)	(30,882)
Total changes in fund equity				(18,325)
Balance at December 31, 2008	$ 34,174	170,323	(24,766)	179,731

(10) Major Customer

One ARRC customer accounted for 39% and 45% of freight revenue in 2008 and 2007, respectively. During 2008 and 2007, ARRC entered into agreements with one customer under the Internal Revenue Code (IRC) §45G. Under the agreements ARRC received $4.6 million for qualified track maintenance expense and gave the customer a shipping credit of $2.6 million.

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NOTES TO FINANCIAL STATEMENTS

December 31, 2008 and 2007

(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 $11,695,000 and $11,018,000 in 2008 and 2007, respectively. The following table summarizes future minimum lease payments as of December 31, 2008:

(in thousands)	Amount
Year ending December 31:	
2009	$ 10,080
2010	9,851
2011	9,489
2012	8,993
2013	8,673
Thereafter	135,072
	$ 182,158

The ARRC has $963,000 in rent credits outstanding on these leases at December 31, 2008. The assets provided by tenants in exchange for the rent credits are included in property and equipment and are depreciated over their useful lives. The balance of the rent credits is included in unearned revenue.

(12) Operating Leases and Agreements

The ARRC leases certain operating equipment and barge services under operating leases and agreements. Payments under the leases and agreements totaled $12,243,000 and $12,069,000 in 2008 and 2007, respectively. Future minimum lease payments as of December 31, 2008 are summarized as follows:

(in thousands)	Amount
Year ending December 31:	
2009	$ 12,248
2010	11,362
2011	2,001
2012	142
2013	—
Thereafter	—
	$ 25,753

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December 31, 2008 and 2007

(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 uses a third party administrator that processes claims based on the provisions of the employee health plan. The ARRC is also self-insured against workers' compensation claims and utilizes a third party administrator to adjust those claims in compliance with the State workers' compensation act. The ARRC carries commercial insurance policies limiting ARRC's exposure for health benefits to $10.7 million, for casualty/liability to $5 million and for property to $10 million at December 31, 2008. Self-insurance activity is summarized as follows during the years ended December 31, 2008 and 2007:

(in thousands)		Balance at December 31, 2007	Incurred claims	Claim payments	Balance at December 31, 2008
Employee health benefits	$	1,756	11,176	(10,636)	2,296
Enviromental remediation		483	1,948	(761)	1,670
Casualty and liability		537	584	(143)	978
Workers' compensation		1,426	3,009	(2,024)	2,411
	$	4,202	16,717	(13,564)	7,355

		Balance at December 31, 2006	Incurred claims	Claim payments	Balance at December 31, 2007
Employee health benefits	$	1,552	8,484	(8,280)	1,756
Environmental remediation		1,580	928	(2,025)	483
Casualty and liability		1,172	470	(1,105)	537
Workers' compensation		1,657	1,228	(1,459)	1,426
	$	5,961	11,110	(12,869)	4,202

(14) Fair Value of Financial Instruments

At December 31, 2008 and 2007 the fair values of cash and cash equivalents, net receivables, accounts payable and accrued liabilities, including payroll, and interest payable, approximate their carrying value due to the short-term nature of these financial instruments.

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The carrying amounts and estimated fair values of ARRC's restricted assets, notes payable and revenue bonds payable are summarized as follows for the years ended December 31, 2008 and 2007:

(in thousands)

		2008		2007	
		Carrying amount	Fair value	Carrying amount	Fair value
Financial assets:					
Restricted assets	$	86,163	86,163	116,443	116,443
Financial liabilities:					
Notes payable	$	30,220	28,000	33,309	32,000
Revenue bonds payable		164,461	167,400	168,379	173,100

Restricted assets which consist of investments in guaranteed investment contracts, commercial paper and money market accounts are measured using quoted market prices at the reporting date multiplied by the quantity held for investments traded in an active market (money market funds or commercial paper) or for those investments that are not traded in an active market (guaranteed investment contracts), the present value technique is used to calculate the fair value of these contracts.

The estimated fair value of notes payable is measured on quoted rates based on ARRC's credit standing and interest rates currently offered to the ARRC for similar debt instruments of comparable maturities by the ARRC's bankers. The present value technique is used to calculate the fair value of these notes.

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

(15) Environmental Remediation Obligation

During 2008, the ARRC accrued certain environmental pollution remediation liabilities for all its properties. The accrual for the Anchorage Terminal Reserve is based on an on-going investigation described below. As to all other locations, ARRC has estimated the liability for pollution remediation by estimating a reasonable range of potential outlays and multiplying those outlays by the probability of occurring, reduced by the allocation of liability to other potentially responsible parties where applicable. The liabilities associated with these sites could change over time due to changes in costs of goods and services, changes in remediation technology, or changes in laws and regulations governing the remediation efforts.

During 2004, the ARRC commenced investigation of the nature and extent of certain environmental conditions at the Anchorage Terminal Reserve (the Site), which includes the Anchorage rail yard and properties the ARRC owns and leases to third parties. The work is being done under an administrative settlement agreement negotiated with the United States Environmental Protection Agency (EPA). Management has accrued a reasonable estimate of its obligations, as the current owner of the Site, for the activities required under the order, which are a remedial investigation and a feasibility study. These activities will be completed in 2009. ARRC has also reflected an anticipated settlement with the United

December 31, 2008 and 2007

States for a share of costs to date based on the United States' ownership of the Site before 1985. Once ARRC's work is complete, EPA will then determine what, if any, future remediation is required for the Site and what parties will be required to perform the work. This will be subject to negotiations with third parties in addition to ARRC. ARRC has accrued a reasonable estimate of its potential obligation for such future work by estimating a reasonable range of potential outlays and multiplying those outlays by the probability of occurring, reduced by the allocation of liability to other potentially responsible parties. If other responsible parties do not contribute or pay their fair share of the liability, or if remedial requirements are more stringent than currently anticipated, the ARRC will revise its estimate. It is the opinion of ARRC's management that the ultimate outcome will not have a material adverse impact on the ARRC's financial position, but may have significant impact on the change in fund equity in a given year.

During 1999, a derailment at Gold Creek resulted in fuel spills along the ARRC tracks. The ARRC is responsible for the remediation, restoration and monitoring of environmental contamination at this site. The ARRC has accrued its best estimate of its remaining obligation with respect to the site, which was $457,000 and $528,000 at December 31, 2008 and 2007, respectively. The amount expected to be paid within the next year, $33,000 and $40,000 at December 31, 2008 and 2007, respectively, is included in accounts payable and accrued liabilities. 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 remaining amount is expected to be incurred through 2011 and beyond and is reported as environmental remediation reserve. 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.

(16) Commitments and Contingencies

Approximately 74% of the ARRC's labor force is subject to one of five collective bargaining agreements. One labor agreement with the United Transportation Union (UTU) expired in 2008. Negotiations with the UTU began in 2008 and continue in 2009.

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

ALASKA RAILROAD CORPORATION

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Passenger Service		1-800-544-0552	
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The Alaska Railroad Corporation has not received any bona-fide offers of a sale arrangement within the calendar year of 2008, nor is the Corporation aware of any potential sales that require analysis under AS 42.40.260.

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