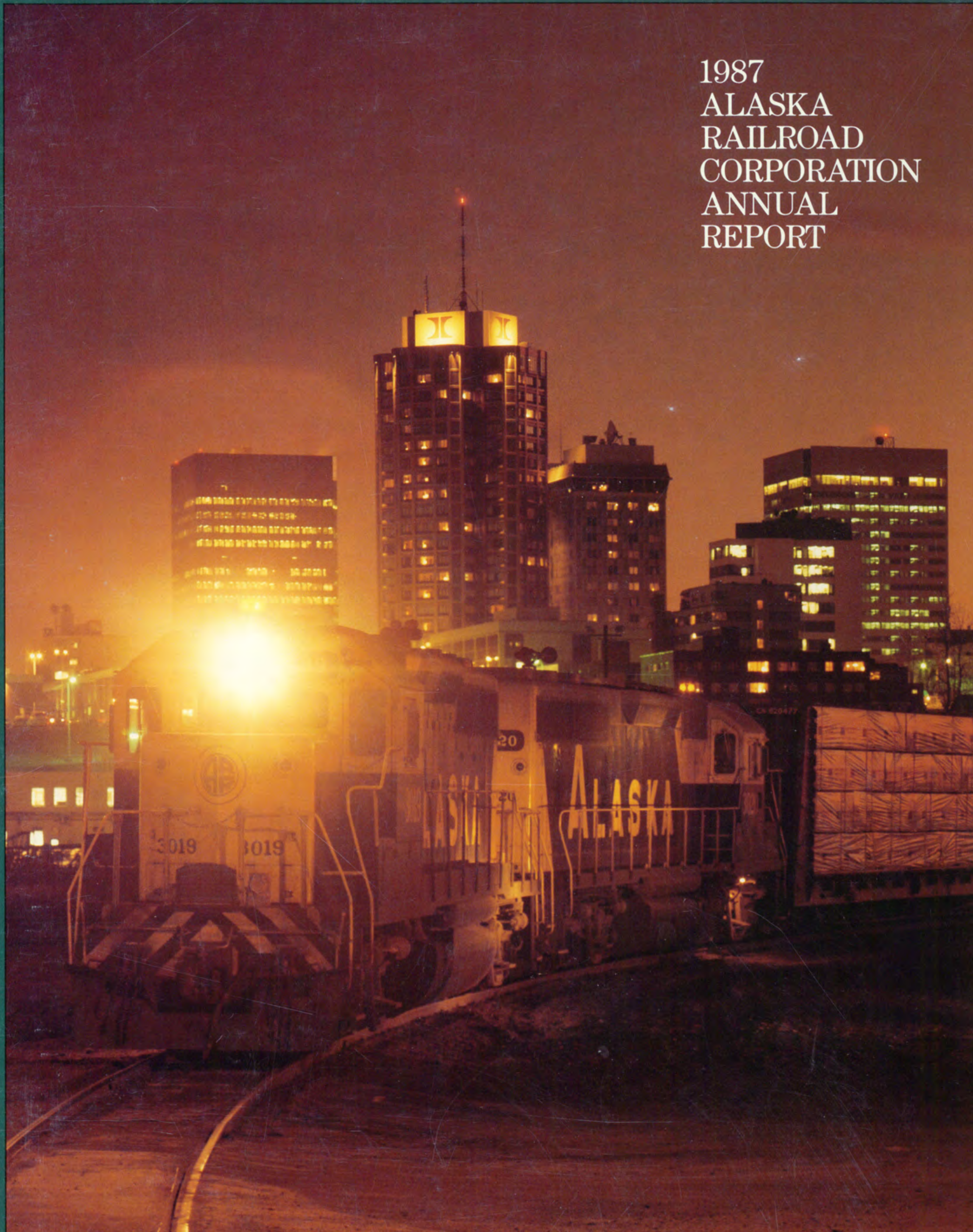
1987 ALASKA RAILROAD CORPORATION ANNUAL REPORT



ALASKA RAILROAD CORPORATION
Pouch 7-2111 • Anchorage, Alaska 99510-7069

March 31, 1988

Dear Governor Cowper,

In three years of operation as a state-owned corporation the Alaska Railroad has weathered more storms than many veteran businesses in Alaska. The railroad's performance score-card throughout the period has been impressive. The corporation has made many improvements in service, equipment and facilities without subsidy from the state.

The Alaska Railroad earned a net income of $7.3 million in 1985 despite the complications involved in organizing a new corporation. In 1986, the railroad suffered a net loss of $985,000, the aftermath of a severe flood and two major derailments combined with a sharp decline in Alaska's economy. Even though the poor economy continued in 1987, the corporation rebounded with a healthy net income of $3 million available for reinvestment.

Making a strong comeback after a bad year is never easy. It requires commitment from each entry-level job to the board room. Plus it calls for stringent cuts to keep operating costs at or below revenues. Just such a stance was taken in the opening months of 1987 after the corporation experienced a dramatic drop in revenue. Immediate steps were taken to curb expenses, including trimming summer work programs, reducing personnel and temporarily cutting the wages of all employees. At the same time the sales staff continued to aggressively pursue as large a share of the transportation market as possible.

In the succeeding months freight revenue began to steadily improve and, when coupled with spending cuts, resulted in a surplus for the year. Without the dedication and sacrifices of the employees of the Alaska Railroad, the positive cash flow would not have been possible.

At the close of 1987 the future appeared far more stable for the railroad. The Alaska Railroad has played an important role in the history of Alaska and it appears that role will not be significantly diminished by financial woes or economic decline. The management and employees of the Alaska Railroad Corporation pledge that the railroad will continue to offer safe, dependable and economical transportation for passengers and freight throughout the state.

F. G. Turpin
President and CEO

The Alaska Railroad Corporation plays a vital role in Alaska's transportation network, serving as a cost-effective link between water carriers, other railroads, and trucks. Again this year the railroad brought goods into Alaska through the ports of Seward, Whittier, and Anchorage, while transporting coal to Seward for export to the Pacific Rim.

Because of the advantages of rail—lower fuel consumption and labor cost per unit hauled—the Alaska Railroad plays an important part in keeping transportation services competitive in Alaska. As a result, the railroad closed the year with a net gain of $3 million, a significant accomplishment in view of the poor economic climate throughout the state over the past two years.

In 1986 oil prices dropped sharply and Alaska's economy suffered a dramatic downturn. Railroad management responded to the economic decline by reducing costs wherever possible to stave off the impact of lower revenue. The economy did not rebound in 1987, and for the second consecutive year revenue fell, totaling $53.7 million or 5.5 percent below the previous year. This revenue shortfall resulted in additional cutbacks and fiscal belt tightening throughout the Alaska Railroad.

The original 80-foot span on the Montana Creek Bridge, damaged in the 1986 flood, was salvaged and a 60-foot span added in 1987 to increase the water flow capacity of the bridge and reduce future risk of flood damage. The work was performed during live track conditions by Building and Bridge crews.

During 1987 summer work programs, Maintenance of Way employees used an undercutter to remove ballast damaged in the October 1986 flood. Specially designed for railroads, the undercutter lifts the rails and ties then digs out the ballast. Nearly 17,000 feet of rail were undercut and nearly 9,000 yards of ballast replaced in locations from Seward to Healy.

Mechanical Department employees designed an extension to the car body on locomotive No. 3010 and added a head-end power unit. This innovative step improved train efficiency both for winter intermodal service and summer passenger service. All of the work was performed by Alaska Railroad shop crews, despite predictions from other railroads and locomotive manufacturers that the project couldn't be done.

The railroad's quick response to the changing economy led to a successful year of railroad operation during which several major goals and objectives were accomplished that will result in long-term cost savings. Highlights of these accomplishments are:

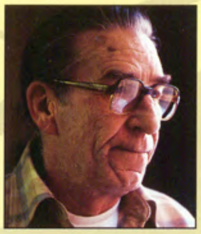
- completed the year with a positive cash flow which was used in 1987 to pay off short-term debt and will be reinvested in capital projects in 1988;
- signed a three-year contract with all five labor unions that provides cost-effective and flexible work rules;
- purchased additional track maintenance equipment to increase productivity;
- overhauled five locomotives and installed a head-end power unit in another to improve the efficiency and versatility of the fleet;
- refined the corporate computer system with upgrades that provided greater flexibility to the users;
- resolved a major land claim with the Native corporation Eklutna, Inc., that sets the stage for future development of a rail yard in the Eagle River area; and
- ordered new passenger cars for the Anchorage/Fairbanks service, the most popular route among summer tourists.

As part of the Administration Department, Wayne Chalker coordinates the railroad's print shop which reproduces a large variety of documents for internal and external distribution. Administration also provides company-wide word processing capabilities which were improved and upgraded in 1987 to provide increased office automation.

Despite the sluggish economy, the Accounting Office of the Alaska Railroad kept a firm grip on receivables and as a result the majority of accounts were collected within 30 days. In the Treasury Office Shawnessy Des Lauriers, left, and Pam Gallivo oversee credit and cash collections.

As a public corporation the Alaska Railroad is self-insured and, despite state ownership, claims against the corporation are not the responsibility of the state. Steve Hagedorn assesses the insurance needs of the railroad and directs the risk management, claims and worker's compensation programs for the General Counsel's Office.

Because there are no heavy equipment shops in Alaska that can accommodate the maintenance needs of the Alaska Railroad, Mechanical Department crews often design changes or improvements to railroad equipment as well as fabricate and install them. For instance, this welder is installing a heavy duty snow plow on a GP49 locomotive to replace the smaller factory-built plow.



"In a state where oil is the primary industry, it's not surprising that petroleum products are a prime source of revenue for the Alaska Railroad." Fairbanks Terminal Superintendent K. A. Smith. Petroleum shipments of jet fuel, gasoline, heating oil and diesel fuel accounted for 29 percent of 1987 freight revenue, totaling $11.6 million.

In 1987 the railroad played a vital role in Alaska's aviation industry, providing jet fuel for the Anchorage International Airport and Elmendorf Air Force Base.

The Alaska Railroad hauled home heating oil and gasoline from Anchorage to Fairbanks for retail markets. Diesel fuel was moved from Fairbanks to Anchorage and as far south as the Port of Seward for use by truckers, local industries and fishing vessels.

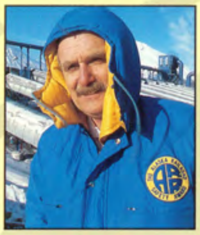
MAPCO Alaska Petroleum refines North Slope crude at its North Pole refinery. Diesel and jet fuels are loaded directly into rail cars at the refinery for shipment to Anchorage for use by airlines, trucking companies and other local industries. Some of the fuel makes its way via railroad as far south as Seward for use by fishing vessels.

Gasoline and home heating fuel were moved safely and economically from Anchorage to Fairbanks by unit train during 1987, helping to hold prices down for local consumers. The fuel was stored at distribution centers in Fairbanks then trucked to retail outlets such as this Tesoro franchise in downtown Fairbanks.

About 50 percent of the petroleum products hauled by the Alaska Railroad in 1987 was jet fuel. A good portion of the fuel was used by fighter jets at Elmendorf Air Force Base, one of the largest military bases in the state. Jet fuel also was hauled to the Anchorage International Airport which is served by more than 45 domestic and international airlines during the year.

Carman Gary Wilson, below, and Ernie Judd, Car Department Superintendent, make a routine car inspection before a train departs. All cars must conform to federal requirements, including placarding and securement, before leaving. The Alaska Railroad works closely with shippers on proper tie-down procedures for moving freight and machinery by rail.

Alaska coal is a primary source of fuel not only in the state but in foreign markets. In 1987 the Alaska Railroad hauled 1.3 million tons of coal from the family-owned Usibelli Coal Mine at Healy; about half was sold to Alaskans and the other half was used by Korea Electric Power Company.



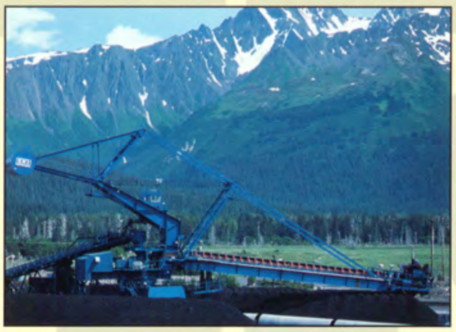
"One of Alaska's most important resources is its vast coal reserves and the railroad is the most effective way to move this product to in-state and world markets." Ralph Lowe, Division Trainmaster. Shipments of coal and gravel account for 35 percent of the Alaska Railroad's freight revenue. Coal is one of the top revenue producers, accounting for about $11.2 million in 1987; gravel revenue was $2.7 million.

There are two markets for the coal, which is hauled from the Usibelli Coal Mine at Healy. Local coal shipments are delivered north to the Fairbanks North Star Borough, the University of Alaska-Fairbanks and three military installations. Coal for export to South Korea is moved south to Seward. In addition, other markets are being explored in the Orient. A test load was hauled to Seward at mid-year for shipment to Taiwan.

Gravel is hauled from gravel pits in the Matanuska Valley to processing plants in Anchorage. The declining Alaska economy has resulted in a sharply reduced market for gravel which is used primarily in the construction industry. In 1987 the revenue from gravel fell about 30 percent below that earned in 1986.

Frequent movements of heavy commodities such as coal and gravel take a toll on the rails. Each year the Engineering Department schedules capital programs to improve the track and roadbed, focusing on rails, ties, bridges, ballast and surfacing. These projects are paid for with the previous year's earnings. In the three years since state ownership, the Alaska Railroad has spent $37.1 million on capital improvements and annual maintenance of the track and roadbed.

Coal-fired steam boilers at the Fairbanks Municipal Utility System provided 118 million kilowatt-hours of electricity and 146 million pounds of steam for steam heat to Fairbanks area residents in 1987. All of the coal for the facility is shipped via the Alaska Railroad and stockpiled in the MUS yard.



The Seward Coal Terminal is owned and operated by Suneel Alaska Corporation, a subsidiary of Sun Eel Shipping Co., Ltd., which ships more than one-half million tons of Alaska coal to Korea each year for electric power generation. The railroad moves an average of 21,000 tons of coal per week to Seward where it is stockpiled for loading onto ships.

Gravel shipped via the Alaska Railroad from three producers in the Matanuska Valley has dropped over the past few years in tandem with the declining Alaska economy. In Anchorage the number of housing starts and other private building programs shrank during 1987; as a result the major demand for gravel was for municipal and state-funded public works programs such as the Lake Otis Parkway extension.

"Each year the Alaska Railroad transports thousands of rail cars from other railroads." Rick Mackowiak, Locomotive Superintendent. Known as interline, this traffic enters and leaves the state via the water carriers Alaska Hydro-Train and Canadian National's AquaTrain. Both dock at the Port of Whittier. Interline resulted in $6.2 million in revenue or about 16 percent of 1987 freight revenue.

Myriad items are shipped interline through Whittier, including machinery and heavy equipment, liquid natural gas, frozen fish, news print, animal feed, flour, automobiles, scrap metal and building supplies.

Heavy traffic into the Port of Whittier also was the impetus for a preliminary design study prepared in 1987 on the Whittier and Portage tunnels. Both tunnels have a history of difficult and costly maintenance and operational conditions. At year-end the engineering design and work specifications were being prepared and rehabilitation was expected to begin in 1988, starting with the Whittier tunnel.

Nearly 6,000 new Ford and General Motors automobiles and light trucks were transported by the Alaska Railroad in 1987. The vehicles arrived at the Port of Whittier from Seattle and were shipped to Anchorage and Fairbanks.

Rail cars from such railroads as the Southern Pacific, Union Pacific, Burlington Northern and Canadian National frequently are moved interline on the Alaska Railroad with shipments ranging from animal feed and grains to machinery and heavy equipment.

Fresh bread baked daily at the Sunrise Bakery is made from flour hauled on the Alaska Railroad. The flour is shipped to Alaska by barge in specially designed rail cars.

Water carriers are the critical link between Outside railroads and the Alaska Railroad. Each year thousands of interline rail cars are shipped by the barge lines Alaska Hydro-Train and Canadian National to Alaska, connecting with the Alaska Railroad at the Port of Whittier.

The Anchorage Yard Office is the hub of the rail yard. Yardmasters such as Ron Petkosek direct the makeup of trains for departure, coordinate distribution of freight cars on arriving trains and oversee all other rail equipment in the yard area.

"Nowhere is the Alaska Railroad's role as a link in Alaska's transportation network more evident than in intermodal freight." Alfred Amoureux, Van Loader Operator. As the name implies, intermodal freight is shipped by several modes including trucks and water carriers. In the case of the Alaska Railroad, intermodal freight is composed of trailers and containers on flatcars both for inter and intrastate movements. Most of the shipments are received from the barge lines Alaska Hydro-Train, Sea-Land and TOTE which dock at Whittier and Anchorage.

Intermodal traffic resulted in about 15 percent of freight revenue or $5.8 million. Items shipped in trailers and containers included groceries, beverages, building and electrical supplies, furniture, electronic equipment, and automotive parts and supplies.

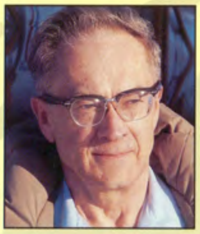
To improve train efficiency, the Mechanical Department modified the 3,000-horsepower locomotive No. 3010 by installing a 315 KW generator set to provide an electrical head-end power system. The first such modification performed by any U.S. railroad, the head-end power system was used during the winter in the "Keep from Freezing" intermodal service, eliminating the need for an auxilary power car for electricity to heat trailers while reducing fuel consumption and equipment maintenance cost. During the summer, locomotive No. 3010 was used in express passenger service to supply auxilary power for lighting and cooling passenger cars.

The SuperValu Store at North pole is among Alaska's largest stores and its goods arrive on the Alaska Railroad each week. Many shoppers in the Fairbanks area paid lower grocery prices in 1987 because stores that shipped by rail didn't have to pass high shipping costs on to their customers.

Carloads of beverages such as Pepsi products are typical of the Alaska Railroad's intermodal business. Soft drinks usually are shipped by barge to Alaska then moved by the Alaska Railroad to a major distribution area where they are trucked to warehouses or to retail outlets.

The Port of Anchorage and the Alaska Railroad are linked by the water carriers Sea-Land and TOTE which each bring barge-loads of goods to Alaska each week. Trailers and containers from the two carriers are hauled to the Interior by rail and by truck.

In 1986 and 1987 pipe movements dropped dramatically, mirroring the fall in oil prices and the resultant decline in Alaska's oil-dependent economy. At the close of 1987 there appeared to be a turnaround in the number of pipe shipments scheduled for 1988 that may herald an improvement in the oil industry.



"In no aspect of the Alaska Railroad freight business was Alaska's slumping oil industry more evident than in movements of pipe and other oil field related products." Larry Burnham, Fairbanks Freight Terminal Supervisor. What once had been a significant revenue source dropped dramatically in 1987 and, as a result, pipe only accounted for approximately 2 percent of revenue or $718,000. Most of the pipe is manufactured by Japanese firms and is later transported by truck to the North Slope oil fields.

About 24,000 tons of pipe were shipped via the Alaska Railroad from Seward to Fairbanks in 1987 compared to nearly 75,000 tons in 1986. However, at year-end, commitments for pipe shipments for 1988 indicated oil exploration and production might begin to improve.

Other oil field supplies continued to move regularly via the Alaska Railroad to Fairbanks in 1987 such as friction reducing agent for the trans-Alaska pipeline, drilling compounds, and anti-freezing chemicals.

Highway crossing safety along the Railbelt was a key issue for the Alaska Railroad in 1987. The railroad adopted a policy that requires crossings to be reviewed by a team of railroad, state highway and local government officials to determine whether there is a need for each crossing and to insure installation of sufficient protection requirements such as signs and signals. Most highway crossings are under permit from the railroad to the Alaska Department of Transportation and Public Facilities or a local governmental body. These agencies benefit from participating on the crossing team because it allows long-range planning for transportation networks and qualifies the agencies for federal funding for crossing projects.

Operators of the trans Alaska pipeline add an agent to the oil flow to reduce oil turbulence and increase throughput. This drag reducing agent is shipped in specially designed rail cars which arrive in Alaska by barge and are hauled by the Alaska Railroad to Fairbanks. From Fairbanks the agent is trucked to pumping stations along the 800-mile pipeline.

During the early 1970s the Alaska Railroad was instrumental in transporting supplies and equipment for development of Prudhoe Bay and for construction of the trans Alaska pipeline. Today the railroad continues to move supplies and equipment to Interior Alaska for shipment to the North Slope.

As a link in the state's transportation chain, the Alaska Railroad often connects with trucking companies to insure that goods arrive in remote, out of the way locations. The link with the truckers is especially important in getting supplies to the oil fields of the North Slope which are linked on land to Interior Alaska solely by the James Dalton Highway, a solitary, gravel road.

"Alaska's appeal to tourists has continued to grow over the past few years and with that growth has come a surge in summer passengers on the Alaska Railroad." Conductor Harry Ross. In 1987 more than 300,000 passengers rode the railroad, of which about 80 percent were summer visitors. To accommodate the influx of seasonal passengers the Alaska Railroad in 1987 added equipment, increased service and improved the reservation and baggage systems. These changes also improved service for local riders who depend on the Alaska Railroad year-round.

Perhaps the biggest change in the Passenger Services Department in 1987 was a shift in strategy in which the Alaska Railroad began to market train trips as part of package tours, making the railroad a full-service tour operator able to book hotel rooms, sightseeing tours, fishing trips and other activities along with train rides.

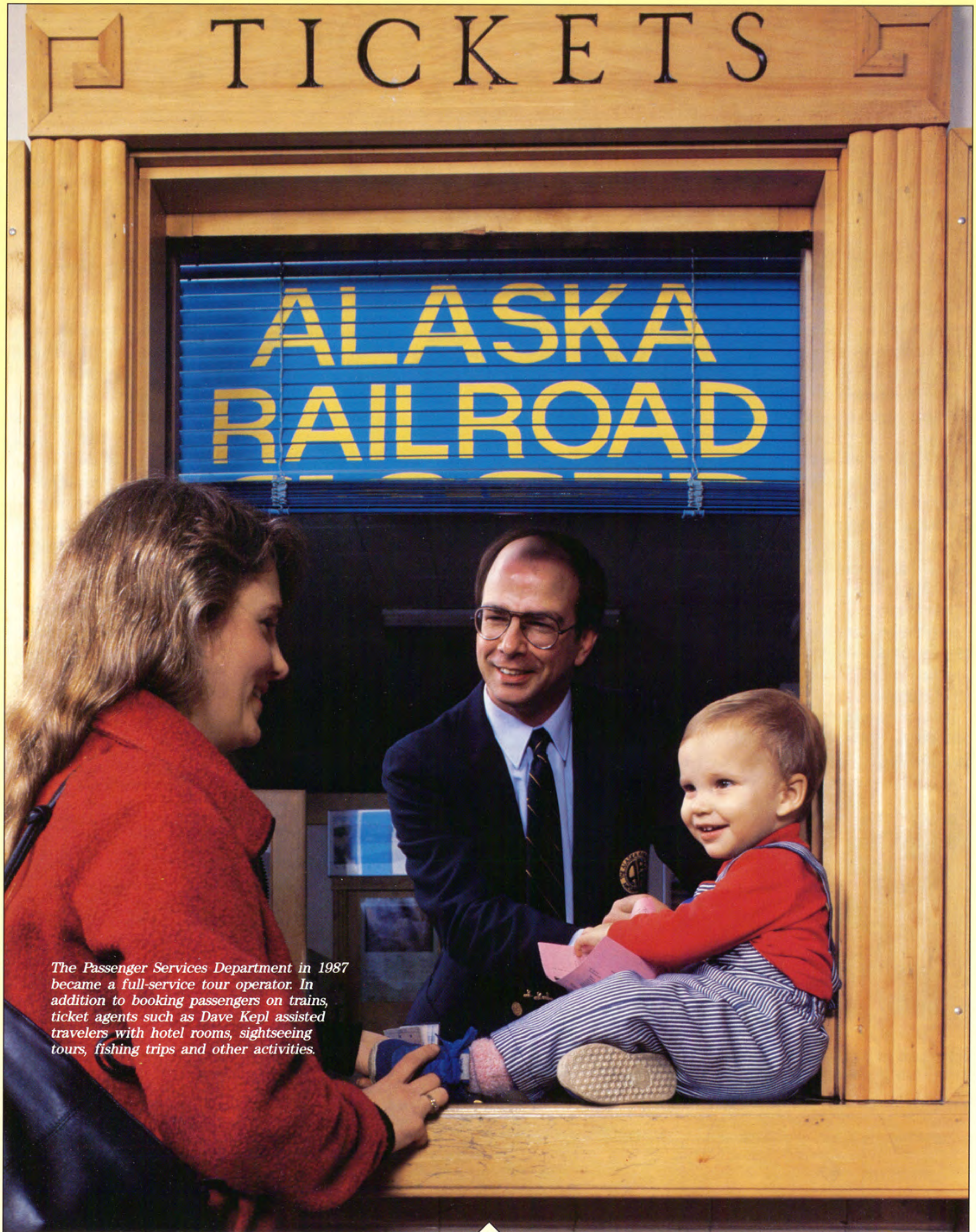
Several steps were taken to improve service to passengers. Summer service to Seward was increased from one to three days per week and a charter train was added exclusively to serve cruise ships docking in Whittier. Two rail diesel cars (RDCs) were added in 1987, doubling the fleet. These self-propelled cars have seating capacity for 76 passengers each. The RDCs are used to provide local service both in summer and winter, to increase service to Whittier and to make the thrice-weekly Seward summer run.

The Alaska Railroad is committed to improving the summer express passenger fleet. As a result, in 1987 six new passenger cars and two food service cars were ordered through Emprotech. The cars are being manufactured by Daewoo Heavy Industries in Korea and are expected to arrive in 1988.

Summer service to Seward was expanded to three times weekly in 1987 after an experimental once-a-week trip in 1986 proved especially popular. As a result, tour operators, such as Quest Charters, offered fishing trips, boating excursions and glacier tours to hundreds of summer travelers.

Westours, a private rail car service operated by Holland America Line, joined the Alaska Railroad in 1987, bringing six domed cars. Tour Alaska, which already had three private domed cars on the Alaska Railroad, increased its cars to four. Both private operators have found a growing interest in rail excursions and are expected to increase their fleets over the coming years.

The cost of providing passenger service is always high but the Alaska Railroad has trimmed its costs by investing in several self-propelled rail diesel cars. In 1987 the railroad doubled its RDC fleet by adding two 76-seat cars. The RDCs are used year-round in local service to rural residents who many times have no road access to their homesteads and use the railroad to move their supplies and animals.



The Passenger Services Department in 1987 became a full-service tour operator. In addition to booking passengers on trains, ticket agents such as Dave Kepl assisted travelers with hotel rooms, sightseeing tours, fishing trips and other activities.

BOARD OF DIRECTORS

The Alaska Railroad Corporation Act set the stage and established the rules for future management of the Alaska Railroad. The drafters are to be complimented. The act, in my opinion, is a model piece of rule-making that incorporates public ownership concepts while addressing private sector objectives. Most important, it provides the flexibility necessary to react quickly to changing markets, as well as operational and financial needs. The railroad continues to demonstrate a firm commitment to its mission as a profitable corporation and has proven it is able to function in a competitive marketplace without special legislative treatment or financial assistance.

Within this same statute is a provision that requires the corporation to document every five years, in the annual report, three attempts to sell the railroad. Discussions have been held with legislators involved in the original drafting of the act to clarify the intent of this requirement. The board understands the legislative responsibility to monitor any legitimate offer to purchase but, somewhere in this process, we need direction from the legislature as to the conditions of a sale.

Does the state want to sell all the land? What about those properties presently used by communities for parks, bike trails and rights-of-ways? Would we require the new owner to continue passenger service at the same level presently provided? And perhaps, most important, what about our employees? I am encouraged and hopeful that we will see revised legislation in 1988.

In 1987, the board adopted a code of ethics for themselves as well as all employees. Aware of our responsibility to our shareholders, the residents of Alaska, a Community Briefing Council was created. Representatives from communities along the Railbelt were selected to work with management on economic development projects, historical preservation of railroad structures, and recreational opportunities in an attempt to achieve the highest and best use of railroad land while protecting the public interest. As a result, public hearings were held throughout the Railbelt to gain input for a High Public Interest Lands Policy.

We would be remiss if we did not acknowledge our employees for making it possible to ratify the master agreement negotiated with all five unions. They set an example for others to follow during this downturn in our economy. Their voluntary wage cut was almost unheard of in other union negotiations in Alaska in 1987.

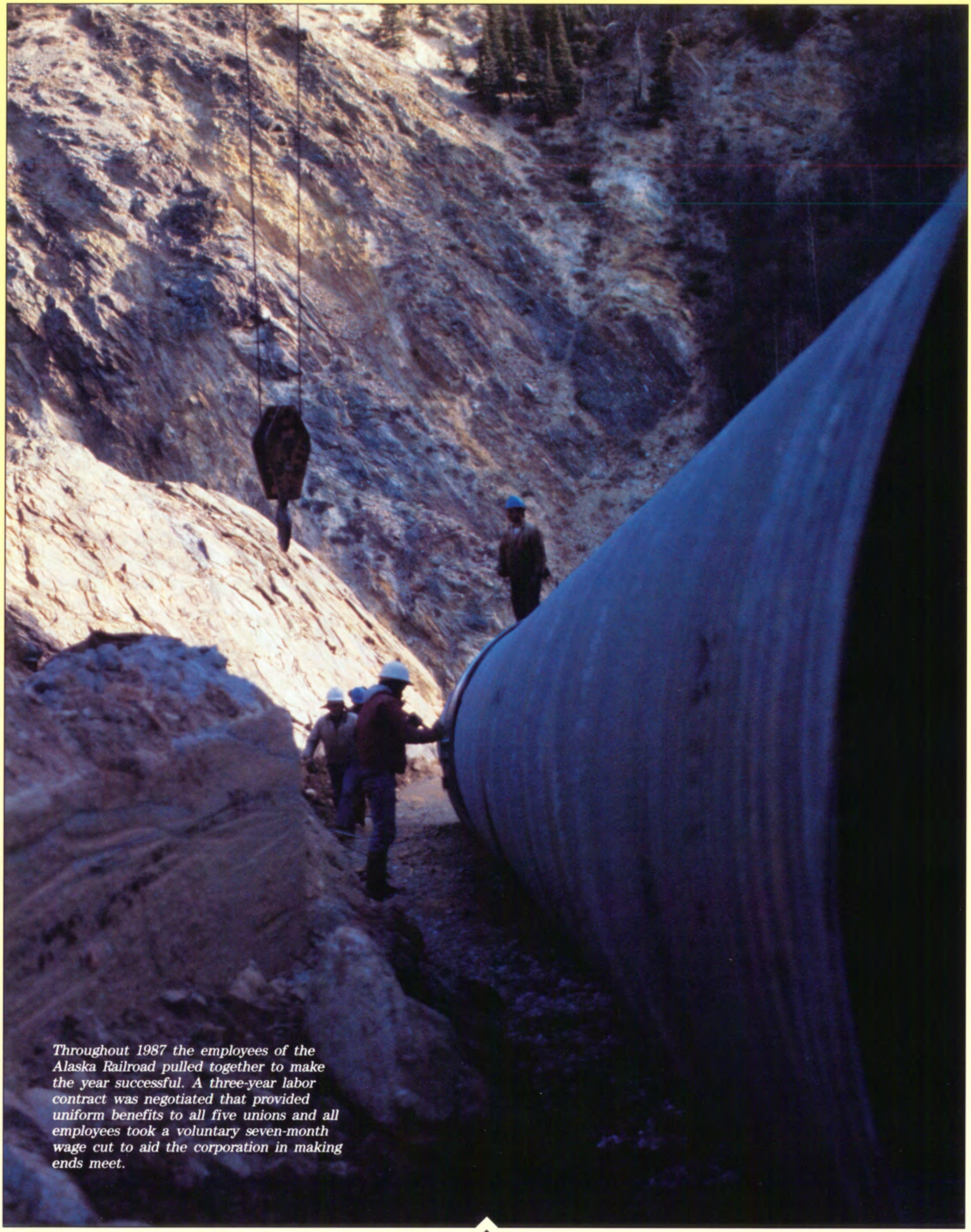
We were successful in 1987 because management was fast to react in the face of declining revenues and because Railroaders are special individuals with a love and concern for their company.

James O. Campbell
Chairman of the Board

Board member Myron Christy, left, was president of Western Pacific Railroad and brings many years of railroad experience to the board. Board Vice Chairman Frank Chapados, center, is a long-time Fairbanks businessman. Both tour the Mechanical Department diesel shop with Michael Sudol, chief mechanical officer.

Dispatcher Virginia Johnson explains the complexities of train dispatching to board members Gerald Valinske, right, and Anthony Smith. Valinske is no stranger to trains. A conductor and member of the United Transportation Union, he represents labor interests on the board. Smith, center, is an Anchorage attorney who serves as Alaska Commissioner of Commerce and Economic Development.

Board member Mark Hickey, left, is Alaska Commissioner of Transportation and Public Facilities. Lewis E. Dickinson, right, is a consulting engineer who, in 1987, retired as a partner in the Anchorage engineering firm DOWL. Jerry Swanson, manager of technical support, reviews the improvements and upgrades to the Alaska Railroad computer system.



Throughout 1987 the employees of the Alaska Railroad pulled together to make the year successful. A three-year labor contract was negotiated that provided uniform benefits to all five unions and all employees took a voluntary seven-month wage cut to aid the corporation in making ends meet.

STATEMENT OF MANAGEMENT'S FINANCIAL RESPONSIBILITY

Management is responsible for the preparation, integrity and objectivity of the corporation's financial statements and other financial information appearing in this report. The financial statements are prepared in conformity with generally accepted accounting principles and in the judgement of management, present fairly and consistently the corporation's financial position and results of operations.

Throughout 1987 the corporation maintained a system of internal accounting controls and procedures which are continually reviewed and supported by written policies and guidelines and supplemented by audit review. The system provides reasonable assurance that assets are safeguarded against loss from unauthorized use and that the books and records reflect the transactions of the corporation and are reliable for the preparation of financial statements. The concept of reasonable assurance recognizes that the cost of a system of internal accounting control should not exceed the benefits derived and also recognizes that the evaluation of these factors necessarily requires estimates and judgments by management.

The Board of Directors pursues its oversight responsibilities for the financial statements and corporate conduct through its Audit Committee. The Audit Committee is composed of directors who are not officers or employees of the Alaska Railroad Corporation. It meets regularly with members of management and the independent accountants to discuss the adequacy of the Alaska Railroad's internal controls and financial statements.

As the financial systems were refined during 1987, emphasis moved to the operations area where initiation of major systems began which will allow the corporation to more accurately capture and analyze revenue information. Additionally, substantial progress was made in providing personal computer capabilities to users throughout the corporation.

The corporation's financial statements are examined by Ernst and Whinney, independent certified public accountants. Their examination is conducted in accordance with generally accepted auditing standards which includes a study and evaluation of the corporation's system of internal accounting controls. The Auditors' Report follows.

Marvin J. Yetter

Marvin J. Yetter
Vice President, Finance

REPORT OF INDEPENDENT ACCOUNTANTS

Board of Directors
Alaska Railroad Corporation
Anchorage, Alaska

We have examined the balance sheets of Alaska Railroad Corporation as of December 31, 1987 and 1986, and the related statements of operations, equity, and cash flows for the years then ended. Our examinations were made in accordance with generally accepted auditing standards and, accordingly, included such tests of the accounting records and such other auditing procedures as we considered necessary in the circumstances.

In our opinion, the financial statements referred to above present fairly the financial position of Alaska Railroad Corporation at December 31, 1987 and 1986, and the results of its operations and cash flows for the years then ended, in conformity with generally accepted accounting principles applied on a consistent basis.

Ernst & Whinney

Anchorage, Alaska
February 26, 1988

BALANCE SHEETS

	Year Ended December 31, 1987	1986
	(In Thousands)	
ASSETS		
CURRENT ASSETS		
Cash and temporary investments—Note C	$ 1,915	$ 3,133
Accounts receivable, less allowance for bad debts of $655,000 in 1987 and $1,241,000 in 1986	7,090	10,529
Operating materials and supplies	2,203	1,785
Other current assets	1,041	1,212
TOTAL CURRENT ASSETS	12,249	16,659
PROPERTY AND EQUIPMENT—Note F		
Road	22,884	19,613
Equipment	24,917	21,429
Road materials and supplies	1,438	2,385
Construction in progress	557	1,345
	49,796	44,772
Less accumulated depreciation	(7,206)	(3,785)
	42,590	40,987
Land—Note D	13,850	13,850
	56,440	54,837
OTHER ASSETS		
Restricted funds—Note E	135	924
Restricted lease proceeds—Note F	220	220
	$ 69,044	$ 72,640
LIABILITIES AND EQUITY		
CURRENT LIABILITIES		
Accounts payable	$ 2,209	$ 2,467
Accrued wages and vacation	3,095	4,706
Notes payable	1,665	6,426
Current portion of long-term debt—Note G	199	183
Current portion of capital lease obligations—Note F	2,345	1,775
Other accrued liabilities	1,866	2,529
Deferred revenues	417	529
TOTAL CURRENT LIABILITIES	11,796	18,615
LONG-TERM DEBT, less current portion—Note G	449	648
CAPITAL LEASE OBLIGATIONS, less current portion—Note F	13,460	13,055
EQUITY		
Contributed capital	34,174	34,174
Retained earnings	9,165	6,148
	43,339	40,322
	$69,044	$72,640

See notes to financial statements.

STATEMENTS OF OPERATIONS

	Year Ended December 31, 1987	1986
	(In Thousands)	
Operating revenue:		
Freight—Note H	$ 39,371	$ 41,676
Passenger	5,434	4,574
Other	3,494	6,395
	48,299	52,645
Operating expense:		
Transportation	13,205	19,044
Ways and structures	10,119	11,795
Equipment	10,592	12,329
General and administrative	11,303	12,560
Depreciation	3,421	2,437
	48,640	58,165
LOSS FROM OPERATIONS	(341)	(5,520)
Other income (expense):		
Real estate, less direct expenses of $385,000 in 1987 and $340,000 in 1986	4,821	4,934
Interest income	198	214
Interest expense	(1,661)	(613)
NET INCOME (LOSS)	$ 3,017	$ (985)

See notes to financial statements.

STATEMENTS OF EQUITY

	Contributed Capital	Retained Earnings
	(In Thousands)	
Balance at December 31, 1985	$ 33,849	$ 7,133
Additional contributed capital	325	
Net loss for the year ended December 31, 1986		(985)
Balance at December 31, 1986	34,174	6,148
Net income for the year ended December 31, 1987		3,017
Balance at December 31, 1987	$ 34,174	$ 9,165

See notes to financial statements.

STATEMENTS OF CASH FLOWS

	Year Ended December 31, 1987	1986
	(In Thousands)	
OPERATING ACTIVITIES		
Net income (loss)	$ 3,017	$ (985)
Adjustments to reconcile net income to net cash provided by operating activities:		
Depreciation	3,421	2,437
Decrease (increase) in accounts receivable	3,439	(172)
Decrease (increase) in operating materials and supplies	(418)	389
Decrease in other current assets and restricted funds	960	44
Increase (decrease) in accounts payable and accrued expenses	(1,869)	279
Increase (decrease) in other accrued liabilities	(663)	2,299
Decrease in deferred revenues	(112)	(597)
NET CASH PROVIDED BY OPERATING ACTIVITIES	7,775	3,694
INVESTING ACTIVITIES		
Purchases of property, plant and equipment	(3,820)	(10,428)
Decrease in road materials and supplies	947	1,059
Decrease in construction in progress	788	1,788
Proceeds from disposal of property		288
NET CASH USED IN INVESTING ACTIVITIES	(2,085)	(7,293)
FINANCING ACTIVITIES		
Proceeds from short-term debt		7,000
Payments on short-term debt	(4,761)	(1,574)
Proceeds from long-term debt		1,000
Payments on long-term debt	(183)	(169)
Payments on capital lease obligations	(1,964)	(1,761)
Proceeds from State of Alaska capital contributions		325
NET CASH PROVIDED BY FINANCING ACTIVITIES	(6,908)	4,821
INCREASE (DECREASE) IN CASH AND TEMPORARY INVESTMENTS	(1,218)	1,222
Cash and temporary investments at beginning of year	3,133	1,911
CASH AND TEMPORARY INVESTMENTS AT END OF YEAR	$ 1,915	$ 3,133

See notes to financial statements.

December 31, 1987

NOTE A — ORGANIZATION AND OPERATIONS

Congress authorized construction of the Alaska Railroad (Railroad) 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 Railroad to the State of Alaska was authorized under the Alaska Railroad Transfer Act of 1982 (ARTA), which was signed into law on January 14, 1983. ARTA requires that the Corporation operate the Railroad for a period of 10 years from the acquisition date and if this requirement is not met, title to all of the Railroad's assets reverts to the federal government. The purchase price, established under the terms of ARTA, was $22,271,000. The Alaska Railroad Corporation (ARRC) is a public 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, and adopted the accounting policies of a commercial enterprise.

The ARRC operates 525 route miles, providing both freight and passenger services. The ARRC serves the Alaska cities of Anchorage and Fairbanks as well as the ports of Whittier, Seward, and Anchorage; Denali National Park; and military installations. Vessel and rail barge connections are provided from Seattle, Washington, and Prince Rupert, British Columbia.

NOTE B — SIGNIFICANT ACCOUNTING POLICIES

CASH AND TEMPORARY INVESTMENTS: Temporary investments are carried at cost which approximates market value.

In November 1987, the Financial Accounting Standards Board issued Statement No. 95, "Statement of Cash Flows." The ARRC adopted the provisions of the Statement in its 1987 financial statements and restated the previously reported statement of changes in financial position for 1986.

MATERIALS AND SUPPLIES INVENTORIES: Materials and supplies inventories are carried at the lower of cost (average cost) or market. Road materials and supplies include rail, ties, ballast, and other track materials. Because these items will generally be capitalized when placed into service, they are included in transportation properties.

PROPERTIES: Properties are stated at cost. Depreciation and amortization is computed on a straight-line basis over the estimated useful lives of the related assets. Preacquisition depreciable property is being depreciated on a straight-line basis over its estimated original remaining life of five years.

CAPITALIZED INTEREST: The ARRC capitalizes interest costs as part of the cost of constructing major facilities and equipment. Interest costs of $161,000 and $624,000 were capitalized in 1987 and 1986, respectively.

INCOME TAXES: As a public corporation, the ARRC is exempt from Federal and State income taxes.

RETAINED EARNINGS: The retained earnings of the ARRC represent the net income from operations and other income since the date of incorporation. The earnings are a source of funding for assets to the ARRC and are invested in property, equipment and working capital. The ARRC is prohibited by State of Alaska statute from paying dividends.

RECLASSIFICATIONS: In 1987, ARRC changed its presentation of the statement of operations to be consistent with general industry standards. The difference in reporting exists primarily in the presentation of operating expenses. In order to conform with the 1987 presentation, 1986 operating revenue has been increased by $272,000 and other income reduced by $272,000. Operating expenses for 1986 have also been reclassified for consistent presentation.

The 1986 statement of operations includes certain changes in estimates and other adjustments relating to 1985 operations. These changes in estimates and adjustments had the effect of reducing the 1986 loss by approximately $900,000.

NOTE C — CASH AND TEMPORARY INVESTMENTS

A summary of the ARRC's demand deposits and time deposits at December 31, 1987 is as follows:

	Carrying Amount	Bank Statement Balance
Demand Deposits	$ 12,000	$ 1,201,000
Time Deposits	1,903,000	1,903,000
	1,915,000	3,104,000
Insured by the Federal Deposit Insurance Corporation	304,000	304,000
Uninsured and uncollateralized	$ 1,611,000	$2,800,000

NOTE D — LAND

Certain parcels of the land are leased under agreements which are cancellable upon 90 days notice by the lessee. The leases terms vary from two to fifty-five years. Annual rentals on the leases were approximately $5,206,000 in 1987 and $5,274,000 in 1986.

NOTE E — RESTRICTED FUNDS

The ARRC received $924,000 from the State of Alaska which is restricted to the purchase of certain passenger equipment for the Whittier Shuttle. The funds which had not been spent as of December 31, 1987 and 1986 are classified as restricted funds.

NOTE F — LEASES

The ARRC leases certain locomotives, freight cars, data processing equipment and other property under capital leases. Future minimum lease payments for capital leases as of December 31, 1987 are summarized as follows:

Year Ending December 31,	1988	$ 3,686,000
	1989	3,513,000
	1990	3,499,000
	1991	3,325,000
	1992	3,198,000
	Thereafter	3,176,000
Total minimum lease payments		20,397,000
Less interest		4,592,000
Present value of net minimum lease payments (including $2,345,000 classified as current)		$15,805,000

Capitalized leased assets aggregated $20,168,351 and $16,995,920 at December 31, 1987 and 1986, respectively. The related accumulated amortization was $2,621,777 and $1,239,312 at December 31, 1987 and 1986, respectively. Amortization expense is included in depreciation expense in the statement of operations.

A lease for freight cars requires that $220,000 be kept on deposit with a financial institution for the term of the lease agreement.

NOTE G — LONG TERM DEBT

Long-term debt at December 31, 1987 consists of a note payable, unsecured, due in monthly installments of $20,349 including interest at 8.15 percent as follows:

Year ending December 31,	1988	$ 199,000
	1989	215,000
	1990	234,000
		648,000
Less current portion		199,000
		$ 449,000

NOTE H — MAJOR CUSTOMERS

Two ARRC customers accounted for 22 percent and 16 percent of freight revenue for the year ended December 31, 1987. In 1986, these two customers accounted for 15 percent and 14 percent of freight revenue.

NOTE I — PENSION PLAN

The ARRC has a defined benefit pension plan that covers all non-represented permanent employees who have not remained in the Civil Service Retirement System and permanent employees who are members of collective bargaining units which have bargained to become covered by this plan. Benefits under this plan are generally based upon the employee's years of service and final average compensation. The ARRC's funding policy is to contribute for each year the amount expressed as a constant percentage of pay equal to the normal cost percentage. Contributions are made continuously throughout the year.

Effective January 1, 1987, the ARRC changed its method of accounting for pension costs to conform with Financial Accounting Standards Board Statement No. 87 "Employers' Accounting for Pensions." The effect of this change was not material to income for 1987. Pension expense for 1986 has not been restated.

The funded status of the pension plan at December 31, 1987 and 1986 is as follows:

	1987	1986
Actuarial present value of benefit obligations:		
Accumulated benefit obligation—all non-vested	$(1,903,000)	$(1,065,000)
Projected benefit obligation for service rendered to date	$(2,519,000)	$(1,411,000)
Plan assets at fair value	1,487,000	499,000
Projected benefit obligation in excess of plan assets	(1,032,000)	(912,000)
Unrecognized net transition obligation	851,000	912,000
Unrecognized net loss	181,000	
PENSION LIABILITY	$ -0-	$ -0-

Net pension costs included the following components:

	1987	1986
Service cost—benefits earned during the period	$ 244,000	
Interest cost on projected benefit obligation	129,000	
Return on plan assets	(25,000)	
Net amortization and deferral	8,000	
NET PERIODIC PENSION COSTS	$ 356,000	$ 190,000

Actuarial assumptions used in 1987 and 1986 to develop net periodic pension costs were:

Assumed discount rate	8%
Assumed salary increase rate	7%
Expected long-term rate of investment return	8%

Assets of the ARRC's pension plan are invested in fixed income securities and common stocks.

Federal employees who transferred to the ARRC will continue participation in the Civil Service Retirement System. The contribution required of the ARRC is 7 percent of the transferred employees' base pay. Pension expense related to the Civil Service Retirement System is $1,118,000 and $1,279,000 for 1987 and 1986, respectively.

NOTE J — FLOOD

In October 1986, a major flood affecting Southcentral Alaska caused substantial damage to the Railroad roadway resulting in reduced rail operations for two weeks.

Total flood damage loss is approximately $2.9 million dollars. The ARRC has received $2.2 million in reimbursement of these damages from the Federal Emergency Management Agency and the Alaska Division of Emergency Services. The balance of the receivable ($700,000) has been recorded as a receivable at December 31, 1987 and included in other current assets. Flood damage expenses in the amount of $700,000 at December 31, 1987 and $2.2 million at December 31, 1986 and reimbursement in the same amount have been netted in the statements of operations.

NOTE K — CONTINGENCIES

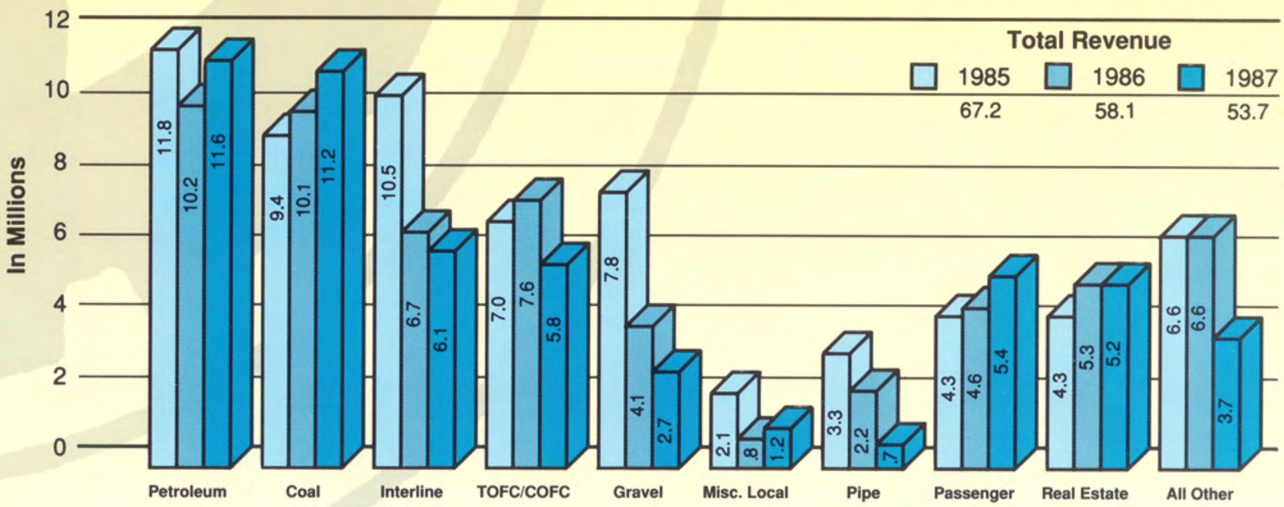
The ARRC is a defendant in a lawsuit filed by certain residents of Crown Point, Alaska, against the ARRC and certain other defendants. This lawsuit arose from an incident on March 2, 1986, when a tank car containing a urea formaldehyde mixture leaked vapors after it was moved to a Railroad siding in Crown Point, Alaska. The ARRC is also a defendant in other legal proceedings related to the conduct of its business. Provision has been made in the financial statements for possible losses from litigation. In the opinion of management, the outcome of the litigation will not have a material effect on the financial position of the ARRC.

NOTE L — INSURANCE

The ARRC is self-insured to certain limits for employee health benefits, and personal property and casualty damage. The ARRC is also self-insured against workers' compensation claims. The ARRC employs a full time "Risk Manager" who monitors all cases involving ARRC liability.

THREE YEAR STATISTICAL REVIEW

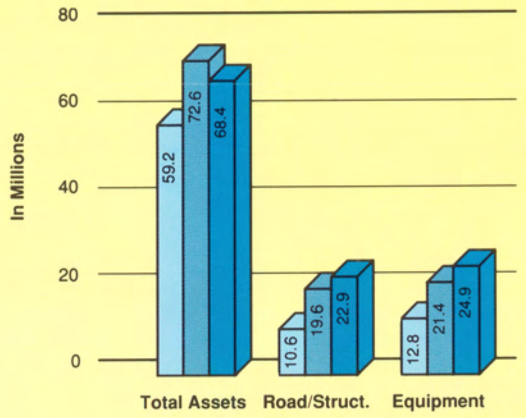
Commodity Revenue by Year



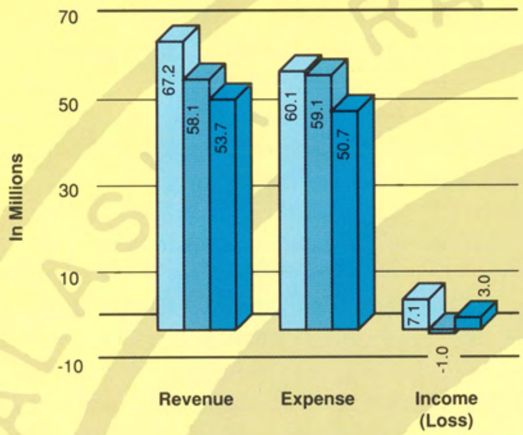
THREE-YEAR STATISTICAL REVIEW

1985 1986 1987

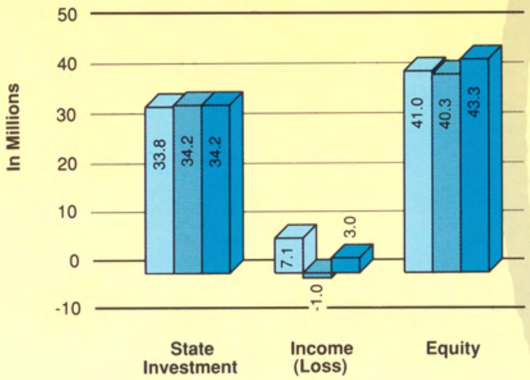
Assets



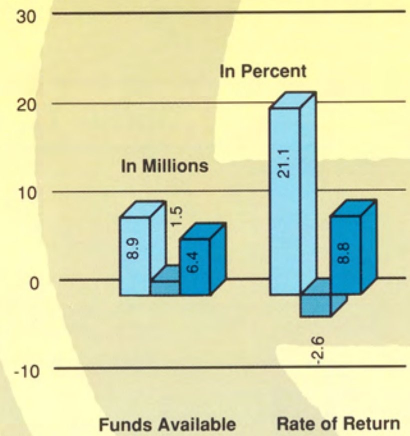
Financial



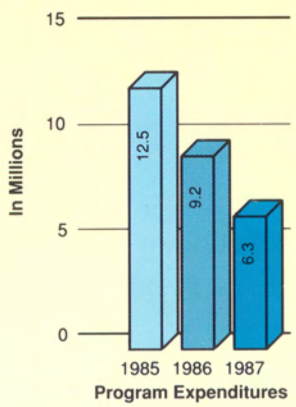
Investment Analysis



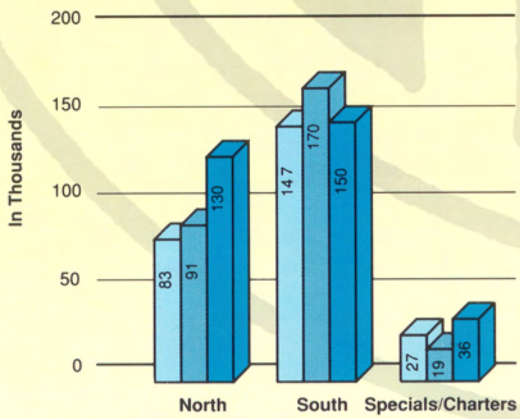
Reinvestment and Return



Capital Spending Program



Passenger Ridership



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Alaska Railroad Corporation
421 W. 1st Avenue
Box 107500
Anchorage, Alaska 99510-7500
(907) 265-2403