ALASKA RAILROAD CORPORATION

Financial Statements

December 31, 2006 and 2005

(With Independent Auditors' Report Thereon)

ALASKA RAILROAD CORPORATION

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ALASKA RAILROAD CORPORATION

Management's Discussion and Analysis

December 31, 2006 and 2005

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, 2006 and 2005. Please read it in conjunction with the ARRC's financial statements, which follow this section.

Financial Highlights

- The ARRC's total fund equity increased 7% over the course of this year's operations and 14% over the course of 2005 operations.
- During the year, the ARRC's operating revenues exceeded operating expenses by $4.3 million, yielding an operating ratio of 0.97. Last year, operating revenues exceeded operating expenses by $6.4 million and yielded an operating ratio of 0.95.
- The total operating costs of the ARRC's programs were $128.4 million, an increase of 5% compared to last year. Total operating costs were $122.8 million, an increase of 16% during 2005.
- Expenditures on capital assets totaled $108.8 million during the year ended December 31, 2006, an increase of 20% compared to last year. Expenditures on capital assets totaled $90.5 million during the year ended December 31, 2005, a decrease of 12% compared to last year.
- Federal grant funding was used for $64.0 million, or 59%, of the 2006 capital expenditures. In 2005 federal grant funding was $64.8 million, or 72%, 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 increased 7% between fiscal years 2005 and 2006 – increasing to approximately $183.6 million. ARRC's fund equity increased 14% between fiscal years 2004 and 2005 – increasing to approximately $171.2 million.

		2006	2005	2004
Assets:				
Current assets	$	53,896	48,005	55,243
Capital assets		599,708	525,851	459,290
Other noncurrent assets		60,642	103	1,043
Total assets	$	714,246	573,959	515,576
Liabilities:				
Current liabilities	$	34,322	27,449	24,566
Notes payable outstanding, less current installments		33,310	24,468	27,446
Revenue bonds payable, net of unamortized premiums and deferred amounts		78,403	—	—
Other liabilities		1,208	1,193	3,036
Regulatory liabilities:				
Postretirement and pension		—	4,279	17,984
Deferred grant revenue		383,435	345,391	292,294
Total liabilities	$	530,678	402,780	365,326
Fund equity:				
Invested in capital assets, net of related debt	$	157,685	153,014	136,500
Restricted for reinvestment in infrastructure		25,883	18,165	13,750
Total fund equity	$	183,568	171,179	150,250

Capital assets – Capital assets, net of accumulated depreciation, increased $73.9 million in 2006 and $66.6 million in 2005. During 2006 and 2005, the ARRC continued an extensive capital improvement plan, including track refurbishing, straightening of curves in the track to allow faster train speed, and building new passenger depots. The majority of capital assets are funded through federal grants.

Long-term debt – Notes payable increased $8.8 million in 2006 and decreased $3.0 million in 2005. During 2006, the ARRC executed two long term loans of $5.3 million and $7.1 million to acquire its general office building and other properties in Anchorage. In 2006, the ARRC issued $76.4 million in FTA capital grant receipt bonds to provide funds to finance various capital improvement projects.

(Continued)

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 $38.0 million in 2006 and $53.1 million in 2005. 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 decreased $4.3 million during 2006, primarily due to a strong market performance of the assets invested and a $2.1 million postretirement contribution. The net postretirement and pension liability decreased $13.7 million during 2005, primarily due to a strong market performance of the assets invested in the pension funds, changes in the assumptions used to calculate the liabilities and a $5.0 million postretirement contribution.

Changes in fund equity – The ARRC's total revenues increased 3% and totaled $149.0 million in 2006. The ARRC's total revenues increased 11% and totaled $144.0 million in 2005. Approximately 60% and 66% of the ARRC's revenue comes from freight revenue during 2006 and 2005, respectively, and 14% and 14% of the revenue comes from passenger services during 2006 and 2005, 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.

ARRC's total expenses including real estate expenses of $8,543,000 in 2006, $7,403,000 in 2005, and $7,066,000 in 2004, increased 5% from 2005 to 2006 and increased less than 5% from 2004 to 2005 (in thousands):

	2006	2005	2004
Operating revenue:			
Freight	$ 89,623	94,485	86,516
Passenger	21,292	19,472	16,923
Other	456	121	116
Total transportation revenue	111,371	114,078	103,555
Grant revenue	21,299	15,115	12,488
Total	132,670	129,193	116,043
Operating expense:			
Transportation	37,777	34,270	28,124
Passenger services	4,644	4,304	3,559
Markets, sales, and service	20,052	17,153	14,364
Passenger operations	5,876	5,187	4,343
Mechanical	17,453	16,877	15,316
Maintenance	30,753	28,095	24,224
Engineering and signals	1,978	1,817	2,098
Health, safety, and environment	1,635	1,884	1,822
General and administrative	8,251	13,254	12,084
Total	128,419	122,841	105,934
Operating income	4,251	6,352	10,109
Nonoperating revenues (expenses):			
Real estate income, net of expenses	6,510	6,506	5,980
Gain on sale of capital assets	616	452	—
Investment income	572	430	371
Interest expense	(1,504)	(1,085)	(1,083)
Net income	10,445	12,655	15,377
Other changes in fund equity	1,944	8,274	(2,340)
Change in fund equity	$ 12,389	20,929	13,037

Several events occurred during 2006 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 2006, reducing general and administrative expenses. The overall indirect cost recovery was $222,000 more than 2005.
- Total transportation revenue was $2.7 million less than 2005. A significant portion of the decrease in transportation revenue resulted from the effect of the negotiated $2.6 million shipping credit.
- During 2006, 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 $2.1 million postretirement contribution decreased the postretirement liabilities. The ARRC's annual required contributions of $609,000 for its defined benefit plan and $2,516,000 for its postretirement plan were made during the year and are included in the accompanying financial statements. The other changes in fund equity of $1.9 million and $8.3 million represents the change from the prior year in the unfunded accrued actuarial liability of the defined benefit and post retirement plans at December 31, 2006 and 2005, respectively.

Several events occurred during 2005 that significantly impacted the change in fund equity:

- The Federal Railroad Administration approval of ARRC's indirect cost rate agreements allowed ARRC to allocate eligible general and administrative expenses to federal grant projects. A total of $1.4 million was allocated to capital projects during 2005, reducing general and administrative expenses. The overall indirect cost recovery was $149,000 more than 2004.
- Total transportation revenue was $11 million greater than 2004. The revenue increases resulted from strong passenger ridership, solid petroleum shipments, increased gravel shipments, increased interline activity and trailer on flat car (TOFC) service.
- 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 change and a $5.0 million postretirement contribution resulted in a decrease of $13.7 million in the net postretirement and pension liabilities. The ARRC's annual required contribution of $668,000 and $2,268,000 for its defined benefit and postretirement plans, respectively, was made during the year and is included in the accompanying financial statements. The other changes in fund equity of $8.3 million and ($2.3) million represents the change from the prior year in the unfunded accrued actuarial liability of the defined benefit and post retirement plans at December 31, 2005 and 2004, respectively.

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Capital Asset and Debt Administration

Capital Assets

At the end of 2006, the ARRC had invested $599.7 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 $73.9 million, or 14%, over last year. Grants have funded $199.7 million of the assets, net of accumulated depreciation (in thousands):

		2006	2005	2004
Land and improvements	$	19,599	19,598	19,587
Road materials and supplies		7,680	12,311	10,197
Road and roadway structures		245,358	189,013	177,760
Equipment		86,958	90,510	93,427
Leasehold improvements		2,022	1,064	1,393
Construction in progress		238,091	213,355	156,926
Total capital assets, net of accumulated depreciation	$	599,708	525,851	459,290

The ARRC's fiscal year 2007 capital budget approved spending another $99.5 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 $52.8 million of the capital additions. The remaining capital projects will be funded out of the FTA Capital Receipts Bonds, Series 2006, current year earnings and cash flow. More detailed information about the ARRC's capital assets is presented in note 4 to the financial statements.

Long-Term Debt

At year-end the ARRC had $36.9 million in notes payable outstanding, an increase of 3.5% from last year and $78.4 million in bonds payable outstanding. Bond issuance costs of $1.4 million are being amortized over the life of the bonds. The ARRC had no bonds payable in 2005. More detailed information about the ARRC's long-term liabilities is presented in note 6 to the financial statements.

Bond Rating

In July 2006, Standard & Poor's Ratings Services and Fitch Ratings assigned A+ and A ratings, respectively to the approximately $80.0 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.

Next Year's Budget

Freight and passenger revenues are projected at $92.3 million and $23.6 million, respectively. As a result, the ARRC's fund equity is expected to increase $11.5 million or 6% by the close of 2007.

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Contacting the ARRC's Financial Management

This financial report is designed to provide residents of the State of Alaska and our customers and creditors with a general overview of the ARRC's finances and to demonstrate accountability for the money it receives. If you have questions about this report or need additional financial information, contact the Alaska Railroad Corporation, P.O. Box 107500, Anchorage, Alaska 99510-7500, or visit us on the Internet at www.alaskarailroad.com.

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Anchorage, AK 99501

Independent Auditors' Report

The Board of Directors
Alaska Railroad Corporation:

We have audited the accompanying balance sheets of the Alaska Railroad Corporation, a component unit of the State of Alaska, as of and for the years ended December 31, 2006 and 2005, 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, 2006 and 2005, 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.

In accordance with *Government Auditing Standards*, we have also issued our report dated March 22, 2007 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.

(Continued)

The management's discussion and analysis on pages 1 through 8 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

March 22, 2007

ALASKA RAILROAD CORPORATION

Balance Sheets

December 31, 2006 and 2005

(In thousands)

Assets		2006	2005
Current assets:			
Cash and cash equivalents (note 3)	$	13,263	2,078
Accounts receivable, net of allowance for doubtful accounts of $192 in 2006 and $137 in 2005		21,438	13,888
Grants receivable (note 8)		9,228	20,131
Materials and supplies		7,911	7,728
Restricted assets (note 3)		—	1,241
Prepaid expenses and other current assets		2,056	2,137
Under recovery of vehicle and equipment allocated costs (note (2k))		—	802
Total current assets		53,896	48,005
Capital assets (note 4):			
Land and improvements (note 11)		19,599	19,598
Road materials and supplies		7,680	12,311
Road and roadway structures		358,114	283,338
Equipment		172,259	164,809
Leasehold improvements (note 11)		2,738	1,650
Accumulated depreciation and amortization		(198,773)	(169,210)
Construction in progress		238,091	213,355
Total capital assets, net		599,708	525,851
Restricted assets (note 3)		60,395	—
Regulatory assets:			
Accrued postretirement and pension benefits (notes 5 and 7)		147	—
Other assets		100	103
	$	714,246	573,959
Liabilities and Fund Equity			
Current liabilities:			
Current portion of long-term debt (notes 5 and 6)	$	3,585	2,978
Accounts payable and accrued liabilities (notes 5, 13, and 14)		11,552	8,622
Interest payable		1,418	13
Payroll liabilities		11,347	10,493
Over recovery of vehicle and equipment allocated costs (note (2k))		557	—
Unearned revenues (note 11)		5,863	5,343
Total current liabilities		34,322	27,449
Notes payable, less current portion (notes 5 and 6)		33,310	24,468
Revenue bonds payable (Net of unamortized premiums and deferred amounts (notes 5 and 6)		78,403	—
Environmental remediation reserve (notes 5, 13, and 14)		646	578
State of Alaska advances (notes 3, 5, and 8)		562	615
Regulatory liabilities:			
Accrued postretirement and pension benefits (notes 5 and 7)		—	4,279
Deferred grant revenue (notes 5 and 8)		383,435	345,391
Total liabilities		530,678	402,780
Fund equity (notes 7 and 9):			
Investment in capital assets, net of related debt and deferred grant revenue (note 4)		157,685	153,014
Restricted for reinvestment in infrastructure (notes 1(m) and 2(a))		25,883	18,165
Total fund equity		183,568	171,179
Commitments and contingencies (notes 7, 10, 12, 13, and 14)			
	$	714,246	573,959

See accompanying notes to basic financial statements.

ALASKA RAILROAD CORPORATION

Statements of Revenues, Expenses, and Changes in Fund Equity

Years ended December 31, 2006 and 2005

(In thousands)

		2006	2005
Operating revenues:			
Freight (note 10)	$	89,623	94,485
Passenger		21,292	19,472
Other		456	121
		111,371	114,078
Grant revenue (note 8)		21,299	15,115
		132,670	129,193
Operating expenses (note 8):			
Transportation		37,777	34,270
Passenger services		4,644	4,304
Markets, sales, and service		20,052	17,153
Passenger operations		5,876	5,187
Mechanical		17,453	16,877
Maintenance		30,753	28,095
Engineering and signals		1,978	1,817
Health, safety, and environment		1,635	1,884
General and administrative, net of indirect cost recovery of $1,590 in 2006 and $1,368 in 2005		8,251	13,254
		128,419	122,841
Operating income		4,251	6,352
Nonoperating revenues (expenses):			
Real estate income, less direct expenses of $8,543 in 2006 and $7,403 in 2005 (notes 8 and 11)		6,510	6,506
Gain on sale of capital assets		616	452
Investment income		572	430
Interest expense		(1,504)	(1,085)
Total nonoperating revenues		6,194	6,303
Net income (note 2(a))		10,445	12,655
Other change in fund equity:			
Change in pension and postretirement funding status (note 7)		1,944	8,274
Change in fund equity		12,389	20,929
Fund equity, beginning of year		171,179	150,250
Fund equity, end of year	$	183,568	171,179

See accompanying notes to basic financial statements.

ALASKA RAILROAD CORPORATION

Statements of Cash Flows

Years ended December 31, 2006 and 2005

(In thousands)

		2006	2005
Cash flows from operating activities:			
Receipts from customers	$	103,821	112,322
Operating grants received		5,024	3,434
Payments to suppliers		(39,816)	(46,218)
Payments to employees		(58,565)	(57,702)
Net cash provided by operating activities		10,464	11,836
Cash flows from capital and related financing activities:			
Principal payments on long-term debt		(2,973)	(3,050)
Interest payments on long-term debt		(1,504)	(1,085)
Proceeds from long-term debt		12,422	—
Revenue bond proceeds, net of bond issuance costs of $1,409		78,403	—
Purchases and construction of capital assets		(103,391)	(90,520)
Proceeds from sales of capital assets		1,218	700
Increase in deferred revenues, net of advances		65,169	61,757
Net cash provided by (used in) capital and related financing activities		49,344	(32,198)
Cash flows from investing activities:			
Real estate income and related cash flows		18,502	17,603
Real estate direct expenses paid		(8,543)	(7,403)
Interest received		572	430
Purchase of restricted investments		(80,808)	1,588
Proceeds from sale of restricted investments		21,654	—
Net cash provided by (used in) investing activities		(48,623)	12,218
Net increase (decrease) in cash and cash equivalents		11,185	(8,144)
Cash and cash equivalents at beginning of year		2,078	10,222
Cash and cash equivalents at end of year	$	13,263	2,078
Reconciliation of operating income to net cash provided by operating activities:			
Operating income	$	4,251	6,352
Adjustments to reconcile operating income to net cash provided by operating activities:			
Depreciation and amortization		26,003	20,224
Grant revenue on capital assets		(16,275)	(11,681)
Changes in operating assets and liabilities:			
Materials and supplies		(183)	(1,688)
Accounts receivable		(7,550)	(1,516)
Prepaid expenses and other assets		84	4,274
Accounts payable and accrued liabilities		2,930	1,905
Interest payable		1,405	—
Over-recovery of vehicle and equipment allocated costs		1,359	107
Payroll liabilities		854	1,083
Environmental reserve		68	(1,793)
Accrued postretirement and pension benefits		(2,482)	(5,431)
Total adjustments		6,213	5,484
Net cash provided by operating activities	$	10,464	11,836
Supplemental disclosure of noncash activity:			
Depreciation included in real estate activity	$	4,029	3,529
Increase in pension and postretirement funding status		1,944	8,274

See accompanying notes to basic financial statements.

(1) Organization and Operations

The United States Congress authorized construction of the Alaska Railroad (ARR) in 1914 and operations began in 1923. The federal government operated the railroad until its sale to the State of Alaska in January 1985. The sale of the ARR to the State of Alaska was authorized under the Alaska Railroad Transfer Act of 1982, which was signed into law on January 14, 1983. The State of Alaska legislature created the Alaska Railroad Corporation (ARRC), a component unit of the State of Alaska, to own and operate the railroad and manage the railroad's rail, industrial, port and other properties. The ARRC commenced operations on January 6, 1985.

The ARRC operates 651 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*.

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. Unrealized gains and losses are reported as a component of investment income. Fair values are based on quoted market prices.

(f) Regulatory Liabilities

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

(h) Grants

Grants are recognized as earned when all eligibility requirements have been met, however, recognition of revenue for grants expended for capital assets is deferred and recognized over the period in which the asset is depreciated as described in note 2(f). Grant funds received but not yet expended are recorded as advance grant funding.

(i) Income Taxes

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

(j) Environmental Remediation Costs

The ARRC accrues for losses associated with environmental remediation obligations when such losses are probable and reasonably estimable. Costs of future expenditures for environmental remediation liabilities are not discounted to their present value.

(k) Vehicle 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 over recovery of $557,000 and an under recovery of $802,000 during the years ended December 31, 2006 and 2005, respectively.

(l) Fair Value of Financial Instruments

Fair values of financial instruments, as defined under FASB Statement No. 107, *Disclosures About Fair Value of Financial Instruments*, are estimated by the ARRC's management. Fair values of restricted assets and investments are based on quoted market prices. Fair values for accounts receivable are estimated using cash flows in comparison to assets with similar estimated average lives but bearing current market interest rates. Fair values of long-term debt are based on the discounted value of contractual cash flows and interest rates being offered for similar debt. The fair values of financial instruments do not differ significantly from their carrying amounts.

(m) Equity

During 2006 and 2005, the ARRC's board of directors restricted $25,883,000 and $18,165,000 of fund equity for reinvestment in infrastructure. Beginning in 2006, the board restricted fund equity is also restricted by the unspent revenue bond proceeds of $53.2 million which represents the project fund balance at December 31, 2006 which is included in the guaranteed investment contract.

(n) Reclassifications

Certain reclassifications not affecting net income have been made to the 2005 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, 2006, the ARRC's carrying amount of cash and cash equivalents was $13,263,000 and the bank balance was $16,062,000. Of the bank balance, $100,000 was covered by federal depository insurance; $4,477,000 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 $11,485,000 represents money market funds held by the ARRC's agent in the ARRC's name.

At December 31, 2005, the ARRC's carrying amount of cash and cash equivalents was $2,078,000 and the bank balance was $2,511,000. Of the bank balance, $100,000 was covered by federal depository insurance; $1,441,000 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 $1,074,000 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, 2006

(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.

(Continued)

The fair value and maturities of the investments consists of the following at December 31, 2006 and 2005 (in thousands):

Investment Type	Maturities		2006	2005
Commercial Paper	01/04/07	$	1,016	—
Guaranteed Investment Contracts (GICs)	12/31/08		58,122	—
	Total Investments	$	59,138	—
Money Market			1,257	1,241
	Total	$	60,395	1,241

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, 2006 and 2005 (in thousands):

	Fair Value			
	2006			
Description of Restriction	Money Market	Commercial Paper	Investment Contract	Total
Capital assets as authorized by the State of Alaska	$ 383	—	—	383
Capital assets as authorized by the Department of Natural Resources	194	—	—	194
Advance grant funding, other federal grants	564	—	—	564
Revenue Bond Proceeds from Capital Grant Receipts, Series 2006	—	—	—	—
Guaranteed Investment Contract (GIC):				
Capital Interest	89	—	4,937	5,026
Project Fund	1	—	53,185	53,186
Forward Sale Agreement:				
2006A Reserve Account	11	434	—	445
2006B Reserve Account	15	582	—	597
	$ 1,257	1,016	58,122	60,395

Description of Restriction		Fair Value 2005 Money Market	Commercial Paper	Investment Contracts	Total
Capital assets as authorized by the State of Alaska	$	434	—	—	434
Capital assets as authorized by the Department of Natural Resources		194	—	—	194
Advance grant funding, other federal grants		613	—	—	613
Revenue Bond Proceeds from Capital Grant Receipts, Series 2006		—	—	—	—
Guaranteed Investment Contract (GIC):					
Capital Interest		—	—	—	—
Project Fund		—	—	—	—
Forward Sale Agreement:					
2006A Reserve Account		—	—	—	—
2006B Reserve Account		—	—	—	—
	$	1,241	—	—	1,241

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, 2006 and 2005.

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, which was updated in 2006, of its indirect cost rate agreement from its federal cognizant agency. This agreement allows ARRC to allocate certain general and administrative expenses to grant projects. Indirect costs allocated to capital projects under this agreement totaled $1,590,000 and $1,368,000 during the years ended December 31, 2006 and 2005, respectively.

The following summarizes activity in the capital assets accounts during the years ended December 31, 2006 and 2005 (in thousands):

	Balance at December 31, 2005	Additions	Reductions	Balance at December 31, 2006
Capital assets not being depreciated:				
Land	$ 19,598	501	(500)	19,599
Road materials and supplies	12,311	—	(4,631)	7,680
Construction in progress	213,355	108,311	(83,575)	238,091
Total capital assets not being depreciated	245,264	108,812	(88,706)	265,370
Capital assets being depreciated:				
Road and roadway structures	283,338	74,962	(186)	358,114
Equipment	164,809	8,613	(1,163)	172,259
Leasehold improvements	1,650	1,088	—	2,738
Total capital assets being depreciated	449,797	84,663	(1,349)	533,111
Less accumulated depreciation for:				
Road and roadway structures	93,660	19,144	(47)	112,757
Equipment	74,964	10,758	(422)	85,300
Leasehold improvements	586	130	—	716
Total accumulated depreciation	169,210	30,032	(469)	198,773
Capital assets being depreciated, net	280,587	54,631	(880)	334,338
Net capital assets	$ 525,851	163,443	(89,586)	599,708

		Balance at December 31, 2004	Additions	Reductions	Balance at December 31, 2005
Capital assets not being depreciated:					
Land	$	19,587	11	—	19,598
Road materials and supplies		10,197	2,114	—	12,311
Construction in progress		156,926	88,406	(31,977)	213,355
Total capital assets not being depreciated		186,710	90,531	(31,977)	245,264
Capital assets being depreciated:					
Road and roadway structures		257,429	25,909	—	283,338
Equipment		159,000	6,057	(248)	164,809
Leasehold improvements		1,848	—	(198)	1,650
Total capital assets being depreciated		418,277	31,966	(446)	449,797
Less accumulated depreciation for:					
Road and roadway structures		79,669	13,991	—	93,660
Equipment		65,573	9,631	(240)	74,964
Leasehold improvements		455	131	—	586
Total accumulated depreciation		145,697	23,753	(240)	169,210
Capital assets being depreciated, net		272,580	8,213	(206)	280,587
Net capital assets	$	459,290	98,744	(32,183)	525,851

(Continued)

Depreciation expenses were charged to the following departments during the years ending December 31, 2006 and 2005 (in thousands):

	2006		2005	
	Grant Funded Depreciation	**Non-Grant Funded Depreciation**	**Grant Funded Depreciation**	**Non-Grant Funded Depreciation**
Transportation	$ 2,669	118	400	28
Passenger services	139	6	139	6
Markets, sales, and service	94	680	94	628
Passenger operations	1,288	496	1,167	442
Mechanical	1,294	3,028	1,247	2,832
Maintenance	6,762	6,842	5,278	6,289
Engineering and signals	511	98	192	62
Health, safety and environment	—	145	—	133
General and administrative	242	1,602	326	961
Real estate	3,237	781	2,838	691
	$ 16,236	13,796	11,681	12,072

Fund equity invested in capital assets, net of related debt and deferred grant revenue, is as follows at December 31, 2006 and 2005 (in thousands):

	2006	2005
Net capital assets (note 4)	$ 599,708	525,851
Notes payable including current portion (note 6)	(36,895)	(27,446)
Proceeds of revenue bonds expended on capital assets (note 6)	(21,693)	—
Deferred grant revenue (note 8)	(383,435)	(345,391)
	$ 157,685	153,014

(5) Long-Term Liabilities

Long-term liability activity is summarized as follows during the years ended December 31, 2006 and 2005 (in thousands):

		Balance at December 31, 2005	Additions	Reductions	Balance at December 31, 2006	Due within one year
Long-term debt:						
Notes payable	$	27,446	12,422	(2,973)	36,895	3,585
Revenue bonds payable		—	78,403	—	78,403	—
Environmental remediation reserve		3,110	581	(1,580)	2,111	1,465
State of Alaska advances		615	—	(53)	562	—
Regulatory liabilities:						
Accrued postretirement and pension benefits		4,279	3,125	(7,404)	—	—
Deferred grant revenue		345,391	54,319	(16,275)	383,435	—
Total long-term liabilities	$	380,841	148,850	(28,285)	501,406	5,050

		Balance at December 31, 2004	Additions	Reductions	Balance at December 31, 2005	Due within one year
Long-term debt:						
Notes payable	$	30,496	—	(3,050)	27,446	2,978
Revenue bonds payable		—	—	—	—	—
Environmental remediation reserve		4,683	—	(1,573)	3,110	2,532
State of Alaska advances		665	—	(50)	615	—
Regulatory liabilities:						
Accrued postretirement and pension benefits		17,984	2,935	(16,640)	4,279	—
Deferred grant revenue		292,294	64,778	(11,681)	345,391	—
Total long-term liabilities	$	346,122	67,713	(32,994)	380,841	5,510

The ARRC has arrangements for two short-term unsecured lines of credit. The general purpose line of credit allows 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. Neither of the lines of credit had an outstanding balance as of December 31, 2006 or 2005.

(6) Long-Term Debt

Long-term debt at December 31, 2006 and 2005 consists of the following (in thousands):

		2006	2005
Notes payable:			
Note payable, secured by equipment, due in monthly payments of $156,934, including interest at 3.79%, matures March 2014.	$	11,937	13,225
Note payable, secured by equipment, due in monthly payments of $97,249, including interest at 3.83%, matures March 2019.		11,457	12,112
Note payable, secured by equipment, due in monthly payments of $44,226, including interest at 2.55%, matures July 2008.		823	1,325
Note payable, secured by equipment, due in monthly payments of $27,557, including interest at 3.35%, matures April 2008.		431	741
Note payable, secured by vehicles and equipment, due in monthly payments of $18,415, including variable interest at 56% of prime rate, adjusted monthly, matures April 2006.		—	43
Note payable, secured by real estate revenue, due in monthly payments of $36,211, including interest at 5.40%, matures June 2026.		5,233	—
Note payable, secured by real estate revenue, due in monthly payments of $48,539, including interest at 5.40%, matures June 2026.		7,014	—
		36,895	27,446
Less current portion		3,585	2,978
	$	33,310	24,468
Revenue bonds:			
Revenue Bonds-Series 2006, (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 premium of $3,382,000 and unamortized issuance costs of $1,369,000.	$	78,403	—
Less current portion		—	—
	$	78,403	—

Annual payments on debt are scheduled as follows at December 31, 2006 (in thousands):

		Notes Payable		Revenue Bonds Payable		
		Principal	**Interest**	**Principal**	**Interest**	**Total**
Year ending December 31:						
2007	$	3,585	1,597	—	3,356	8,538
2008		3,090	1,397	4,065	3,564	12,116
2009		2,784	1,283	4,230	3,401	11,698
2010		2,898	1,169	4,385	3,248	11,700
2011		3,018	1,049	4,580	3,052	11,699
2012 – 2016		11,463	3,559	26,090	12,062	53,174
2017 – 2019		10,057	2,230	33,040	5,110	50,437
	$	36,895	12,284	76,390	33,793	159,362
Current portion of principal	$	(3,585)		—		(3,585)
Unamortized premium		—		3,382		3,382
Unamortized issuance cost		—		(1,369)		(1,369)
Total long-term portion	$	33,310		78,403		157,790

Notes Payable

In June 2006, the ARRC executed two term loans of $5,308,000 and $7,114,000 to acquire its general office building and other properties located in the Anchorage Terminal Reserve. The ARRC has pledged and assigned real estate lease revenue for payment of the principal and interest on the loans (note 6). These loans have debt service reserves of $455,000 and $597,000.

Bonds Payable

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. 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) 2006 and 2007, and estimated apportionments for FFY 2008 and 2009:

FFY		Section 5307 Formula Program	Section 5309 Formula Program	Total
2006	$	17,377,036	13,048,631	30,425,667
2007		17,621,141	15,304,280	32,925,421
2008*		19,109,865	16,593,729	35,703,594
2009*		20,329,124	17,613,662	37,942,786

Source: FFY 2006 and 2007 FTA apportionments published in Federal Register February 3, 2006 and March 23, 2007, respectively. FFY 2008 and 2009 estimates based on calculated growth rates contained in SAFETEA-LU authorizations for Sec 5307 and 5309 program funds.

During 2006, the ARRC expended $23.1 million of the bond proceeds on eligible capital costs related to the capital improvement program. Of these costs, $120,000 was capitalized interest, which is calculated from the interest earnings of $1,165,000 and the accrued interest expense of $1,285,000.

State of Alaska Authorizations

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, $76.4 million in bonds have been issued with a premium of $3.4 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.

(Continued)

(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 assets of $9,473,000 and $4,555,000 at December 31, 2006 and 2005, respectively. The funded status of the postretirement benefit plan is reported as a regulatory liability of $9,326,000 and $8,834,000 at December 31, 2006 and 2005, respectively. The change in pension and postretirement funding status presented as other changes in fund equity of $1,945,000 and $8,274,000 in 2006 and 2005, 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, 2006 and 2005, and related information is as follows:

	2006	2005
Actuarial assumptions compounded annually:		
Inflation rate	2.50%	3.00%
Investment return for funding purposes	7.50	7.50
Investment return on employee accounts	4.50	7.00
Projected salary increase	4.00	4.00
Cost of living allowance	1.25	1.75

The following table sets forth the Plan's assets and funded status at December 31, 2006 and 2005 (in thousands):

		2006	2005
Income:			
Contributions received:			
Employee	$	3,433	3,214
Employer		609	668
Investment earnings		6,354	3,481
Net accrued		143	1
Total income		10,539	7,364
Disbursements:			
Benefit payments:			
Periodic		612	466
Nonperiodic:			
Termination		1,424	444
Retirement		—	26
Disability		47	37
Death		13	—
Total benefit payments		2,096	973
Administrative and investment consulting expenses		315	259
Total disbursements		2,411	1,232
Net income		8,128	6,132
Net assets at beginning of year		57,454	51,322
Net assets at the end of year		65,582	57,454
Actuarial accrued liability (AAL)		56,109	52,899
Overfunded AAL	$	(9,473)	(4,555)

The ARRC's annual required contribution included in the accompanying financial statements was $609,000 and $668,000 for the years ended December 31, 2006 and 2005, 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.

The annual post employment benefit cost for the years ended December 31, 2006 and 2005, and related information is as follows:

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

	2006	2005
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, 2006 and 2005 (in thousands):

		2006	2005
Income:			
Contributions received – employer	$	4,997	7,701
Investment earnings		925	265
Net accrued		25	—
Total income		5,947	7,966
Disbursements:			
Benefit payments paid		195	—
Benefit payments payable		103	336
Administrative and investment consulting expenses		28	16
Total disbursements		326	352
Net income		5,621	7,614
Net assets at beginning of year		7,614	—
Net assets at the end of year		13,235	7,614
Actuarial accrued liability (AAL)		22,561	16,448
Unfunded AAL	$	9,326	8,834

The ARRC's annual other postemployment benefit (OPEB) cost of $2,516,000 and $2,268,000 was included in the accompanying financial statements for the years ended December 31, 2006 and 2005, respectively.

(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 $428,000 and $440,000 for the years ended December 31, 2006 and 2005, 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 46% 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 $446,000 and $383,000 for the years ended December 31, 2006 and 2005, 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, 2006 and 2005, 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, 2006 and 2005 consists of the following (in thousands):

			2006	**2005**
Land		$	1,804	1,304
Road and roadway structures	15 – 32 year life		217,149	158,644
Equipment	5 – 25 year life		40,597	37,791
Construction in process			185,653	198,990
		$	445,203	396,729

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, 2006 and 2005 consist of the following (in thousands):

	2006		2005	
	Advance grant funding (receivable)	**Deferred grant revenue**	**Advance grant funding (receivable)**	**Deferred grant revenue**
Federal Railroad Administration:				
Net book value of assets constructed	$ —	138,748	—	104,508
Construction in process	—	115,250	—	125,533
Amount receivable from grantor	(7,167)	—	(9,346)	—
Taxpayer Relief Act:				
Net book value of assets purchased and constructed	—	14,975	—	14,177
Construction in process	—	5,970	—	7,927
Nondepreciable asset	—	(1,349)	—	(1,303)
Federal Transit Administration:				
Net book value of assets purchased and constructed	—	37,117	—	28,613
Construction in process	—	61,949	—	55,641
Nondepreciable asset	—	(455)	—	—
Amortize Bond Issuance Costs	—	(49)	—	—
Amount receivable from grantor	(816)	—	(9,276)	—
Federal Emergency Management Agency:				
Net book value of assets constructed	—	1,337	—	1,334
Construction in process	—	1,357	—	566
Amount receivable from grantor	(1,019)	—	(566)	—
Department of Interior:				
Grant funding received in advance	531	—	578	—
Accrued derailment expense (note 14)	(531)	—	(578)	—
Department of Agriculture:				
Net book value of assets constructed	—	782	—	955
Construction in process	—	221	—	—
Amount receivable from grantor	(141)	—	—	—

	2006 Advance grant funding (receivable)	2006 Deferred grant revenue	2005 Advance grant funding (receivable)	2005 Deferred grant revenue
U.S. Fish and Wildlife:				
Net book value of assets constructed	$ —	391	—	—
Construction in process	—	27	—	327
Amount receivable from grantor	(52)	—	(147)	—
Department of Homeland Security:				
Net book value of assets constructed	—	458	—	257
Construction in process	—	33	—	53
Amount receivable from grantor	(33)	—	(53)	—
State of Alaska Wishbone Hill Coal Project:				
Grant funding commitments	(373)	5,157	—	4,077
Construction in process	—	—		1,396
Grant funding received in advance	373	—	—	—
Municipality of Anchorage Ship Creek Economic Development:				
Net book value of assets constructed	—	154	—	164
Alaska State Fair:				
Net book value of assets constructed	—	341	—	—
Construction in process	—	—	—	192
Rasmuson Foundation:				
Construction in process	—	800	—	743
Amount receivable from grantor	—	—	(743)	—
State of Alaska Other:				
Net book value of assets constructed	—	184	—	—
Construction in process	—	47	—	231
	$ (9,228)	383,445	(20,131)	345,391

The ARRC recognized the following grant revenue during the years ended December 31, 2006 and 2005 (in thousands):

	2006	2005
Federal Railroad Administration:		
Depreciation on assets constructed	$ 11,063	7,372
Federal Transit Administration:		
Depreciation on assets purchased and constructed	3,208	2,526
Grant funded maintenance and transit security expense	7,393	6,241
Grant funded principal, interest and issuance costs	49	—
Right of Way Acquisition	454	—
Federal Emergency Management Agency:		
Depreciation on assets constructed	119	98
Grant funded disaster recovery expense	359	31
Department of Agriculture:		
Depreciation on assets constructed	198	172
Department of Interior:		
Grant funding of accrued derailment expense (note 14)	33	14
Derailment expense paid in current year	(33)	(14)
Homeland Security:		
Depreciation on assets purchased and constructed	58	181
Municipality of Anchorage Ship Creek Economic Development:		
Depreciation on assets constructed	10	10
Alaska State Fair		
Depreciation on assets constructed	11	—
State of Alaska:		
Depreciation on assets purchased	37	5
State of Alaska Wishbone Hill Coal Project:		
Depreciation on assets purchased	372	257
Taxpayer Relief Act:		
Depreciation on assets purchased and constructed	1,160	1,060
Right of Way Acquisition	45	—
	24,536	17,953
Less grant revenue included in real estate nonoperating revenues	(3,237)	(2,838)
	$ 21,299	15,115

(9) Fund Equity

Fund equity consists of the following major items as of December 31, 2006 and 2005 (in thousands):

	Investment by the State of Alaska	Cumulative net income	Cumulative other changes in fund equity	Total fund equity
Balance at December 31, 2004	$ 34,174	118,416	(2,340)	150,250
Net income	—	12,655	—	12,655
Other changes in fund equity	—	—	8,274	8,274
Total changes in fund equity				20,929
Balance at December 31, 2005	34,174	131,071	5,934	171,179
Net income	—	10,445	—	10,445
Other changes in fund equity	—	—	1,944	1,944
Total changes in fund equity				12,389
Balance at December 31, 2006	$ 34,174	141,516	7,878	183,568

(10) Major Customer

One ARRC customer accounted for 45% and 47% of freight revenue in 2006 and 2005, respectively. During 2006, 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.

(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 $10,256,000 and $9,675,000 in 2006 and 2005, respectively. The following table summarizes future minimum lease payments as of December 31, 2006 (in thousands):

		Amount
Year ending December 31:		
2007	$	9,091
2008		8,946
2009		8,516
2010		8,318
2011		8,138
Thereafter		143,009
	$	186,018

The ARRC has $934,000 in rent credits outstanding on these leases at December 31, 2006. 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 $11,952,000 and $12,024,000 in 2006 and 2005, respectively. Future minimum lease payments as of December 31, 2006 are summarized as follows (in thousands):

		Amount
Year ending December 31:		
2007	$	11,540
2008		10,902
2009		10,404
2010		10,339
2011		1,865
Thereafter		113
	$	45,163

(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. The ARRC carries commercial insurance policies limiting ARRC's exposure for health benefits to $8.5 million, for casualty/liability to $5.0 million and for property to $10.0 million at December 31, 2006. Self-insurance activity is summarized as follows during the years ended December 31, 2006 and 2005 (in thousands):

	Balance at December 31, 2005	Incurred claims	Claim payments	Balance at December 31, 2006
Employee health benefits	$ 1,344	7,221	(7,013)	1,552
Casualty and liability	2,781	1,789	(1,818)	2,752
Workers' compensation	1,451	1,924	(1,718)	1,657
	$ 5,576	10,934	(10,549)	5,961

	Balance at December 31, 2004	Incurred claims	Claim payments	Balance at December 31, 2005
Employee health benefits	$ 1,338	5,479	(5,473)	1,344
Casualty and liability	2,454	1,710	(1,383)	2,781
Workers' compensation	1,003	1,649	(1,201)	1,451
	$ 4,795	8,838	(8,057)	5,576

(14) Commitments and Contingencies

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 U.S. EPA. Management has accrued a reasonable estimate of its obligations, as the current owner of the Site, for the activities required under the order. However, it is not possible at this time to reasonably estimate the ARRC's ultimate liability associated with the Site because the extent of environmental impacts attributable to the ARRC, the allocation of liability to other potentially responsible parties, the potential cleanup alternatives and the concurrence of regulatory authorities have not yet advanced to the stage where reasonable estimates of liability can be made. The ARRC management believes most, if not all, contamination would have occurred prior to the transfer of the ARRC from the federal government to the State of Alaska or as a result of actions by third party tenants. If this is the case, the liability for contamination that occurred prior to the transfer ultimately may be imposed on the federal government under terms of the transfer act (as originally enacted and amended in 2004) and a 1990 agreement between the federal government and the ARRC. The ARRC also will seek cost recovery and contribution from third-party former and current tenants for contamination as a result of their actions on leased portions of the Site. The eventual disposition of such cost-recovery and contribution claims and the ultimate realization of any judgments or allocations awards, however, cannot be predicted with certainty at this time. If other responsible parties do not contribute or pay their fair share of the liability, or if remedial requirements are more stringent than currently anticipated, the ARRC will revise its estimate. It is the opinion of ARRC's management that the ultimate outcome will not have a material adverse impact on the ARRC's financial position, but may have significant impact on the change in fund equity in a given year.

During 1999, 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 were $531,000 and $578,000 at December 31, 2006 and 2005, respectively. The amount expected to be paid within the next year, $43,000 and $159,000 at December 31, 2006 and 2005, respectively, is included in accounts payable and accrued liabilities. The remaining amount is expected to be incurred through 2020 and is reported as environmental remediation reserve. ARRC received grants to cover the costs associated with the Gold Creek derailment and the 1999/2000 winter storm disaster. The grants are expected to cover ARRC's remaining obligation. The aggregate undiscounted amount has been recorded since it represents management's best estimate of the cost, but the payments are not considered to be fixed and reliably determinable. The estimate of costs and their timing of payment could change as a result of changes to the remediation plan, changes in technology available to treat the site and unforeseen circumstances existing at the site. It is not possible to estimate the amount losses may exceed amounts accrued at this time as a result of these factors.

Approximately 72% of the ARRC's labor force is subject to one of five collective bargaining agreements. One of the agreements, representing 40% of the labor force, expired in 2005 and is being renegotiated. Another agreement representing 5% of the labor force expired in 2006.

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