ALASKA AIR GROUP INC
Form 10-Q/A
December 23, 2004

UNITED STATES SECURITIES AND EXCHANGE COMMISSION
WASHINGTON, DC 20549

FORM 10-Q/A

(Amendment No. 1)

(Mark One)

þ **QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934**

For the quarterly period ended September 30, 2004.

OR

o **TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934**

For the transition period from . . . . . . to . . . . . .

Commission file number 1-8957

ALASKA AIR GROUP, INC.

(Exact name of registrant as specified in its charter)

Delaware (State or other jurisdiction of incorporation or organization)	91-1292054 (I.R.S. Employer Identification No.)

19300 Pacific Highway South, Seattle, Washington 98188
(Address of principal executive offices)

Registrant s telephone number, including area code: (206) 392-5040

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days. Yes X No __

Indicate by check mark whether the registrant is an accelerated filer (as defined in Rule 12b-2 of the Exchange Act). Yes X No __

APPLICABLE ONLY TO CORPORATE ISSUERS:

Indicate the number of shares outstanding of each of the issuer s classes of common stock, as of the latest practicable date.

The registrant has 26,886,515 common shares, par value $1.00, outstanding at September 30, 2004.

Table of Contents

Revision to Previously Filed Financial Statements and SEC Filings

In December, we discovered a clerical error in our calculation of deferred Mileage Plan revenue that existed as of September 30, 2004. As a result, we have revised our third quarter and year to date reported condensed consolidated financial statements to adjust for this item. The revision increases the total Mileage Plan liability and deferred revenue balance from $379.2 million to $387.6 million (which amounts are included in other accrued liabilities-current in the condensed consolidated financial statements), and results in an $8.4 million (pretax) decrease to other revenues for the third quarter and nine months ended September 30, 2004.

The revised 2004 third quarter consolidated net income is $74.0 million, or $2.75 per diluted share, and the revised consolidated net income for the nine months ended September 30, 2004 is $29.6 million, or $1.10 per diluted share. We originally reported third quarter net income of $79.2 million (or $2.94 per diluted share) and net income for the nine month period of $34.8 million (or $1.29 per diluted share).

The revisions have no impact on previously reported operating expenses as determined in accordance with GAAP or on previously reported operating cost per Available Seat Mile excluding fuel, a non-GAAP measure we believe is important to some users of our financial statements. See Selected Consolidated Financial and Operating Data, Management s Discussion and Analysis of Financial Condition and Results of Operations, and the Consolidated Financial Statements including the Notes to Consolidated Financial Statements, for the impact of the reclassifications. This Amendment No. 1 to the Company s Quarterly Report on Form 10-Q/A for the three and nine months ended September 30, 2004 amends and reclassifies those items of the previously filed Form 10-Q which have been affected by the revisions. For additional information regarding the revisions, see Note 13 in the Notes to Condensed Consolidated Financial Statements included in Part I, Item 1.

This Form 10-Q/A has not been updated except as required to reflect the effects of the foregoing restatement. In order to preserve the nature and character of the disclosures set forth in such items as originally filed, no attempt has been made in this amendment to modify or update the disclosures in the original Quarterly Report on Form 10-Q except for the foregoing restatement. As a result, this Quarterly Report on Form 10-Q/A contains forward-looking information which has not been updated for events subsequent to the date of the original filing, and the Company directs you to its SEC filings made subsequent to that original filing date for additional information.

TABLE OF CONTENTS

Cautionary Note regarding Forward-Looking Statements

In addition to historical information, this Quarterly Report on Form 10-Q/A contains forward-looking statements that relate to future events of our future financial performance and involve a number of risks and uncertainties. These forward-looking statements are intended to be subject to the safe harbor protection provided by Section 27A of the Securities Act of 1933 and Section 21E of the Securities Exchange Act of 1934. In some cases, you can identify forward-looking statements by terminology such as forecast, may, will, could, should, expect, plan, belie or other similar words indicating future events or contingencies. Some of the things that could cause our actual results to differ from our expectations are: changes in our operating costs including fuel; the competitive environment and other trends in our industry; economic conditions; our reliance on automated systems; actual or threatened terrorist attacks, global instability and potential U.S. military involvement; our ability to meet our cost reduction goals; the outcome of contract talks with the Air Line Pilots Association, whether as a result of negotiations or binding arbitration; labor disputes; changes in laws and regulations; liability and other claims asserted against us; failure to expand our business; interest rates and the availability of financing; our ability to attract and retain qualified personnel; changes in our business plans; our significant indebtedness; downgrades of our credit ratings; and inflation. For a discussion of these and other risk factors, review the information under the caption Business Business Risks in Item 1 of the Company s Annual Report on Form 10-K/A for the year ended December 31, 2003. All of the forward-looking statements are qualified in their entirety by reference to the risk factors discussed therein. Our forward-looking statements are based on the information currently available to us and speak only as of the date of this report. You should not place undue reliance on our forward-looking statements because the matters they describe are subject to known and unknown risks, uncertainties and other unpredictable factors, many of which are beyond our control. We undertake no obligation to publicly update or revise any forward-looking statements, whether as a result of new information, future events or otherwise, after the date of this report to conform them to actual results. Over time, our actual results, performance or achievements will likely differ from the anticipated results, performance or achievements that are expressed or implied by our forward-looking statements, and such differences might be significant and materially adverse.

Table of Contents

PART I. FINANCIAL INFORMATION

ITEM 1. Condensed Consolidated Financial Statements

PART I. FINANCIAL INFORMATION

ITEM 1. Condensed Consolidated Financial Statements

CONDENSED CONSOLIDATED BALANCE SHEETS (unaudited)

Alaska Air Group, Inc.

ASSETS

(In Millions)	December 31, 2003	September 30, 2004
		Revised (See Note 13)
Current Assets		
Cash and cash equivalents	$ 192.9	**$ 222.9**
Marketable securities	619.4	**655.6**
Receivables net	120.7	**120.5**
Inventories and supplies net	45.8	**47.4**
Deferred income taxes	90.6	**77.7**
Prepaid expenses and other current assets	78.9	**169.5**
Total Current Assets	1,148.3	**1,293.6**
Property and Equipment		
Flight equipment	2,327.6	**2,287.0**
Other property and equipment	464.2	**466.9**
Deposits for future flight equipment	78.1	**61.8**
	2,869.9	**2,815.7**
Less accumulated depreciation and amortization	920.7	**898.6**
Total Property and Equipment Net	1,949.2	**1,917.1**
Intangible Assets	45.6	**44.6**
Other Assets	116.1	**156.2**
Total Assets	$3,259.2	**$ 3,411.5**

See accompanying notes to condensed consolidated financial statements.

Table of Contents

CONDENSED CONSOLIDATED BALANCE SHEETS (unaudited)
Alaska Air Group, Inc.

LIABILITIES AND SHAREHOLDERS EQUITY

(In Millions)	December 31, 2003	September 30, 2004
		Revised (See Note 13)
Current Liabilities		
Accounts payable	$ 132.9	**$ 139.3**
Accrued aircraft rent	75.6	**71.6**
Accrued wages, vacation and payroll taxes	92.7	**121.5**
Other accrued liabilities	271.8	**299.0**
Air traffic liability	237.7	**279.9**
Current portion of long-term debt and capital lease obligations	206.7	**52.1**
Total Current Liabilities	1,017.4	**963.4**
Long-Term Debt and Capital Lease Obligations	906.9	**1,007.6**
Other Liabilities and Credits		
Deferred income taxes	192.0	**207.5**
Deferred revenue	252.4	**291.2**
Other liabilities	216.3	**233.4**
	660.7	**732.1**
Commitments and Contingencies		
Shareholders Equity		
Preferred stock, $1 par value		
Authorized: 5,000,000 shares		
Common stock, $1 par value		
Authorized: 100,000,000 shares		
Issued: 2003 - 29,474,919 shares; 2004 - 29,593,158 shares	29.5	**29.6**

Capital in excess of par value		486.3	**488.4**
Treasury stock, at cost:	2003 - 2,712,979 shares 2004 - 2,706,643 shares	(61.9)	**(61.8)**
Accumulated other comprehensive income (loss)		(79.0)	**(76.7)**
Retained earnings		299.3	**328.9**
		674.2	**708.4**
Total Liabilities and Shareholders Equity		$3,259.2	**$ 3,411.5**

See accompanying notes to condensed consolidated financial statements.

Table of Contents

CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS (unaudited)
Alaska Air Group, Inc.

Three Months Ended September 30 (In Millions Except Per Share Amounts)	2003	2004
	Revised (See Note 13)	Revised (See Note 13)
Operating Revenues		
Passenger	$ 645.8	**$ 706.0**
Freight and mail	22.6	**25.5**
Other net	33.8	**33.9**
Total Operating Revenues	702.2	**765.4**
Operating Expenses		
Wages and benefits	237.9	**247.0**
Contracted services	24.4	**21.2**
Aircraft fuel	96.8	**148.4**
Aircraft maintenance	42.4	**37.0**
Aircraft rent	49.2	**46.7**
Food and beverage service	17.6	**14.3**
Other selling expenses and commissions	36.1	**37.5**
Depreciation and amortization	32.7	**35.7**
Loss (gain) on sale of assets	0.1	**(2.8)**
Landing fees and other rentals	43.3	**48.0**
Other	45.0	**48.1**
Restructuring charges		**27.5**
Total Operating Expenses	625.5	**708.6**
Operating Income	76.7	**56.8**
Nonoperating Income (Expense)		
Interest income	5.5	**7.9**
Interest expense	(13.3)	**(13.6)**
Interest capitalized	0.4	**0.5**
Other net	(1.1)	**67.6**
	(8.5)	**62.4**

Income before income tax	68.2	**119.2**
Income tax expense	27.5	**45.2**
Net Income	$ 40.7	**$ 74.0**
Basic Earnings Per Share	$ 1.53	**$ 2.75**
Diluted Earnings Per Share	$ 1.52	**$ 2.75**
Shares used for computation:		
Basic	26.660	**26.862**
Diluted	26.796	**26.932**

See accompanying notes to condensed consolidated financial statements.

Table of Contents

CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS (unaudited)
Alaska Air Group, Inc.

Nine Months Ended September 30 (In Millions Except Per Share Amounts)	**2003**	**2004**
	Revised (See Note 13)	**Revised (See Note 13)**
Operating Revenues		
Passenger	$ 1,678.2	**$1,896.7**
Freight and mail	63.6	**68.3**
Other net	89.7	**97.5**
Total Operating Revenues	1,831.5	**2,062.5**
Operating Expenses		
Wages and benefits	697.5	**733.9**
Contracted services	74.5	**81.7**
Aircraft fuel	270.5	**384.8**
Aircraft maintenance	140.2	**137.9**
Aircraft rent	146.1	**141.5**
Food and beverage service	46.6	**39.5**
Other selling expenses and commissions	99.1	**111.5**
Depreciation and amortization	98.2	**105.8**
Loss (gain) on sale of assets	0.2	**(1.4)**
Landing fees and other rentals	120.6	**136.2**
Other	139.3	**146.3**
Restructuring charges		**27.5**
Impairment of aircraft and spare engines		**39.6**
Total Operating Expenses	1,832.8	**2,084.8**
Operating Loss	(1.3)	**(22.3)**
Nonoperating Income (Expense)		
Interest income	11.5	**18.6**
Interest expense	(38.6)	**(38.9)**
Interest capitalized	1.9	**1.1**
U.S. government compensation	71.4	**-**
Other net	8.2	**93.8**

	54.4	**74.6**
Income before income tax	53.1	**52.3**
Income tax expense	23.5	**22.7**
Net Income	$ 29.6	**$ 29.6**
Basic Earnings Per Share	$ 1.11	**$ 1.10**
Diluted Earnings Per Share	$ 1.11	**$ 1.10**
Shares used for computation:		
Basic	26.621	**26.820**
Diluted	26.680	**26.922**

See accompanying notes to condensed consolidated financial statements.

Table of Contents

CONDENSED CONSOLIDATED STATEMENT OF SHAREHOLDERS EQUITY (unaudited)
Alaska Air Group, Inc.

(In Millions)	Common Shares Outstanding	Common Stock	Capital in Excess of Par Value	Treasury Stock, at Cost	Accumulated Other Comprehensive Income (Loss)	Retained Earnings	Total
Balances at December 31, 2003:	*26.762*	$ 29.5	$ 486.3	$ (61.9)	$ (79.0)	$ 299.3	$ 674.2
Net income for the nine months ended September 30, 2004 - Revised (See Note 13)						29.6	29.6
Other comprehensive income (loss):							
Officers supplemental retirement plan net of $0.4 tax benefit					0.7		0.7
Related to marketable securities:							
Change in fair value					(3.5)		
Reclassification to earnings					0.5		
Income tax effect					1.1		
					(1.9)		(1.9)
Related to fuel hedges:							
Change in fair value					18.1		
Reclassification to earnings					(12.5)		
Income tax effect					(2.1)		
					3.5		3.5
Total comprehensive loss							31.9
Treasury stock sales	*0.007*			0.1			0.1
Stock issued for employee stock purchase plan	*0.103*	0.1	1.8				1.9
Stock issued under stock plans	*0.015*		0.3				0.3
Balances at September 30, 2004 - Revised (See Note 13)	***26.887***	**$ 29.6**	**$ 488.4**	**$ (61.8)**	**$ (76.7)**	**$ 328.9**	**$ 708.4**

See accompanying notes to condensed consolidated financial statements.

Table of Contents

CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS (unaudited)
Alaska Air Group, Inc.

Nine Months Ended September 30 (In Millions)	**2003**	**2004**
		Revised (See Note 13)
Cash flows from operating activities:		
Net income	$ 29.6	**$ 29.6**
Adjustments to reconcile net income to net cash provided by (used in) operating activities:		
Impairment of aircraft and spare engines		**39.6**
Depreciation and amortization	98.2	**105.8**
Amortization of airframe and engine overhauls	47.8	**48.3**
Changes in fair values of fuel hedges	1.8	**(80.4)**
Loss (gain) on sale of assets	0.1	**(1.4)**
Increase in deferred income taxes	23.6	**28.4**
(Increase) decrease in receivables net	(16.3)	**0.2**
Increase in prepaid expenses and other current assets	(1.6)	**(13.8)**
Increase in air traffic liability	54.2	**42.2**
Increase in other current liabilities	22.0	**58.9**
Increase in deferred revenue and other net	13.1	**26.1**
Net cash provided by operating activities	272.5	**283.5**
Cash flows from investing activities:		
Proceeds from disposition of assets	3.1	**11.1**
Purchases of marketable securities	(695.2)	**(637.9)**
Sales and maturities of marketable securities	535.3	**598.7**
Property and equipment additions:		
Aircraft purchase deposits	(35.3)	**(10.3)**
Capitalized overhauls	(56.1)	**(44.1)**
Aircraft	(194.4)	**(41.7)**
Other flight equipment	(12.1)	**(22.0)**
Other property	(22.8)	**(25.7)**
Aircraft deposits returned	1.2	**19.2**
Restricted deposits and other	(32.3)	**(4.5)**
Net cash used in investing activities	(508.6)	**(157.2)**
Cash flows from financing activities:		
Proceeds from issuance of long-term debt, net	247.0	**94.6**
Long-term debt and capital lease payments	(60.3)	**(193.2)**
Proceeds from issuance of common stock	2.1	**2.3**

Net cash provided by (used in) financing activities	188.8	**(96.3)**
Net change in cash and cash equivalents	(47.3)	**30.0**
Cash and cash equivalents at beginning of period	269.0	**192.9**
Cash and cash equivalents at end of period	$ 221.7	**$ 222.9**
Supplemental disclosure of cash paid (refunded) during the period for:		
Interest (net of amount capitalized)	$ 31.1	**$ 34.8**
Income taxes	(0.1)	**(39.6)**
Noncash investing and financing activities:		
Assets acquired under long-term debt		**44.7**

See accompanying notes to condensed consolidated financial statements.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (unaudited)
Alaska Air Group, Inc.

Note 1. Basis of Presentation and Significant Accounting Policies

Organization and Basis of Presentation

The accompanying unaudited condensed consolidated financial statements of Alaska Air Group, Inc. (Air Group or the Company) include the accounts of the parent company, Alaska Air Group, Inc., and its principal subsidiaries, Alaska Airlines, Inc. (Alaska) and Horizon Air Industries, Inc. (Horizon), through which the Company conducts substantially all of its operations. These interim condensed consolidated financial statements are unaudited and should be read in conjunction with the consolidated financial statements in the Company s Annual Report on Form 10-K/A for the year ended December 31, 2003. In the opinion of management, all adjustments have been made which are necessary to present fairly the Company s financial position as of September 30, 2004, as well as the results of operations for the three and nine months ended September 30, 2003 and 2004. The adjustments made were of a normal recurring nature.

The Company s condensed consolidated financial statements have been prepared in conformity with accounting principles generally accepted in the United States of America (GAAP). In preparing these condensed consolidated financial statements, the Company is required to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent liabilities, as well as the reported amounts of revenues and expenses. Significant estimates made include assumptions used to record liabilities, expenses and revenues associated with the Company s Mileage Plan, lease return provisions, the fair market value of surplus or impaired aircraft, engines and parts, assumptions used in the calculation of pension expense in the Company s defined benefit plans and the amounts of certain accrued liabilities. Actual results may differ from the Company s estimates.

Stock Options

The Company has awards outstanding under five long-term incentive equity plans, one of which continues to provide for the grant of stock options to purchase Air Group common stock at market prices on the date of the grant to officers and employees of Air Group and its subsidiaries. The Company applies the intrinsic value method in accordance with the provisions of Accounting Principles Board (APB) Opinion No. 25, Accounting for Stock Issued to Employees , and related Interpretations, in accounting for stock options. Accordingly, no compensation cost has been recognized for these plans as the exercise price of options equals the fair market value on the date of grant.

The following table represents the effect on net income and earnings per share if the Company had applied the fair value based method and recognition provisions of Statement on Financial Accounting Standards (SFAS) No. 123, Accounting for Stock-Based Compensation, to its stock-based employee compensation (in millions, except per share amounts):

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2003	2004	2003	2004
Net income:				
As reported	$40.7	**$74.0**	$29.6	**$29.6**
Deduct: Total stock-based employee compensation expense determined under fair value based methods for all awards, net of related tax effects	(1.4)	**(1.1)**	(4.6)	**(3.4)**
Pro forma net income	$39.3	**$72.9**	$25.0	**$26.2**
Basic earnings per share:				
As reported	$1.53	**$2.75**	$1.11	**$1.10**
Pro forma	1.47	**2.71**	0.94	**0.98**
Diluted earnings per share:				
As reported	$1.52	**$2.75**	$1.11	**$1.10**
Pro forma	1.47	**2.71**	0.94	**0.97**

Note 2. Restructuring Charges

During the third quarter of 2004, the Company announced a management reorganization and the closure of its Oakland maintenance base, contracting out of the Company s Fleet Service, Ground Equipment and Facility maintenance functions and other initiatives. In total, these restructuring activities are expected to result in a reduction of approximately 900 employees when fully implemented in 2005. Severance and related costs associated with this restructuring are estimated at $50-$55 million, of which $27.5 million was recorded during the third quarter of 2004 and $23 to $27 million will be recorded in the fourth quarter. The Company is also currently evaluating any possible asset impairment that may result from the announced initiatives. Any impairment charge would be in addition to the severance estimates above.

The following table displays the activity and balances of the restructuring charges for the three and nine months ended September 30, 2004. There were no restructuring charges during the same period of 2003 ($ in millions):

Severance and Related Costs	
Balance at December 31, 2003	$
Restructuring charges	27.5
Cash payments*	(1.2)
Balance at September 30, 2004	$26.3

* The Company expects the majority of cash payments will be made during the first and second quarters of 2005.

11

Table of Contents

Note 3. Impairment of Aircraft and Related Spare Engines

Impairment of 737-200C Aircraft

In June 2004, the Company s Board approved a plan to accelerate the retirement of its Boeing 737-200C fleet and remove those aircraft from service (by the end of 2007) earlier than initially planned. In July 2004, the Company announced its plan to replace these aircraft by modifying five existing 737-400 aircraft and using other existing 737-400 aircraft for the remaining passenger capacity. Four of the five modified airplanes will be converted into combination passenger/cargo aircraft and one will be converted to an all cargo aircraft. The Company expects to backfill the 737-400s with Boeing 737-800s to be delivered in 2005 and 2006.

As a result of this decision, the Company evaluated impairment as required by SFAS No. 144, Accounting for the Impairment or Disposal of Long-Lived Assets and concluded that the carrying value of the 737-200C fleet was no longer recoverable when compared to the estimated remaining future cash flows. Accordingly, during the second quarter of 2004, the Company recorded an impairment charge totaling $36.8 million (pretax) to write down the fleet to its estimated fair market value.

The estimated fair value of the Company s aircraft was derived using third-party appraisals and market data compiled by an independent pricing authority, and adjusted for other factors that management deemed appropriate. In conjunction with the fair value determination, the Company has reassessed the useful lives and residual values of the fleet and related spare equipment and will depreciate the remaining carrying values through 2007 when the last aircraft will be retired.

Impairment of F-28 Aircraft and Related Spare Engines

During the first and second quarters of 2004, Horizon recorded impairment charges of $2.4 million and $0.4 million, respectively, associated with its F-28 aircraft and spare engines to lower the carrying value of these assets to their estimated net realizable value.

Note 4. Derivative Financial Instruments

The Company s operations are inherently dependent upon the price and availability of aircraft fuel, which accounted for 15% and 19% of year-to-date 2003 and 2004 operating expenses (excluding impairment and restructuring charges), respectively. To manage economic risks associated with fluctuations in aircraft fuel prices, the Company enters into swap agreements and call options for crude oil. Prior to the second quarter of 2004, these hedging contracts were highly correlated to changes in aircraft fuel prices, and therefore qualified as cash flow hedges under SFAS No. 133 whereby the majority of the changes in fair value were deferred in Accumulated Other Comprehensive Income on the Company s Balance Sheet until these hedge positions were settled at which point they were recognized in earnings.

The Company s current fuel hedge program includes the same underlying commodities used historically. However, because of variations in the spread between the prices of crude oil and jet fuel since April 1, 2004, the Company s hedge contracts are no longer highly correlated to changes in prices of aircraft fuel, as defined in SFAS No. 133. The impacts on the Company s reported results are as follows:

Table of Contents

All changes in the fair value of fuel hedge contracts that existed as of March 31, 2004 or hedge positions entered into subsequent to March 31, 2004 (the end of the first quarter of 2004) are reported in other non-operating income (expense).

Because the Company will be recording fair value changes in its consolidated statement of operations as they occur (in non-operating income (expense)), actual gains or losses realized upon settlement of the hedge contracts entered into subsequent to March 31, 2004 will not be reflected in fuel expense.

Reported fuel expense will include the effective portion of gains associated with hedge positions that settled during the current period on contracts that existed at March 31, 2004 to the extent that mark-to-market gains were already included in Accumulated Other Comprehensive Income at March 31, 2004.

The following table summarizes realized fuel hedging gains and changes in fair value of hedging contracts outstanding as of September 30, 2004 and 2003 (in millions):

	Three Months Ended September 30,		**Nine Months Ended September 30,**	
	2003	**2004**	**2003**	**2004**
Settled hedging gains included in aircraft fuel	$ 5.1	**$ 4.0**	$16.5	**$12.5**
Settled hedging gains (losses) included In non-operating income (expense)***	$(0.8)	**$ 9.7**	$ 4.3	**$13.3**
Mark-to-market hedging gains included in non-operating income (expense)**	$	$**57.2**	$	$**80.0**
Hedging gains included in non-operating income (expense)*	$(0.8)	$**66.9**	$ 4.3	**$93.3**

* Includes the ineffective portion recorded currently in earnings using hedge accounting through the first quarter of 2004.
** Includes changes in fair value since March 31, 2004 resulting from the loss of hedge accounting .
*** 2003 includes the ineffective portion of fair market value changes under hedge accounting .

Table of Contents

Fuel hedge positions entered into by Alaska and Horizon are currently as follows:

	Approximate % of Expected Fuel Requirements	**Gallons Hedged (in millions)**	**Approximate Crude Oil Price per Barrel**
Fourth Quarter 2004	50%	49.0	$30.39
First Quarter 2005	50%	49.3	$29.86
Second Quarter 2005	50%	51.9	$28.97
Third Quarter 2005	50%	55.7	$28.81
Fourth Quarter 2005	50%	50.4	$31.85
First Quarter 2006	40%	40.7	$33.22
Second Quarter 2006	30%	32.1	$34.41
Third Quarter 2006	20%	22.9	$36.05
Fourth Quarter 2006	10%	10.4	$37.28
First Quarter 2007	5%	5.2	$35.75
Second Quarter 2007	5%	5.5	$35.48
Third Quarter 2007	5%	5.9	$35.23

As of December 31, 2003 and September 30, 2004, the fair values of the Company s fuel hedge positions were $18.4 million and $117.0 million, respectively, and are presented in the consolidated balance sheets as follows (in millions):

	December 31, 2003	**September 30, 2004**
Prepaid expenses and other current assets	$ 12.0	**$ 81.6**
Other assets	6.4	**35.4**
	$ 18.4	**$ 117.0**

Note 5. Other Assets

At December 31, 2003 and September 30, 2004, other assets consisted of the following (in millions):

	December 31, 2003	**September 30, 2004**
Restricted deposits (primarily restricted investments)	$ 70.8	**$ 80.8**
Derivative financial instruments (fuel hedges)	6.4	**35.4**
Deferred costs and other	27.7	**34.5**
Restricted cash for senior convertible notes	11.2	**5.5**

	$116.1	**$ 156.2**

14

Table of Contents

Note 6. Frequent Flyer Program

Alaska s Mileage Plan liabilities are included under the following balance sheet captions (in millions):

	December 31, 2003	**September 30, 2004**
Current Liabilities:		
Other accrued liabilities	$112.9	**$ 129.5**
Other Liabilities and Credits (non-current):		
Deferred revenue	204.5	**238.4**
Other liabilities	18.6	**19.7**
Total	$336.0	**$ 387.6**

Note 7. Employee Benefit Plans

Pension Plans-Defined Benefit

Net pension expense for the three and nine months ended September 30 included the following components (in millions):

	Three Months Ended September 30,		**Nine Months Ended September 30,**	
	2003	**2004**	2003	**2004**
Service cost	$11.1	**$ 13.5**	$ 33.3	**$ 40.9**
Interest cost	10.8	**11.8**	32.4	**35.8**
Expected return on assets	(8.5)	**(10.9)**	(25.5)	**(32.3)**
Amortization of prior service cost	1.3	**1.1**	3.9	**3.7**
Actuarial loss	3.7	**3.6**	11.1	**11.0**
SFAS No. 88 curtailment charge*		**1.0**		**1.0**
Net pension expense	$18.4	**$ 20.1**	$ 55.2	**$ 60.1**

* In connection with the restructuring charge and reduction in force as discussed in Note 2, the Company recorded a curtailment charge pursuant to SFAS No. 88. This charge is estimated at $1.0 million and is included in restructuring charges in the condensed consolidated financial statements.

The Company made $37.8 million in contributions to its defined benefit pension plans during the three and nine months ended September 30, 2003. The Company made $16.5 million and $49.4 million in contributions during the three and nine months ended September 30, 2004, respectively, and does not expect to make any additional contributions to these plans during the remainder of 2004.

Table of Contents

Pension Plans-Noncontributory

Net pension expense for the unfunded, noncontributory defined benefit plans for certain elected officers of the Company for the three and nine months ended September 30 included the following components (in millions):

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2003	**2004**	2003	**2004**
Service cost	$0.2	**$0.2**	$0.6	**$0.8**
Interest cost	0.5	**0.4**	1.5	**1.4**
Actuarial loss	0.1	**0.1**	0.3	**0.5**
Net pension expense	$0.8	**$0.7**	$2.4	**$2.7**

Other Postretirement Benefits

Net periodic benefit cost for the postretirement medical plans for the three and nine months ended September 30 included the following components (in millions):

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2003	**2004**	2003	**2004**
Service cost	$0.9	**$ 0.6**	$2.7	**$ 3.0**
Interest cost	1.1	**0.7**	3.3	**3.3**
Amortization of prior service cost		**(0.1)**		**(0.3)**
Actuarial loss	0.4	**0.4**	1.2	**1.8**
Net periodic benefit cost	$2.4	**$ 1.6**	$7.2	**$ 7.8**

Note 8. Earnings Per Share

Earnings per share calculations were as follows (in millions except per share amounts). Stock options are included in the computation of diluted loss per share unless their impact is antidilutive. For the three months ended September 30, 2003 and 2004, options to purchase 2.4 million shares and 3.3 million shares of common stock, respectively, were excluded from the calculations. For the nine months ended September 30, 2003 and 2004, options to purchase 3.1 million shares and 3.2 million shares of common stock, respectively, were excluded from the calculations.

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2003	**2004**	2003	**2004**
Basic				
Net income	$ 40.7	**$ 74.0**	$ 29.6	**$ 29.6**
Weighted average shares outstanding	26.660	**26.862**	26.621	**26.820**
Earnings per share	$ 1.53	**$ 2.75**	$ 1.11	**$ 1.10**

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2003	**2004**	2003	**2004**
Diluted				
Net income	$ 40.7	**$ 74.0**	$ 29.6	**$ 29.6**
Weighted average shares outstanding	26.660	**26.862**	26.621	**26.820**
Assumed exercise of stock options	.136	**.070**	.059	**.102**
Diluted EPS shares	26.796	**26.932**	26.680	**26.922**
Earnings per share	$ 1.52	**$ 2.75**	$ 1.11	**$ 1.10**

Diluted shares also excludes the shares of common stock issuable upon conversion of the Company s floating rate senior convertible notes due in 2023 (the Notes) issued on March 21, 2003, because the closing prices of Air Group s common stock during the first, second and third quarters of 2003 and 2004 did not trigger the convertibility feature, their effect would have been antidilutive. Holders may not surrender the notes for conversion into shares of the Company s common stock (or cash, at the election of the Company) unless the closing sale price of the Company s common stock exceeds 110% of the accreted conversion price under the Notes for 20 days in the 30 trading-day period ending on the last day of the fiscal quarter. In addition, holders may require the Company to purchase all or a portion of their Notes, for a purchase price equal to principal plus accrued interest, on the 5th, 10th and 15th anniversaries of the issuance of the Notes, or upon the occurrence of a change of control or tax event. On September 30, 2004, we entered into the First Supplemental Indenture with respect to the Notes to rescind the Company s right to pay for such a repurchase of the Notes at the option of the holders, in whole or in part, in shares of our common stock. Pursuant to the terms of the notes, as amended, any such repurchases shall be paid for in cash.

The Company may redeem all or a portion of the Notes in cash at any time on or after the third anniversary of the issuance of the Notes or if holders of the Notes require the Company to purchase the Notes.

For each $1,000 of original principal amount per Note, the conversion price through March 21, 2008 is equal to the original principal amount of the Notes, divided by 38.4615. At the date of issuance, the conversion price was equal to $26.00 per share and the conversion trigger price was equal to 110% of the conversion price, or $28.60 per share. After March 21, 2008, the conversion price and conversion trigger price increase based on the variable yield of the notes. Once the closing sale price of the Company s common stock exceeds the conversion trigger price for the requisite period, the notes will be convertible at any time thereafter at the option of the holder, through maturity.

During the third quarter of 2004, the Emerging Issues Task Force (EITF) affirmed its tentative conclusion reached in July of 2004 on EITF Issue No. 04-08, The Effect of Contingently Convertible Debt on Diluted EPS (EITF 04-08). EITF 04-08 requires companies to include certain contingently convertible securities in the calculation of diluted EPS to the extent the inclusion of the shares would be dilutive. Adoption of EITF 04-08 is expected to be required during the fourth quarter of 2004 and will impact periods and comparative periods on a go forward basis. Because the Company s convertible notes fall under the scope of EITF 04-08, beginning in the fourth

17

quarter of 2004 and for all comparative periods presented, the Company expects to report a lower diluted EPS to the extent the convertible notes are not anti-dilutive. Had EITF 04-08 been required during the third quarter of 2003 and 2004, diluted EPS would include an additional 5.7 million shares and would have resulted in diluted EPS of $1.29 and $2.31 for the three months ended September 30, 2003 and 2004, respectively, and $1.00 and $1.04 per share for the nine months ended September 30, 2003 and 2004, respectively.

Note 9. Operating Segment Information

Operating segment information for Alaska and Horizon for the three and nine month periods ended September 30 was as follows (in millions):

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2003	**2004**	2003	**2004**
Operating revenues:				
Alaska	$585.3	**$632.8**	$ 1,522.9	**$1,701.7**
Horizon	132.7	**139.3**	342.3	**374.3**
Elimination of intercompany revenues	(15.8)	**(6.7)**	(33.7)	**(13.5)**
Consolidated	$702.2	**$765.4**	$ 1,831.5	**$2,062.5**
Income (loss) before income tax:				
Alaska	$ 50.1	**$ 97.9**	$ 39.1	**$ 41.9**
Horizon	19.5	**24.4**	19.9	**18.7**
Other*	(1.4)	**(3.1)**	(5.9)	**(8.3)**
Consolidated	$ 68.2	**$119.2**	$ 53.1	**$ 52.3**
Total assets at end of period:				
Alaska			$ 3,072.7	**$3,161.1**
Horizon			257.4	**304.1**
Other*			911.1	**882.2**
Elimination of intercompany accounts			(1,001.8)	**(935.9)**
Consolidated			$ 3,239.4	**$3,411.5**

* Includes the parent company, Alaska Air Group, Inc, including Alaska Air Group Leasing and investments in Alaska and Horizon, which are eliminated in consolidation.

18

Table of Contents

Note 10. Long-Term Debt and Capital Lease Obligations

At December 31, 2003, and September 30, 2004, long-term debt and capital lease obligations were as follows (in millions):

	December 31, 2003	September 30, 2004
Fixed rate notes payable due through 2015	$ 382.6	**$ 368.6**
Variable rate notes payable due through 2018	572.5	**540.6**
Senior convertible notes due through 2023	150.0	**150.0**
Long-term debt	1,105.1	**1,059.2**
Capital lease obligations	8.5	**0.5**
Less current portion	(206.7)	**(52.1)**
	$ 906.9	$ **1,007.6**

During the first nine months of 2004, Alaska issued $94.6 million of debt secured by flight equipment, having interest rates that vary with LIBOR and payment terms ranging from 12 to 16 years. Debt issuances during the period were offset by normal long-term debt payments of $43.2 million and full repayment of the Company s credit facility of $150.0 million.

During the first nine months of 2004, Horizon financed three Bombardier Q400s under long-term debt arrangements totaling $44.7 million. These debt arrangements have a 15-year term and interest rates that vary with LIBOR. Two of the aircraft were originally leased in January 2004 and were treated as capital leases at that time. The resulting re-financing transactions did not result in any gain or loss in the consolidated statements of operations.

Note 11. Contingencies

The Company is a party to routine litigation incidental to its business and with respect to which no material liability is expected. Management believes the ultimate disposition of these matters is not likely to materially affect the Company s financial position or results of operations. However, this belief is based on management s current understanding of the relevant law and facts; it is subject to various contingencies, including the potential costs and risks associated with litigation and the actions of judges and juries.

Note 12. U.S. Government Compensation

On April 16, 2003, the Emergency Wartime Supplemental Appropriations Act (the Act) was signed into legislation. The Act included $2.3 billion of one-time cash payments to air carriers, allocated based on each carrier s share of security fees remitted and carrier fees paid to the Transportation Security Administration (TSA) since its inception in February 2002. In May 2003, the Company received its share of the one-time cash grant in the amount of $71.4 million ($52.8 million for Alaska and $18.6 million for Horizon).

19

Table of Contents

Note 13. Revision of Previously Issued Financial Statements and SEC Filings

In December, we discovered a clerical error in our calculation of deferred Mileage Plan revenue that existed as of September 30, 2004. As a result, we have revised our third quarter and year to date reported condensed consolidated financial statements to adjust for this item. The revision increases the total Mileage Plan liability and deferred revenue balance from $379.2 million to $387.6 million (which amounts are included in other accrued liabilities-current in the condensed consolidated financial statements) and results in an $8.4 million (pretax) decrease to other revenues for the third quarter and nine months ended September 30, 2004.

The revised 2004 third quarter consolidated net income is $74.0 million, or $2.75 per diluted share, and the revised consolidated net income for the nine months ended September 30, 2004 is $29.6 million, or $1.10 per diluted share. We originally reported third quarter net income of $79.2 million (or $2.94 per diluted share) and net income for the nine month period of $34.8 million (or $1.29 per diluted share).

The effect of the revisions on the condensed consolidated income statement for 2004 is as follows (in millions):

	Three Months Ended September 30, 2004	Nine Months Ended September 30, 2004
Total Operating Revenues:		
As Previously Reported	$ 773.8	$2,070.9
Revised	$ 765.4	$2,062.5
Operating Income (Loss):		
As Previously Reported	$ 65.2	$ (13.9)
Revised	$ 56.8	$ (22.3)
Income Before Income Taxes		
As Previously Reported	$ 127.6	$ 60.7
Revised	$ 119.2	$ 52.3
Net Income		
As Previously Reported	$ 79.2	$ 34.8
Revised	$ 74.0	$ 29.6
Basic Earnings Per Share		
As Previously Reported	$ 2.95	$ 1.30
Revised	$ 2.75	$ 1.10
Diluted Earnings Per Share		
As Previously Reported	$ 2.94	$ 1.29
Revised	$ 2.75	$ 1.10

Table of Contents

The effect of the revision on selected balance sheet items is as follows as of September 30, 2004 (in millions):

Deferred Income Taxes (Current Assets):	
As Previously Reported	$ 75.3
Revised	$ 77.7
Total Current Assets:	
As Previously Reported	$1,291.2
Revised	$1,293.6
Total Assets:	
As Previously Reported	$3,409.1
Revised	$3,411.5
Other Accrued Liabilities (Current Liabilities):	
As Previously Reported	$ 290.6
Revised	$ 299.0
Total Current Liabilities:	
As Previously Reported	$ 955.0
Revised	$ 963.4
Deferred Income Taxes:	
As Previously Reported	$ 208.3
Revised	$ 207.5
Shareholders Equity	
As Previously Reported	$ 713.6
Revised	$ 708.4

Table of Contents

In its previously reported 2003 Form 10-Q s, the Company recorded unrealized gains and losses related to the ineffective portion of changes in fair value of our fuel hedge positions as nonoperating income (expense) and then reclassified those gains and losses to fuel expense as those hedges were settled. This practice was not consistent with its stated policy, which is to record the ineffective portion in nonoperating income (expense). The Company has revised its 2003 reported condensed consolidated financial statements to adjust its historical presentation of such items. Such revisions have resulted in reclassification between operating income (loss) and nonoperating income (expense) in the condensed consolidated statements of operations. The revisions have no impact on previously reported pretax income, net income, earnings per share, the condensed consolidated balance sheets, the condensed consolidated statements of shareholders equity or the condensed consolidated statements of cash flows for any periods.

The effect of the revisions for 2003 is as follows (in millions):

	Three Months Ended September 30, 2003	Nine Months Ended September 30, 2003
Total Aircraft Fuel:		
As Previously Reported	$ 94.7	$ 265.0
As Revised	$ 96.8	$ 270.5
Total Operating Expenses:		
As Previously Reported	$ 623.4	$1,827.3
As Revised	$ 625.5	$1,832.8
Total Operating Income (Loss):		
As Previously Reported	$ 78.8	$ 4.2
As Revised	$ 76.7	$ (1.3)
Nonoperating Income (Expense):		
As Previously Reported	$ (10.6)	$ 48.9
As Revised	$ (8.5)	$ 54.4

Table of Contents

Alaska Airlines Financial and Statistical Data

	Three Months Ended September 30			Nine Months Ended September 30		
Financial Data (in millions):	2003*	**2004***	% Change	2003*	**2004***	% Change
Operating Revenues:						
Passenger	$ 532.5	**$ 576.6**	8.3%	$1,380.1	**$1,545.8**	12.0%
Freight and mail	21.4	**24.5**	14.5%	59.8	**65.3**	9.2%
Other net	31.4	**31.7**	1.0%	83.0	**90.6**	9.2%
Total Operating Revenues	585.3	**632.8**	8.1%	1,522.9	**1,701.7**	11.7%
Operating Expenses:						
Wages and benefits	198.7	**207.3**	4.3%	578.7	**611.8**	5.7%
Contracted services	20.5	**17.8**	-13.2%	60.9	**70.3**	15.4%
Aircraft fuel	83.3	**130.2**	56.3%	232.2	**336.4**	44.9%
Aircraft maintenance	35.2	**27.1**	-23.0%	117.7	**111.3**	-5.4%
Aircraft rent	31.1	**28.1**	-9.6%	92.8	**85.5**	-7.9%
Food and beverage service	17.0	**13.7**	-19.4%	44.8	**37.9**	-15.4%
Other selling expenses and commissions	43.4	**35.9**	-17.3%	109.0	**101.1**	-7.2%
Depreciation and amortization	29.7	**32.0**	7.7%	87.8	**95.2**	8.4%
Loss on sale of assets	0.8	**(2.5)**	NM	1.3	**(0.6)**	NM
Landing fees and other rentals	33.6	**37.6**	11.9%	93.5	**106.1**	13.5%
Other	34.5	**37.1**	7.5%	102.9	**111.0**	7.9%
Restructuring charges		**27.5**	100.0%		**27.5**	NM
Impairment of aircraft			0.0%		**36.8**	NM
Total Operating Expenses	527.8	**591.8**	12.1%	1,521.6	**1,730.3**	13.7%
Operating Income (Loss)	57.5	**41.0**	-28.7%	1.3	**(28.6)**	NM
Interest income	4.6	**8.4**		10.3	**20.0**	
Interest expense	(11.2)	**(11.6)**		(33.9)	**(33.1)**	
Interest capitalized	0.2	**0.4**		1.3	**0.7**	
U.S. government compensation				52.8	**-**	
Other net	(1.0)	**59.7**		7.3	**82.9**	
	(7.4)	**56.9**		37.8	**70.5**	

Income Before Income Tax	$ 50.1	**$ 97.9**	95.4%	$ 39.1	**$ 41.9**	7.2%
Operating Statistics:						
Revenue passengers (000)	4,280	**4,589**	7.2%	11,335	**12,296**	8.5%
RPMs (000,000)	4,126	**4,571**	10.8%	10,946	**12,255**	12.0%
ASMs (000,000)	5,693	**6,012**	5.6%	15,611	**16,825**	7.8%
Passenger load factor	72.5%	**76.0%**	3.5 pts	70.1%	**72.8%**	2.7 pts
Yield per passenger mile	12.91¢	**12.62¢**	-2.2%	12.61¢	**12.61¢**	0.0%
Operating revenue per ASM	10.28¢	**10.53¢**	2.4%	9.76¢	**10.11¢**	3.6%
Operating expenses per ASM (a)	9.27¢	**9.84¢**	6.1%	9.75¢	**10.28¢**	5.4%
Operating expenses per ASM excluding fuel, navigation fee settlement, restructuring and impairment charges (a)	7.81¢	**7.35¢**	-6.0%	8.26¢	**7.95¢**	-3.9%
Raw fuel cost per gallon (a)	95.2¢	**139.6¢**	46.6%	97.0¢	**129.8¢**	33.8%
GAAP fuel cost per gallon (a)	90.5¢	**135.9¢**	50.2%	91.5¢	**125.7¢**	37.4%
Economic fuel cost per gallon (a)	88.7¢	**127.0¢**	43.2%	89.6¢	**121.3¢**	35.4%
Fuel gallons (000,000)	92.0	**95.8**	4.1%	253.9	**267.6**	5.4%
Average number of employees	10,114	**10,201**	0.9%	10,079	**10,147**	0.7%
Aircraft utilization (blk hrs/day)	11.1	**11.8**	6.3%	10.6	**11.1**	4.7%
Operating fleet at period-end	109	**107**	-1.8%	109	**107**	-1.8%

NM = Not Meaningful

(a) See Note A on Page 25

* As revised. See Note 13 to our condensed consolidated financial statements.

Table of Contents

Horizon Air Financial and Statistical Data

Financial Data (in millions):	Three Months Ended September 30			Nine Months Ended September 30		
	2003*	**2004**	% Change	**2003***	**2004**	% Change
Operating Revenues:						
Passenger	$ 127.2	**$ 134.5**	5.7%	$ 326.8	**$ 360.4**	10.3%
Freight and mail	1.2	**1.0**	-16.7%	3.8	**3.0**	-20.9%
Other net	4.3	**3.8**	-11.6%	11.7	**10.9**	-6.8%
Total Operating Revenues	132.7	**139.3**	5.0%	342.3	**374.3**	9.3%
Operating Expenses:						
Wages and benefits	39.2	**39.7**	1.3%	118.8	**122.1**	2.8%
Contracted services	5.7	**5.0**	-12.3%	18.4	**15.4**	-16.3%
Aircraft fuel	13.5	**18.2**	34.8%	38.3	**48.4**	26.4%
Aircraft maintenance	7.2	**9.9**	37.5%	22.5	**26.6**	18.2%
Aircraft rent	18.1	**18.6**	2.8%	53.3	**56.0**	5.1%
Food and beverage service	0.6	**0.6**	0.0%	1.8	**1.6**	-11.1%
Other selling expenses and commissions	6.6	**6.7**	1.5%	18.8	**19.9**	5.9%
Depreciation and amortization	2.7	**3.4**	25.9%	9.5	**9.7**	2.1%
Gain on sale of assets	(0.7)	**(0.3)**	NM	(1.1)	**(0.8)**	NM
Landing fees and other rentals	10.3	**11.0**	6.8%	28.2	**31.2**	10.6%
Other	9.7	**9.7**	0.0%	32.6	**32.0**	-1.8%
Impairment of aircraft and spare engines			0.0%		**2.8**	NM
Total Operating Expenses	112.9	**122.5**	8.5%	341.1	**364.9**	7.0%
Operating Income	19.8	**16.8**	-15.2%	1.2	**9.4**	NM
Interest income	0.2	**0.3**		0.5	**0.9**	
Interest expense	(0.6)	**(0.9)**		(1.9)	**(3.2)**	
Interest capitalized	0.2	**0.1**		0.6	**0.4**	
Government compensation				18.6	**-**	
Other net	(0.1)	**8.1**		0.9	**11.2**	
	(0.3)	**7.6**		18.7	**9.3**	

Income Before Income Tax	$ 19.5	**$ 24.4**	25.1%	$ 19.9	**$ 18.7**	-5.9%
Operating Statistics:						
Revenue passengers (000)	1,376	**1,641**	19.3%	3,671	**4,362**	18.8%
RPMs (000,000)	466	**601**	29.0%	1,224	**1,586**	29.6%
ASMs (000,000)	701	**830**	18.4%	1,950	**2,314**	18.7%
Passenger load factor	66.5%	**72.4%**	5.9 pts	62.8%	**68.5%**	5.7 pts
Yield per passenger mile	27.29¢	**22.38¢**	-18.0%	26.70¢	**22.73¢**	-14.9%
Operating revenue per ASM	18.93¢	**16.78¢**	-11.4%	17.56¢	**16.18¢**	-7.9%
Operating expenses per ASM (a)	16.11¢	**14.76¢**	-8.4%	17.49¢	**15.77¢**	-10.0%
Operating expenses per ASM excluding fuel and impairment charges (a)	14.18¢	**12.57¢**	-11.4%	15.53¢	**13.56¢**	-12.7%
Raw fuel cost per gallon (a)	98.6¢	**143.8¢**	46.0%	100.2¢	**134.1¢**	33.8%
GAAP fuel cost per gallon (a)	93.1¢	**140.0¢**	50.4%	94.1¢	**130.1¢**	38.3%
Economic fuel cost per gallon (a)	90.3¢	**131.2¢**	45.2%	91.9¢	**125.8¢**	36.8%
Fuel gallons (000,000)	14.5	**13.0**	-10.3%	40.7	**37.2**	-8.6%
Average number of employees	3,368	**3,439**	2.1%	3,375	**3,399**	0.7%
Aircraft utilization (blk hrs/day)	8.2	**8.7**	6.1%	7.9	**8.3**	5.1%
Operating fleet at period-end	61	**65**	6.6%	61	**65**	6.6%

NM = Not Meaningful

(a) See Note A on Page 25

* As revised. See Note 13 to our condensed consolidated financial statements.

Table of Contents

Note A:

Pursuant to Item 10 of Regulation S-K, we are providing disclosure of the reconciliation of reported non-GAAP financial measures to their most directly comparable financial measures reported on a GAAP basis. The non-GAAP financial measures provide management the ability to measure and monitor performance both with and without the cost of aircraft fuel (including the gains and losses associated with our fuel hedging program where appropriate), restructuring charges, aircraft impairment charges, government compensation in 2003 and a large recovery in 2004 of disputed navigation fees paid in prior years (of which $7.7 million was recorded in operating expenses and $3.3 million was recorded in non-operating income). Because the cost and availability of aircraft fuel are subject to many economic and political factors beyond our control and we record changes in the fair value of our hedge portfolio in our income statement, it is our view that the measurement and monitoring of performance without fuel is important. The following tables reconcile our non-GAAP financial measures to the most directly comparable GAAP financial measures for both Alaska Airlines, Inc. and Horizon Air Industries, Inc.: (Certain amounts included below have been revised as explained further in Note 13 to our condensed consolidated financial statements)

Alaska Airlines, Inc.:

($ in millions)	Three Months Ended September 30,		Nine Months Ended September 30,	
Unit cost reconciliations:	**2003**	**2004**	**2003**	**2004**
Operating expenses	$ 527.8	**$ 591.8**	$ 1,521.6	**$ 1,730.3**
ASMs (000,000)	5,693	**6,012**	15,611	**16,825**
Operating expenses per ASM	9.27¢	**9.84¢**	9.75¢	**10.28¢**
Operating expenses	$ 527.8	**$ 591.8**	$ 1,521.6	**$ 1,730.3**
Less: aircraft fuel	(83.3)	**(130.2)**	(232.2)	**(336.4)**
Less: impairment of aircraft				**(36.8)**
Less: restructuring charges		**(27.5)**		**(27.5)**
Add: navigation fee settlement		**7.7**		**7.7**
Operating expense excluding fuel, navigation fee settlement, impairment and restructuring charges	$ 444.5	**$ 441.8**	$ 1,289.4	**$ 1,337.3**
ASMs (000,000)	5,693	**6,012**	15,611	**16,825**
Operating expense per ASM excluding fuel, navigation fee settlement, impairment and restructuring charges	7.81¢	**7.35¢**	8.26¢	**7.95¢**
Aircraft fuel reconciliations:				
Fuel expense before hedge activities (raw fuel)	$ 87.6	**$ 133.7**	$ 246.2	**$ 347.4**

Fuel gallons (000,000)	92.0	**95.8**	253.9	**267.6**
Raw fuel cost per gallon	95.2¢	**139.6¢**	97.0¢	**129.8¢**
Fuel expense before hedge activities (raw fuel)	$ 87.6	**$ 133.7**	$ 246.2	**$ 347.4**
Less: gains on settled hedges included in fuel expense	(4.3)	**(3.5)**	(14.0)	**(11.0)**
GAAP fuel expense	$ 83.3	**$ 130.2**	$ 232.2	**$ 336.4**
Fuel gallons (000,000)	92.0	**95.8**	253.9	**267.6**
GAAP fuel cost per gallon	90.5¢	**135.9¢**	91.5¢	**125.7¢**
GAAP fuel expense	$ 83.3	**$ 130.2**	$ 232.2	**$ 336.4**
Less: gains on settled hedges included in nonoperating income (expense)	(1.7)	**(8.5)**	(4.6)	**(11.7)**
Adjusted fuel	81.6	**121.7**	227.6	**324.7**
Fuel gallons (000,000)	92.0	**95.8**	253.9	**267.6**
Economic fuel cost per gallon	88.7¢	**127.0¢**	89.6¢	**121.3¢**
Mark-to-market gains included in non-operating income related to hedges that settle in future periods		**$ 50.3**		**$ 70.4**
Reconciliation to GAAP pretax income (loss), revised:				
Pretax income (loss) excluding impairment and restructuring charges, navigation fee settlement, government compensation and mark-to-market hedging gains	$ 50.1	**$ 64.1**	($13.7)	**$ 24.8**
Less: impairment of aircraft				**(36.8)**
Less: restructuring charges		**(27.5)**		**(27.5)**
Add: government compensation			52.8	**-**
Add: mark-to-market hedging gains included in nonoperating income (expense)		**50.3**		**70.4**
Add: navigation fee settlement		**11.0**		**11.0**

Pretax income (loss) reported GAAP amounts	$ 50.1	**$ 97.9**	$ 39.1	**$ 41.9**

Table of Contents

Horizon Air Industries, Inc.

($ in millions) Unit cost reconciliations:	Three Months Ended September 30, 2003	Three Months Ended September 30, 2004	Three Months Ended September 30, 2003	Three Months Ended September 30, 2004
Operating expenses	$ 112.9	**$ 122.5**	$ 341.1	**$ 364.9**
ASMs (000,000)	701	**830**	1,950	**2,314**
Operating expenses per ASM	16.11¢	**14.76¢**	17.49¢	**15.77¢**
Operating expenses	$ 112.9	**$ 122.5**	$ 341.1	**$ 364.9**
Less: aircraft fuel	(13.5)	**(18.2)**	(38.3)	**(48.4)**
Less: impairment of aircraft				**(2.8)**
Operating expense excluding fuel and impairment charge	$ 99.4	**$ 104.3**	$ 302.8	**$ 313.7**
ASMs (000,000)	701	**830**	1,950	**2,314**
Operating expense per ASM excluding fuel and impairment charge	14.18¢	**12.57¢**	15.53¢	**13.56¢**
Aircraft fuel reconciliations:				
Fuel expense before hedge activities (raw fuel)	$ 14.3	**$ 18.7**	$ 40.8	**$ 49.9**
Fuel gallons (000,000)	14.5	**13.0**	40.7	**37.2**
Raw fuel cost per gallon	98.6¢	**143.8¢**	100.2¢	**134.1¢**
Fuel expense before hedge activities (raw fuel)	$ 14.3	**$ 18.7**	$ 40.8	**$ 49.9**
Less: gains on settled hedges included in fuel expense	(0.8)	**(0.5)**	(2.5)	**(1.5)**
GAAP fuel expense	$ 13.5	**$ 18.2**	$ 38.3	**$ 48.4**
Fuel gallons (000,000)	14.5	**13.0**	40.7	**37.2**
GAAP fuel cost per gallon	93.1¢	**140.0¢**	94.1¢	**130.1¢**

GAAP fuel expense	$ 13.5	**$ 18.2**	$ 38.3	**$ 48.4**
Less: gains on settled hedges included in nonoperating income (expense)	(0.3)	**(1.2)**	(0.8)	**(1.6)**