

ALASKA AIR GROUP INC

Form 10-Q/A

December 23, 2004

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**UNITED STATES SECURITIES AND EXCHANGE COMMISSION
WASHINGTON, DC 20549**

FORM 10-Q/A

(Amendment No. 1)

(Mark One)

**☐ 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

**○ 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 No

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

APPLICABLE ONLY TO CORPORATE ISSUERS:

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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.

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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.

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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, believe, 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.

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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 |
| | <hr/> | <hr/> |
| Total Current Assets | 1,148.3 | 1,293.6 |
| | <hr/> | <hr/> |
| 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 |
| | <hr/> | <hr/> |
| | 2,869.9 | 2,815.7 |
| Less accumulated depreciation and amortization | 920.7 | 898.6 |
| | <hr/> | <hr/> |
| Total Property and Equipment Net | 1,949.2 | 1,917.1 |
| | <hr/> | <hr/> |
| Intangible Assets | 45.6 | 44.6 |
| | <hr/> | <hr/> |
| Other Assets | 116.1 | 156.2 |
| | <hr/> | <hr/> |
| Total Assets | \$3,259.2 | \$ 3,411.5 |
| | <hr/> | <hr/> |

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 | <u>1,017.4</u> | <u>963.4</u> |
| Long-Term Debt and Capital Lease Obligations | <u>906.9</u> | <u>1,007.6</u> |
| Other Liabilities and Credits | | |
| Deferred income taxes | 192.0 | 207.5 |
| Deferred revenue | 252.4 | 291.2 |
| Other liabilities | 216.3 | 233.4 |
| | <u>660.7</u> | <u>732.1</u> |
| 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 | | |
| 2003 - 29,474,919 | | |
| Issued: shares | | |
| 2004 - 29,593,158 | | |
| shares | 29.5 | 29.6 |

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| | | |
|--|------------------|-------------------|
| Capital in excess of par value | 486.3 | 488.4 |
| 2003 - 2,712,979 | | |
| Treasury stock, at cost: 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 |
| | <u> </u> | <u> </u> |
| | 674.2 | 708.4 |
| | <u> </u> | <u> </u> |
| Total Liabilities and Shareholders Equity | \$3,259.2 | \$ 3,411.5 |
| | <u> </u> | <u> </u> |

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 |
| | <hr/> | <hr/> |
| Total Operating Revenues | 702.2 | 765.4 |
| | <hr/> | <hr/> |
| 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 |
| | <hr/> | <hr/> |
| Total Operating Expenses | 625.5 | 708.6 |
| | <hr/> | <hr/> |
| Operating Income | 76.7 | 56.8 |
| | <hr/> | <hr/> |
| 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 |
| | <hr/> | <hr/> |
| | (8.5) | 62.4 |
| | <hr/> | <hr/> |

| | | |
|-----------------------------------|----------------|----------------|
| Income before income tax | 68.2 | 119.2 |
| Income tax expense | 27.5 | 45.2 |
| | <hr/> | <hr/> |
| Net Income | \$ 40.7 | \$ 74.0 |
| | <hr/> | <hr/> |
| Basic Earnings Per Share | \$ 1.53 | \$ 2.75 |
| | <hr/> | <hr/> |
| Diluted Earnings Per Share | \$ 1.52 | \$ 2.75 |
| | <hr/> | <hr/> |
| 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 |
| | <hr/> | <hr/> |
| Total Operating Revenues | 1,831.5 | 2,062.5 |
| | <hr/> | <hr/> |
| 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 |
| | <hr/> | <hr/> |
| Total Operating Expenses | 1,832.8 | 2,084.8 |
| | <hr/> | <hr/> |
| Operating Loss | (1.3) | (22.3) |
| | <hr/> | <hr/> |
| 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 |
| | <hr/> | <hr/> |

| | | |
|-----------------------------------|-------------------|-------------------|
| | 54.4 | 74.6 |
| | <u> </u> | <u> </u> |
| Income before income tax | 53.1 | 52.3 |
| Income tax expense | 23.5 | 22.7 |
| | <u> </u> | <u> </u> |
| Net Income | \$ 29.6 | \$ 29.6 |
| | <u> </u> | <u> </u> |
| Basic Earnings Per Share | \$ 1.11 | \$ 1.10 |
| | <u> </u> | <u> </u> |
| Diluted Earnings Per Share | \$ 1.11 | \$ 1.10 |
| | <u> </u> | <u> </u> |
| 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 | | Capital in Excess of Par Value | Accumulated | | Retained Earnings | Total |
|---|-----------------------|-----------------|---|-------------------------------|--|----------------------|-----------------|
| | Shares Outstanding | Common Stock | | Treasury Stock, at Cost | Other Comprehensive Income (Loss) | | |
| 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.

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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 |
| | <hr/> | <hr/> |
| Net cash provided by operating activities | 272.5 | 283.5 |
| | <hr/> | <hr/> |
| 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) |
| | <hr/> | <hr/> |
| Net cash used in investing activities | (508.6) | (157.2) |
| | <hr/> | <hr/> |
| 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.

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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):

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| | 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.

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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:

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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 .

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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 |
| | <u> </u> | <u> </u> |
| | \$ 18.4 | \$ 117.0 |
| | <u> </u> | <u> </u> |

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 |
| _____ | _____ |

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 |
|--|-----------------------------|-----------------------------|
| | <u> </u> | <u> </u> |
| 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 |
| | <u> </u> | <u> </u> |
| Total | \$336.0 | \$ 387.6 |
| | <u> </u> | <u> </u> |

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 |
| | <u> </u> | <u> </u> | <u> </u> | <u> </u> |
| 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 |
| | <u> </u> | <u> </u> | <u> </u> | <u> </u> |
| Net pension expense | \$18.4 | \$ 20.1 | \$ 55.2 | \$ 60.1 |
| | <u> </u> | <u> </u> | <u> </u> | <u> </u> |

* 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 |
| | <u> </u> | <u> </u> | <u> </u> | <u> </u> |
| Net pension expense | \$0.8 | \$0.7 | \$2.4 | \$2.7 |
| | <u> </u> | <u> </u> | <u> </u> | <u> </u> |

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 |
| | <u> </u> | <u> </u> | <u> </u> | <u> </u> |
| Net periodic benefit cost | \$2.4 | \$ 1.6 | \$7.2 | \$ 7.8 |
| | <u> </u> | <u> </u> | <u> </u> | <u> </u> |

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 |

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| | 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 | <u>26.796</u> | <u>26.932</u> | <u>26.680</u> | <u>26.922</u> |
| Earnings per share | <u>\$ 1.52</u> | <u>\$ 2.75</u> | <u>\$ 1.11</u> | <u>\$ 1.10</u> |

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

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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.

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 |
| | <hr/> | <hr/> |
| Long-term debt | 1,105.1 | 1,059.2 |
| Capital lease obligations | 8.5 | 0.5 |
| Less current portion | (206.7) | (52.1) |
| | <hr/> | <hr/> |
| | \$ 906.9 | \$1,007.6 |
| | <hr/> | <hr/> |

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).

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 |

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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 |

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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 | | | Nine Months Ended September | | |
|--|------------------------------|-----------------|-------------|-----------------------------|-------------------|-------------|
| | 30 | | | 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.

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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, | |
|--|-------------------------------------|--------------------------------------|------------------------------------|--|
| | 2003 | 2004 | 2003 | 2004 |
| Unit cost reconciliations: | | | | |
| Operating expenses ASMs (000,000) | \$ 527.8 5,693 | \$ 591.8 6,012 | \$ 1,521.6 15,611 | \$ 1,730.3 16,825 |
| Operating expenses per ASM | 9.27¢ | 9.84¢ | 9.75¢ | 10.28¢ |
| Operating expenses Less: aircraft fuel Less: impairment of aircraft Less: restructuring charges Add: navigation fee settlement | \$ 527.8 (83.3) | \$ 591.8 (130.2) (27.5) 7.7 | \$ 1,521.6 (232.2) | \$ 1,730.3 (336.4) (36.8) (27.5) 7.7 |
| Operating expense excluding fuel, navigation fee settlement, impairment and restructuring charges ASMs (000,000) | \$ 444.5 5,693 | \$ 441.8 6,012 | \$ 1,289.4 15,611 | \$ 1,337.3 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 |

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| | | | | |
|--|---------|-----------------|----------|-----------------|
| Fuel gallons (000,000) | 92.0 | 95.8 | 253.9 | 267.6 |
| | <hr/> | <hr/> | <hr/> | <hr/> |
| Raw fuel cost per gallon | 95.2¢ | 139.6¢ | 97.0¢ | 129.8¢ |
| | <hr/> | <hr/> | <hr/> | <hr/> |
| 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) |
| | <hr/> | <hr/> | <hr/> | <hr/> |
| GAAP fuel expense | \$ 83.3 | \$ 130.2 | \$ 232.2 | \$ 336.4 |
| | <hr/> | <hr/> | <hr/> | <hr/> |
| Fuel gallons (000,000) | 92.0 | 95.8 | 253.9 | 267.6 |
| | <hr/> | <hr/> | <hr/> | <hr/> |
| GAAP fuel cost per gallon | 90.5¢ | 135.9¢ | 91.5¢ | 125.7¢ |
| | <hr/> | <hr/> | <hr/> | <hr/> |
| 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) |
| | <hr/> | <hr/> | <hr/> | <hr/> |
| Adjusted fuel | 81.6 | 121.7 | 227.6 | 324.7 |
| Fuel gallons (000,000) | 92.0 | 95.8 | 253.9 | 267.6 |
| | <hr/> | <hr/> | <hr/> | <hr/> |
| Economic fuel cost per gallon | 88.7¢ | 127.0¢ | 89.6¢ | 121.3¢ |
| | <hr/> | <hr/> | <hr/> | <hr/> |
| Mark-to-market gains included in non-operating income related to hedges that settle in future periods | | \$ 50.3 | | \$ 70.4 |
| | | <hr/> | | <hr/> |
| 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 |
| | <hr/> | <hr/> | <hr/> | <hr/> |

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

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| | | | | |
|--|---------|---------|---------|---------|
| 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) |
| Adjusted fuel | 13.2 | 17.0 | 37.5 | 46.8 |
| Fuel gallons (000,000) | 14.5 | 13.0 | 40.7 | 37.2 |
| Economic fuel cost per gallon | 90.3¢ | 131.2¢ | 91.9¢ | 125.8¢ |
| Mark-to-market gains (losses) included in non-operating income related to hedges that settle in future periods | | \$ 6.9 | | \$ 9.6 |
| Reconciliation to GAAP pretax income (loss): | | | | |
| Pretax income (loss) excluding impairment charge, government compensation and mark-to-market hedging gains | \$ 19.5 | \$ 17.5 | \$ 1.3 | \$ 11.9 |
| Less: impairment of aircraft and related spare parts | | | | (2.8) |
| Add: government compensation | | | 18.6 | - |
| Add: mark-to-market hedging gains included in nonoperating income (expense) | | 6.9 | | 9.6 |
| Pretax income (loss) reported GAAP amounts | \$ 19.5 | \$ 24.4 | \$ 19.9 | \$ 18.7 |

Table of ContentsAir Group Net Income and EPS Reconciliation:

The following table summarizes Alaska Air Group, Inc.'s net income and diluted earnings per share during 2003 and 2004 excluding restructuring and impairment charges, navigation fee recovery, the second and third quarter of 2004 hedging mark-to-market gains, government compensation and as reported in accordance with GAAP (in millions except per share amounts). These tables have been revised as further explained in Note 13 to the condensed consolidated financial statements.

| | Three Months Ended September 30, | | | |
|--|----------------------------------|-------------|---------|-------------|
| | 2003 | | 2004* | |
| | Dollars | Diluted EPS | Dollars | Diluted EPS |
| Net income and diluted EPS excluding mark-to-market hedging gains, navigation fee settlement and restructuring charges | \$40.7 | \$ 1.52 | \$ 50.7 | \$ 1.89 |
| Mark-to-market hedging gains, net of tax | | | 32.8 | 1.22 |
| Navigation fee settlement | | | 6.3 | 0.23 |
| Restructuring charge, net of tax | | | (15.8) | (0.59) |
| Reported GAAP amounts | \$40.7 | \$ 1.52 | \$ 74.0 | \$ 2.75 |

| | Nine Months Ended September 30, | | | |
|---|---------------------------------|-------------|---------|-------------|
| | 2003 | | 2004* | |
| | Dollars | Diluted EPS | Dollars | Diluted EPS |
| Net income (loss) and diluted EPS excluding mark-to-market hedging gains, navigation fee settlement, restructuring charges, government compensation and impairment charge | (\$14.7) | (\$0.55) | \$ 19.5 | \$ 0.73 |
| Government compensation, net of tax | 44.3 | 1.66 | | |
| Navigation fee settlement | | | 6.3 | 0.23 |
| Mark-to-market hedging gains, net of tax | | | 45.9 | 1.71 |
| Impairment charge, net of tax | | | (26.3) | (0.98) |
| Restructuring charge, net of tax | | | (15.8) | (0.59) |
| Reported GAAP amounts | \$ 29.6 | \$ 1.11 | \$ 29.6 | \$ 1.10 |

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ITEM 2. Management's Discussion and Analysis of Financial Condition and Results of Operations

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 Note 13 to the condensed consolidated financial statements for further discussion of this matter.

The following discussion should be read in conjunction with our condensed consolidated financial statements and the related notes contained elsewhere in this quarterly report on Form 10-Q/A. All statements in the following discussion that are not reports of historical information or descriptions of current accounting policy are forward-looking statements. Please consider our forward-looking statements in light of the risks referred to in this report's introductory cautionary note.

Air Group's filings with the Securities and Exchange Commission, including its annual report on Form 10-K/A, quarterly reports on Form 10-Q and 10-Q/A, current reports on Form 8-K and amendments to those reports are accessible free of charge at www.alaskaair.com. The information contained on our website is not a part of this quarterly report on Form 10-Q/A. As used in this Form 10-Q/A, the terms "Air Group," "our," "we" and "the Company" refer to Alaska Air Group, Inc. and its subsidiaries, unless the context indicates otherwise.

Third Quarter in Review and Current Events

We recorded a third quarter 2004 net income of \$74.0 million, or \$2.75 per diluted share, compared to \$40.7 million, or \$1.52 per diluted share, in the third quarter of 2003. Third quarter results include a restructuring charge of \$27.5 million (\$15.8 million net of tax, or \$0.59 per share) related to the restructuring initiatives announced in late August and early September. Third quarter results also include mark-to-market fuel hedging gains, reflecting the increase in the fair value of our hedge portfolio during the quarter, of \$57.2 million (\$32.8 million net of tax, or \$1.22 per share). These amounts are net of the gains realized on contracts which settled during the quarter. Finally, third quarter results include the recovery of certain disputed Mexico navigation fees which were originally paid in 2002 and 2003, that amounted to \$11.0 million (\$6.3 million net of tax, or \$0.23 per share). Approximately \$7.7 million of this refund was recorded in operating expenses for fees previously

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remitted and the remaining \$3.3 million was recorded in non-operating income for interest accrued on the fees. Without these items in 2004, net income would have been \$50.7 million, or \$1.89 per share during 2004. Financial and statistical data comparisons for Alaska and Horizon are shown on pages 23 and 24, respectively. A discussion of the three-month data follows. On pages 25 through 27, we have included a reconciliation of reported non-GAAP financial measures to the most directly comparable GAAP financial measures.

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 and Ground Support Equipment 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-\$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. We expect savings from these job-related initiatives to be approximately \$35 million per year when fully implemented.

Labor Costs and Negotiations

Alaska Airlines continues to pursue the restructuring of its labor agreements so that they are in line with the market. Our objectives as we restructure these agreements are to achieve market labor costs, productivity and employee benefit costs. Based on these three objectives, in 2003 Alaska targeted \$112 million per year of labor savings. As a result of increases in our wage rates since that time combined with labor cost decreases achieved by our competitors, we believe that our wages and benefits are now above market by more than \$112 million. Alaska believes that its pilot labor costs represent the majority of this amount. Alaska is currently in negotiations with the Air Line Pilots Association (ALPA) on the pilot collective bargaining agreement. If we do not reach an agreement, the parties will submit the contract to binding arbitration, the decision of which will be effective in May 2005. The arbitration will cover wages plus five issues submitted by each of the Company and ALPA. The pilot labor contract contains market related standards for wages and benefits. Nevertheless, we cannot predict the outcome of this proceeding, particularly whether the arbitrator's award will reflect cost savings in wage rates, productivity and benefits equal to what we consider to be the current excess over market.

Mark-to-Market Fuel Hedging Gains

Beginning in the second quarter of 2004, we lost the ability to defer, as a component of comprehensive income, recognition of any unrealized gain or loss on our fuel hedge contracts until the hedged fuel is consumed. We lost this ability because the correlation between crude oil, the commodity we use to hedge, and West Coast jet fuel fell below required thresholds. For more discussion, see Note 4 to our condensed consolidated financial statements.

The implications of this change in the current period and on a go-forward basis are twofold: First, we will have more volatile earnings as we mark our entire hedge portfolio to market each quarter-end and report the gain or loss in other non-operating income or expense. Second, to an increasing

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extent, the impact of our fuel hedge program will not be reflected in fuel expense. We had unrealized gains on our balance sheet of \$26.5 million at March 31, 2004 when we last qualified for hedge accounting. These unrealized gains will be recognized in fuel expense as the hedged fuel is consumed, which will occur through the second quarter of 2006. Subsequent gains or losses resulting from changes in the fair value of our current hedge positions will be recorded in other non-operating income or expense until correlation returns and the positions are redesignated.

We have provided information on mark-to-market gains or losses, as well as calculations of our economic fuel cost per gallon on pages 25 through 27.

We continue to believe that our fuel hedge program is an important part of our strategy to reduce our exposure to volatile fuel prices.

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 737-800 aircraft 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. In addition, we revised our estimates of 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.

Other Events

In October 2004, Alaska entered into a 10 year outsourcing power-by-the-hour engine maintenance agreement with a third party. Under terms of this arrangement, the third party will provide routine and major overhaul maintenance services on certain engines in our 737-400 fleet at an agreed upon rate per hour flown.

On January 1, 2004, Horizon began operating regional jet service branded as Frontier JetExpress under a 12-year agreement with Frontier Airlines. Service under this agreement became fully operational during the second quarter of 2004 and Horizon is currently operating nine regional jet aircraft under the Frontier JetExpress brand. Flying under this agreement represented 23.1% of Horizon's third quarter capacity and 9.2% of passenger revenues.

The arrangement with Frontier provides for reimbursement of expected costs plus a base mark up and certain incentives. However, since Horizon is not responsible for many of the typical costs of

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operations such as fuel, landing fees, marketing costs and station labor and rents, revenue per ASM, cost per ASM and cost per ASM excluding fuel for this flying is significantly lower than Horizon's native network flying.

For 2004, Alaska and Horizon expect capacity increases of approximately 7% and 20%, respectively. The expected capacity increase at Alaska is due largely to the annualization of the additional aircraft added in 2003 combined with increases in utilization. Horizon's expected capacity increase is due largely to the annualization of aircraft additions in late 2003, the addition of two aircraft in the first half of 2004, the arrival of a third aircraft in early July 2004 and higher utilization resulting from the new contract flying for Frontier.

Alaska is currently in the process of adding a row of seats to its 737-400 fleet. When complete, this will result in an increase of approximately 2.3% in available seat miles on an annualized basis. We expect this change will represent a significant portion of our capacity growth in 2005.

In 2005, Horizon will be adding a row of seats to the Q400 fleet increasing capacity from 70 to 74 seats. When complete, this will result in an increase of approximately 1.5% in available seat miles on an annualized basis.

Results of Operations

Comparison of Three Months Ended September 30, 2004 to Three Months Ended September 30, 2003

During the third quarter of 2004, we recorded consolidated operating and pre-tax income of \$56.8 million and \$119.2 million, respectively, versus \$76.7 million and \$68.2 million, respectively, in the third quarter of 2003.

Alaska Airlines Revenues

Operating revenues increased \$47.5 million, or 8.1%, during 2004 as compared to 2003. For the quarter, available seat miles (ASMs or capacity) increased 5.6% and revenue passenger miles (RPMs or traffic) increased 10.8%. The majority of our 2004 ASM growth came from expansion in our Trans-Continental markets. We also experienced slight increases in capacity in Nevada, Mexico and Anchorage/Fairbanks-Lower 48, partially offset by decreases in service to Northern Alaska, Canada, Arizona, the Bay Area and the Pacific Northwest. Traffic increases primarily reflect increases in traffic in the Trans Continental, Denver, Southern California, Mexico, Arizona, Nevada and Anchorage/Fairbanks-Lower 48 markets, partially offset by decreases in traffic in Northern Alaska, the Bay Area and Canada.

Passenger revenues increased by 8.3% as a result of a 10.8% increase in traffic partially offset by a 2.2% decrease in yield per passenger mile. Load factors were up year over year in all of our regions.

Freight and mail revenues increased by \$3.1 million, or 14.5%, compared to the same period in 2003 as a result of a new mail contract we have in the State of Alaska and due to revenues associated with an agreement with PenAir to provide flight services to Dutch Harbor that began in January of 2004. These increases are partially offset by lower contract maintenance revenue.

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Other-net revenues was essentially flat during the period.

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Alaska Airlines Expenses

For the quarter, total operating expenses increased \$64.0 million, or 12.1%, as compared to the same period in 2003. Operating expenses per ASM increased 6.1% in 2004 as compared to 2003. These increases are due largely to the restructuring charge, significant increases in fuel costs and higher wages and benefit costs. Operating expense per ASM excluding fuel, the navigation fee recovery and the restructuring charge decreased 6.0% as compared to the same period in 2003. Explanations of significant period-over-period changes in the components of operating expenses are as follows:

Wages and benefits increased \$8.6 million, or 4.3%, during the third quarter. Approximately \$1.5 million of this increase reflects higher benefit costs, resulting from increases in pension, medical and health insurance costs. The remaining \$7.1 million increase primarily reflects scale and step increases.

In May 2004, under terms of our union contract, our pilots received a 4% wage rate increase, which represented 50.7% of the total increase in wages.

Contracted services decreased \$2.7 million, or 13.2%, due largely to the recovery in 2004 of disputed Mexico navigation fees paid in 2002 and 2003, partially offset by expenses associated with an agreement with PenAir to provide flight services to Dutch Harbor that began in January of 2004 and costs associated with a temporary charter contract we had for our new mail contract in Alaska, and higher security costs.

Aircraft fuel increased \$46.9 million, or 56.3%, due to a 50.2% increase in the GAAP fuel cost per gallon and a 4.1% increase in fuel gallons consumed. Our economic cost per gallon (the raw price paid less all benefits from settled hedges) was \$1.27 per gallon, a 43.2% increase over the prior year. Fuel prices remain at very high levels and continue to be volatile. At September 30, 2004, we have fuel hedge contracts in place to hedge 50% of our anticipated fuel consumption for the remainder of 2004 and 2005 and 25% of our anticipated fuel consumption in 2006 at prices ranging from \$28.81 to \$37.28 per crude oil barrel.

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The following table summarizes fuel cost per gallon realized by Alaska (the economic cost per gallon), the cost per gallon on a GAAP basis (including hedging gains recorded in aircraft fuel and non-operating income (expense)) and fuel cost per gallon excluding all hedging activities:

| | Three Months Ended September 30, | | Nine Months Ended September 30, | |
|--|---|-----------------------|--|-----------------------|
| | 2003 | 2004 | 2003 | 2004 |
| 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 | <u>95.2¢</u> | <u>139.6¢</u> | <u>97.0¢</u> | <u>129.8¢</u> |
| Fuel expense before hedge activities (raw fuel) | \$ 87.6 | \$ 133.7 | \$246.2 | \$ 347.4 |
| Less: gains on settled hedges included in fuel expense | <u>(4.3)</u> | <u>(3.5)</u> | <u>(14.0)</u> | <u>(11.0)</u> |
| 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 | <u>90.5¢</u> | <u>135.9¢</u> | <u>91.5¢</u> | <u>125.7¢</u> |
| GAAP fuel expense | \$ 83.3 | \$ 130.2 | \$232.2 | \$ 336.4 |
| Less: gains on settled hedges included in nonoperating income (expense) | <u>(1.7)</u> | <u>(8.5)</u> | <u>(4.6)</u> | <u>(11.7)</u> |
| 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 | <u>88.7¢</u> | <u>127.0¢</u> | <u>89.6¢</u> | <u>121.3¢</u> |
| Mark-to-market gains included in nonoperating income related to hedges that settle in future periods (in millions) | | <u>\$ 50.3</u> | | <u>\$ 70.4</u> |

Aircraft maintenance decreased \$8.1 million, or 23.0%, due largely to fewer engine overhauls and a change in the mix of heavy maintenance versus routine maintenance.

For the remainder of the year we anticipate that aircraft maintenance will be somewhat higher than in 2003 as outsourcing of all base maintenance work takes effect. The anticipated savings from contracting out will be reflected through lower wages and benefits in future periods.

Aircraft rent decreased \$3.0 million, or 9.6%, due to lower rates on extended leases.

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Other selling expenses and commissions decreased \$7.5 million, or 17.3%. This decrease is due largely to a decrease in incentive payments made to Horizon. Incentive payments to Horizon are eliminated in consolidation at the Air Group level.

Landing fees and other rentals increased \$4.0 million, or 11.9%. The higher rates primarily reflect higher joint-use rental fees at Seattle, Portland and Los Angeles, combined with modest volume growth. We expect landing fees and other rentals to continue to increase as a result of airport facility expansions and increased costs for security due to unfunded government mandates.

Horizon Air Revenues

For the quarter, operating revenues increased \$6.6 million, or 5.0% as compared to 2003. This increase is due largely to \$12.4 million in revenue from contract flying for Frontier Airlines, which began January 1, 2004, partially offset by a 4.4% decrease in revenue associated with the Horizon brand (native network) flying resulting from a decrease in incentive payments made from Alaska to Horizon.

For the three months ending September 30, 2004, capacity increased 18.4% and traffic was up 29.0%, compared to the same period in 2003. Contract flying with Frontier represented approximately 23.1% of capacity and 9.2% of passenger revenues during the third quarter of 2004. Passenger load factor increased 5.9 percentage points to 72.4%. Passenger yield decreased 18.0% to 22.38 cents, reflecting the inclusion of the Frontier contract flying, the yield for which is significantly lower than native network flying, and a slight decrease in yield from native network flying. Contract revenue and increases in traffic, combined with lower native network yields and a decrease in incentive payments from Alaska to Horizon resulted in an increase in passenger revenue of \$7.3 million, or 5.7%.

Horizon Air Expenses

Operating expenses increased \$9.6 million, or 8.5%, as compared to the same period in 2003. Total operating expenses per ASM decreased 8.4% as compared to 2003. Operating expenses per ASM excluding fuel decreased 11.4% as compared to the same period in 2003. Explanations of other significant period-over-period changes in the components of operating expenses are as follows:

Wages and benefits increased \$0.5 million, or 1.3%, due primarily to a 2.1% increase in the average number of employees partially offset by a \$2.0 million accrual reduction for estimated medical costs.

Aircraft fuel increased \$4.7 million, or 34.8%, due to a 50.4% increase in the GAAP fuel cost per gallon, partially offset by a 10.3% decrease in gallons consumed, reflecting the addition of four aircraft as compared to the same period in 2003, offset by a reduction in fuel consumption for the capacity flown in the Frontier JetExpress operation. Horizon's fuel hedge contracts are consistent with those at Alaska.

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The following table summarizes fuel cost per gallon realized by Horizon (the economic cost per gallon), on a GAAP basis (including hedging gains recorded in aircraft fuel and non-operating income (expense)) and fuel cost per gallon excluding all hedging activities:

| | Three Months Ended September 30, | | Nine Months Ended September 30, | |
|--|-------------------------------------|---------|------------------------------------|---------|
| | 2003 | 2004 | 2003 | 2004 |
| 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) |
| Adjusted fuel | \$ 13.2 | \$ 17.0 | \$ 37.5 | \$ 46.8 |
| Fuel gallons (000,000) | 14.5 | 13.0 | 40.7 | 37.2 |
| Economic fuel cost per gallon | 90.3¢ | 131.2¢ | 91.9¢ | 125.8¢ |
| Mark-to-market gains included in nonoperating income related to hedges that settle in future periods (in millions) | | \$ 6.9 | | \$ 9.6 |

Aircraft maintenance expense increased \$2.7 million, or 37.5%, primarily due to an increase in block hours, fewer aircraft covered by warranty and higher routine maintenance costs for the Q400 fleet.

Landing fees and other rentals increased \$0.7 million, or 6.8%. Higher landing fees are a result of higher rates and increased costs for capital improvement, debt service and security. We expect landing fees and other rentals to continue to increase as a result of airport facility expansions and increased costs for security.

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Consolidated Nonoperating Income (Expense)

Net nonoperating income was \$62.4 million in 2004 compared to net nonoperating expense of \$8.5 million in 2003.

Other-net includes \$2.0 million and \$9.7 million in gains resulting from settled fuel hedge contracts in 2003 and 2004, respectively. In addition, other-net includes mark-to-market hedging gains of \$57.2 million in 2004 as previously discussed.

Comparison of Nine Months Ended September 30, 2004 to Nine Months Ended September 30, 2003

During the nine months ended September 30, 2004, we recorded net income of \$29.6 million, or \$1.10 per diluted share, compared to net income of \$29.6 million, or \$1.11 per diluted share, during the same period of 2003. Our 2003 consolidated net income includes \$71.4 million (\$52.8 million for Alaska and \$18.6 million for Horizon) received in connection with government assistance received under the Emergency Wartime Supplemental Appropriations Act. The 2004 results include four unusual items. First, we recorded a restructuring charge of \$27.5 million (\$15.8 million net of tax, or \$0.59 per share) related to the restructuring initiatives announced in late August and early September. Second, like last quarter, this quarter's results include mark-to-market fuel hedging gains, which reflect the increase in the fair value of our hedge portfolio during the quarter, of \$80.0 million (\$45.9 million net of tax, or \$1.71 per share). These amounts exclude gains realized on contracts which settled during the quarter. Third, 2004 results also include impairment charges of \$39.6 million (\$26.3 million net of tax, or \$0.98 per share), substantially all of which was associated with a decision to accelerate the retirement of the Company's Boeing 737-200C fleet. Finally, this quarter's results include the recovery of certain disputed Mexico navigation fees which were originally paid in 2002 and 2003, that amounted to \$11.0 million (\$6.3 million net of tax, or \$0.23 per share). Without these items in 2004 and excluding the government compensation received in 2003, net income would have been \$19.5 million, or \$0.73 per share during 2004, compared to a net loss of \$14.7 million, or \$0.55 per share, in 2003. Financial and statistical data comparisons for Alaska and Horizon are shown on pages 23 and 24, respectively. A discussion of the nine-month data follows. On pages 25 through 27, we have included a reconciliation of reported non-GAAP financial measures to the most directly comparable GAAP financial measures.

Alaska Airlines Revenues

Operating revenues increased \$178.8 million, or 11.7%, during 2004 as compared to 2003. For the first nine months of 2004, ASM's increased 7.8% and RPM's increased 12.0%.

Yield per passenger mile remained flat at 12.61 cents and passenger load factor increased 2.7 points during the first nine months of 2004 as compared to the same period in 2003. Increases in traffic and yield resulted in a 12.0% increase in passenger revenues in 2004.

Freight and mail revenues increased \$5.5 million, or 9.2%, compared to the same period in 2003 because of a new mail contract we have in the State of Alaska.

Other-net revenues increased \$7.6 million, or 9.2%, due largely to revenues received from an agreement with PenAir to provide flight services to Dutch Harbor that began in January of 2004.

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Alaska Airlines Expenses

For the nine months ended September 30, 2004, total operating expenses increased \$208.7 million, or 13.7%, as compared to the same period in 2003. Operating expenses per ASM increased 5.4% in 2004 as compared to 2003. These increases are due largely to the 7.8% increase in capacity combined with a significant increase in fuel costs, higher wages and benefits, landing fees and other rental costs, restructuring charges and an impairment charge related to our Boeing 737-200 fleet. Operating expense per ASM excluding fuel, navigation fee recovery, restructuring and impairment charges decreased 3.9% as compared to the same period in 2003. Explanations of significant period-over-period changes in the components of operating expenses are as follows:

Wages and benefits increased \$33.1 million, or 5.7%, during the first nine months of 2004. Approximately \$12.5 million of this increase reflects higher benefit costs, resulting from increases in pension, medical and health insurance costs. The remaining \$20.6 million increase primarily reflects scale and step increases.

In May of 2004, under terms of our union contract, our pilots received a 4% wage rate increase, which represented approximately 51.0% of the total increase in wages.

Contracted services increased \$9.4 million, or 15.4%, due largely to expenses associated with an agreement with PenAir to provide flight services to Dutch Harbor that began in January of 2004, costs associated with a temporary charter contract we have for our new mail contract in Alaska and higher security costs, partially offset by the recovery in 2004 of disputed Mexico navigation fees paid in 2002 and 2003.

Aircraft fuel increased \$104.2 million, or 44.9%, due to a 37.4% increase in the GAAP fuel cost per gallon and a 5.4% increase in fuel gallons consumed. Air Group's fuel hedging program resulted in Alaska recognizing a \$11.0 million reduction in aircraft fuel expense for hedging gains realized on hedge positions settled during the first half of 2004.

Aircraft maintenance decreased \$6.4 million, or 5.4%, due largely to fewer engine overhauls during the first nine months and a change in the mix of heavy maintenance versus routine maintenance.

Aircraft rent decreased \$7.3 million, or 7.9%, due to lower rates on extended leases and MD-80 returns, offset by one new 737-700 aircraft and one new 737-900 aircraft since the end of the third quarter of 2003.

Depreciation and amortization increased \$7.4 million, or 8.4%, reflecting accelerated depreciation on the planned retirement of three Boeing 737-200C's and an increase in depreciation resulting from two aircraft purchased in the last twelve months.

Landing fees and other rentals increased \$12.6 million, or 13.5%. The higher rates primarily reflect higher joint-use rental fees at Seattle, Portland, Los Angeles and Oakland, combined with modest volume growth. We expect landing fees and other rentals to continue to

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increase as a result of airport facility expansions and increased costs for security due to unfunded government mandates.

Other expense increased \$8.1 million, or 7.9%, primarily reflecting a \$6.4 million increase in professional services and a \$1.1 million increase in property taxes.

Horizon Air Revenues

For the first nine months of 2004, operating revenues increased \$32.0 million, or 9.3% as compared to 2003. This increase is due largely to a 0.1% increase in revenue associated with the native network flying combined with \$31.8 million in revenue from contract flying for Frontier Airlines, which began January 1, 2004.

For the nine months ended September 30, 2004, capacity increased 18.7% and traffic was up 29.6%, compared to the same period in 2003. Contract flying with Frontier represented approximately 8.8% of passenger revenues and 20.8% of capacity, during the first nine months of 2004. Passenger load factor increased 5.7 percentage points to 68.5%. Passenger yield decreased 14.9% to 22.73 cents, reflecting the inclusion of the Frontier contract flying, the yield for which is significantly lower than native network flying. Contract revenue and higher yields in Horizon's native network combined with the increases in traffic, resulted in an increase in passenger revenue of \$33.6 million, or 10.3%.

Horizon Air Expenses

Operating expenses increased \$23.8 million, or 7.0%, as compared to the same period in 2003. Operating expenses per ASM including fuel and the impairment charge decreased 10.0% as compared to 2003. Operating expenses per ASM excluding fuel and the impairment charge decreased 12.7% as compared to the same period in 2003. Operating expenses include \$2.8 million related to an impairment charge on our held-for-sale F-28 aircraft and spare engines to lower the carrying value of these assets to their estimated fair value. Explanations of other significant period-over-period changes in the components of operating expenses are as follows:

Wages and benefits increased \$3.3 million, or 2.8%, reflecting an increase in the average number of employees and in average wages and payroll taxes, partially offset by an accrual reduction for medical costs resulting from a downward trend in claims activity.

Aircraft fuel increased \$10.1 million, or 26.4%, due to a 38.3% increase in the GAAP fuel cost per gallon, partially offset by an 8.6% decrease in gallons consumed, reflecting the addition of four aircraft as compared to the same period in 2003, offset by the reduction in fuel consumption for the capacity flown in the Frontier JetExpress operation. Air Group's fuel hedging program resulted in Horizon recognizing a \$1.5 million reduction in aircraft fuel expense for hedging gains realized on hedge positions settled during the first nine months of 2004.

Aircraft maintenance expense increased \$4.1 million, or 18.2%, primarily due to an increase in block hours, a higher number of routine maintenance activities and engine overhauls for the Q200 fleet and less aircraft covered by warranty.

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Aircraft rent increased \$2.7 million, or 5.1%, reflecting the addition of one CRJ and the addition of spare engines in 2004 as compared to the same period in 2003.

Landing fees and other rentals increased \$3.0 million, or 10.6%. Higher landing fees are a result of higher rates associated with modest volume growth, an increase in airport fees and increased costs for security. We expect landing fees and other rentals to continue to increase as a result of airport facility expansions and increased costs for security.

Consolidated Nonoperating Income (Expense)

Net nonoperating income was \$74.6 million in 2004 compared to \$54.4 million in 2003. Interest income increased \$7.1 million due to a larger marketable securities portfolio in 2004 combined with a negative adjustment of premium and discount amortization on our marketable securities portfolio in 2003. Interest expense (net of capitalized interest) increased \$1.1 million due to increases in debt balances as compared to 2003.

The 2003 results include \$71.4 million (\$52.8 million for Alaska and \$18.6 million for Horizon) received in connection with the government reimbursement of security fees remitted and carrier fees paid under the Emergency Wartime Supplemental Appropriations Act.

Other-net includes \$5.4 million and \$13.3 million in gains from settled fuel hedging contracts in 2003 and 2004, respectively. In addition, other-net includes mark-to-market gains on unsettled hedge contracts of \$80.0 million in 2004.

Consolidated Income Tax Benefit

Accounting standards require us to provide for income taxes each quarter based on either our estimate of the effective tax rate for the full year or the actual year-to-date effective tax rate if it is our best estimate of our annual expectation. The volatility of airfares and fuel prices and the seasonality of our business make it difficult to accurately forecast full-year pretax results. In addition, a relatively small change in pretax results can cause a significant change in the effective tax rate due to the magnitude of nondeductible expenses, such as employee per diem costs, relative to pretax profit or loss. We used our actual 2004 year-to-date effective rate of 43.4%. In arriving at this rate, we considered a variety of factors, including year-to-date pretax results, the U.S. federal rate of 35%, estimated year-to-date nondeductible expenses and estimate state income taxes. We evaluate this rate each quarter and make adjustments when necessary.

Critical Accounting Policies

For information on our critical accounting policies, see Item 7 of our Annual Report on Form 10-K/A for the year ended December 31, 2003.

Table of Contents**Liquidity and Capital Resources**

The table below presents the major indicators of financial condition and liquidity.

| | December 31, 2003 | September 30, 2004 | Change |
|---|--|-------------------------------|---------------|
| | (In millions, except per share and debt-to-capital amounts) | | |
| Cash and marketable securities | \$ 812.3 | \$ 878.5 | \$ 66.2 |
| Working capital | 130.9 | 330.2 | 199.3 |
| Long-term debt and capital lease obligations | 906.9 | 1,007.6 | 100.7 |
| Shareholders' equity | 674.2 | 708.4 | 34.2 |
| Book value per common share | \$ 25.19 | \$ 26.35 | \$ 1.16 |
| Long-term debt-to-capital | 57%:43% | 59%:41% | NA |
| Long-term debt-to-capital assuming aircraft operating leases are capitalized at seven times annualized rent | 77%:23% | 77%:23% | NA |

During the nine months ended September 30, 2004, our cash and marketable securities increased \$66.2 million to \$878.5 million at September 30, 2004. This increase reflects cash provided by operating activities of \$283.5 million, partially offset by cash used in financing activities of \$96.3 million and cash used for the purchase of property and equipment of \$113.5 million.

Cash Provided by Operating Activities

During the first nine months of 2004, net cash provided by operating activities was \$283.5 million (including \$42.7 million of cash received from a tax refund during the second quarter of 2004), versus \$272.5 million during the first nine months of 2003.

Cash Used in Investing Activities

Cash used in investing activities was \$157.2 million during the first nine months of 2004, compared to \$508.6 million in 2003. We had net purchases of \$39.2 million of marketable securities and \$113.5 million for property and equipment. During the first nine months of 2004, our aircraft related capital expenditures decreased \$197.8 million as compared to 2003, primarily reflecting a reduction in spending for new aircraft and capitalized overhauls.

Cash Provided by (Used in) Financing Activities

Net cash used in financing activities was \$96.3 million during the first nine months of 2004 compared to net cash provided by financing activities of \$188.8 million during the same period in 2003. Debt issuances during the first nine months of 2004 of \$94.6 million were secured by flight equipment. These debt issuances have interest rates that vary with the London Interbank Offered Rate (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 our credit facility of \$150 million.

We plan to meet our capital and operating commitments through internally generated funds from operations and cash and marketable securities on hand at September 30, 2004 totaling \$878.5 million. We also have restricted cash of \$14.2 million, which is intended to collateralize interest payments due

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in the next two years on our \$150 million floating rate senior convertible notes due 2023 issued in 2003.

In 2003, we completed the private placement of \$150.0 million of floating rate senior convertible notes due in 2023 pursuant to Rule 144A of the Securities Act of 1933, as amended. Net proceeds from the offering were \$144.9 million, of which \$22.3 million was used to acquire U.S. government securities to fund the first three years of interest payments. In 2003, we made a capital contribution to Alaska Airlines of the remaining net proceeds from the sale of the notes. Alaska Airlines has used the remaining proceeds from the notes for working capital requirements and expects in the future to continue to use these remaining proceeds for working capital requirements as well as other general corporate purposes. Although we have not yet determined how each payment of principal or interest due will be funded in the future, we anticipate that these payments will be funded either by dividends, distributions, loans, advances or other payments from our subsidiaries or through new borrowings or financings by Alaska Air Group. Any such payments by our subsidiaries to us could be subject to statutory or contractual restrictions. Currently, the only contractual restrictions are contained in Alaska Airlines' \$150 million credit facility, which expires in December 2004 and requires maintenance of specific levels of net worth, maintenance of certain debt and leases to net worth, leverage and fixed charge coverage ratios, and limits on investments, lease obligations, sales of assets, and additional indebtedness. Such provisions limit the amount of funds Alaska Airlines can distribute via dividend to Alaska Air Group. As of September 30, 2004, \$195.3 million was available to distribute to Alaska Air Group via dividend without violating the covenants in Alaska Airlines' credit facility. The notes do not restrict the ability of our subsidiaries to enter into additional agreements limiting or prohibiting the distribution of earnings, loans or other payments to Alaska Air Group. We are considering various alternatives including renewing or replacing the credit facility, although there can be no assurance that this can be accomplished on acceptable terms to us.

The holders of the \$150.0 million of floating rate senior convertible notes due in 2023 may elect to have the Company redeem all or a portion of the notes on the 5th, 10th and 15th anniversaries of the date of issuance. 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.

Supplemental Disclosure of Noncash Investing and Financing Activities

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.

Contractual Obligations, Commitments and Off-Balance Sheet Arrangements

At September 30, 2004, we had firm orders for 12 aircraft requiring aggregate payments of approximately \$284.4 million, as set forth below. In addition, Alaska has options to acquire 26 additional B737's, and Horizon has options to acquire 15 Q400's and 25 CRJ 700's. Alaska and Horizon expect to finance the firm orders and to the extent exercised, the option aircraft with leases,

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long-term debt or internally generated cash. During the first quarter of 2004, Alaska converted two 737-900 aircraft it had on firm order with Boeing for two 737-800s. The planes are due for delivery in February and July of 2005.

The following table summarizes aircraft commitments and payments by year:

| Aircraft | Delivery Period - Firm Orders | | | | | | Total |
|---------------------|-------------------------------|--------|--------|--------|--------|-------------|---------|
| | October 1-December 31, 2004 | 2005 | 2006 | 2007 | 2008 | Beyond 2008 | |
| Boeing 737-800 | | 3 | | | | | 3 |
| Bombardier CRJ700 | | 1 | 2 | 2 | 2 | 2 | 9 |
| Total | | 4 | 2 | 2 | 2 | 2 | 12 |
| Payments (Millions) | \$12.9 | \$82.4 | \$52.5 | \$49.5 | \$49.6 | \$37.5 | \$284.4 |

The table above does not include our planned acquisition of three Boeing 737-800 s in 2006 to replace the Boeing 737-400 s being converted since we do not have firm commitments at this time.

The following table provides a summary of our principal payments under current and long-term debt obligations, capital lease obligations, operating lease commitments and aircraft purchase commitments as of September 30, 2004. This table excludes other obligations that we may have, such as pension obligations and routine purchase obligations entered into in the normal course of business.

| (in millions) | October 1-December 31, 2004 | 2005 | 2006 | 2007 | 2008 | Beyond 2008* | Total |
|--|-----------------------------|---------|---------|---------|---------|--------------|-----------|
| Current and long-term debt and capital lease obligations | \$ 16.7 | \$ 53.5 | \$ 57.1 | \$ 60.2 | \$ 63.3 | \$ 808.9 | \$1,059.7 |
| Operating lease commitments | 82.2 | 278.0 | 223.3 | 195.9 | 189.5 | 1,136.1 | 2,105.0 |
| Aircraft purchase commitments | 12.9 | 82.4 | 52.5 | 49.5 | 49.6 | 37.5 | 284.4 |
| Total | \$ 111.8 | \$413.9 | \$332.9 | \$305.6 | \$302.4 | \$1,982.5 | \$3,449.1 |

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- * Includes \$150 million related to the Company's senior convertible notes due in 2023. Holders of these Notes 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 in control or tax event. See Note 8 in the condensed consolidated financial statements.

New Accounting Standards

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 not be anti-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 quarter of 2004 and for all comparative periods presented, the Company expects to report a lower diluted EPS

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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 \$2.47 for the three months ended September 30, 2003 and 2004, respectively, and \$1.00 and \$1.20 per share for the nine months ended September 30, 2003 and 2004, respectively.

ITEM 3. Quantitative and Qualitative Disclosures about Market Risk

There have been no material changes in market risk from the information provided in Item 7A Quantitative and Qualitative Disclosure About Market Risk in our 2003 10-K/A except as follows:

Fuel Hedging

We purchase jet fuel at prevailing market prices, and seek to manage the risk of price fluctuations through execution of a documented hedging strategy. We utilize derivative financial instruments as hedges to decrease our exposure to the volatility of jet fuel prices. We believe there is risk in not hedging against the possibility of fuel price increases. At September 30, 2004, we had fuel hedge contracts in place to hedge 49.0 million gallons of our expected jet fuel usage during the remainder of 2004, 207.3 million gallons in 2005, 106.1 million gallons in 2006 and 16.6 million gallons in 2007. This represents 50% of our anticipated fuel consumption in 2004 and 2005 and 25% and 4% of our anticipated fuel consumption in 2006 and 2007, respectively. Prices of these agreements range from \$28.81 to \$37.28 per crude oil barrel. We estimate that a 10% increase or decrease in crude oil prices as of September 30, 2004 would impact hedging positions by approximately \$6.0 million.

As of December 31, 2003 and September 30, 2004, the fair values of our fuel hedge positions were \$18.4 million and \$117.0 million, respectively. Of these amounts, \$12.0 million of the 2003 fair value amounts and \$81.6 million of the 2004 fair value amounts were included in prepaid and other current assets in the consolidated balance sheets. The remaining \$6.4 million 2003 fair value and \$35.4 million 2004 fair value is reflected in other assets in the consolidated balance sheets.

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

| | <u>Three Months Ended September 30,</u> | | <u>Nine Months Ended September 30,</u> | |
|--|---|-------------|--|-------------|
| | <u>2003</u> | <u>2004</u> | <u>2003</u> | <u>2004</u> |
| 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 three months 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 value changes under hedge accounting .

Financial Market Risk

During the first nine months of 2004, we 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.

ITEM 4. Controls and Procedures

As of September 30, 2004, an evaluation was performed under the supervision and with the participation of our management, including our chief executive officer and chief financial officer (collectively, our certifying officers), of the effectiveness of the design and operation of our disclosure controls and procedures. These disclosure controls and procedures are designed to ensure that the information required to be disclosed by us in our periodic reports filed with the Securities and Exchange Commission (the SEC) is recorded, processed, summarized and reported within the time periods specified by the SEC's rules and forms, and that the information is communicated to our certifying officers on a timely basis.

Our certifying officers concluded, based on their evaluation, that disclosure controls and procedures were effective.

In December, we discovered a clerical error in our calculation of deferred Mileage Plan revenue that existed at September 30, 2004. As a result, we have revised our third quarter and year to date condensed consolidated financial

statements to adjust for this item. In response to this finding,

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management has taken the following steps to strengthen internal controls and disclosure over the deferred revenue calculation. We have:

provided additional training to the individuals responsible for preparing and reviewing the calculation

implemented additional levels of testing and review to ensure the clerical accuracy of the calculation

developed new monitoring reports to identify unusual variations in mileage plan accounts

Management believes the actions taken will be sufficient to ensure that our disclosure controls and procedures and internal controls over financial reporting are effective.

We made no changes in our internal controls over financial reporting during the fiscal quarter ended September 30, 2004, that our certifying officers concluded materially affected, or are reasonably likely to materially affect, our internal control over financial reporting.

We intend to regularly review and evaluate the design and effectiveness of our disclosure controls and procedures and internal controls over financial reporting on an ongoing basis and to improve these controls and procedures over time and to correct any deficiencies that we may discover in the future. While we believe the present design of our disclosure controls and procedures and internal controls over financial reporting, as modified by the steps described above, are effective, future events affecting our business may cause us to modify these controls and procedures in the future.

PART II. OTHER INFORMATION

ITEM 1. Legal Proceedings

We are a party to ordinary routine litigation incidental to our 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 our financial position or results of operations. This forward-looking statement 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.

ITEM 2. Unregistered Sales of Equity Securities and Use of Proceeds

None

ITEM 3. Default on Senior Securities

None

ITEM 4. Submission of Matters to a Vote of Security Holders

None

ITEM 5. Other Information

No changes have been made to the procedures by which security holders may recommend nominees to our Board of Directors since the filing of our definitive proxy statement for our 2004 annual meeting of shareholders.

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Signatures

Pursuant to the requirements of the Securities Act of 1934, the registrant has duly caused this report to be signed on its behalf by the undersigned thereunto duly authorized.

ALASKA AIR GROUP, INC.
Registrant

Date: December 23, 2004

By: /s/ Brandon S. Pedersen
Brandon S. Pedersen
Staff Vice President/Finance and
Controller

By: /s/ Bradley D. Tilden
Bradley D. Tilden
Executive Vice President/Finance and
Chief Financial Officer

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Table of Contents**EXHIBIT INDEX**

Pursuant to Item 601(a)(2) of Regulation S-K, this Exhibit Index immediately precedes the exhibits.

The following exhibits are numbered in accordance with Item 601 of Regulation S-K.

| Exhibit No. | Description |
|--------------------|--|
| 4.1** | Indenture dated as of March 31, 2003 between Alaska Air Group, Inc. and U.S. Bank National Association, as Trustee, and First Supplemental Indenture dated September 30, 2004 between Alaska Air Group, Inc. and U.S. Bank National Association as Trustee, relating to senior convertible notes due 2023. |
| 10.19** | 2004 Alaska Air Group performance based pay plan*** |
| 31.1* | 302 Certification of Chief Executive Officer Pursuant to 15 U.S.C. Section 7241 |
| 31.2* | Section 302 Certification of Chief Financial Officer Pursuant to 15 U.S.C. Section 7241 |
| 32.1* | Section 906 Certification of Chief Executive Officer Pursuant to 18 U.S.C. Section 1350 |
| 32.2* | Section 906 Certification of Chief Financial Officer Pursuant to 18 U.S.C. Section 1350 |

* Filed herewith.

** Previously filed.

*** Indicates management contract or compensatory plan or arrangement.