Consolidated Financial Highlights

Alaska Air Group

(In Millions, Except Per Share Amounts)	1999	2000	% Change
Revenues and Income			
Operating revenues	$2,082.0	**$2,177.2**	4.6
Operating expenses	1,882.1	**2,197.8**	16.8
Operating income (loss)	199.9	**(20.6)**	NM
Net income (loss)	134.2	**(70.3)**	NM
Basic earnings (loss) per share	5.09	**(2.66)**	NM
Diluted earnings (loss) per share	5.06	**(2.66)**	NM
Average number of common shares outstanding —			
Basic	26.4	**26.4**	0.0
Diluted	26.5	**26.4**	– 0.4
Assets and Equity			
Total assets	$2,180.1	**$2,630.0**	20.6
Total shareholders' equity	930.7	**862.3**	– 7.3
Return on shareholders' equity	15.6%	**– 7.8%**	– 23.4 pts
Book value per share	$35.24	**$32.59**	– 7.5
Debt/equity ratio	27:73	**41:59**	NA
Employees at year end	14,179	**14,996**	5.8
Shareholders of record at year end	4,450	**4,276**	– 3.9

Glossary of Terms

Available Seat Mile (ASM) — One seat flown one mile. An aircraft with 100 passenger seats, flown a distance of 100 miles would represent 10,000 available seat miles (ASMs).

Capacity — Total number of available seat miles, typically shown on a systemwide or individual market basis.

Code Sharing — A marketing practice in which two airlines share the same two-letter code used to identify carriers in the computer reservation systems used by travel agents.

Computer Reservation System (CRS) — A system for reserving seats on commercial flights electronically. Several airlines own and market such systems, which are used by airline personnel and travel agents.

Connecting Flight — A flight requiring passengers to change aircraft and/or airlines at an intermediate stop.

Load Factor — The percentage of available seats that are filled with paying passengers. Technically, this is revenue passenger miles divided by available seat miles.

Revenue Passenger Mile (RPM) — One paying passenger flown one mile. This is a principal measure of airline passenger business.

Unit Cost — A barometer for measuring the ability to manage costs. Derived by dividing total operating expenses by total ASMs.

Yield — A measure of airline revenue derived by dividing passenger revenue by passenger miles and expressed in cents per mile.

Yield Management — The term describing the process used to set prices for a flight. The goal is to find the mix of seat prices that produces the most revenue.

Financials Contents

Industry Conditions

The airline industry is cyclical. Generally speaking, economic conditions have been strong during the years covered by this discussion. Because the industry has high fixed costs in relation to revenues, a small change in load factors or fare levels has a large impact on profits.

For most airlines, labor and fuel account for almost half of operating expenses. The strong economy has increased employee turnover and put upward pressure on labor costs. Fuel prices have been volatile in the last three years. For Alaska Airlines, fuel cost per gallon decreased 25% in 1998, increased 23% in 1999 and increased 54% in 2000.

In recent years, airlines have reduced their ticket distribution costs by capping travel agent commissions, by decreasing commission rates from 10% to 5%, by partially eliminating paper tickets and by selling tickets directly to passengers via the Internet.

Results of Operations

2000 Compared with 1999

In accordance with guidance provided in the SEC's Staff Accounting Bulletin 101, Alaska changed its method of accounting for the sale of miles in its Mileage Plan. In connection with the change, Alaska recognized a $56.9 million cumulative effect charge, net of income taxes of $35.6 million, effective January 1, 2000. The consolidated loss before accounting change for 2000 was $13.4 million, or $0.51 per share, compared with net income of $134.2 million, or $5.06 per share (diluted) in 1999. The 1999 results (fourth quarter impact) included an after-tax gain on sale of shares in Equant N.V. of $2.2 million ($0.08 per diluted share). The consolidated operating loss was $20.6 million in 2000, compared with an operating income of $199.9 million in 1999. Higher fuel prices increased operating expenses by approximately $125 million. A discussion of operating results for the two airlines follows.

Alaska Airlines Revenues

Capacity increased 2.8% in the first quarter due to normal growth but decreased 1.3% in the second quarter due to maintenance delays. Capacity was then reduced 3.2% in the third quarter in order to improve schedule reliability. Finally, capacity increased 1.5% in the fourth quarter as schedule reliability returned to near-normal levels. For the full year 2000, capacity was flat but traffic grew by 1.8%, resulting in a 1.3 point increase in passenger load factor. The Canada and Lower 48 states-to-Alaska markets experienced the largest increases in load factor. Passenger yields were up 4.6% (3.2% excluding the impact of a new accounting method for the sale of miles), primarily due to fuel-related fare increases. Yields were up in virtually all major markets. The higher traffic combined with the higher yield resulted in a 6.5% increase in passenger revenue.

Freight and mail revenues decreased 4.5%, primarily due to 6.7% lower freight volumes that resulted from 1.8% fewer flights operated, lower seafood shipments, and more competition.

Other net revenues decreased $26.5 million (32.6%) due to the change in accounting for the sale of miles in Alaska's frequent flyer program. If the new accounting method had been in effect in 1999, other-net revenues would have increased $3.7 million (7.3%).

Alaska Airlines Expenses
Operating expenses grew by 17.2 % as a result of a 17.3% increase in cost per ASM. The increase in cost per ASM was largely due to higher fuel prices, higher labor and aircraft maintenance costs, and a special charge related to Mileage Plan estimates. Explanations of significant year-over-year changes in the components of operating expenses are as follows:

• Wages and benefits increased 14.1% due to a 4.7% increase in the number of employees combined with a 9.0% increase in average wages and benefits per employee. Management employees were hired in many areas (e.g. maintenance and quality control, computer services, training, marketing, and employee services) to better manage the existing operations. The number of pilots and flight attendants increased, in spite of no increase in capacity, due to training requirements. The 2000 results include a $1.8 million charge for a flight attendant early retirement program. Absent this charge, average wages and benefits per employee increased 8.7%. The full-year impact of new labor contracts for mechanics, flight attendants, passenger service, and ramp service employees, combined with longevity increases for pilots and annual merit raises for management employees, all contributed to the higher average wage rates.

• Contracted services increased 18.9%. The 2000 results include $1.9 million for aircraft-accident-related expenses not covered by insurance. Absent these expenses, contracted services increased 15.5% due to new costs for marketing information, higher contract labor and security costs, and higher rates for ground handling services.

• Fuel expense increased 52.6%, primarily due to a 54.2% increase in the cost per gallon of fuel. The fuel consumption rate decreased 2.1% due to the use of more fuel-efficient B737-700 aircraft. Fuel hedging, which started in July 2000, saved $3.8 million.

• Maintenance expense increased 34.2% due to greater use of outside contractors for airframe checks and a greater number of those checks, increased expenses for engine repairs and overhauls, and increased work on airframe components.

• Aircraft rent expense decreased 8.2% due to the leasing of four fewer MD-80 aircraft and two fewer B737-400 aircraft for most of 2000.

• Commission expense decreased 28.5% on a 6.5% increase in passenger revenue. The commission rate paid to travel agents in 2000 was 5% compared to the 8% rate that was paid during most of 1999. In 2000, 64% of ticket sales were made through travel agents, versus 67% in 1999. In 2000, 10.4% of ticket sales were made through Alaska's Internet web site versus 5.2% in 1999.

• Other selling expense increased 19.8%, higher than the 6.5% increase in passenger revenue, due to an $11.4 million increase in Mileage Plan awards expense as a result of the following trends: (a) more ways to earn miles, (b) less forfeiture of miles, (c) greater use of travel awards on other airlines, and (d) higher costs to obtain awards on other airlines.

• Depreciation and amortization increased 23.6%, primarily due to owning more aircraft in 2000.

• Other expense increased 23.7%, primarily due to higher expenditures for legal fees, supplies, passenger remuneration, flight crew hotel charges and meals, recruiting, personnel expenses, and insurance.

• The $24.0 million special charge in 2000 recognizes the increased incremental cost of travel awards earned by flying on Alaska and travel partners. The higher cost is due to an increase in the estimated costs Alaska incurs to acquire travel awards on other airlines for its Mileage Plan members, as well as lower assumed forfeiture of miles.

Horizon Air Revenues
Capacity grew by 4.8%, primarily due to additional flights in the Canadian and Montana markets. Traffic grew by 3.6%, resulting in a 0.8 point decrease in passenger load factor. The loss of the marketing alliance with Canadian Airlines in August 2000 and fires in Montana during the Summer of 2000 contributed to the lower load factor. Passenger yields were up 3.7%, largely due to "fuel surcharge" fare increases. The higher traffic, combined with the higher yield, resulted in a 7.4% increase in passenger revenue.

Horizon Air Expenses
Operating expenses grew by 14.9% as a result of a 4.8% increase in capacity and a 9.6% increase in cost per ASM. Explanations of significant year-over-year changes in the components of operating expenses are as follows:

- Wages and benefits increased 11.7% due to a 5.3% increase in the number of employees, combined with a 6.1% increase in average wages and benefits per employee. Employees were added to support 4.5% more block hours of flying and to prepare for growth in future periods.

- Contracted services increased 20.3%, higher than the 4.8% increase in capacity, due to increased expenses for ground handling, security, and employee recruiting.

- Fuel expense increased 57.4% due to a 51.2% increase in the cost per gallon of fuel, combined with a 4.1% increase in fuel consumption. Fuel hedging, which started in July 2000, saved $0.9 million.

- Maintenance expense increased 30.4%, higher than the 4.5% increase in block hours, due in part to increased expenses related to the earlier than previously estimated timeframe for phasing out the Fokker F-28 jet aircraft.

- Commission expense decreased 28.4% on a 7.4% increase in passenger revenue, because a smaller percentage of sales were made through travel agents and commission rates dropped from 8% to 5%, effective in October 1999.

- Depreciation and amortization expense increased 24.0% due in part to added depreciation on Fokker F-28 jet aircraft spare parts.

- Landing fees and other rentals increased 14.4% due to increased rates at Seattle and Portland airports.

- Other expense increased 14.1%, primarily due to higher expenditures for supplies, insurance, personnel expenses, and communications.

Consolidated Nonoperating Income (Expense)
Net nonoperating income decreased $15.9 million, primarily due to higher interest expense resulting from new debt incurred in late 1999 and in the second half of 2000. In addition, a $3.6 million gain on sale of shares in Equant N.V. (a telecommunication network company owned by many airlines) was recorded in December 1999.

1999 Compared with 1998
Consolidated net income in 1999 was $134.2 million, or $5.06 per share (diluted), compared with net income of $124.4 million, or $4.81 per share in 1998. Consolidated operating income was $199.9 million in 1999, compared with $211.0 million in 1998. Higher fuel prices impacted operating income by $41.6 million.

Alaska Airlines
Operating income decreased 9.1% to $176.3 million, resulting in a 10.5% operating margin compared with a 12.4% margin in 1998. Capacity increased 3.2% and traffic grew by 4.4%. Operating revenue per ASM increased 4.0% to 9.69 cents, while operating expenses per ASM increased 6.3% to 8.68 cents. The increase in revenue per ASM was due to higher passenger yields combined with a higher passenger load factor. Higher unit costs were largely due to increased fuel, labor, and maintenance costs.

Horizon Air
Operating income increased 36.3% to $24.8 million, resulting in a 6.0% operating margin compared with a 5.2% margin in 1998. Capacity increased 20.9% and traffic grew by 20.6%. Operating revenue per ASM decreased 1.1% to 18.96 cents, while operating expenses per ASM decreased 1.8% to 17.83 cents.

Consolidated Nonoperating Income (Expense)
Net nonoperating items improved $27.4 million over 1998 due to a $16.5 million litigation settlement charge in 1998, $4.9 million lower interest expense, and a $3.6 million gain on sale of shares in Equant N.V in 1999.

Liquidity and Capital Resources

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

(In millions, except debt-to-capital and per-share amounts)	December 31 1999	**2000**	Change
Cash and marketable securities	$329.0	**$461.7**	$132.7
Working capital (deficit)	(36.8)	**94.9**	131.7
Long-term debt and capital lease obligations	337.0	**609.2**	272.2
Shareholders' equity	930.7	**862.3**	(68.4)
Book value per common share	$35.24	**$32.59**	$(2.65)
Debt-to-capital	27%:73%	**41%:59%**	NA
Debt-to-capital assuming aircraft operating leases are capitalized at seven times annualized rent	64%:36%	**69%:31%**	NA

2000 Financial Changes

The Company's cash and marketable securities portfolio increased by $132.7 million during 2000. Operating activities provided $265.0 million of cash during this period. Additional cash was provided by the issuance of $338.2 million of new debt. Another $39.1 million was provided by insurance proceeds from an aircraft accident and other asset dispositions. Cash was used for $448.6 million of capital expenditures, including the purchase of seven new Boeing 737 aircraft, flight equipment deposits and airframe and engine overhauls, and for $65.8 million of debt and capital lease repayment.

Shareholders' equity decreased $68.4 million due to the net loss of $70.3 million, which was partly offset by stock issued under stock plans and changes in deferred compensation.

Financing Activities

During 2000, Alaska issued $238.2 million of 12-year debt secured by flight equipment. $148.2 million of the new debt has fixed interest rates of approximately 7.6% . Interest rates on the other $90.0 million varies with LIBOR. Alaska also issued $100.0 million of unsecured debt, which is expected to be repaid in 2003 and 2004 and has an interest rate that varies with LIBOR.

Aircraft Accident

On January 31, 2000, Alaska Airlines Flight 261 from Puerto Vallarta en route to San Francisco, went down in the water off the coast of California near Point Mugu. The flight carried 83 passengers and five crew members. There were no survivors. At present, 82 wrongful death lawsuits have been filed against Alaska. The plaintiffs seek unspecified compensatory and punitive damages. Because the Company cannot predict the outcome of this litigation, it can give no assurance that these proceedings, if determined adversely to Alaska, would not have a material adverse effect on the financial position or results of operations of the Company. While we cannot predict or quantify the outcome of these matters, management believes their ultimate dispostion is not likely to materially affect the Company's financial postion or results of operations. Consistent with industry standards, the Company maintains insurance against aircraft accidents. The Company expects substantially all accident response and civil litigation costs to be covered by insurance.

Safety Activities

In March 2000, to enhance existing lines of communication, Alaska established a "safety hotline" for employees to contact the chairman's office directly regarding any safety concern. In April 2000, an independent team of outside safety experts began a full audit of the maintenance, flight operations, hazardous materials handling, and security areas of Alaska. The team presented its final report to Alaska in June 2000 and Alaska is implementing those recommendations. In November 2000, the team returned to review progress on its recommendations and to assist Alaska in focusing its ongoing safety efforts. Alaska has also hired a vice president of safety, who reports directly to the chairman.

Commitments
At December 31, 2000, the Company had firm orders for 60 aircraft requiring aggregate payments of approximately $1.2 billion, as set forth below. In addition, Alaska has options to acquire 26 more B737s and Horizon has options to acquire 15 Dash 8-400s and 25 CRJ 700s. Alaska and Horizon expect to finance the new planes with leases, long-term debt, or internally generated cash.

	Delivery Period — Firm Orders					
Aircraft	2001	2002	2003	2004	2005	Total
Boeing 737-700	3	—	—	—	—	3
Boeing 737-900	5	8*	—	—	—	13
Bombardier Dash 8-400	14	—	—	—	—	14
Bombardier CRJ 700	14	—	4	6	6	30
Total	36	8	4	6	6	60
Payments (Millions)	$726	$147	$100	$127	$108	$1,208

* Seven of these firm orders may be converted to other Next Generation Boeing 737 aircraft.

Deferred Taxes
At December 31, 2000, net deferred tax liabilities were $104 million, which includes $156 million of net temporary differences offset by $52 million of deferred tax assets.

New Accounting Standards
Effective January 1, 2001, the Company will adopt Statement of Financial Accounting Standard No. 133, Accounting for Derivative Instruments and Hedging Activities, as amended. SFAS 133 requires companies to record derivatives on the balance sheet as assets or liabilities, measured at fair value. Gains or losses resulting from changes in the values of those derivatives would be accounted for depending on the use of the derivative and whether it qualfies for hedge accounting. If the derivative qualifies as a hedge, the change in its fair value will be recognized in other comprehensive income until the hedged item is recognized in earnings. At December 31, 2000, the Company's fuel hedge contracts had an estimated fair value of $2.1 million, with unrealized losses of $1.2 million.

1999 Financial Changes
The Company's cash and marketable securities portfolio increased by $22 million during 1999. Operating activities provided $330 million of cash in 1999. Additional cash was provided by the issuance of new debt ($232 million), sale and leaseback of three Dash 8-200 aircraft ($30 million), flight equipment deposits returned ($8 million) and the exercise of stock options ($6 million). Cash was used for $565 million of capital expenditures, including the purchase of nine new Boeing 737 aircraft, two formerly leased Boeing 737s, three new Dash 8-200 aircraft, flight equipment deposits, an aircraft simulator and airframe and engine overhauls, and for $27 million of debt repayment.

1998 Financial Changes
The Company's cash and marketable securities portfolio increased by $94 million during 1998. Operating activities provided $310 million of cash in 1998. Additional cash was provided by the sale and leaseback of nine B737-400 aircraft and 12 Dash 8-200 aircraft ($402 million) and the return of $33 million of equipment deposits. Cash was used for $613 million of capital expenditures, including the purchase of nine new B737-400 aircraft, a previously leased B737-400 aircraft, 12 new Dash 8-200 aircraft, flight equipment deposits and airframe and engine overhauls, and the repayment of debt ($46 million). Shareholders' equity increased $314 million due to the conversion of $186 million of convertible bonds into common stock, net income of $124 million and issuance of $7 million of common stock under stock plans.

Effect of Inflation
Inflation and specific price changes do not have a significant effect on the Company's operating revenues, operating expenses, and operating income, because such revenues and expenses generally reflect current price levels.

Market Risk
The Company does not purchase or hold any derivative financial instruments for trading purposes. The Company has material market risk exposure to jet fuel price increases. Currently, a one-cent change in the fuel price per gallon affects annual fuel costs by approximately $3.7 million. To help manage this exposure, the Company began purchasing primarily crude oil call options during 2000. Settlement of these options during the last half of 2000 resulted in a gain of $4.7 million. At December 31, 2000, the Company had purchased crude oil call options in place to hedge approximately 23% of its 2001 expected jet fuel requirements. A hypothetical 10% increase in jet fuel prices would increase 2001 fuel expense by approximately $31 million. This analysis includes the effect of the fuel hedging contracts in place at December 31, 2000.

Consolidated Balance Sheets

Alaska Air Group

ASSETS

As of December 31 (In Millions)	1999	2000
Current Assets		
Cash and cash equivalents	$ 132.5	**$ 101.1**
Marketable securities	196.5	**360.6**
Receivables — less allowance for doubtful accounts (1999 - $1.0; 2000 - $1.7)	74.6	**82.1**
Inventories and supplies	54.3	**63.7**
Prepaid expenses and other assets	124.0	**198.2**
Total Current Assets	581.9	**805.7**
Property and Equipment		
Flight equipment	1,386.6	**1,638.3**
Other property and equipment	337.2	**362.9**
Deposits for future flight equipment	217.7	**281.8**
	1,941.5	**2,283.0**
Less accumulated depreciation and amortization	486.7	**563.4**
	1,454.8	**1,719.6**
Capital leases:		
Flight and other equipment	44.4	**44.4**
Less accumulated amortization	31.8	**33.8**
	12.6	**10.6**
Total Property and Equipment — Net	1,467.4	**1,730.2**
Intangible Assets — Subsidiaries	55.5	**53.4**
Other Assets	75.3	**40.7**
Total Assets	$2,180.1	**$2,630.0**

See accompanying notes to consolidated financial statements.

LIABILITIES AND SHAREHOLDERS' EQUITY

As of December 31 (In Millions Except Per Share Amounts)		1999	2000
Current Liabilities			
Accounts payable		$ 104.2	**$ 140.9**
Accrued aircraft rent		81.8	**85.7**
Accrued wages, vacation and payroll taxes		83.0	**67.0**
Other accrued liabilities		99.5	**137.4**
Air traffic liability		183.7	**213.1**
Current portion of long-term debt and capital lease obligations		66.5	**66.7**
Total Current Liabilities		618.7	**710.8**
Long-Term Debt and Capital Lease Obligations		337.0	**609.2**
Other Liabilities and Credits			
Deferred income taxes		144.0	**155.6**
Deferred revenue		37.4	**135.8**
Other liabilities		112.3	**156.3**
		293.7	**447.7**
Commitments			
Shareholders' Equity			
Preferred stock, $1 par value			
Authorized:	5,000,000 shares	—	**—**
Common stock, $1 par value			
Authorized:	100,000,000 shares		
Issued:	1999 — 29,157,108 shares		
	2000 — 29,201,169 shares	29.2	**29.2**
Capital in excess of par value		480.0	**481.2**
Treasury stock, at cost:	1999 — 2,746,304 shares		
	2000 — 2,743,774 shares	(62.7)	**(62.6)**
Deferred compensation		(0.6)	**0.0**
Retained earnings		484.8	**414.5**
		930.7	**862.3**
Total Liabilities and Shareholders' Equity		$2,180.1	**$2,630.0**

Consolidated Statements of Income

Alaska Air Group

Year Ended December 31 (In Millions Except Per Share Amounts)	1998	1999	**2000**
Operating Revenues			
Passenger	$1,728.0	$1,904.8	**$2,032.3**
Freight and mail	94.4	91.2	**87.6**
Other — net	75.3	86.0	**57.3**
Total Operating Revenues	1,897.7	2,082.0	**2,177.2**
Operating Expenses			
Wages and benefits	594.4	652.6	**715.5**
Contracted services	55.5	64.9	**77.6**
Aircraft fuel	192.5	249.8	**383.3**
Aircraft maintenance	120.9	144.7	**192.3**
Aircraft rent	199.5	199.9	**186.8**
Food and beverage service	51.6	51.7	**54.2**
Commissions	97.5	99.0	**67.1**
Other selling expenses	94.8	104.1	**121.2**
Depreciation and amortization	75.1	84.8	**105.5**
Loss on sale of assets	1.0	0.9	**—**
Landing fees and other rentals	76.3	88.4	**99.8**
Other	127.6	141.3	**170.5**
Special charge — Mileage Plan	—	—	**24.0**
Total Operating Expenses	1,686.7	1,882.1	**2,197.8**
Operating Income (Loss)	211.0	199.9	**(20.6)**
Nonoperating Income (Expense)			
Interest income	22.2	20.2	**24.3**
Interest expense	(21.2)	(16.3)	**(36.0)**
Interest capitalized	6.6	10.2	**15.5**
Other — net	(14.2)	6.7	**1.1**
	(6.6)	20.8	**4.9**
Income (loss) before income tax and accounting change	204.4	220.7	**(15.7)**
Income tax expense (credit)	80.0	86.5	**(2.3)**
Income (loss) before accounting change	124.4	134.2	**(13.4)**
Cumulative effect of accounting change, net of income taxes of $35.6 million	—	—	**(56.9)**
Net Income (Loss)	$ 124.4	$ 134.2	**$ (70.3)**
Basic Earnings Per Share:			
Income (loss) before accounting change	5.32	5.09	**(0.51)**
Cumulative effect of accounting change	—	—	**(2.15)**
Net Income (Loss)	$ 5.32	$ 5.09	**$ (2.66)**
Diluted Earnings (Loss) Per Share:			
Income (loss) before accounting change	4.81	5.06	**(0.51)**
Cumulative effect of accounting change	—	—	**(2.15)**
Net Income (Loss)	$ 4.81	$ 5.06	**$ (2.66)**
Shares used for computation:			
Basic	23.388	26.372	**26.440**
Diluted	26.367	26.507	**26.440**

See accompanying notes to consolidated financial statements.

Consolidated Statements of Shareholders' Equity

Alaska Air Group

(In Millions)	*Common Shares Outstanding*	Common Stock	Capital in Excess of Par Value	Treasury Stock at Cost	Deferred Compen-sation	Retained Earnings	Total
Balances at December 31, 1997	*18.283*	$21.0	$292.5	$ (62.6)	$ (1.8)	$226.2	$475.3
1998 net income						124.4	124.4
Stock issued under stock plans	*0.196*	0.3	4.6				4.9
Tax benefit related to stock issued to employees		0.0	1.8				1.8
Stock issued for convertible subordinated debentures	*7.747*	7.7	175.0				182.7
Treasury stock purchase	*(0.002)*			(0.1)			(0.1)
Employee Stock Ownership Plan shares allocated					0.5		0.5
Balances at December 31, 1998	*26.224*	29.0	473.9	(62.7)	(1.3)	350.6	789.5
1999 net income						134.2	134.2
Stock issued under stock plans	*0.183*	0.2	4.7				4.9
Tax benefit related to stock issued to employees		0.0	1.4				1.4
Treasury stock sale	*0.004*			0.0			0.0
Employee Stock Ownership Plan shares allocated					0.7		0.7
Balances at December 31, 1999	*26.411*	29.2	480.0	(62.7)	(0.6)	484.8	930.7
2000 net loss						(70.3)	(70.3)
Stock issued under stock plans	*0.043*	0.0	1.2				1.2
Treasury stock sale	*0.003*			0.1			0.1
Employee Stock Ownership Plan shares allocated					0.6		0.6
Balances at December 31, 2000	***26.457***	**$29.2**	**$481.2**	**$ (62.6)**	**$ 0.0**	**$414.5**	**$862.3**

See accompanying notes to consolidated financial statements.

Consolidated Statements of Cash Flows

Alaska Air Group

Year Ended December 31 (In Millions)	1998	1999	2000
Cash flows from operating activities:			
Net income (loss)	$ 124.4	$ 134.2	**$ (70.3)**
Adjustments to reconcile net income (loss) to cash:			
Cumulative effect of accounting change	—	—	**56.9**
Special charge — Mileage Plan	—	—	**24.0**
Depreciation and amortization	75.1	84.8	**105.5**
Amortization of airframe and engine overhauls	41.1	50.1	**65.3**
Loss on sale of assets	1.0	0.9	**—**
Increase in deferred income taxes	26.9	44.8	**11.6**
Decrease (increase) in accounts receivable	2.0	(4.0)	**(7.5)**
Increase in other current assets	(12.3)	(26.7)	**(45.4)**
Increase in air traffic liability	12.2	5.1	**29.4**
Increase in other current liabilities	41.9	48.4	**62.4**
Other — net	(2.1)	(7.5)	**33.1**
Net cash provided by operating activities	310.2	330.1	**265.0**
Cash flows from investing activities:			
Proceeds from disposition of assets	2.1	2.2	**39.1**
Purchases of marketable securities	(323.4)	(137.8)	**(464.1)**
Sales and maturities of marketable securities	156.3	218.5	**300.0**
Flight equipment deposits returned	33.2	8.3	**4.0**
Additions to flight equipment deposits	(182.1)	(177.0)	**(161.3)**
Additions to property and equipment	(431.3)	(388.0)	**(287.3)**
Restricted deposits and other	(1.3)	5.9	**(0.4)**
Net cash used in investing activities	(746.5)	(467.9)	**(570.0)**
Cash flows from financing activities:			
Proceeds from sale and leaseback transactions	402.0	29.8	**—**
Proceeds from issuance of long-term debt	—	232.0	**338.2**
Long-term debt and capital lease payments	(45.5)	(27.2)	**(65.8)**
Proceeds from issuance of common stock	6.6	6.3	**1.2**
Net cash provided by financing activities	363.1	240.9	**273.6**
Net change in cash and cash equivalents	(73.2)	103.1	**(31.4)**
Cash and cash equivalents at beginning of year	102.6	29.4	**132.5**
Cash and cash equivalents at end of year	$ 29.4	$ 132.5	**$ 101.1**
Supplemental disclosure of cash paid during the year for:			
Interest (net of amount capitalized)	$ 15.8	$ 6.6	**$ 28.5**
Income taxes	48.5	35.1	**3.6**

Noncash investing and financing activities:
1998 — $186.0 million of convertible debentures were converted into 7.7 million shares of common stock.
1999 and 2000 — None

See accompanying notes to consolidated financial statements.

Note 1. Summary of Significant Accounting Policies

Organization and Basis of Presentation
The consolidated financial statements include the accounts of Alaska Air Group, Inc. (Company or Air Group) and its subsidiaries, the principal subsidiaries being Alaska Airlines, Inc. (Alaska) and Horizon Air Industries, Inc. (Horizon). All significant intercompany transactions are eliminated. Preparation of financial statements requires the use of management's estimates. Actual results could differ from those estimates. Certain reclassifications have been made in prior years' financial statements to conform to the 2000 presentation.

Nature of Operations
Alaska and Horizon operate as airlines. However, their business plans, competition, and economic risks differ substantially. Alaska is a major airline serving Alaska; Vancouver, Canada; the U.S. West Coast; and Mexico. It operates an all jet fleet and its average passenger trip is 886 miles. Horizon is a regional airline serving the Pacific Northwest, California, and Western Canada. It operates both jet and turboprop aircraft, and its average passenger trip is 283 miles. Substantially all of Alaska's and Horizon's sales occur in the United States. See Note 11 for operating segment information.

Cash and Cash Equivalents
Cash equivalents consist of highly liquid investments with purchase maturities of three months or less. They are carried at cost, which approximates market. The Company reduces its cash balance when checks are disbursed. Due to the time delay in checks clearing the banks, the Company normally maintains a negative cash balance on its books, which is reported as a current liability. The amount of the negative cash balance was $22.6 million and $31.6 million at December 31, 1999 and 2000, respectively.

Inventories and Supplies
Expendable and repairable aircraft parts, as well as other materials and supplies, are stated at average cost. An allowance for obsolescence of flight equipment expendable and repairable parts is accrued based on estimated disposal date and salvage value. Surplus inventories are carried at their net realizable value. The allowance at December 31, 1999 and 2000 for all inventories was $23.8 million and $27.6 million, respectively.

Property, Equipment and Depreciation
Property and equipment are recorded at cost and depreciated using the straight-line method over their estimated useful lives, which are as follows:

Aircraft and related flight equipment:	
Boeing 737-200C	12/31/05*
Boeing 737-400/700	20 years
Boeing MD-80	20 years
Bombardier Dash 8	10 years
Fokker F-28	12/31/01*
Buildings	10 – 30 years
Capitalized leases and leasehold improvements	Term of lease
Other equipment	3 – 15 years

* Estimated final aircraft retirement date

Assets and related obligations for items financed under capital leases are initially recorded at an amount equal to the present value of the future minimum lease payments. The cost of major airframe overhauls, engine overhauls, and other modifications that extend the life or improve the usefulness of aircraft are capitalized and amortized over their estimated period of use. Other repair and maintenance costs are expensed when incurred. The Company periodically reviews long-lived assets for impairment.

Intangible Assets — Subsidiaries
The excess of the purchase price over the fair value of net assets acquired is recorded as an intangible asset and is amortized over 40 years. Accumulated amortization at December 31, 1999 and 2000 was $27.2 million and $29.3 million, respectively.

Frequent Flyer Awards
Alaska operates a frequent flyer program ("Mileage Plan") that provides travel awards to members based on accumulated mileage. For miles earned by flying on Alaska and travel partners, the estimated incremental cost of providing free travel awards is recognized as a selling expense and accrued as a liability as miles are accumulated. Alaska also sells mileage credits to non-airline partners, such as hotels, car rental agencies, and a credit

card company. Effective January 1, 2000, the Company began deferring a majority of the sales proceeds and recognizing those proceeds as revenue when the award transportation is provided. The deferred proceeds are recognized as passenger revenue for awards issued on Alaska and as other revenue-net for awards issued on other airlines. See Note 12 for more information.

Deferred Revenue
Deferred revenue results from the sale of mileage credits, the sale and leaseback of aircraft, and the receipt of manufacturer or vendor credits. This revenue is recognized either when award transportation is provided or over the term of the applicable agreements.

Leased Aircraft Return Costs
The costs associated with returning leased aircraft are accrued over the lease periods. As leased aircraft are retired, the costs are charged against the established reserve. The reserve is part of other liabilities, and at December 31, 1999 and 2000 was $48.9 million and $57.9 million, respectively.

Passenger Revenues
Passenger revenues are recognized when the passenger travels. Tickets sold but not yet used are reported as air traffic liability.

Contracted Services
Contracted services includes expenses for ground handling, security, navigation fees, temporary employees, data processing fees, and other similar services.

Other Selling Expenses
Other selling expenses includes credit card commissions, computerized reservations systems (CRS) charges, Mileage Plan free travel awards, advertising, and promotional costs. Advertising production costs are expensed the first time the advertising takes place. Advertising expense was $17.9 million, $17.0 million, and $19.7 million, respectively, in 1998, 1999 and 2000.

Capitalized Interest
Interest is capitalized on flight equipment purchase deposits and ground facility progress payments as a cost of the related asset and is depreciated over the estimated useful life of the asset.

Income Taxes
Income taxes are accounted for in accordance with Statement of Financial Accounting Standards No. 109, which requires the recognition of deferred tax assets and liabilities for the expected future tax consequences of events that have been recognized in the Company's financial statements or tax returns.

Stock Options
The Company applies APB Opinion No. 25 and related Interpretations in accounting for stock options. See Note 6 for more information.

Derivative Financial Instruments
The Company enters into foreign exchange forward contracts, generally with maturities of less than one month, to manage risk associated with net foreign currency transactions. Resulting gains and losses are recognized currently in other operating expense. The Company periodically enters into interest rate swap agreements to hedge interest rate risk. The differential to be paid or received from these agreements is accrued as interest rates change and is recognized currently in the income statement. At December 31, 2000, there were no foreign currency contracts or interest rate swap agreements outstanding. The Company periodically enters into hedge agreements to reduce its exposure to fluctuations in the price of jet fuel. Resulting gains and losses are recognized currently in fuel expense.

Effective January 1, 2001, the Company will adopt Statement of Financial Accounting Standard No. 133, Accounting for Derivative Instruments and Hedging Activities, as amended. SFAS 133 requires companies to record derivatives on the balance sheet as assets or liabilities, measured at fair value. Gains or losses resulting from changes in the values of those derivatives would be accounted for depending on the use of the derivative and whether it qualfies for hedge accounting. If the derivative qualifies as a hedge, the change in its fair value will be recognized in other comprehensive income until the hedged item is recognized in earnings. At December 31, 2000, the Company's fuel hedge contracts had an estimated fair value of $2.1 million, with unrealized losses of $1.2 million.

Note 2. Marketable Securities

Marketable securities are investments that are readily convertible to cash and have original maturities that exceed three months. They are classified as available for sale and consisted of the following at December 31 (in millions):

	1999	2000
Cost:		
U.S. government securities	$146.7	**$245.5**
Asset backed obligations	19.3	**79.1**
Other corporate obligations	30.5	**36.0**
	$196.5	**$360.6**
Fair value:		
U.S. government securities	$146.2	**$246.3**
Asset backed obligations	19.1	**79.5**
Other corporate obligations	29.9	**36.4**
	$195.2	**$362.2**

There were no material unrealized holding gains or losses at December 31, 1999 or 2000.

Of the marketable securities on hand at December 31, 2000, 57% are expected to mature in 2001, 42% in 2002, and 1% in 2003. Based on specific identification of securities sold, the following occurred in 1998, 1999 and 2000 (in millions):

	1998	1999	2000
Proceeds from sales	$156.3	$218.5	**$300.0**
Gross realized gains	$ 0.2	$ 0.4	**$ 0.3**
Gross realized losses	—	$ 0.3	**$ 0.6**

Realized gains and losses are reported as a component of interest income.

Note 3. Other Assets

Other assets consisted of the following at December 31 (in millions):

	1999	2000
Restricted deposits	$63.5	**$26.2**
Deferred costs and other	11.8	**14.5**
	$75.3	**$40.7**

At December 31, 2000, Alaska owned approximately 81,000 depository certificates convertible, subject to certain restrictions, into the common stock of Equant N.V., a telecommunication network company. The certificates had an estimated fair value of $2 million. Alaska's carrying value of the certificates was de minimis.

Note 4. Long-Term Debt and Capital Lease Obligations

At December 31, 1999 and 2000, long-term debt and capital lease obligations were as follows (in millions):

	1999	2000
7.9%* fixed rate notes payable due through 2015	$309.5	**$406.4**
6.7%* variable rate notes payable due through 2012	73.5	**251.7**
Long-term debt	383.0	**658.1**
Capital lease obligations	20.5	**17.8**
Less current portion	(66.5)	**(66.7)**
	$337.0	**$609.2**

* weighted average for 2000

At December 31, 2000, borrowings of $558.1 million are secured by flight equipment and real property. During 2000, Alaska issued $238.2 million of 12-year debt secured by flight equipment. $148.2 million of the new debt has fixed interest rates of approximately 7.6%. Interest rates on the other $90.0 million varies with LIBOR. Alaska also issued $100.0 million of unsecured debt, which is expected to be repaid in 2003 and 2004, and has an interest rate which varies with LIBOR.

At December 31, 2000, Alaska had a credit facility with commercial banks that allows it to borrow up to $150 million until December 2004. Borrowings under this facility bear interest at a rate that varies based on LIBOR. At December 31, 2000, no borrowings were outstanding under this credit facility.

Certain Alaska loan agreements contain provisions that require maintenance of specific levels of net worth, leverage and fixed charge coverage, and limit investments, lease obligations, sales of assets, and additional indebtedness. At December 31, 2000 the Company was in compliance with all loan provisions, and, under the most restrictive loan provisions, Alaska had $301 million of net worth above the minimum.

At December 31, 2000, long-term debt principal payments for the next five years were (in millions):

2001	$ 62.8
2002	$ 31.2
2003	$ 52.8
2004	$122.4
2005	$ 24.9

Note 5. Commitments

Lease Commitments
Lease contracts for 104 aircraft have remaining lease terms of one to 16 years. The majority of airport and terminal facilities are also leased. Total rent expense was $241.6 million, $244.3 million and $242.0 million, in 1998, 1999 and 2000, respectively. Future minimum lease payments under long-term operating leases and capital leases as of December 31, 2000 are shown below (in millions):

	Capital Leases	Operating Leases	
		Aircraft	Facilities
2001	$ 4.1	$ 163.8	$ 21.8
2002	4.1	151.7	12.1
2003	4.1	135.9	10.2
2004	8.4	111.9	8.6
2005	0.2	107.2	8.4
Thereafter	0.2	875.8	112.9
Total lease payments	21.1	$1,546.3	$174.0
Less amount representing interest	(3.3)		
Present value of capital lease payments	$17.8		

Aircraft Commitments
The Company has firm orders for 16 Boeing 737 series aircraft to be delivered between 2001 and 2002, 14 Dash 8-400s during 2001, and 30 Canadair RJ 700 jets between 2001 and 2005. The firm orders require payments of approximately $1.2 billion between 2001 and 2005. As of December 31, 2000, deposits of $266 million related to the firm orders had been made. In addition to the ordered aircraft, the Company holds purchase options on 26 Boeing 737s, 15 Dash 8-400s, and 25 CRJ 700s.

Note 6. Stock Plans

Air Group has three stock option plans, which provide for the purchase of Air Group common stock at a stipulated price on the date of grant by certain officers and key employees of Air Group and its subsidiaries. Under the 1996, 1997, and 1999 Plans, options for 1,940,900 shares have been granted and, at December 31, 2000, 736,375 shares were available for grant. Under all plans, the incentive and nonqualified stock options granted have terms of up to approximately ten years. Substantially all grantees are 25% vested after one year, 50% after two years, 75% after three years, and 100% after four years.

The fair value of each option grant is estimated on the date of grant using the Black-Scholes option pricing model with the following assumptions used for grants in 1998, 1999, and 2000, respectively: dividend yield of 0% for all years; volatility of 35%, 40%, and 44%; risk-free interest rates of 5.67%, 5.53%, and 6.62%; and expected lives of 5 years for all years. Using these assumptions, the weighted average fair value of options granted was $19.33, $17.39, and $14.58 in 1998, 1999 and 2000, respectively.

Air Group follows APB Opinion 25 and related Interpretations in accounting for stock options. Accordingly, no compensation cost has been recognized for these plans. Had compensation cost for the Company's stock options been determined in accordance with Statement of Financial Accounting Standard No. 123, income before accounting change and applicable earnings per share (EPS) would have been reduced to the pro forma amounts indicated below.

	1998	1999	**2000**
Net income (loss) before accounting change (in millions):			
As reported	$124.4	$134.2	**$(13.4)**
Pro forma	122.2	131.0	**(17.9)**
Basic EPS:			
As reported	$ 5.32	$ 5.09	**$(0.51)**
Pro forma	5.23	4.97	**(0.68)**
Diluted EPS:			
As reported	$ 4.81	$ 5.06	**$(0.51)**
Pro forma	4.73	4.94	**(0.68)**

Changes in the number of shares subject to option, with their weighted average exercise prices, are summarized below:

	Shares	Price
Outstanding, December 31, 1997	879,925	$23.72
Granted	324,900	47.45
Exercised	(159,475)	17.88
Canceled	(5,200)	36.88
Outstanding, December 31, 1998	1,040,150	31.96
Granted	494,400	46.81
Exercised	(148,688)	20.19
Canceled	(47,050)	38.66
Outstanding, December 31, 1999	1,338,812	38.51
Granted	609,900	30.27
Exercised	(21,725)	16.66
Canceled	(106,050)	38.11
Outstanding, December 31, 2000	1,820,937	$34.10
Exercisable at year-end		
December 31, 1998	253,350	$22.92
December 31, 1999	434,612	28.95
December 31, 2000	736,462	32.52

The following table summarizes stock options outstanding and exercisable at December 31, 2000 with their weighted average remaining contractual lives:

Range of Exercise Prices	Remaining Life (years)	Shares	Price
Outstanding:			
$15 to $29	5.9	360,325	$21.57
$30 to $40	8.5	1,174,662	34.68
$41 to $58	7.3	285,950	47.49
$15 to $58	7.8	1,820,937	$34.10
Exercisable:			
$15 to $29		308,525	$20.59
$30 to $40		265,087	37.24
$41 to $58		162,850	47.43
$15 to $58		736,462	$32.52

Note 7. Employee Benefit Plans

Pension Plans

Four defined benefit and five defined contribution retirement plans cover various employee groups of Alaska and Horizon.

The defined benefit plans provide benefits based on an employee's term of service and average compensation for a specified period of time before retirement. Pension plans are funded as required by the Employee Retirement Income Security Act of 1974 (ERISA). The defined benefit plan assets consist primarily of marketable equity and fixed income securities. The following table sets forth the status of the plans for 1999 and 2000 (in millions):

	1999	**2000**
Projected benefit obligation		
Beginning of year	$371.8	**$369.3**
Service cost	25.8	**24.0**
Interest cost	25.3	**28.5**
Amendments	9.8	**0.7**
Change in assumptions	(54.9)	**16.0**
Actuarial gain	(1.9)	**0.9**
Benefits paid	(6.6)	**(9.2)**
End of year	$369.3	**$430.2**
Plan assets at fair value		
Beginning of year	$373.0	**$437.1**
Actual return on plan assets	27.8	**5.8**
Employer contributions	42.9	**5.0**
Benefits paid	(6.6)	**(9.2)**
End of year	$437.1	**$438.7**
Funded status	67.8	**8.5**
Unrecognized loss (gain)	(40.7)	**13.9**
Unrecognized transition asset	(0.1)	**(0.1)**
Unrecognized prior service cost	54.8	**51.0**
Prepaid pension cost	$ 81.8	**$ 73.3**
Weighted average assumptions as of December 31		
Discount rate	7.75%	**7.50%**
Expected return on plan assets	10.0%	**10.0%**
Rate of compensation increase	5.4%	**5.4%**

Net pension expense for the defined benefit plans included the following components for 1998, 1999 and 2000 (in millions):

	1998	1999	**2000**
Service cost	$22.4	$25.8	**$24.0**
Interest cost	21.9	25.3	**28.5**
Expected return on assets	(28.7)	(36.7)	**(43.4)**
Amortization of prior service cost	3.8	4.4	**4.5**
Recognized actuarial loss (gain)	—	0.1	**(0.1)**
Amortization of transition asset	(0.2)	(0.2)	**—**
Net pension expense	$19.2	$18.7	**$13.5**

Alaska and Horizon also maintain an unfunded, noncontributory benefit plan for certain elected officers. The $26 million unfunded accrued pension cost for this plan was accrued as of December 31, 2000.

The defined contribution plans are deferred compensation plans under section 401(k) of the Internal Revenue Code. All of these plans require Company contributions. Total expense for the defined contribution plans was $11.6 million, $13.5 million, and $16.9 million, respectively, in 1998, 1999, and 2000.

Profit Sharing Plans
Alaska and Horizon have employee profit sharing plans. Profit sharing expense for 1998, 1999, and 2000 was $23.2 million, $22.8 million, and $0.0, respectively.

Other Postretirement Benefits
The Company allows retirees to continue their medical, dental, and vision benefits by paying all or a portion of the active employee plan premium until eligible for Medicare, currently age 65. This results in a subsidy to retirees, because the premiums received by the Company are less than the actual cost of the retirees' claims. The accumulated postretirement benefit obligation (APBO) for this subsidy at December 31, 1999 and 2000 was $25.4 million and $28.7 million, respectively. The APBO is unfunded and is included with other liabilities on the Consolidated Balance Sheet. Annual expense related to this subsidy is not considered material to disclose.

Note 8. Income Taxes

Deferred income taxes result from temporary differences in the timing of recognition of revenue and expense for tax and financial reporting purposes. Deferred tax assets and liabilities comprise the following at December 31, 2000 (in millions):

	1999	**2000**
Excess of tax over book depreciation	$195.8	**$209.4**
Employee benefits	3.4	**5.9**
Other — net	3.8	**6.0**
Gross deferred tax liabilities	203.0	**221.3**
Loss carryforward	(0.1)	—
Alternative minimum tax	(3.5)	**(0.1)**
Capital leases	(3.4)	**(2.4)**
Ticket pricing adjustments	(1.7)	**(1.8)**
Frequent flyer program	(14.9)	**(70.8)**
Aircraft return provisions	(14.9)	**(15.8)**
Deferred gains	(13.9)	**(12.4)**
Capitalized interest	(2.5)	**(3.1)**
Inventory obsolescence	(8.4)	**(10.7)**
Gross deferred tax assets	(63.3)	**(117.1)**
Net deferred tax liabilities	$139.7	**$104.2**
Current deferred tax asset	$ (4.3)	**$ (51.4)**
Noncurrent deferred tax liability	144.0	**155.6**
Net deferred tax liabilities	$139.7	**$104.2**

The components of income tax expense (credit) were as follows (in millions):

	1998	1999	**2000**
Current tax expense (credit):			
Federal	$43.0	$31.0	**$ (1.8)**
State	7.8	6.8	**0.1**
Total current	50.8	37.8	**(1.7)**
Deferred tax expense (credit):			
Federal	27.8	45.5	**(0.1)**
State	1.4	3.2	**(0.5)**
Total deferred	29.2	48.7	**(0.6)**
Total before acctg. change	80.0	86.5	**(2.3)**
Deferred tax credit, cumulative effect of acctg. change	—	—	**(35.6)**
Total tax expense (credit)	$80.0	$86.5	**$(37.9)**

Income tax expense (credit) reconciles to the amount computed by applying the U.S. federal rate of 35% to income before taxes and accounting change as follows (in millions):

	1998	1999	**2000**
Income (loss) before income tax and accounting change	$204.4	$220.7	**$(15.7)**
Expected tax expense (credit)	$ 71.5	$ 77.2	**$ (5.5)**
Nondeductible expenses	3.0	2.6	**3.4**
State income tax	6.2	6.7	**(0.2)**
Other — net	(0.7)	—	—
Actual tax expense (credit)	$ 80.0	$ 86.5	**$ (2.3)**
Effective tax rate	39.1%	39.2%	**14.6%**

After consideration of temporary differences, taxable income for 2000 was approximately $11 million.

Note 9. Financial Instruments

The estimated fair values of the Company's financial instruments were as follows (in millions):

	December 31, 1999		**December 31, 2000**	
	Carrying Amount	Fair Value	**Carrying Amount**	**Fair Value**
Cash and cash equivalents	$132.5	$132.5	**$101.1**	**$101.1**
Marketable securities	196.5	195.2	**360.6**	**362.2**
Fuel hedge contracts	—	—	**3.3**	**2.1**
Restricted deposits and depository certificates	63.5	70.5	**26.2**	**28.2**
Long-term debt	383.0	383.0	**658.1**	**678.1**

The fair value of cash equivalents approximates carrying value due to the short maturity of these instruments. The fair value of marketable securities is based on quoted market prices. The fair value of fuel hedge contracts is based on commodity exchange prices. The fair value of restricted deposits approximates the carrying amount. At December 31, 1999, the fair value of restricted depository certificates convertible into the common stock of Equant N.V. was $7 million based on sales of Equant N.V. stock in 1999. At December 31, 2000, the fair value of these certificates was $2 million based on a purchase offer from an independent organization. The fair value of long-term debt is based on a discounted cash flow analysis.

Note 10. Earnings Per Share (EPS)

Basic EPS is calculated by dividing net income by the average number of common shares outstanding. Diluted EPS is calculated by dividing net income plus the after-tax interest expense on convertible debt by the average common shares outstanding plus additional common shares that would have been outstanding if conversion of the convertible debt and exercise of in-the-money stock options is assumed. Stock options excluded from the calculation of diluted EPS because they are antidilutive, represented 0.3 million, 0.3 million, and 1.8 million shares, respectively, in 1998, 1999, and 2000. EPS calculations were as follows (in millions except per share amounts):

	1998	1999	**2000**
Basic			
Income (loss) before acctg. change	$ 124.4	$ 134.2	**$ (13.4)**
Average shares outstanding	23.388	26.372	**26.440**
EPS before acctg. change	$ 5.32	$ 5.09	**$ (0.51)**
Diluted			
Income (loss) before acctg. change	$ 124.4	$ 134.2	**$ (13.4)**
After-tax interest on:			
6-1/2% debentures	2.2	—	—
6-7/8% debentures	0.3	—	—
Diluted EPS income	$ 126.9	$ 134.2	**$ (13.4)**
Average shares outstanding	23.388	26.372	**26.440**
Assumed conversion of:			
6-1/2% debentures	2.543	—	—
6-7/8% debentures	0.255	—	—
Assumed exercise of stock options	0.181	0.135	—
Diluted EPS shares	26.367	26.507	**26.440**
EPS before acct. change	$ 4.81	$ 5.06	**$ (0.51)**

Note 11. Operating Segment Information

Financial information for Alaska and Horizon follows (in millions):

	1998	1999	**2000**
Operating revenues:			
Alaska	$1,566.3	$1,680.8	**$1,749.0**
Horizon	347.8	415.9	**443.5**
Elimination of intercompany revenues	(16.4)	(14.7)	**(15.3)**
Consolidated	1,897.7	2,082.0	**2,177.2**
Depreciation and amortization expense:			
Alaska	61.9	67.9	**83.9**
Horizon	12.9	16.7	**20.7**
Interest income:			
Alaska	23.2	21.7	**27.9**
Horizon	—	—	**—**
Interest expense:			
Alaska	17.4	16.3	**36.0**
Horizon	1.0	1.5	**3.1**
Income (loss) before income tax and accounting change:			
Alaska	190.5	196.4	**(8.2)**
Horizon	18.9	25.5	**(5.8)**
Air Group	(5.0)	(1.2)	**(1.7)**
Consolidated	204.4	220.7	**(15.7)**
Capital expenditures:			
Alaska	420.1	482.7	**373.4**
Horizon	193.4	82.3	**75.2**
Total assets at end of period:			
Alaska	1,548.8	1,981.2	**2,406.4**
Horizon	187.1	213.0	**258.7**
Air Group	790.5	945.7	**876.3**
Elimination of intercompany accounts	(794.6)	(959.8)	**(911.4)**
Consolidated	$1,731.8	$2,180.1	**$2,630.0**

During 2000, Air Group made capital contributions of $99.0 million and $33.0 million to Alaska and Horizon, respectively.

Note 12. Frequent Flyer Program

Change in Accounting Principle
In December 1999, the Securities and Exchange Commission issued Staff Accounting Bulletin 101 (SAB 101), Revenue Recognition in Financial Statements. SAB 101 gives specific guidance on the conditions that must be met before revenue may be recognized, and in June 2000 Alaska changed its method of accounting for the sale of miles in its Mileage Plan. Under the new method, a majority of the sales proceeds are deferred, then recognized ratably over the estimated period of time that the award transportation is provided. The deferred proceeds are recognized as passenger revenue for awards issued on Alaska, and as other revenue-net for awards issued on other airlines. In connection with the change, Alaska recognized a $56.9 million cumulative effect charge, net of income taxes of $35.6 million, effective January 1, 2000.

Proforma Results (Unaudited)
The change in accounting for the sale of miles, if applied to prior years, would have produced these pro forma results (in millions except per share amounts).

	1998	1999	**2000**
Income (loss) before acctg. change:			
As reported	$124.4	$134.2	**$(13.4)**
Pro forma	117.3	128.9	**(13.4)**
Basic EPS:			
As reported	$ 5.32	$ 5.09	**$(0.51)**
Pro forma	5.05	4.89	**(0.51)**
Diluted EPS:			
As reported	$ 4.81	$ 5.06	**$(0.51)**
Pro forma	4.54	4.86	**(0.51)**

Special Charge — Mileage Plan
In June 2000, Alaska recorded a $24.0 million special charge to recognize the increased incremental cost of travel awards earned by flying on Alaska and travel partners. The higher cost is due to an increase in the estimated costs Alaska incurs to acquire awards on other airlines for its Mileage Plan members, as well as lower assumed forfeiture of miles.

Balance Sheet Classification of Liabilities
Alaska's Mileage plan liabilities are included under the following balance sheet captions at December 31 (in millions):

	1999	**2000**
Current Liabilities:		
Other accrued liabilities	$40.0	**$ 59.5**
Other Liabilities and Credits:		
Deferred revenue	—	**94.0**
Other liabilities	—	**45.0**
Total	$40.0	**$198.5**

Note 13. Contingencies

In December 1998, search warrants and a grand jury subpoena (for the U.S. District Court for the Northern District of California) were served on Alaska, initiating an investigation into the Company's Oakland maintenance base by the U.S. Attorney for the Northern District of California. Alaska has cooperated with the U.S. Attorney's initial and subsequent requests for information concerning the Company's maintenance operations. In addition, the Federal Aviation Administration (FAA) issued a letter of investigation (LOI) to Alaska relating to maintenance performed on an MD-80 aircraft. In April 1999, the FAA issued a notice of proposed civil penalty for $44,000. In July 1999, Alaska responded informally to the notice, disputing that any violation occurred, and to date the FAA has not taken any further action. The Company understands that information developed by the National Transportation Safety Board in connection with the crash of Flight 261 on January 31, 2000 is being shared with the U.S. Attorney and that the U.S. Attorney is using this information, along with other records relating to the aircraft Alaska has produced, to evaluate whether any crimes were committed in connection with Flight 261. To the Company's knowledge, no charges have been filed as a result of the grand jury investigation.

Alaska is currently a defendant in a number of lawsuits relating to Flight 261. The Company is unable to predict the amount of claims that may ultimately be made against it or how those claims might be resolved. Consistent with industry standards, the Company maintains insurance against aircraft accidents.

In April 2000, the FAA began an audit of Alaska's maintenance and flight operations departments to ensure adherence to mandated procedures. During the audit, the FAA requested that Alaska take a number of actions, which Alaska has done or is currently implementing. In June 2000, the FAA informed Alaska that it was proposing to amend Alaska's operations specification to suspend the Company's ability to perform heavy maintenance on its aircraft. In June 2000, Alaska submitted an Airworthiness and Operations Action Plan describing numerous steps Alaska would take to address the FAA's concerns. In response to this plan the FAA withdrew its proposal. The FAA also requested that the Company submit a growth plan to demonstrate its ability to operationally handle its planned fleet additions. In June 2000, Alaska submitted its growth plan to the FAA. In July 2000, Alaska responded in writing to each of the FAA's findings from its April audit. The FAA has issued a number of LOIs stemming from the resulting increased FAA oversight. Alaska is investigating and responding to these LOIs. In December 2000, Alaska received notices of proposed civil penalties, totaling approximately $1 million, relating to some of these LOIs. The Company has not been informed what further actions, if any, the FAA intends to take with respect to these matters.

The Company cannot predict the outcome of any of the pending civil or potential criminal proceedings described above. As a result, the Company can give no assurance that these proceedings, if determined adversely to Alaska, would not have a material adverse effect on the financial position or results of operations of the Company. However, while we cannot predict or quantify the outcome of these matters, management believes their ultimate disposition is not likely to materially affect the Company's 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.

Report of Management

Alaska Air Group

To the Shareholders of Alaska Air Group, Inc.:

The Company's management is responsible for the integrity and objectivity of the financial and other information in this report. The financial statements were prepared in conformity with generally accepted accounting principles.

The Company's internal financial controls include the selection and training of managers, organizational arrangements that provide a division of responsibilities, a financial variance review process, and communication programs explaining policies and standards. The effectiveness of the internal accounting controls is monitored by operational departments, augmented by internal auditing and the independent public accountants' review. We believe that this system provides reasonable assurance as to the integrity and reliability of the financial reporting process and that the Company's assets are safeguarded against loss or unauthorized use.

The Audit Committee of the Board of Directors is composed entirely of outside directors. The Committee meets periodically and privately with the Company's independent accountants, the internal auditors, and management to review accounting, auditing, internal controls, and financial reporting matters.

The Company positively views all recommendations concerning its internal controls made by its internal auditors and independent accountants. Such recommendations are implemented, unless costs exceed benefits. For the periods covered by the audited financial statements, our internal auditors and independent accountants have made no recommendations involving material internal control weaknesses.

JOHN F. KELLY
Chairman, President and Chief Executive Officer

BRADLEY D. TILDEN
Vice President Finance & Chief Financial Officer

Report of Independent Public Accountants

Alaska Air Group

To the Board of Directors and Shareholders of Alaska Air Group, Inc.:

We have audited the accompanying consolidated balance sheet of Alaska Air Group, Inc. (a Delaware corporation) and subsidiaries as of December 31, 2000 and 1999, and the related consolidated statements of income, shareholders' equity and cash flows for each of the three years in the period ended December 31, 2000. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with auditing standards generally accepted in the United States. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of Alaska Air Group, Inc. and subsidiaries as of December 31, 2000 and 1999, and the results of their operations and their cash flows for each of the three years in the period ended December 31, 2000, in conformity with accounting principles generally accepted in the United States.

As explained in Notes 1 and 12 to the financial statements, effective January 1, 2000, the Company changed its method of accounting for the sale of airline miles in its Mileage Plan.

Arthur Andersen LLP

ARTHUR ANDERSEN LLP
Seattle, Washington
January 25, 2001

Selected Quarterly Consolidated Financial Information (Unaudited)

Alaska Air Group

Selected financial data for each quarter of 1999 and 2000 is as follows (in millions except per share):

	1st Quarter		2nd Quarter		3rd Quarter		4th Quarter	
	1999	**2000**	1999	**2000**	1999	**2000**	1999	**2000**
Operating revenues	$461.2	**$489.7**	$529.7	**$552.8**	$589.1	**$602.3**	$501.9	**$532.4**
Operating income (loss)	28.6	**(16.6)**	65.3	**13.1**	86.3	**37.2**	19.7	**(54.3)**
Income (loss) before accounting change	20.2	**(9.2)**	42.1	**8.8**	54.9	**15.9**	17.0	**(28.9)**
Net income (loss)	20.2	**(66.1)**	42.1	**8.8**	54.9	**15.9**	17.0	**(28.9)**
Basic earnings (loss) per share:								
Income before accounting change	0.77	**(0.35)**	1.60	**0.33**	2.08	**0.60**	0.64	**(1.09)**
Net income	0.77	**(2.50)**	1.60	**0.33**	2.08	**0.60**	0.64	**(1.09)**
Diluted earnings (loss) per share:								
Income before accounting change	0.76	**(0.35)**	1.59	**0.33**	2.07	**0.60**	0.64	**(1.09)**
Net income	0.76	**(2.50)**	1.59	**0.33**	2.07	**0.60**	0.64	**(1.09)**

Effective January 1, 2000, Alaska changed its method of accounting for the sale of miles in its frequent flyer program. In connection with the change, Alaska recognized a $56.9 million cumulative effect charge, net of income taxes of $35.6 million, ($2.15 per share), in the first quarter of 2000.

Stock Price and Dividend Policy and Other Investor Information

Alaska Air Group

As of December 31, 2000, there were 26,457,395 shares of common stock issued and outstanding and 4,276 shareholders of record. The Company also held 2,743,774 treasury shares at a cost of $62.6 million. The Company has not paid dividends on the common stock since 1992. Air Group's common stock is listed on the New York Stock Exchange (symbol: ALK).

The following table shows the trading range of Alaska Air Group common stock on the New York Stock Exchange for 1999 and 2000.

	1999		**2000**	
	High	Low	**High**	**Low**
First Quarter	54.6875	42.6250	**36.7500**	**25.2500**
Second Quarter	51.9375	38.0625	**32.0000**	**26.5625**
Third Quarter	46.6250	38.0000	**28.9375**	**23.1250**
Fourth Quarter	43.7500	33.1250	**31.7500**	**19.5000**

Eleven-Year Summary of Selected Consolidated Financial and Operating Data

Alaska Air Group

Year Ended December 31 (In Millions, Except Per Share)	1990	1991	1992
Consolidated Financial Data:			
Operating Revenues			
Passenger	$ 953.2	$ 999.9	$ 1,000.6
Freight, mail and other	93.8	104.1	114.8
Total Operating Revenues	1,047.0	1,104.0	1,115.4
Operating Expenses	(1,018.6)	(1,069.4)	(1,210.2)
Operating Income (Loss)	28.4	34.6	(94.8)
Interest expense, net of interest capitalized	(11.2)	(31.9)	(37.1)
Interest income	7.3	11.7	7.4
Other — net	3.4	1.8	(1.2)
Income (loss) before income tax and accounting change	27.9	16.2	(125.7)
Income (loss) before accounting change	17.2	10.3	(80.3)
Net Income (Loss)	$ 17.2	$ 10.3	$ (84.8)
Per Common Share Data:			
Average shares outstanding	13.555	13.198	13.309
Basic earnings (loss) per share before accounting change	$ 0.83	$ 0.28	$ (6.53)
Basic earnings (loss) per share[a]	0.83	0.28	(6.87)
Diluted earnings (loss) per share[a]	0.83	0.28	(6.87)
Cash dividends per share	0.20	0.20	0.15
Book value per share	$ 21.23	$ 21.50	$ 14.76
Balance Sheet Data:			
Cash and marketable securities	$ 52.3	$ 102.8	$ 83.4
Total assets	1,021.4	1,225.5	1,208.4
Long-term debt and capital lease obligations	281.8	500.0	487.8
Redeemable preferred stock	60.7	60.9	61.2
Shareholders' equity	$ 279.8	$ 284.4	$ 196.7
Return on average shareholders' equity[b]	3.6%	1.3%	(38.0%)
Ratio of earnings to fixed charges[c]	1.13	0.97	(0.37)
Alaska Airlines Operating Data:			
Revenue passenger miles (000,000)	4,494	4,948	5,537
Available seat miles (000,000)	8,380	8,789	9,617
Revenue passenger load factor	53.6%	56.3%	57.6%
Breakeven passenger load factor	51.9%	55.9%	66.4%
Yield per passenger mile	17.76¢	16.70¢	14.50¢
Operating revenues per available seat mile	10.55¢	10.48¢	9.44¢
Operating expenses per available seat mile	10.25¢	10.16¢	10.49¢
Average full-time equivalent employees	5,822	6,127	6,514
Horizon Air Operating Data:			
Revenue passenger miles (000,000)	357	405	486
Available seat miles (000,000)	720	786	905
Revenue passenger load factor	49.6%	51.5%	53.7%
Breakeven passenger load factor	49.0%	49.6%	52.1%
Yield per passenger mile	43.37¢	42.88¢	40.69¢
Operating revenues per available seat mile	22.75¢	23.30¢	23.00¢
Operating expenses per available seat mile	21.95¢	22.30¢	22.19¢
Average full-time equivalent employees	1,831	1,953	2,152

(a) For 1992, basic and diluted earnings per share include $(0.34) for the $4.6 million cumulative effect of the accounting change for postretirement benefits.
For 2000, basic and diluted earnings per share include $(2.15) for the $56.9 million cumulative effect of the accounting change for the sale of frequent flyer miles.

1993	1994	1995	1996	1997	1998	1999	**2000**
$ 1,002.0	$ 1,170.2	$ 1,258.2	$ 1,427.7	$ 1,574.5	$ 1,728.0	$ 1,904.8	**$ 2,032.3**
126.3	145.4	159.3	164.5	164.9	169.7	177.2	**144.9**
1,128.3	1,315.6	1,417.5	1,592.2	1,739.4	1,897.7	2,082.0	**2,177.2**
(1,145.1)	(1,241.6)	(1,341.8)	(1,503.2)	(1,600.4)	(1,686.7)	(1,882.1)	**(2,197.8)**
(16.8)	74.0	75.7	89.0	139.0	211.0	199.9	**(20.6)**
(37.2)	(46.6)	(51.3)	(37.4)	(28.3)	(14.6)	(6.1)	**(20.5)**
7.1	7.8	10.4	11.1	10.6	22.2	20.2	**24.3**
1.1	5.8	(0.8)	1.6	2.3	(14.2)	6.7	**1.1**
(45.8)	41.0	34.0	64.3	123.6	204.4	220.7	**(15.7)**
(30.9)	22.5	17.3	38.0	72.4	124.4	134.2	**(13.4)**
$ (30.9)	$ 22.5	$ 17.3	$ 38.0	$ 72.4	$ 124.4	$ 134.2	**$ (70.3)**
13.340	13.367	13.471	14.241	14.785	23.388	26.372	**26.440**
$ (2.51)	$ 1.69	$ 1.28	$ 2.67	$ 4.90	$ 5.32	$ 5.09	**$ (0.51)**
(2.51)	1.69	1.28	2.67	4.90	5.32	5.09	**(2.66)**
(2.51)	1.62	1.26	2.05	3.53	4.81	5.06	**(2.66)**
—	—	—	—	—	—	—	**—**
$ 12.51	$ 14.27	$ 15.67	$ 18.83	$ 26.00	$ 30.11	$ 35.24	**$ 32.59**
$ 101.1	$ 104.9	$ 135.1	$ 101.8	$ 212.7	$ 306.6	$ 329.0	**$ 461.7**
1,135.0	1,315.8	1,313.4	1,311.4	1,533.1	1,731.8	2,180.1	**2,630.0**
525.4	589.9	522.4	404.1	401.4	171.5	337.0	**609.2**
—	—	—	—	—	—	—	**—**
$ 166.8	$ 191.3	$ 212.5	$ 272.5	$ 475.3	$ 789.5	$ 930.7	**$ 862.3**
(18.4%)	12.6%	8.6%	15.7%	19.4%	19.7%	15.6%	**(7.8%)**
0.51	1.36	1.28	1.57	2.10	2.93	3.14	**0.73**
5,514	7,587	8,584	9,831	10,386	11,283	11,777	**11,986**
9,426	12,082	13,885	14,904	15,436	16,807	17,341	**17,315**
58.5%	62.8%	61.8%	66.0%	67.3%	67.1%	67.9%	**69.2%**
61.7%	60.2%	59.4%	62.4%	60.5%	58.0%	59.1%	**69.7%**
14.32¢	12.20¢	11.59¢	11.67¢	12.49¢	12.50¢	12.90¢	**13.50¢**
9.62¢	8.79¢	8.23¢	8.70¢	9.38¢	9.32¢	9.69¢	**10.10¢**
9.88¢	8.27¢	7.71¢	8.10¢	8.51¢	8.17¢	8.68¢	**10.18¢**
6,191	6,486	6,993	7,652	8,236	8,704	9,183	**9,611**
560	733	841	867	889	1,143	1,379	**1,428**
986	1,165	1,414	1,462	1,446	1,815	2,194	**2,299**
56.8%	62.9%	59.5%	59.3%	61.5%	63.0%	62.9%	**62.1%**
54.5%	59.1%	58.5%	59.3%	60.2%	59.1%	58.4%	**63.2%**
37.93¢	33.35¢	31.48¢	33.14¢	32.56¢	29.01¢	28.77¢	**29.85¢**
22.65¢	22.06¢	19.77¢	20.61¢	21.00¢	19.16¢	18.96¢	**19.29¢**
21.76¢	20.95¢	19.47¢	20.60¢	20.60¢	18.16¢	17.83¢	**19.54¢**
2,267	2,557	2,864	2,891	2,756	3,019	3,603	**3,795**

(b) For the 1990-1993 calculations, net income (loss) was reduced for preferred stock dividends, and shareholders' equity excluded redeemable preferred stock.

(c) For 1991, 1992, 1993 and 2000, earnings are inadequate to cover fixed charges by $2.4 million, $142.1 million, $50.0 million and $31.2 million, respectively.

Alaska Air Group Directors

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Chairman, President & CEO
Alaska Air Group

William S. Ayer, *age 46*
President & COO
Alaska Airlines

Ronald F. Cosgrave, *age 69*
Executive Manager
ANP, LLC
& Chairman Emeritus
Alaska Airlines

Mary Jane Fate, *age 67*
General Manager of
family business

Bruce R. Kennedy, *age 62*
Chairman Emeritus
Alaska Air Group

R. Marc Langland, *age 59*
Chairman, President & CEO
Northrim Bank

Byron I. Mallott, *age 57*
President
First Alaskans Foundation

John V. Rindlaub, *age 56*
President
Bank of America, Northwest

J. Kenneth Thompson, *age 49*
Chairman & CEO
Pacific Rim Leadership
Development

Richard A. Wien, *age 65*
Chairman & CEO
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John F. Kelly
R. Marc Langland

Nominating:
Bruce R. Kennedy, Chairman
Ronald F. Cosgrave
R. Marc Langland

Safety:
Richard A. Wien, Chairman
J. Kenneth Thompson

Sitting from left:
Bruce R. Kennedy
John F. Kelly
Ronald F. Cosgrave

Standing from left:
J. Kenneth Thompson
Byron I. Mallott
William S. Ayer
Mary Jane Fate
Richard A. Wien
John V. Rindlaub
R. Marc Langland

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Chairman, President & CEO

Keith Loveless
Vice President Legal & Corporate Affairs General Counsel & Corporate Secretary

Bradley D. Tilden
Vice President Finance & Chief Financial Officer

Alaska Airlines Officers

John F. Kelly
Chairman & CEO

William S. Ayer
President & COO

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Information & Communications Services

Gregg A. Saretsky
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Horizon Air Officers

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Thomas M. Gerharter
Senior Vice President Operations

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Daniel S. Scott
Flight Operations

Arthur E. Thomas
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Patrick A. Zachwieja
Marketing & Planning