ALASKA AIR GROUP INC
Form 10-K
February 17, 2006
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UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

WASHINGTON, DC 20549

FORM 10-K

(Mark One)

x **ANNUAL REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934** ***[NO FEE REQUIRED]***

For the fiscal year ended December 31, 2005

OR

¨ **TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934** ***[NO FEE REQUIRED]***

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	**91-1292054**

(State or other jurisdiction of incorporation or organization)	**(I.R.S. Employer Identification No.)**

19300 International Boulevard, Seattle, Washington 98188

(Address of Principal Executive Offices)

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

Securities registered pursuant to Section 12(b) of the Act:

Title of Each Class	Name of Each Exchange on Which Registered
Common Stock, $1.00 Par Value	New York Stock Exchange

Securities registered pursuant to Section 12(g) of the Act: None

Indicate by check mark if the registrant is a well-known seasoned issuer, as defined in Rule 405 of the Securities Act. Yes **x** No ¨

Indicate by check mark if the registrant is not required to file reports pursuant to Section 13 or Section 15(d) of the Act. Yes ¨ No **x**

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

Indicate by check mark if disclosure of delinquent filers pursuant to Item 405 of Regulation S-K is not contained herein, and will not be contained, to the best of registrant s knowledge, in definitive proxy or information statements incorporated by reference in Part III of this Form 10-K or any amendment to this Form 10-K. x

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, or a non-accelerated filer. See definition of accelerated filer and large accelerated filer in Rule 12b-2 of the Exchange Act (Check one):

Large accelerated filer **x** Accelerated filer ¨ Non-accelerated filer ¨

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act.): Yes ¨ No x

As of December 31, 2005, shares of common stock outstanding totaled 33,454,146. The aggregate market value of the shares of common stock of Alaska Air Group, Inc. held by nonaffiliates on June 30, 2005, was approximately $991 million (based on the closing price of $29.75 per share on the New York Stock Exchange on that date).

DOCUMENTS TO BE INCORPORATED BY REFERENCE

Title of Document	Part Hereof Into Which Document is to be Incorporated
Definitive Proxy Statement Relating to 2006 Annual Meeting of Shareholders	Part III

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ALASKA AIR GROUP, INC.

Annual Report on Form 10-K for the year ended December 31, 2005

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Cautionary Note regarding Forward-Looking Statements

In addition to historical information, this Form 10-K contains forward-looking statements within the meaning of Section 27A of the Securities Act of 1933, as amended, and Section 21E of the Securities Exchange Act of 1934, as amended. Forward-looking statements are those that predict or describe future events or trends and that do not relate solely to historical matters. You can generally identify forward-looking statements as statements containing the words believe, expect, will, anticipate, intend, estimate, project, assume or other similar exp although not all forward-looking statements contain these identifying words. Forward-looking statements include, without limitation, our expectations concerning operations and financial conditions, including changes in capacity, revenues and costs, future financing plans and needs, overall economic conditions, plans and objectives for future operations, and the impact on us of our results of operations in recent years and the sufficiency of our financial resources to absorb that impact. Other forward-looking statements include statements which do not relate solely to historical facts, such as, without limitation, statements which discuss the possible future effects of current known trends or uncertainties, or which indicate that the future effects of known trends or uncertainties cannot be predicted, guaranteed, or assured. 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. Our forward-looking statements are based on the information currently available to us and speak only as of the date on which this report was filed with the SEC. We expressly disclaim any obligation to issue any updates or revisions to our forward-looking statements, even if subsequent events cause our expectations to change regarding the matters discussed in those

statements. 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 to our shareholders. Many important factors that could cause such a difference are described in this Form 10-K, on page 12, under the caption Item 1A: Risk Factors, and beginning on page 42 under the caption Risk Factors under Item 7 below, which you should review carefully. Please consider our forward-looking statements in light of those risks as you read this report.

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PART I

ITEM 1. ***BUSINESS***

GENERAL INFORMATION

Alaska Air Group, Inc. (Air Group or the Company) is a holding company that was incorporated in Delaware in 1985. Our two principal subsidiaries are Alaska Airlines, Inc. (Alaska) and Horizon Air Industries, Inc. (Horizon). Both subsidiaries operate as airlines, although their business plans, competition, and economic risks differ substantially. Alaska is a major airline, operates an all-jet fleet, and its average passenger trip length is 1,009 miles. Horizon is a regional airline, operates jet and turboprop aircraft, and its average passenger trip is 382 miles. Individual financial information for Alaska and Horizon is reported in Note 13 to the Consolidated Financial Statements.

Air Group s corporate offices are located at 19300 International Boulevard, Seattle, Washington, 98188. Air Group s filings with the Securities and Exchange Commission, including its annual report on Form 10-K, quarterly reports on Form 10-Q, 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 annual report on Form 10-K. As used in this Form 10-K, the terms Air Group, our, we and the Company refer to Alaska Air Group, Inc. and its subsidiaries, unless the context indicates otherwise.

Alaska

Alaska Airlines, Inc. is an Alaska corporation that was organized in 1932 and incorporated in 1937. Alaska principally serves destinations in the state of Alaska and North/South service between cities in the Western U.S., Canada and Mexico. Alaska also provides East/West service to 8 cities, primarily from Seattle. In 2005, Alaska carried 16.8 million revenue passengers. In each year since 1973, Alaska has carried more passengers between Alaska and the U.S. mainland than any other airline. West Coast passenger traffic accounted for 47% of Alaska s 2005 revenue passenger miles, passenger traffic within Alaska and between Alaska and the U.S. mainland accounted for 20%, the Mexico markets accounted for 10%, the Canada markets accounted for 5%, and other markets accounted for 18%. Based on passenger enplanements, Alaska s leading airports are Seattle, Los Angeles, Portland and Anchorage. Based on 2005 revenues, its leading nonstop routes are Seattle-Anchorage, Seattle-Los Angeles, and Seattle-San Diego. At December 31, 2005, Alaska s operating fleet consisted of 110 jet aircraft.

Horizon

Horizon Air Industries, Inc., a Washington corporation, was acquired by Air Group in 1986. It is the largest regional airline in the Pacific Northwest, and serves 40 cities in seven states and six cities in Canada under the Horizon brand. The Horizon brand flying consists of Horizon s native network flying and contract flying for Alaska. In addition to operating under the Horizon brand, on January 1, 2004, Horizon began operating regional jet service branded as Frontier JetExpress under a 12-year agreement with Frontier Airlines. Horizon is currently operating nine 70-seat Bombardier CRJ-700 aircraft under the Frontier JetExpress brand, representing approximately 23% of total Horizon capacity and approximately 9% of total Horizon revenue in 2005. In 2005, Horizon carried 6.5 million revenue passengers. Approximately 95% of Horizon s revenue passenger miles are flown domestically, primarily in the states of Washington, Oregon and Idaho. The Canada markets accounted for 5% of revenue passenger miles in 2005. Based on passenger enplanements, Horizon s leading airports are Seattle, Portland, Boise, and Spokane. Based on revenues in 2005, its leading nonstop routes are Portland-Seattle, Spokane-Seattle, and Seattle-Vancouver. At December 31, 2005, Horizon s operating fleet consisted of 19 jets and 46 turboprop aircraft. Except for those flights operating as Frontier JetExpress, Horizon flights

are listed under the Alaska Airlines designator code in airline reservation systems.

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Alaska and Horizon integrate their flight schedules to provide service between any two points served by their systems. In 2005, 24% of Horizon s passengers connected to flights operated by Alaska compared to 28% in 2004. Both airlines endeavor to distinguish themselves from competitors by providing a higher level of customer service. The airlines outstanding employees and excellent service in the form of advance seat assignments, expedited check-in, attention to customer needs, a generous frequent flyer program, well-maintained aircraft, a first-class section aboard Alaska aircraft, and other amenities are regularly recognized by independent studies and surveys of air travelers.

Industry Conditions

The airline industry is highly competitive and is characterized by low profit margins and high fixed costs, primarily for wages, aircraft fuel, aircraft ownership costs and facilities rents. Because expenses of a flight do not vary significantly with the number of passengers carried, a relatively small change in the number of passengers or in pricing has a disproportionate effect on an airline s operating and financial results. Accordingly, a minor shortfall in expected revenue levels could cause a disproportionately negative impact on our results of operations. Passenger demand and ticket prices are, to a large measure, influenced by the general state of the economy, current events and industry capacity.

The industry is currently in a state of flux. The airline industry continued to be challenged in 2005, resulting in bankruptcy filings by several of the major legacy carriers during the year, including Delta Airlines and Northwest Airlines. Under bankruptcy reorganization, carriers gain a competitive advantage by significantly reducing their costs. In addition, so called Low Cost Carriers (LCCs) have continued to grow rapidly and currently carry more than 30% of total U.S. domestic passenger traffic. Because of their cost advantage, LCCs have and continue to exert downward pressure on ticket prices from historical levels, although fares have increased on average in 2005 in response to high fuel prices. Because of the relatively low barriers to entry, we expect the expansion of low cost and low fare carriers to continue. We compete with many of these carriers now, and expect to compete with new entrants in the future.

Most major US carriers, including Alaska, are working aggressively to cut operating costs, including renegotiation of collective bargaining agreements and vendor agreements. Labor costs generally make up 30% to 40% of an airline s total operating costs. Most major airlines, including ours, have employee groups who are represented by collective bargaining agreements. Often, airlines with unionized work forces have higher labor costs than carriers without unionized work forces, and may not have the ability to adjust labor costs downward fast enough to respond to new competition. We have been able to reduce our wage and benefit costs during 2005 primarily as a result of a reduction in pilot wages which took effect in May 2005, subcontracting our ramp services operation in Seattle beginning in the second quarter of 2005, the closure of our heavy maintenance facility in Oakland, the subcontracting of our fleet services, and our management reorganization, all of which occurred during the last six months of 2004. Our wage and benefit costs decreased 5% in 2005, versus increases of 3% and 10% in 2004 and 2003, respectively.

Fuel costs generally represent 15% to 25% of an airline s operating costs. Fuel prices can be volatile and largely uncontrollable. Fuel prices have increased significantly over the past three years. Our fuel cost per gallon increased 36%, 44%, and 15% in 2005, 2004 and 2003, respectively. Our economic fuel cost per gallon (which is the net price we pay after the benefit of settled fuel hedges) increased 21% in 2005, 39% in 2004 and 14% in 2003.

During 2005 and 2004, load factors increased in the wake of strong demand and a healthy economy. Load factor growth slowed in the second half of 2005; however, revenues remained strong due to improving yields as the industry responded to record high fuel prices.

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MARKETING AND COMPETITION

Alliances with Other Airlines

Alaska and Horizon have marketing alliances with other airlines that provide reciprocal frequent flyer mileage credit and redemption privileges and code sharing on certain flights as set forth below. Alliances enhance Alaska s and Horizon s revenues by offering our customers more travel destinations and better mileage credit/redemption opportunities and by gaining us access to more connecting traffic from other airlines, and by providing members of our alliance partners frequent flyer programs an opportunity to travel on Alaska and Horizon while earning mileage credit in our partners programs. Our marketing agreements have various termination dates and at any time, one or more may be in the process of renegotiation. If a significant agreement were terminated, it could adversely impact revenues and increase the costs of our other marketing agreements. In September 2005, both Northwest and Delta filed for protection under Chapter 11 of the Bankruptcy Code, followed by Era Aviation in December 2005. Any of these carriers could propose plans of reorganization that would seek to modify or terminate some or all of these agreements.

Most of our code share relationships are free-sell code shares, where the marketing carrier sells seats on the operating carrier s flights from the operating carrier s inventory, but takes no inventory risk. The table below identifies our marketing alliances with other airlines as of December 31, 2005.

	Frequent Flyer Agreement	Code sharing Alaska Flight # on Flights Operated by Other Airline	Code sharing Other Airline Flight # On Flights Operated by Alaska/Horizon
Major U.S. or International Airlines			
American Airlines/American Eagle	Yes	Yes	Yes
British Airways	Yes	No	No
Cathay Pacific Airways	Yes	No	No
Continental Airlines	Yes	Yes	Yes
Delta	Yes	Yes	Yes
Frontier Airlines**	No	No	Yes
Hawaiian Airlines	Yes	Yes	Yes
KLM	No	No	Yes
Lan Chile	Yes	No	Yes
Northwest Airlines	Yes	Yes	Yes
Qantas	Yes	No	Yes
Commuter Airlines			
Era Aviation	Yes*	Yes	No
PenAir	Yes*	Yes	No
Big Sky Airlines	Yes*	Yes	No

* This airline does not have its own frequent flyer program. However, Alaska s Mileage Plan members can earn and redeem miles on this airline s route system.

** Capacity purchase arrangement as described under Business General Information Horizon.

Competition

Competition in the airline industry is intense. We believe the principal competitive factors in the industry that are important to customers are:

- safety record and reputation;
- flight schedules;
- fares;

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- customer service;
- routes served;
- frequent flyer programs;
- on-time arrivals;
- on-board amenities;
- type of aircraft and
- code-sharing relationships.

Any domestic air carrier issued a certificate of public convenience and necessity by the Department of Transportation (DOT) and an operating certificate from the Federal Aviation Administration (FAA) is allowed to operate scheduled passenger service in the United States. Together, Alaska and Horizon carry approximately 3.3% of all U.S. domestic passenger traffic. Alaska and Horizon compete with one or more domestic or foreign airlines on most of their routes, including Southwest Airlines, United Airlines, Northwest Airlines, Continental Airlines, American Airlines, Delta Airlines and regional affiliates associated with some of these carriers. Many of these airlines are larger and have significantly greater financial resources and name recognition or lower operating costs than our company. Others are operating under bankruptcy court protection and may institute substantial fare discounts in order to maintain cash flows and enhance customer loyalty. In addition, competitors who successfully reorganize out of bankruptcy could have lower operating costs derived from renegotiated labor, supply and financing agreements. Some of these competitors have chosen to add service, reduce their fares, or both, in our markets. Continuing growth of low-cost carriers, including Southwest Airlines, AirTran Airways, Frontier Airlines, jetBlue Airways, and the emergence of Virgin America, in the United States, places significant competitive pressures on us and other network carriers since they have the ability to charge a lower fare for travel between similar cities and thus exert downward pressure on yields. As such, we may be unable to compete effectively against other airlines that introduce service or discounted fares in the markets that we serve. Due to its short haul markets, Horizon also competes with ground transportation, including train, bus and automobile transportation.

Ticket Distribution

Airline tickets are distributed through three primary channels:

- Airline websites such as alaskaair.com or horizonair.com. It is less expensive for us to sell through these direct channels and, as a result, we continue to invest in online capabilities.
- Traditional and online travel agents. Consumer reliance on traditional travel agencies is shrinking, while usage of online travel agencies is increasing. Both traditional and online travel agencies typically use Global Distribution Systems (GDS), such as Sabre, to obtain their fare and inventory data from airlines. Bookings made through these agencies result in a fee, the GDS fee, that is charged to the airline.

Telephone reservation call centers.

We currently participate in all of these distribution channels, but we cannot predict the terms on which we may be able to continue to participate in these or other channels, or their effect on our ability to compete with other airlines.

EMPLOYEES

The airline business is labor intensive. Air Group had 13,768 (Alaska and Horizon had 9,866 and 3,902, respectively) active full-time and part-time employees at December 31, 2005, compared to 14,584 (10,850 at Alaska and 3,734 at Horizon) as of December 31, 2004. Wages, salaries and benefits represented approximately 31% and 35% of our total operating expenses in 2005 and 2004, respectively.

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At December 31, 2005, labor unions represented 84% of Alaska s and 46% of Horizon s employees. Our relations with our labor organizations are governed by the Railway Labor Act (RLA). Under this act, the collective bargaining agreements between the respective airlines and these organizations do not expire but instead become amendable as of a stated date. If either party wishes to modify the terms of any such agreement, it must notify the other party in the manner prescribed by the RLA and/or described in the agreement. After receipt of such notice, the parties must meet for direct negotiations, and if no agreement is reached, either party may request the National Mediation Board to appoint a federal mediator. If no agreement is reached in mediation, the National Mediation Board may declare that an impasse exists, at which point the National Mediation Board proffers binding arbitration to the parties. Either party may decline to submit to arbitration. If arbitration is rejected by either party, a 30-day cooling off period commences. During that period, a Presidential Emergency Board may be established, which examines the parties positions and recommends a solution. The Presidential Emergency Board process lasts for 30 days and is followed by a cooling off period of 30 days. At the end of a cooling off period, unless an agreement is reached or action is taken by Congress, the labor organization may strike and the airline may resort to self-help , including the imposition of any or all of its proposed amendments and the hiring of workers to replace strikers.

Alaska s union contracts at December 31, 2005 were as follows:

Union	Employee Group	Number of Employees	Contract Status
Air Line Pilots Association International (ALPA)	Pilots	1,450	Amendable 5/01/07
Association of Flight Attendants (AFA)	Flight attendants	2,486	In Negotiations
International Association of Machinists and Aerospace Workers (IAM/RSSA)	Ramp service and stock clerks	630	In Negotiations
	Clerical, office and passenger service	2,868	In Negotiations
Aircraft Mechanics Fraternal Association (AMFA)	Mechanics, inspectors and cleaners	707	Amendable 10/01/09
Mexico Workers Association of Air Transport	Mexico airport personnel	79	Amendable 9/29/06
Transport Workers Union of America (TWU)	Dispatchers	34	Amendable 7/01/10*

* Collective bargaining agreement contains interest arbitration provision.

Horizon s union contracts at December 31, 2005 were as follows:

Union	Employee Group	Number of Employees	Contract Status
International Brotherhood of Teamsters (IBT)	Pilots	696	Amendable 9/12/06
AFA	Flight attendants	544	Amendable 11/21/07
AMFA	Mechanics and related classifications	450	Amendable 11/30/08
TWU	Dispatchers	21	Amendable 9/9/07
National Automobile, Aerospace, Transportation and General Workers	Station personnel in Vancouver and Victoria, BC, Canada	88	Amendable 2/14/07

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REGULATION

General

The Airline Deregulation Act of 1978, as amended, eliminated most domestic economic regulation of passenger and freight transportation. However, the Department of Transportation (DOT) and the Federal Aviation Administration (FAA) still exercise significant regulatory authority over air carriers. In order to provide passenger and cargo air transportation in the U.S., a domestic airline is required to hold a certificate of public convenience and necessity issued by the DOT. Subject to certain individual airport capacity, noise and other restrictions, this certificate permits an air carrier to operate between any two points in the U.S. A certificate is of unlimited duration, but may be revoked for failure to comply with federal aviation statutes, regulations, orders or the terms of the certificate itself. In addition, the DOT maintains jurisdiction over the approval of international code share agreements, alliance agreements between domestic major airlines, international route authorities and certain consumer protection matters, such as advertising, denied boarding compensation and baggage liability.

The FAA, through the promulgation of the Federal Aviation Regulations (FARs), generally regulates all aspects of airline operations, including establishing personnel, maintenance and flight operation standards. Domestic airlines are required to hold a valid air carrier-operating certificate issued by the FAA. Pursuant to these regulations, we have established, and the FAA has approved, both our operations specifications and a maintenance program for each type of aircraft we operate. The maintenance program provides for the ongoing maintenance of such aircraft, ranging from frequent routine inspections to major overhauls. From time to time the FAA issues airworthiness directives (ADs) that must be incorporated into our aircraft maintenance program and operations. We are and expect to be in compliance with all applicable requirements of these ADs within the required time periods. All airlines, including Alaska and Horizon, are subject to routine enforcement actions, from time to time, brought by the FAA for alleged violations of the requirements of the FARs or ADs. At this time, we are not aware of any enforcement proceedings that could either materially affect our financial position or impact our authority to operate.

The Department of Justice has jurisdiction over airline antitrust matters. The U.S. Postal Service has jurisdiction over certain aspects of the transportation of mail and related services. Labor relations in the air transportation industry are regulated under the Railway Labor Act, which vests in the National Mediation Board (NMB) certain functions with respect to disputes between airlines and labor unions relating to union representation and collective bargaining agreements. To the extent we continue to fly to foreign countries and pursue alliances with international carriers, we may be subject to certain regulations of foreign agencies.

The Aviation and Transportation Security Act (the Security Act) generally provides for enhanced aviation security measures. Pursuant to the Security Act, the Transportation Security Administration (TSA) is responsible for aviation security. The Security Act mandates that the TSA shall provide for the screening of all passengers and property, including U.S. mail, cargo, carry-on and checked baggage, and other articles that will be carried aboard a passenger aircraft. The TSA performs these functions with its own federal employees. The TSA also provides for increased security on flight decks of aircraft and requires federal air marshals to be present on certain flights.

The Security Act imposes a $2.50 per enplanement security service fee (maximum $5.00 one-way fee), which is collected by the air carriers and submitted to the government to pay for these enhanced security measures. In addition, carriers are required to pay an additional amount to the TSA to cover the total cost of providing security measures equal to the amount the air carriers paid for screening passengers and property in 2000. We paid $12.6 million to TSA for this security charge in both 2005 and 2004, and $8.4 million in 2003. In January 2006, the TSA notified air carriers of an increased assessment for the cost of security. The industry has opposed and disagrees with the higher assessment and is working with the TSA on a resolution. The additional assessment for us was not material. Separate from the TSA assessment, the U.S. Congress is currently considering a new law that could significantly increase this security fee.

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Airline Fares

Airlines are permitted to establish their own domestic fares without governmental regulation, and the industry is characterized by vigorous price competition. The DOT maintains authority over international (generally outside of North America) fares, rates and charges. International fares and rates are also subject to the jurisdiction of the governments of the foreign countries we serve. While air carriers are required to file and adhere to international fare and rate tariffs, substantial commissions, overrides and discounts to travel agents, brokers and wholesalers characterize many international markets.

Although we do not currently anticipate such, to the extent legislation is enacted that would inhibit our flexibility with respect to fares, our revenue management system, our operations or other aspects of our customer service operations, our financial results could be adversely affected.

Environmental Matters

We are subject to various laws and government regulations concerning environmental matters and employee safety and health in the U.S. and other countries. U.S. federal laws that have a particular impact on us include the Airport Noise and Capacity Act of 1990, the Clean Air Act, the Resource Conservation and Recovery Act, the Clean Water Act, the Safe Drinking Water Act, and the Comprehensive Environmental Response, Compensation and Liability Act, or Superfund Act. We are also subject to the oversight of the Occupational Safety and Health Administration, known as OSHA, concerning employee safety and health matters. The U.S. Environmental Protection Agency, or EPA, OSHA, and other federal agencies have been authorized to promulgate regulations that have an impact on our operations. In addition to these federal activities, various states have been delegated certain authorities under the aforementioned federal statutes. Many state and local governments have adopted environmental and employee safety and health laws and regulations, some of which are similar to federal requirements. We maintain our own continuing safety, health and environmental programs in order to meet or exceed these requirements.

The Airport Noise and Capacity Act recognizes the rights of airport operators with noise problems to implement local noise abatement programs so long as they do not interfere unreasonably with interstate or foreign commerce or the national air transportation system. Authorities in several cities have promulgated aircraft noise reduction programs, including the imposition of nighttime curfews. The Airport Noise and Capacity Act generally requires FAA approval of local noise restrictions on aircraft. We have had and believe we will continue to have sufficient scheduling flexibility to accommodate local noise restrictions.

At December 31, 2005, all of our aircraft met the Stage 3 noise requirements under the Airport Noise and Capacity Act of 1990. However, special noise ordinances restrict the timing of flights operated by Alaska, Horizon and other airlines at Burbank, Long Beach, Orange County, San Diego, San Jose, Sun Valley, Chicago O Hare, and Palm Springs. In addition, Orange County, Reagan National, and Long Beach airports restrict the type of aircraft and number of flights.

Although we do not currently anticipate that these regulatory matters, individually or collectively, will have a material impact on our financial condition, results of operations or cash flows, we cannot be assured that new regulations or compliance issues that we do not currently anticipate will not harm our financial condition, results of operations or cash flows in future periods.

Customer Service

Along with other domestic airlines, we have implemented a Customer Service Plan to address a number of service goals, including, but not limited to, goals relating to lowest fare availability, delays, cancellations and diversions, baggage delivery and liability, guaranteed fares and ticket refunds.

FUEL

Our operations are significantly affected by the price and, potentially, the availability of jet fuel. Fuel costs were approximately 24% of our total operating expenses in 2005, 19% in 2004, and 15% in 2003, before the benefit of fuel hedges that settled during the period. Raw, or unhedged, fuel prices, which are volatile and outside of our control, can have a significant impact on our operating results. Currently, a one-cent change in the economic fuel price per gallon affects annual fuel costs by approximately $4.0 million. We believe that operating fuel-efficient aircraft helps to mitigate the effect of high fuel prices.

In order to reduce our exposure to fluctuations in the price of jet fuel, we purchase fuel hedge contracts that include call options and collar agreements and, in addition, we have entered into a fuel purchase agreement that fixes the spread between crude oil prices and jet fuel prices. Due to the competitive nature of the airline industry, airlines often have been unable to pass on increased fuel prices to customers by increasing fares; although, some fuel-related industry fare increases have occurred recently. Conversely, any potential benefit of lower fuel prices may be offset by increased fare competition and lower revenues. Because of rising fuel prices over the last few years, our fuel-hedging program has resulted in significant savings. See Item 7, Management s Discussion and Analysis of Financial Condition and Results of Operations, for a discussion of our fuel hedging activities.

While we do not currently anticipate a significant reduction in fuel availability, dependency on foreign imports of crude oil and the possibility of changes in government policy on jet fuel production, transportation and marketing make it impossible to predict the future availability of jet fuel. In the event of significant hostilities or other conflicts in oil producing areas, there could be reductions in the production and/or importation of crude oil and resulting price increases, which could adversely affect our business. If there were major reductions in the availability of jet fuel, our business would be adversely affected.

MILEAGE PLAN PROGRAM

All major airlines have developed frequent flyer programs as a way of increasing passenger loyalty. Alaska s Mileage Plan allows members to earn mileage by flying on Alaska, Horizon and other participating airlines, and by using the services of non-airline partners, which include a credit card partner, a grocery store chain, a telephone company, hotels, and car rental agencies. Alaska is paid by non-airline partners for the miles it credits to member accounts. With advance notice, Alaska has the ability to change the Mileage Plan terms, conditions, partners, mileage credits, and award levels or terminate the program.

Mileage can be redeemed for free or discounted travel and for other travel industry awards. Upon accumulating the necessary mileage, members notify Alaska of their award selection. Over 75% of the free flight awards on Alaska and Horizon are subject to capacity-controlled seating. Mileage Plan accounts are generally deleted after three years of inactivity in that member s account. As of December 31, 2005 and 2004, Alaska estimated that approximately 3.0 million and 2.5 million, respectively, round-trip flight awards were eligible for redemption by Mileage Plan members who have mileage credits exceeding the 20,000-mile free round-trip domestic ticket award threshold. Of those eligible awards, Alaska estimated that approximately 88% of those awards would ultimately be redeemed. For the years 2005, 2004, and 2003, approximately 750,000 631,000, and 606,000, round-trip flight awards were redeemed and flown on Alaska and Horizon. Those awards represent approximately 7.9%, 7.3%, and 8.7% for 2005, 2004, and 2003, respectively, of the total passenger miles flown on Alaska and Horizon. For the years 2005, 2004, and 2003, approximately 239,900, 212,000, and 174,000, respectively, round-trip flight awards were redeemed and flown on airline partners.

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. The incremental cost does not include a contribution to overhead, aircraft cost, or

profit. Alaska also sells mileage credits to its non-airline partners. Alaska defers a majority of the sales proceeds, and recognizes these proceeds as revenue when the award transportation is provided on Alaska or another partner airline. The deferred proceeds

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are recognized as passenger revenue for awards issued and flown on Alaska or Horizon and as other revenue-net for awards issued and flown on other airlines. At December 31, 2005 and 2004, the deferred revenue and the total liability for providing free travel on Alaska and Horizon and for estimated payments to partner airlines was $466.8 million and $409.3 million, respectively, the majority of which is deferred revenue from the sale of mileage credits. Revenue attributable to the Mileage Plan was $180.2 million, $143.1 million, and $139.0 million in 2005, 2004 and 2003, respectively.

OTHER INFORMATION

Seasonality and Other Factors

Our results of operations for any interim period are not necessarily indicative of those for the entire year, because our business is subject to seasonal fluctuations. Our operating income is generally lowest (or loss the greatest) during the first and fourth quarters due principally to lower traffic and sometimes due to adverse weather conditions, generally increases in the second quarter and generally reaches its highest level during the third quarter as a result of spring and summer vacation travel, including increased activity in the state of Alaska.

In addition to passenger loads, factors that could cause our quarterly operating results to vary include:

- changes in fuel, security and insurance costs,
- increases in personnel, marketing, aircraft ownership and other operating expenses to support our existing operation and anticipated growth,
- the timing and amount of maintenance expenditures,
- the timing and success of our growth plan as we increase flights in existing markets and enter new markets and
- pricing initiatives.

In addition, seasonal variations in traffic, the timing of various expenditures and weather affect our operating results from quarter to quarter. Many of our areas of operations experience inclement weather conditions in the winter, causing increased costs associated with deicing aircraft, canceled flights and accommodating displaced passengers. Due to our geographic area of operations, we can be more susceptible to adverse weather conditions (particularly in the State of Alaska and in the Pacific Northwest) than some of our competitors, who may be better able to spread weather-related risks over larger route systems.

The results of operations in the air transportation business have also significantly fluctuated in the past in response to general economic conditions. Fare initiatives, fluctuations in fuel prices, labor actions and other factors could impact this seasonal pattern.

No material part of our business or that of our subsidiaries is dependent upon a single customer or very few customers. Consequently, the loss of our largest few customers would not have a material adverse effect upon our financial condition, results of operations or cash flows.

Insurance

We carry insurance for passenger liability and property and aircraft damage in amounts and of the type generally consistent with industry practice.

As a result of the events of September 11, 2001, aviation insurers have significantly reduced the maximum amount of insurance coverage available to commercial air carriers for third-party liability for claims resulting from acts of terrorism, war or similar events. At the same time, they significantly increased the premiums for such coverage as well as for aviation insurance in general. Although insurance rates have declined since that time, they are still somewhat above pre-September 11 levels and will likely remain there for the foreseeable future.

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Pursuant to authority granted in the Air Transportation Safety and System Stabilization Act, the Homeland Security Act of 2002, as amended by the Consolidated Appropriations Act, 2005, the Government has offered, and we have accepted, war risk insurance to replace commercial war risk insurance through August 31, 2006.

Other Government Matters

We have elected to participate in the Civil Reserve Air Fleet program, whereby we have agreed to make available to the federal government a certain number of aircraft in the event of a military call-up. The government would reimburse us for the use of such aircraft.

ITEM 1A. ***RISK FACTORS***

Our operations and financial results are subject to various uncertainties, such as global and industry instability, intense competition, volatile fuel prices, a largely unionized labor force, the need to finance large capital expenditures, government regulation, potential aircraft incidents and general economic conditions. Please see Risk Factors on page 42 for a full discussion of these items.

ITEM 1B. ***UNRESOLVED STAFF COMMENTS***

None

ITEM 2. ***PROPERTIES***

Aircraft

The following tables describe the aircraft we operate and their average age at December 31, 2005:

Aircraft Type	Passenger Capacity	Owned	Leased	Total	Average Age in Years
Alaska Airlines					
Boeing 737-200C	111	7		7	24.5
Boeing 737-400	144	9	31	40	10.7
Boeing 737-700	124	17	5	22	4.8
Boeing 737-800	160	2	1	3	0.7
Boeing 737-900	172	12		12	3.4
Boeing MD-80	140	15	11	26	13.8
		62	48	110	10.1

Horizon Air					
Bombardier Q200	37		28	28	7.8
Bombardier Q400	74	3	15	18	4.0
Bombardier CRJ 700*	70	1	18	19	3.6
		4	61	65	5.5

* Horizon also operates one CRJ 700 under a short-term operating lease set to expire in February 2006.

Part II, Item 7, Management s Discussion and Analysis of Financial Condition and Results of Operations, discusses future orders and options for additional aircraft.

As of December 31, 2005, 32 of the 62 aircraft owned by Alaska are subject to liens securing long-term debt and the majority of the other owned aircraft serve as collateral on our $160 million line of credit. Alaska s leased 737-400, 737-700, 737-800 and MD-80 aircraft have lease expiration dates between 2006 and 2016, between 2006 and 2010, in 2015, and between 2007 and 2013, respectively. Horizon s leased Q400 and CRJ 700 aircraft have expiration dates between 2006 and 2018 and between 2018 and 2020, respectively. Alaska and Horizon have the option to extend most of the leases for additional periods, or the right to purchase the aircraft at the end of the lease term, usually at the then-fair-market value of the aircraft.

Ground Facilities and Services

Alaska and Horizon lease ticket counters, gates, cargo and baggage space, office space, and other support areas at the majority of the airports they serve. Alaska also owns terminal buildings in various cities in the state of Alaska.

Alaska has centralized operations in several buildings located at or near Seattle-Tacoma International Airport (Sea-Tac) in Seattle, Washington. The owned buildings, including land unless located on leased airport property, include a three-bay hangar facility with maintenance shops, a flight operations and training center, an air cargo facility, an information-processing center, several office buildings and our corporate headquarters. Alaska also leases a two-bay hangar/office facility at Sea-Tac, a warehouse and reservation/office facility in Kent, WA, and a reservation center in Boise, ID. Alaska s other major facilities include a regional headquarters building and hangar in Anchorage, an air cargo facility, leased land in Anchorage, and a reservations center in Phoenix.

Horizon owns its Seattle corporate headquarters building. It leases an operations, training, and aircraft maintenance facility in Portland and maintenance facilities in Boise, Pasco, Seattle and Spokane.

During 2005, Alaska subcontracted its ground handling services at the Seattle-Tacoma International Airport to a vendor that provides similar services to Alaska at airports, including Portland, Los Angeles and San Francisco. Alaska continues to use its own employees for ground handling services at airports in the state of Alaska. Other airports throughout our system are contracted to various third-party vendors.

ITEM 3. ***LEGAL PROCEEDINGS***

In May 2005, the Air Line Pilots Association filed a lawsuit in federal district court in Seattle to overturn the current labor contract covering Alaska s pilots as established by an arbitrator, which was effective May 1, 2005. On July 21, 2005, Alaska filed a motion to dismiss the lawsuit. On October 28, 2005, the district court granted Alaska s motion to dismiss. This matter is closed.

In March 2005, Alaska filed a lawsuit in federal district court in Seattle against the International Association of Machinists (IAM) seeking to compel arbitration of a dispute regarding the permissibility, under the collective bargaining agreement, of subcontracting of Alaska s ramp service operation in Seattle. On May 10, 2005, the IAM filed a counter claim against Alaska alleging that Alaska violated the Railway Labor Act status quo and engaged in bad faith bargaining by, among other things, stating that it would subcontract the Seattle ramp work if it could not reach agreement with the IAM on an acceptable new labor contract. On May 13, 2005, Alaska subcontracted the ramp service operation in Seattle, resulting in the immediate reduction of approximately 475 employees represented by the IAM. Shortly after this event, the IAM filed a motion for preliminary injunction seeking to reverse the subcontracting by Alaska. That motion was heard and denied by a federal court judge on June 2, 2005. Alaska filed a motion to dismiss the IAM counterclaim. The court dismissed the IAM s status quo claim, and the bad faith bargaining claim to the extent it was based on the Seattle ramp subcontracting (as opposed to other conduct during the parties negotiations). The court stated that the IAM shall file an amended counterclaim by January 18, 2006, but the IAM did not do so. On February 6, 2006, the court entered an order directing the IAM to show cause why its counterclaim should not be dismissed for failure to prosecute. The IAM submitted its response to the court s order to show cause on February 16, 2006, but the court has not yet issued a ruling on the matter. A trial date has been set for September 2006.

In addition to the cases noted above, we are a party to 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.

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ITEM 4. ***SUBMISSION OF MATTERS TO A VOTE OF SECURITY HOLDERS***

None

EXECUTIVE OFFICERS OF THE REGISTRANT

The executive officers of Alaska Air Group, Inc. (including its subsidiaries Alaska and Horizon), their positions and their respective ages (as of February 1, 2006) are as follows:

Name	Position	Age	Air Group or Subsidiary Officer Since
William S. Ayer	Chairman, President and Chief Executive Officer of Alaska Air Group, Inc. and Alaska Airlines, Inc.	51	1985
Bradley D. Tilden	Executive Vice President/Finance and Chief Financial Officer of Alaska Air Group, Inc. and Alaska Airlines, Inc.	45	1994
Kevin Finan	Executive Vice President/Operations of Alaska Airlines, Inc.	58	2000
Keith Loveless	Vice President/Legal and Corporate Affairs, General Counsel and Corporate Secretary of Alaska Air Group, Inc. and Alaska Airlines, Inc.	49	1996
Gregg Saretsky	Executive Vice President/Marketing and Planning of Alaska Airlines, Inc.	46	1998
Jeffrey D. Pinneo	President and Chief Executive Officer of Horizon Air Industries, Inc.	49	1990

Mr. Ayer has been our President since February 2003 and became our Chairman and Chief Executive Officer in May 2003. Mr. Ayer is also Chairman, President and Chief Executive Officer of Alaska Airlines. He has served as Alaska Airlines Chairman since February 2003, as Chief Executive Officer since January 2002 and as President since November 1997. Prior thereto, he was Sr. Vice President/Customer Service, Marketing and Planning of Alaska Airlines from January 1997, and Vice President/Marketing and Planning from August 1995. Prior thereto, he served as Sr. Vice President/Operations of Horizon Air from January 1995. Mr. Ayer serves on the boards of Alaska Airlines, Puget Sound Energy, the Alaska Airlines Foundation, Angel Flight America, Inc., and the Museum of Flight. He also serves on the University of Washington Business School Advisory Board.

Mr. Tilden joined Alaska Airlines in 1991, became controller of Alaska Airlines and Alaska Air Group in 1994, CFO in February 2000 and Executive Vice President/Finance in January 2002.

Mr. Finan became Executive Vice President/Operations in January 2006 to fill the position held by George Bagley upon his retirement. Prior to his appointment, Mr. Finan was Vice President/Flight Operations and had held that position since 2000.

Mr. Loveless became Corporate Secretary and Assistant General Counsel of Alaska Air Group and Alaska Airlines in 1996. In 1999, he was named Vice President/Legal and Corporate Affairs, General Counsel and Corporate Secretary of Alaska Air Group and Alaska Airlines.

Mr. Saretsky joined Alaska Airlines in March 1998 as Vice President/Marketing and Planning. In 2000 he became Senior Vice President/Marketing and Planning, and in January 2002 was elected Executive Vice President/Marketing and Planning of Alaska Airlines.

Mr. Pinneo became Vice President/Passenger Service of Horizon Air Industries in 1990. In January 2002 he was named President and CEO of Horizon Air.

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PART II

ITEM 5. ***MARKET FOR THE REGISTRANT S COMMON STOCK, RELATED STOCKHOLDER MATTERS, AND ISSUER PURCHASES OF EQUITY SECURITIES***

As of December 31, 2005, there were 33,454,146 shares of common stock of Alaska Air Group, Inc. issued and outstanding and 3,875 shareholders of record. We also held 2,478,779 treasury shares at a cost of $56.6 million. We have not paid dividends on the common stock since 1992. Our common stock is listed on the New York Stock Exchange (symbol: ALK).

The following table shows the trading range of Alaska Air Group, Inc. common stock on the New York Stock Exchange.

	2005		2004	
	High	**Low**	**High**	**Low**
First Quarter	**$ 34.00**	**$ 27.45**	$ 29.27	$ 22.30
Second Quarter	**31.50**	**25.55**	27.17	19.26
Third Quarter	**35.72**	**28.38**	25.70	18.74
Fourth Quarter	**37.86**	**28.22**	33.67	22.93

Sales of Non-Registered Securities

None

Equity Compensation Plan Information

The Company has a shareholder-approved equity plan that enables the Compensation Committee of the Board of Directors to make awards of equity-based compensation, which we believe are an important tool to attract and retain key employees.

The table below provides information, as of the end of the most recently completed fiscal year, concerning securities authorized for issuance under current and former equity compensation plans.

Plan Category	(a) Number of Securities to be Issued Upon Exercise of	(b) Weighted Average Exercise Price of Outstanding Options, Warrants	(c) Number of Securities Remaining Available for Future Issuance under Equity

	Outstanding Options, Warrants and Rights	and Rights	Compensation Plans (excluding Securities Reflected in Column (a))
Equity compensation plans approved by security holders	1,696,809	32.2876	1,229,955
Equity compensation plans not approved by security holders	807,570	32.7568	
Total	2,504,379	32.4389	1,229,955

The shares to be issued under plans not approved by stockholders relate to the Company s 1997 Long-Term Incentive Equity Plan. This plan was adopted by the Board of Directors in 1997 and did not require stockholder approval because no grants to executive officers were allowed under the plan.

1997 Long-Term Incentive Equity Plan (the 1997 Plan)

The 1997 Plan terminated on November 3, 2002 and no further awards may be made. Awards granted before that date remain outstanding in accordance with their terms.

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2004 Long-Term Incentive Equity Plan (the 2004 Plan)

The 2004 Plan became effective on May 18, 2004 and shall terminate on May 18, 2014 unless otherwise terminated earlier by the Board. Under the 2004 Plan, awards can be made to any board director, executive officer or employee of the Company. Awards can be made in the form of stock options, SARs or stock awards. The Compensation Committee of the Board of Directors administers the 2004 Plan.

In addition, the 2004 Plan authorizes the granting of shares to board members according to the terms described below.

Each member of the Board of Directors of the Company who is not employed by the Company or any of its subsidiaries is an eligible director. Each year on the first business day following that year s annual meeting of stockholders, a portion of an eligible director s annual retainer for services as a director for the coming year is paid in shares of common stock having a total value of $15,000.

In addition, each eligible director may elect to reduce his or her annual cash retainer and to receive instead a number of shares of common stock equal in value to the amount of the reduction on the same date the stock payment described above is made.

Directors have the right to vote and receive dividends on shares that have been issued under the 2004 Plan. The shares are not forfeited when participants leave the Board or otherwise become ineligible to continue in the 2004 Plan.

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ITEM 6. ***SELECTED CONSOLIDATED FINANCIAL AND OPERATING DATA***

	2005	2004	2003	2002	2001
Consolidated Financial Data:					
Year Ended December 31 (in millions, except per share amounts):					
Operating Revenues	**$ 2,975.3**	$ 2,723.8	$ 2,444.8	$ 2,224.1	$ 2,152.8
Operating Expenses	**2,982.7**	2,803.6	2,462.3	2,317.3	2,279.1
Operating Loss	**(7.4)**	(79.8)	(17.5)	(93.2)	(126.3)
Nonoperating income (expense), net (a)	**144.6**	59.2	46.5	(8.6)	62.8
Income (loss) before income tax and accounting change	**137.2**	(20.6)	29.0	(101.8)	(63.5)
Income (loss) before accounting change	**84.5**	(15.3)	13.5	(67.2)	(43.4)
Net Income (Loss)	**$ (5.9)**	$ (15.3)	$ 13.5	$ (118.6)	$ (43.4)
Average basic shares outstanding	**27.609**	26.859	26.648	26.546	26.499
Average diluted shares outstanding	**33.917**	26.859	26.730	26.546	26.499
Basic earnings (loss) per share before accounting change	**$ 3.06**	$ (0.57)	$ 0.51	$ (2.53)	$ (1.64)
Basic earnings (loss) per share (b)(c)	**(0.21)**	(0.57)	0.51	(4.47)	(1.64)
Diluted earnings (loss) per share before accounting change	**2.65**	(0.57)	0.51	(2.53)	(1.64)
Diluted earnings (loss) per share (b)(c)	**(0.01)**	(0.57)	0.51	(4.47)	(1.64)
At End of Period (in millions, except ratio):					
Total assets	**$ 3,792.0**	$ 3,335.0	$ 3,259.2	$ 2,880.7	$ 2,950.5
Long-term debt and capital lease obligations, net of current	**969.1**	989.6	906.9	856.7	852.2
Shareholders equity	**827.6**	664.8	674.2	655.7	851.3
Ratio of earnings to fixed charges (d)	**1.77**	0.89	1.22	0.28	0.48
Alaska Airlines Operating Data:					
Revenue passengers (000)	**16,759**	16,295	15,047	14,154	13,668
Revenue passenger miles (RPM) (000,000)	**16,915**	16,231	14,554	13,186	12,249
Available seat miles (ASM) (000,000)	**22,292**	22,276	20,804	19,360	17,919
Revenue passenger load factor	**75.9%**	72.9%	70.0%	68.1%	68.4%
Yield per passenger mile	**12.91¢**	12.47¢	12.65¢	12.65¢	13.12¢
Operating revenues per ASM	**10.84¢**	10.02¢	9.74¢	9.47¢	9.84¢
Operating expenses per ASM	**10.89¢**	10.41¢	9.84¢	9.87¢	10.24¢
Average number of full-time equivalent employees	**9,065**	9,968	10,040	10,142	10,115
Horizon Air Operating Data (e):					
Revenue passengers (000)	**6,481**	5,930	4,934	4,815	4,668
Revenue passenger miles (RPM) (000,000)	**2,475**	2,155	1,640	1,514	1,350
Available seat miles (ASM) (000,000)	**3,400**	3,107	2,569	2,428	2,148
Revenue passenger load factor	**72.8%**	69.3%	63.9%	62.4%	62.8%
Yield per passenger mile	**21.98¢**	22.61¢	26.96¢	26.02¢	28.15¢
Operating revenues per ASM	**16.36¢**	16.20¢	18.06¢	17.29¢	19.02¢
Operating expenses per ASM	**16.18¢**	15.90¢	17.76¢	17.87¢	21.02¢
Average number of full-time equivalent employees	**3,456**	3,423	3,359	3,476	3,764

(a) Includes capitalized interest of $8.9 million, $1.7 million, $2.3 million, $2.7 million and $10.6 million for 2005, 2004, 2003, 2002, and 2001, respectively.

(b) For 2002, basic and diluted earnings per share include $(1.94) per share for the $51.4 million cumulative effect of the accounting change in connection with the impairment of goodwill.

(c) For 2005, basic and diluted earnings per share include $(3.27) per share and $(2.66) per share, respectively, for the $90.4 million, net of tax, cumulative effect of the change in accounting policy for major airframe and engine overhauls.

(d) For 2004, 2002 and 2001 earnings are inadequate to cover fixed charges by $17.4 million, $99.5 million, and $69.1 million, respectively. See Exhibit 12 to this Form 10-K.

(e) Includes Horizon services operated as Frontier JetExpress in 2005 and 2004.

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Alaska Airlines Financial and Statistical Data

	Quarter Ended December 31			Year Ended December 31		
	2005	**2004**	**% Change**	**2005**	**2004**	**% Change**
Financial Data (in millions):						
Operating Revenues:						
Passenger	**$ 526.4**	$ 477.8	10.2	**$ 2,183.0**	$ 2,023.6	7.9
Freight and mail	**21.9**	21.1	3.8	**90.3**	86.4	4.5
Other net	**38.9**	32.4	20.1	**142.8**	123.0	16.1
Total Operating Revenues	**587.2**	531.3	10.5	**2,416.1**	2,233.0	8.2
Operating Expenses:						
Wages and benefits	**181.2**	187.9	(3.6)	**737.4**	799.7	(7.8)
Contracted services	**32.9**	26.2	25.6	**119.9**	96.5	24.2
Aircraft fuel	**170.9**	135.6	26.0	**626.6**	472.0	32.8
Aircraft maintenance	**41.7**	34.5	20.9	**185.2**	145.8	27.0
Aircraft rent	**29.6**	28.0	5.7	**116.8**	113.5	2.9
Food and beverage service	**12.5**	11.9	5.0	**47.7**	49.8	(4.2)
Selling expenses	**29.0**	31.1	(6.8)	**126.9**	132.2	(4.0)
Depreciation and amortization	**32.5**	32.9	(1.2)	**125.4**	128.1	(2.1)
Landing fees and other rentals	**40.4**	35.9	12.5	**161.9**	142.0	14.0
Other	**39.0**	38.2	2.1	**158.7**	148.6	6.8
Restructuring charges	**(0.3)**	25.9	NM	**20.4**	53.4	NM
Impairment of aircraft and related spare parts					36.8	NM
Total Operating Expenses	**609.4**	588.1	3.6	**2,426.9**	2,318.4	4.7
Operating Loss	**(22.2)**	(56.8)	NM	**(10.8)**	(85.4)	NM
Interest income	**9.4**	6.2		**32.5**	26.2	
Interest expense	**(14.3)**	(11.0)		**(51.2)**	(44.1)	
Interest capitalized	**3.6**	0.4		**8.1**	1.1	
Fuel hedging gains (losses)	**(21.5)**	(6.8)		**150.6**	75.3	
Other net	**(1.3)**	(0.9)		**(5.0)**	(0.1)	
	(24.1)	(12.1)		**135.0**	58.4	
Income (Loss) Before Income Tax and Accounting Change	**$ (46.3)**	$ (68.9)	NM	**$ 124.2**	$ (27.0)	NM
Operating Statistics:						
Revenue passengers (000)	**4,043**	3,998	1.1	**16,759**	16,295	2.8
RPMs (000,000)	**4,104**	3,976	3.2	**16,915**	16,231	4.2
ASMs (000,000)	**5,556**	5,452	1.9	**22,292**	22,276	0.1
Passenger load factor	**73.9%**	72.9%	1.0pts	**75.9%**	72.9%	3.0pts
Yield per passenger mile	**12.83¢**	12.02¢	6.7	**12.91¢**	12.47¢	3.5
Operating revenue per ASM	**10.57¢**	9.75¢	8.5	**10.84¢**	10.02¢	8.1
Operating expenses per ASM (a)	**10.97¢**	10.79¢	1.7	**10.89¢**	10.41¢	4.6

Operating expenses per ASM excluding fuel, navigation fee refund, restructuring and impairment charges (a)	**7.90¢**	7.83¢	1.0	**8.01¢**	7.92¢	1.1
Raw fuel cost per gallon (a)	**$ 2.02**	$ 1.60	26.3	**$ 1.84**	$ 1.37	34.3
GAAP fuel cost per gallon (a)	**$ 1.99**	$ 1.56	27.6	**$ 1.81**	$ 1.33	36.2
Economic fuel cost per gallon (a)	**$ 1.69**	$ 1.40	20.7	**$ 1.53**	$ 1.26	21.5
Fuel gallons (000,000)	**85.7**	87.1	(1.6)	**346.4**	354.7	(2.3)
Average number of full-time equivalent employees	**8,937**	9,433	(5.3)	**9,065**	9,968	(9.1)
Aircraft utilization (blk hrs/day)	**10.8**	10.8	0.0	**10.8**	11.0	(1.8)
Operating fleet at period-end	**110**	108	1.9	**110**	108	1.9

NM = Not Meaningful

(a) See Note A on page 20.

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Horizon Air Financial and Statistical Data

	Quarter Ended December 31			Year Ended December 31		
	2005	2004	% Change	2005	2004	% Change
Financial Data (in millions):						
Operating Revenues:						
Passenger	**$ 138.2**	$ 125.1	10.5	**$ 544.0**	$ 487.3	11.6
Freight and mail	**0.9**	0.9	0.0	**3.8**	3.9	(2.6)
Other net	**1.8**	2.9	(37.9)	**8.6**	12.0	(28.3)
Total Operating Revenues	**140.9**	128.9	9.3	**556.4**	503.2	10.6
Operating Expenses:						
Wages and benefits	**46.8**	41.4	13.0	**178.4**	163.5	9.1
Contracted services	**6.1**	5.3	15.1	**23.8**	20.7	15.0
Aircraft fuel	**25.9**	20.3	27.6	**96.2**	68.7	40.0
Aircraft maintenance	**12.2**	11.7	4.3	**43.3**	38.3	13.1
Aircraft rent	**17.4**	17.9	(2.8)	**70.2**	73.9	(5.0)
Food and beverage service	**0.6**	0.5	20.0	**2.5**	2.1	19.0
Selling expenses	**7.0**	6.6	6.1	**29.1**	26.5	9.8
Depreciation and amortization	**4.8**	3.7	29.7	**16.8**	13.4	25.4
Landing fees and other rentals	**12.0**	10.2	17.6	**47.7**	41.4	15.2
Other	**11.2**	10.8	3.7	**42.2**	42.0	0.5
Impairment of aircraft and related spare parts		0.6	NM		3.4	NM
Total Operating Expenses	**144.0**	129.0	11.6	**550.2**	493.9	11.4
Operating Income (Loss)	**(3.1)**	(0.1)	NM	**6.2**	9.3	NM
Interest income	**0.6**	0.2		**1.6**	1.1	
Interest expense	**(1.2)**	(0.7)		**(5.5)**	(3.9)	
Interest capitalized	**0.4**	0.2		**0.8**	0.6	
Fuel hedging gains (losses)	**(3.2)**	(1.0)		**23.3**	10.2	
Other net	**(0.1)**	(0.2)			(0.2)	
	(3.5)	(1.5)		**20.2**	7.8	
Income (Loss) Before Income Tax and Accounting Change	**$ (6.6)**	$ (1.6)	NM	**$ 26.4**	$ 17.1	NM
Operating Statistics:						
Revenue passengers (000)	**1,613**	1,568	2.9	**6,481**	5,930	9.3
RPMs (000,000)	**632**	569	11.1	**2,475**	2,155	14.8
ASMs (000,000)	**858**	793	8.2	**3,400**	3,107	9.4
Passenger load factor	**73.7%**	71.7%	2.0pts	**72.8%**	69.3%	3.5pts
Yield per passenger mile	**21.87¢**	21.99¢	(0.5)	**21.98¢**	22.61¢	(2.8)
Operating revenue per ASM	**16.42¢**	16.25¢	1.0	**16.36¢**	16.20¢	1.0
Operating expenses per ASM (a)	**16.78¢**	16.26¢	3.2	**16.18¢**	15.90¢	1.8
Operating expenses per ASM excluding fuel and impairment charges (a)	**13.76¢**	13.62¢	1.1	**13.35¢**	13.58¢	(1.7)

Raw fuel cost per gallon (a)	**$ 2.06**	$ 1.66	24.1	**$ 1.90**	$ 1.42	33.8
GAAP fuel cost per gallon (a)	**$ 2.04**	$ 1.62	25.9	**$ 1.87**	$ 1.38	35.5
Economic fuel cost per gallon (a)	**$ 1.74**	$ 1.48	17.6	**$ 1.58**	$ 1.31	20.6
Fuel gallons (000,000)	**12.7**	12.5	1.6	**51.3**	49.7	3.2
Average number of full-time equivalent employees	**3,537**	3,493	1.3	**3,456**	3,423	1.0
Aircraft utilization (blk hrs/day)	**8.7**	8.5	2.4	**8.7**	8.3	4.8
Operating fleet at period-end	**65**	65	0.0	**65**	65	0.0

NM = Not Meaningful

(a) See Note A on page 20.

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Note A:

Pursuant to Item 10 of Regulation S-K, we are providing disclosure of the reconciliation of reported non-GAAP financial measures to their most directly comparable financial measures reported on a GAAP basis. The non-GAAP financial measures provide management the ability to measure and monitor performance both with and without the cost of aircraft fuel (including the gains and losses associated with our fuel hedging program where appropriate), the navigation fee refund, restructuring charges or adjustments thereto, and aircraft impairment charges. 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. In addition, we believe the disclosure of financial performance without impairment and restructuring charges is useful to investors. Finally, these non-GAAP financial measures are also more comparable to financial measures reported to the Department of Transportation by other major network airlines.

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.:

Alaska Airlines, Inc.:

($ in millions)

	Three Months Ended December 31,		Twelve Months Ended December 31,	
	2005	**2004**	**2005**	**2004**
Unit cost reconciliations:				
Operating expenses	**$ 609.4**	$ 588.1	**$ 2,426.9**	$ 2,318.4
ASMs (000,000)	**5,556**	5,452	**22,292**	22,276
Operating expenses per ASM	**10.97¢**	10.79¢	**10.89¢**	10.41¢
Operating expenses	**$ 609.4**	$ 588.1	**$ 2,426.9**	$ 2,318.4
Less: aircraft fuel	**(170.9)**	(135.6)	**(626.6)**	(472.0)
Less: restructuring charges	**0.3**	(25.9)	**(20.4)**	(53.4)
Add: navigation fee refund			**4.7**	7.7
Less: impairment of aircraft and related spare parts				(36.8)
Operating expenses excluding fuel, navigation fee refund, restructuring and impairment charges	**$ 438.8**	$ 426.6	**$ 1,784.6**	$ 1,763.9
ASMs (000,000)	**5,556**	5,452	**22,292**	22,276
Operating expenses per ASM excluding fuel, navigation fee refund, restructuring and impairment charges	**7.90¢**	7.83¢	**8.01¢**	7.92¢
Reconciliation to GAAP income (loss) before taxes and accounting change:				

Income (loss) before taxes and accounting change, excluding mark-to-market hedging gains (losses), navigation fee refund, restructuring and impairment charges	**$ 0.5**	$ (22.7)	**$ 85.8**	$ 2.1
Add: mark-to-market hedging gains (losses) included in nonoperating income (expense)	**(47.1)**	(20.3)	**53.1**	50.1
Less: restructuring charges	**0.3**	(25.9)	**(20.4)**	(53.4)
Add: navigation fee refund and related interest received			**5.7**	11.0
Less: impairment of aircraft and related spare parts				(36.8)
GAAP income (loss) before taxes and accounting change as reported	**$ (46.3)**	$ (68.9)	**$ 124.2**	$ (27.0)

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	Three Months Ended December 31,			
	2005		2004	
	(in millions)	Cost/Gal	(in millions)	Cost/Gal
Aircraft fuel reconciliations:				
Fuel expense before hedge activities (raw or into-plane fuel cost)	**$ 172.7**	**$ 2.02**	$ 139.3	$ 1.60
Less: gains on settled hedges included in fuel expense	**(1.8)**	**(0.03)**	(3.7)	(0.04)
GAAP fuel expense	**$ 170.9**	**$ 1.99**	$ 135.6	$ 1.56
Less: gains on settled hedges included in nonoperating income (expense)	**(25.6)**	**(0.30)**	(13.5)	(0.16)
Economic fuel expense	**$ 145.3**	**$ 1.69**	$ 122.1	$ 1.40
Fuel gallons (000,000)	**85.7**		87.1	
Mark-to-market gains (losses) included in non-operating income (expense) related to hedges that settle in future periods, net of the reclassification of previously recorded mark-to-market gains to *gains on settled hedges included in nonoperating income (expense)*	**$ (47.1)**		$ (20.3)	

	Twelve Months Ended December 31,			
	2005		2004	
	(in millions)	Cost/Gal	(in millions)	Cost/Gal
Fuel expense before hedge activities (raw or into-plane fuel cost)	**$ 637.9**	**$ 1.84**	$ 486.6	$ 1.37
Less: gains on settled hedges included in fuel expense	**(11.3)**	**(0.03)**	(14.6)	(0.04)
GAAP fuel expense	**$ 626.6**	**$ 1.81**	$ 472.0	$ 1.33
Less: gains on settled hedges included in nonoperating income (expense)	**(97.5)**	**(0.28)**	(25.2)	(0.07)
Economic fuel expense	**$ 529.1**	**$ 1.53**	$ 446.8	$ 1.26
Fuel gallons (000,000)	**346.4**		354.7	
Mark-to-market gains included in non-operating income (expense) related to hedges that settle in future periods, net of the reclassification of previously recorded mark-to-market gains to *gains on settled hedges included in nonoperating income (expense)*	**$ 53.1**		$ 50.1	

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Horizon Air Industries, Inc.

($ in millions)

	Three Months Ended December 31,		Twelve Months Ended December 31,	
	2005	**2004**	**2005**	**2004**
Unit cost reconciliations:				
Operating expenses	**$ 144.0**	$ 129.0	**$ 550.2**	$ 493.9
ASMs (000,000)	**858**	793	**3,400**	3,107
Operating expenses per ASM	**16.78¢**	16.26¢	**16.18¢**	15.90¢
Operating expenses	**$ 144.0**	$ 129.0	**$ 550.2**	$ 493.9
Less: aircraft fuel	**(25.9)**	(20.3)	**(96.2)**	(68.7)
Less: impairment of aircraft and related spare parts		(0.6)		(3.4)
Operating expenses excluding fuel and impairment charges	**$ 118.1**	$ 108.1	**$ 454.0**	$ 421.8
ASMs (000,000)	**858**	793	**3,400**	3,107
Operating expenses per ASM excluding fuel and impairment charges	**13.76¢**	13.62¢	**13.35¢**	13.58¢
Reconciliation to GAAP income (loss) before taxes and accounting change:				
Income before taxes and accounting change, excluding impairment charges and mark-to-market hedging gains (losses)	**$ 0.4**	$ 1.8	**$ 17.8**	$ 13.7
Add: mark-to-market hedging gains (losses) included in nonoperating income (expense)	**(7.0)**	(2.8)	**8.6**	6.8
Less: impairment of aircraft and related spare parts		(0.6)		(3.4)
GAAP income (loss) before taxes and accounting change as reported	**$ (6.6)**	$ (1.6)	**$ 26.4**	$ 17.1

	Three Months Ended December 31,			
	2005		**2004**	
	(in millions)	**Cost/Gal**	**(in millions)**	**Cost/Gal**
Aircraft fuel reconciliations:				
Fuel expense before hedge activities (raw or into-plane fuel cost)	**$ 26.1**	**$ 2.06**	$ 20.8	$ 1.66
Less: gains on settled hedges included in fuel expense	**(0.2)**	**(0.02)**	(0.5)	(0.04)
GAAP fuel expense	**$ 25.9**	**$ 2.04**	$ 20.3	$ 1.62
Less: gains on settled hedges included in nonoperating income (expense)	**(3.8)**	**(0.30)**	(1.8)	(0.14)
Economic fuel expense	**$ 22.1**	**$ 1.74**	$ 18.5	$ 1.48
Fuel gallons (000,000)	**12.7**		12.5	
Mark-to-market gains (losses) included in non-operating income (expense) related to hedges that settle in future periods, net of the reclassification of previously recorded	**$ (7.0)**		$ (2.8)	

mark-to-market gains to *gains on settled hedges included in nonoperating income (expense)*

	Twelve Months Ended December 31,			
	2005		**2004**	
	(in millions)	**Cost/Gal**	**(in millions)**	**Cost/Gal**
Fuel expense before hedge activities (raw or into-plane fuel cost)	**$ 97.7**	**$ 1.90**	$ 70.7	$ 1.42
Less: gains on settled hedges included in fuel expense	**(1.5)**	**(0.03)**	(2.0)	(0.04)
GAAP fuel expense	**$ 96.2**	**$ 1.87**	$ 68.7	$ 1.38
Less: gains on settled hedges included in nonoperating income (expense)	**(14.7)**	**(0.29)**	(3.4)	(0.07)
Economic fuel expense	**$ 81.5**	**$ 1.58**	$ 65.3	$ 1.31
Fuel gallons (000,000)	**51.3**		49.7	
Mark-to-market gains included in non-operating income (expense) related to hedges that settle in future periods, net of the reclassification of previously recorded mark-to-market gains to *gains on settled hedges included in nonoperating income (expense)*	**$ 8.6**		$ 6.8	

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ITEM 7. ***MANAGEMENT S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS***

The following discussion should be read in conjunction with our financial statements and the related notes contained elsewhere in this Annual Report on Form 10-K. All statements in the following discussion that are not reports of historical information or descriptions of current accounting policies are forward-looking statements. Please consider our forward-looking statements in light of the risks referred to in this report s introductory cautionary note. There can be no assurance that actual developments will be those anticipated by us. Actual results could differ materially from those projected as a result of a number of factors, some of which we cannot predict or control. For a discussion of our risk factors, see Item 1A: Risk Factors, beginning on page 12 and Risk Factors beginning on page 42.

General

Alaska and Horizon operate as airlines. However, their business plans, competition, and economic risks differ substantially. Alaska is a major airline and principally serves destinations in the state of Alaska and North/South service between cities in the Western U.S., Canada and Mexico. Alaska also provides East/West service to 8 cities, primarily from Seattle. It operates an all-jet fleet, and its average passenger trip in 2005 was 1,009 miles. Horizon is a regional airline serving primarily the Pacific Northwest, Northern California, and Western Canada. It operates both jet and turboprop aircraft, and its average passenger trip in 2005 was 382 miles.

Year in Review and Current Events

Improved revenue from industry-wide fare increases, record load factors, and a 4.2% increase in passenger traffic helped to define a positive story for 2005, despite relatively flat capacity at Alaska. Alaska s capacity was flat compared to the prior year due to actions taken in response to the operational difficulties described below. Horizon reported significant increases in passenger traffic, resulting in increased revenues, offset by slightly lower yield. Operating expenses per available seat mile increased 4.6% at Alaska to 10.89 cents and 1.8% at Horizon to 16.18 cents compared to 2004. Although fuel prices dipped in the fourth quarter, fuel again hit record highs during 2005 and played a major part in the increase in unit costs. At Alaska, our unit costs excluding fuel, a navigation fee refund, restructuring and impairment charges increased 1.1% to 8.01 cents compared to 2004. This is primarily due to the capacity reduction during the summer and slightly higher non-fuel operating costs. Compared to 2004, Horizon had a 1.7% decrease in unit costs excluding fuel and impairment charges, coming in at 13.35 cents. Overall, our operating results are positive considering the continued significant losses for the industry as a whole and several large carriers seeking bankruptcy protection in 2005.

Although revenues and pre-tax income at Alaska improved over the prior year, we faced operational difficulties during much of the year due to the combined effects of the labor and operational changes across our Company during 2005. The result was operational performance that was well below our goal during much of the summer months. However, we began to see improvement in on-time arrivals and departures during much of September and October; although we again experienced seasonal declines in these metrics in the latter months of the year. In order to improve our operational performance, we reduced our 2005 summer capacity from our original expectations through schedule reductions and the elimination of certain flights.

Common Stock Offering

In December 2005, we completed an offering of 5.7 million shares of our common stock, resulting in net proceeds of approximately $200 million. See Note 16 to the Consolidated Financial Statements.

Accounting Change

Effective January 1, 2005, we changed our method of accounting for major airframe and engine overhauls from the *capitalize and amortize* method to the *direct expense* method. Accordingly, effective January 1, 2005, we wrote off the net book value of our previously capitalized airframe and engine overhauls for all aircraft in a charge totaling $144.7 million pre-tax ($90.4 million after tax). See Note 2 to our consolidated financial statements for further details.

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Restructuring Charges

In the first quarter of 2005, we recorded asset impairment and rental charges of $8.0 million related to our decision to terminate the lease at our Oakland heavy maintenance base. These charges are included in restructuring charges in the statements of operations. As of December 31, 2005, there was no accrual remaining related to these charges.

During the second quarter of 2005, we contracted out our Seattle ramp operations to a third party. This resulted in an immediate reduction of approximately 475 employees. We offered a severance package, substantially the same as the severance packages offered to other employees in late 2004, to those affected by the subcontracting that included cash payments based on years of service, one year of medical coverage after the severance date and continued travel benefits for a period of time. The labor group accepted the severance package in June 2005 and, as a result, we recorded a charge of $16.1 million in the second quarter of 2005.

Offsetting these charges is a $3.7 million adjustment related to changes in our estimated costs of medical coverage extended to impacted employees from current and prior restructuring efforts and a change in the number of employees affected since the original accruals were recorded, resulting in a net restructuring charge for the year of $20.4 million ($12.7 million after tax).

The following table displays the activity and balance of the severance and related cost components of the Company s restructuring accrual as of and for the year ended December 31, 2005 ($ in millions):

Accrual for Severance and Related Costs	
Balance at December 31, 2004	**$ 38.7**
Restructuring charges	**16.1**
Restructuring charge adjustments	**(3.7)**
Cash payments	**(48.0)**
Balance at December 31, 2005	**$ 3.1**

Labor Costs and Negotiations

We executed new labor contracts with the Alaska pilots, dispatchers and mechanics and with the Horizon mechanics and dispatchers in 2005 through either the negotiation or arbitration process, as further described below:

Despite ongoing negotiations, we were unable to reach a new agreement with the Air Line Pilots Association (ALPA) and, therefore, pursuant to the terms of the collective bargaining agreement, submitted to binding arbitration during the first quarter of 2005, the decision of which became effective on May 1, 2005 and becomes amendable on May 1, 2007. This agreement resulted in an average pilot wage reduction of 26%.

During the second quarter of 2005, we presented a contract offer to the International Association of Machinists (IAM, representing our ramp workers) that was rejected by this work group. We subcontracted our Seattle ramp operations to a third party effective May 13, 2005. This resulted in an immediate reduction of approximately 475 employees.

During the fourth quarter, Alaska reached an agreement with the Aircraft Mechanics Fraternal Association (AMFA) resulting in a new four-year contract covering Alaska s approximately 700 aircraft technicians. This contract includes, among other items, a market-based wage increase of approximately 10% and a one-time $1,000 bonus to each of the employees covered under the contract, which was paid in the fourth quarter of 2005.

Alaska also reached an agreement with the Transport Workers Union (TWU) in 2005 that resulted in a new five-year contract covering Alaska s 34 dispatchers.

In October 2005, Horizon reached an agreement with the TWU resulting in a new three-year contract covering 21 dispatchers at Horizon.

During the fourth quarter of 2005, Horizon reached an agreement with AMFA on a three-year contract covering Horizon s 450 mechanics and fleet service agents.

We are pleased with the contracts that have been reached recently and we are continuing to negotiate with our other workgroups to reach agreement on contracts that would benefit both our employees and our shareholders. None of the contract negotiations is at an impasse or has reached the 30-day cooling off period required under the Railway Labor Act that would trigger self help. Therefore, we currently believe the risk of a work stoppage is low.

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 price correlation between crude oil, the commodity we use to hedge, and West Coast jet fuel fell below required thresholds. For more discussion, see Note 11 to our consolidated financial statements.

The implications of this change are twofold: First, our earnings are more volatile 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, even though the actual consumption will take place in a future period. In times of rising fuel prices such as in 2005, this will have the effect of increasing our reported net income or decreasing our reported net loss. Our mark-to-market gains recorded in 2005 for contracts that settle in future periods, net of the reclassification of previously recorded mark-to-market gains for settled hedges, were $61.7 million ($38.6 million after tax). Second, to a large extent, the impact of our fuel hedge program will not be reflected in fuel expense. In 2005, we recorded gains from settled fuel hedges totaling $125.0 million, but only $12.8 million of that gain is reflected as an offset to fuel expense with the balance reported in other non-operating income (expense).

We have provided information on mark-to-market gains or losses, as well as calculations of our economic fuel cost per gallon on pages 21 and 22.

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

Navigation Fee Refund

In August 2005, Alaska recorded a net refund totaling $5.7 million ($3.6 million after tax) from the Mexican government related to navigation fees paid in 2004. Approximately $4.7 million of the refund was recorded as a reduction to contracted services expenses and $1.0 million was recorded as interest income. This is compared to an $11.0 million refund ($6.3 million after tax) recorded during the third quarter of 2004.

Aircraft Commitments

On June 15, 2005, Alaska Airlines, Inc. entered into an aircraft purchase agreement with The Boeing Company to purchase 35 B737-800 aircraft with deliveries beginning in January 2006 and continuing through April 2011. The purchase agreement includes options to purchase an additional 15 aircraft with deliveries between July 2007 and April 2009. The order also includes rights to purchase an additional 50 737-800s under the same terms, except that purchase rights are not assigned specific delivery dates. In December, 20 of the purchase rights were converted to options with deliveries in 2010 and 2011. Subsequent to year-end, Alaska converted one option and two purchase rights into firm orders for three additional B737-800s to be delivered in 2007 and 2008. Separate from the purchase agreement, Alaska has negotiated operating lease agreements for two additional B737-800 aircraft to be delivered in late 2006.

In October 2005, Horizon finalized an agreement to purchase 12 Bombardier Q400 aircraft with delivery dates beginning in December 2006 and continuing through July 2007. This agreement, in part, replaced firm orders for seven CRJ-700 aircraft that were to be delivered over the next several years. This agreement also provides for an option to purchase up to an additional 20 Q400 aircraft. In connection with the agreement, Bombardier agreed to provide certain remarketing assistance for up to 12 Q200 aircraft currently leased by Horizon for a fee as set forth in the agreement. Should Horizon decide to sublease any or all of the 12 Q200 aircraft, it is reasonably likely that the sublease income, including any support from Bombardier, would not be sufficient to cover our existing lease obligation and we would have an immediate recognition of the related loss on the sublease.

Other Events

In October 2005, Alaska finalized a $172 million variable-rate, pre-delivery payment facility to provide a portion of the pre-delivery funding requirements of Alaska s purchase of up to 38 new Boeing 737-800 aircraft (23 of which are firm orders) under the current aircraft purchase agreement. This facility will expire on August 31, 2009 and the interest rate is based on one-month LIBOR plus a specified margin. Any borrowings will be secured by the Company s rights under the Boeing purchase agreement.

We began daily non-stop service from Los Angeles to Mexico City in August 2005 and from Seattle to Dallas/Fort Worth in September 2005.

Capacity Outlook

For 2006, Alaska and Horizon expect capacity increases of approximately 5% to 6% and 6%, respectively. The expected capacity increase at Alaska is due largely to the return of the full schedule and the introduction of 12 new B737-800 aircraft in 2006, with most of those coming later in the year. Horizon s expected capacity increase is due largely to the annualization of increasing capacity of the Q400 fleet from 70 to 74 seats and to the four Q400 aircraft that will be delivered in 2006 (including two used Q400s to be delivered in February or March). The addition of the aircraft deliveries in 2006 at both Alaska and Horizon will be used to increase frequency in our existing markets and, to a lesser degree, serve new markets.

Alaska will continue to work toward operational excellence in 2006 to improve our on-time performance, completion rates, baggage handling, and other important customer-facing operational measures. As part of this initiative, Alaska will remain focused on improving the performance of the ramp services at the Seattle-Tacoma International Airport.

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RESULTS OF OPERATIONS

2005 Compared with 2004

Our consolidated net loss for 2005 was $5.9 million, or $0.01 per diluted share, versus a consolidated net loss of $15.3 million, or $0.57 per diluted share, in 2004.

Our consolidated income (loss) before the accounting change for 2005 was $84.5 million compared ($15.3) million in 2004. The 2005 results include certain items that impact the comparability of the years. These items are discussed in the Year in Review and Current Events section beginning on page 23. Our 2004 results also include certain items that impact comparability, including severance charges of $53.4 million ($31.8 million after tax), an impairment charge of $40.2 million ($26.7 million after tax) related primarily to our Boeing 737-200C fleet, mark-to-market hedging gains, net of the reclassification of previously recorded mark-to-market gains for settled hedges, of $56.9 million ($31.7 million after tax), and a navigation fee refund of $11.0 million ($6.3 million after tax). Excluding those items, consolidated income before the accounting change would have been $55.0 million in 2005 compared to $5.2 million in 2004. The year-over-year improvement can be characterized by higher revenues, offset by slightly higher non-fuel operating costs and significantly higher fuel costs.

Financial and statistical data comparisons for Alaska and Horizon are shown on pages 18 and 19, respectively. On pages 20 through 22, 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 $183.1 million, or 8.2%, during 2005 as compared to 2004 due to an 8.1% increase in operating revenue per available seat mile (RASM) on relatively flat capacity. The increase in RASM was driven by a 3.5% increase in ticket yields that resulted from an increase in ticket prices designed to offset higher fuel prices, higher load factors, and higher freight, mail and other revenues. The flat capacity is primarily a direct result of the reduction in our summer flight schedule that was announced in June 2005, offset by the addition of three B737-800 aircraft during the year.

Load factor increased 3.0 percentage points to a record 75.9% for 2005, due primarily to an increase in passenger traffic. The yield environment is currently strong. In 2006, yield improvement is expected to come from year over year increases in fares (particularly in the first half of 2006) and, to a lesser extent, a new $10 fee that will be charged to customers that book travel through our reservation call centers.

Freight and mail revenues increased by $3.9 million, or 4.5%, compared to 2004 as a result of a mail contract we have in the state of Alaska that began in the third quarter of 2004 and fuel surcharges added to our freight services during the third quarter of 2005, offset by lower freight volumes.

Other-net revenues increased $19.8 million, or 16.1%, due largely to an increase in Mileage Plan revenues, resulting from higher award redemption on our partner airlines and an increase in cash receipts from miles sold, of which a portion is recognized immediately as other

revenue and an increase in our revenues from service to Dutch Harbor, which is operated by a third party.

Alaska Airlines Expenses

In 2005, total operating expenses increased $108.5 million, or 4.7%, compared to 2004. Operating expenses per ASM increased 4.6% from 10.41 cents in 2004 to 10.89 cents in 2005. The increase in operating expenses is due largely to the significant increase in raw or into-plane fuel costs and increases in aircraft maintenance, contracted services, landing fees and other rentals, and other, offset by declines in wages and benefits, food and beverage service, selling expenses, depreciation and amortization, restructuring charges, and the impairment charge in 2004 related to our Boeing 737-200C fleet. Operating expenses per ASM excluding fuel, the navigation fee refund, restructuring and impairment charges increased 1.1% compared to 2004. Our current estimates of costs per ASM, excluding fuel for the first quarter and full year of 2006, are 8.35 cents and 7.65 cents, respectively.

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Explanations of significant year-over-year changes in the components of operating expenses are as follows:

Wages and benefits decreased $62.3 million, or 7.8%, during 2005 compared to 2004. Wages have been reduced by the following:

- restructuring initiatives announced in late 2004
- the reduction in pilot wages resulting from the new pilot contract that took effect in May 2005
- during the second quarter of 2005, we subcontracted our ramp services operation in Seattle
- during 2005, there were an average of 9,065 full-time equivalents (FTEs), which is down by 903 FTEs from the average in 2004
- a reduction in benefits costs due to the reduction in FTEs and pension expense

The year-over-year decline in wages and benefits was partially offset by the following:

- a $14 million increase in employee variable pay awards including profit sharing, operational performance rewards and performance based pay compared to 2004
- a favorable $6.6 million adjustment in 2004 related to the ultimate loss estimates for workers compensation

Overall, the reduction in wages and benefits costs are partially offset by increases in contracted services and maintenance expense due to the subcontracting of certain operations. We expect to continue to see year-over-year declines in wages throughout 2006, although to a lesser extent than in 2005.

Contracted services increased $23.4 million, or 24.2%, due largely to contracting out of the Company s fleet service and ground support equipment and facility maintenance functions in the fourth quarter of 2004, and the Seattle ramp operations in May 2005. Additionally, the navigation fee refund recorded in contracted services was $5.1 million in 2005 compared to $7.7 million in 2004. We expect that contracted services will increase in 2006 as we annualize the costs associated with the 2005 changes.

Aircraft fuel increased $154.6 million, or 32.8%, due to a 36.2% increase in the GAAP fuel cost per gallon, offset by a 2.3% decline in fuel gallons consumed. During 2005, Alaska also realized $108.8 million of gains from settled hedges, the majority of which are recorded in other non-operating income (expense). The total gains from settled hedges represents 87.6% of Alaska s income before income taxes and the accounting change. After including all gains from settled hedges recorded during the period, our economic, or net, fuel expense increased $82.3 million, or 18.4%, compared to 2004. Our economic fuel cost per gallon increased 21.5% over 2004 from $1.26 to $1.53.

In the second quarter of 2005, we entered into a fuel contract whereby the spread between crude oil prices and jet fuel prices is fixed for approximately one-third of our fuel consumption through April 2006. This contract resulted in approximately $10 million in savings for Alaska

during 2005.

See page 21 for a table summarizing 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 fuel cost per gallon excluding all hedging activities.

Aircraft maintenance increased $39.4 million, or 27.0%, due largely to the performance of more airframe work and engine overhauls in 2005 compared to 2004. Other factors causing the increase were our power-by-the-hour maintenance agreement whereby we expense B737-400 engine maintenance on a flight-hour basis, regardless of whether the work was actually performed during the period; the contracting out of related heavy maintenance to third parties, which resulted in a shift of costs from wages and benefits into aircraft maintenance; the change in our accounting policy regarding engine and airframe overhauls (see Note 2 to our Consolidated Financial Statements); as well as certain enhancements to aircraft interiors, systems and flight decks to assist with reliability improvement. We expect maintenance costs to decline marginally in 2006 due to the timing of maintenance events and expected savings from process improvement initiatives.

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Aircraft rent increased $3.3 million, or 2.9%, due to the additional operating lease on a B737-800 that was delivered in March 2005, offset by lower rates negotiated in 2004 on extended leases. We expect 2006 aircraft rent to be slightly higher due to the addition of two new B737-800 aircraft in the fourth quarter of 2006.

Food and beverage service expense decreased $2.1 million, or 4.2%, due primarily to a reduction in the average cost per passenger meal, offset by higher transportation costs and an increase in the number of meals served resulting from our new Mexico City and Dallas flights.

Selling expenses decreased $5.3 million, or 4.0% primarily due to a decline in the incentive payments to Horizon for certain flying. Incentive payments to Horizon are eliminated in consolidation. Excluding the intercompany payments, selling expenses increased by $10.2 million as a result of higher codeshare fees and commissions resulting from the increase in revenues. In 2005, 36.5% of Air Group ticket sales were made through traditional travel agents, compared to 38.0% in 2004. In 2005, 34.8% of the ticket sales were made through Alaska s Internet web site compared to 30.4% in 2004.

Depreciation and amortization decreased $2.7 million, or 2.1%. In 2004, we recorded an impairment charge of $36.8 million to reduce the carrying value of the Boeing 737-200C fleet, resulting in lower depreciation expense in future periods. This is offset by the increased depreciation on two new owned aircraft delivered during 2005. We expect depreciation and amortization to increase in 2006 as we take delivery of several new B737-800 aircraft, the majority of which will be owned.

Landing fees and other rentals increased $19.9 million, or 14.0%. The increase reflects higher landing fee rates and increased rental costs, primarily in Seattle, Portland and Los Angeles, offset by fewer departures. We expect landing fees and other rentals to be higher in 2006 as a result of higher departures and increased airport costs.

Other expenses increased $10.1 million, or 6.8%, primarily reflecting increases in passenger remuneration, crew costs, supplies, and legal settlement costs, partly offset by lower insurance premiums. Additionally, in 2004 there were $2.0 million in losses on disposal of assets compared to $3.0 million in the current year. We expect other expenses to decline slightly in 2006 due to lower insurance rates and passenger remuneration costs.

Horizon Air Revenues

In 2005, operating revenues increased $53.2 million, or 10.6% compared to 2004. This increase is due largely to the increased capacity in both the Horizon-brand flying and contract flying for Frontier Airlines, which began in January 2004, combined with the slight increase in operating revenues per available seat mile (RASM). The increase in RASM was primarily due to an increase in load factors, partially offset by a 2.8% decline in ticket yields.

Load factor increased 3.5 percentage points to 72.8% for 2005, due primarily to the 14.8% increase in passenger traffic outpacing the 9.4% increase in capacity. The increases in passenger traffic and capacity are primarily due to increased contract flying with Frontier, the harmonization flying with Alaska, the addition of one CRJ-700 in 2005 and four additional seats on each of our Q400s. Contract flying with Frontier represented approximately 9.3% of passenger revenues and 22.9% of capacity, during 2005 compared to 9.1% and 21.4%, respectively, in 2004.

Horizon Air Expenses

Operating expenses for 2005 increased $56.3 million, or 11.4%, compared to 2004. Operating expenses per ASM increased 1.8% compared to 2004. Operating expenses per ASM excluding fuel and impairment charges decreased 1.7% compared to 2004. Our estimates of costs per ASM excluding fuel for the first quarter and full year of 2006 are 14.4 cents and 14.0 cents, respectively.

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Explanations of significant year-over-year changes in the components of operating expenses are as follows:

Wages and benefits increased $14.9 million, or 9.1%, reflecting a slight increase in the average number of employees and wages per employee, a new performance-based incentive program for all employees, and the move to a new paid time off program resulting in a one-time charge related to the transition.

Contracted services increased $3.1 million, or 15.0%, due primarily to the increase in contract flying with Alaska that results in higher payments to non-Horizon employees for ground handling services.

Aircraft fuel increased $27.5 million, or 40.0%, due to a 35.5% increase in the GAAP fuel cost per gallon. During 2005, Horizon also realized $16.2 million of gains from settled hedges, the majority of which are recorded in other non-operating income (expense). The total gains from settled hedges represents 61.4% of Horizon s pre-tax income. After including all gains from settled hedges recorded during the period, the economic, or net, fuel expense increased $16.2 million, or 24.8%, over 2004. Our economic fuel cost per gallon increased 20.6% from $1.31 in 2004 to $1.58 in 2005.

See page 22 for a table summarizing fuel cost per gallon realized by Horizon (the economic cost per gallon), the cost per gallon on a GAAP basis (including hedging gains recorded in aircraft fuel) and fuel cost per gallon excluding all hedging activities.

Aircraft maintenance expense increased $5.0 million, or 13.1%, primarily due to a higher number of engine overhauls and propeller work for the Q400 fleet and fewer aircraft covered by warranty. We expect maintenance expense to increase substantially in 2006 due to the timing of maintenance events and the increased number of aircraft that are exiting their warranty periods.

Aircraft rent decreased $3.7 million, or 5.0%, primarily due to lower rents on extended leases, return of one aircraft on a short-term lease and fewer leased engines.

Selling expenses are up $2.6 million, or 9.8%, from 2004 due primarily to an increase in credit card and other commissions resulting from higher revenues.

Depreciation and amortization increased $3.4 million, or 25.4%, primarily due to the addition of one CRJ-700 at the end of the first quarter of 2005 and a Q400 in the third quarter of 2004.

Landing fees and other rentals increased $6.3 million, or 15.2%. Higher landing fees are a result of significant rate increases in several of our key airports, increased departures and new markets being served.

Consolidated Nonoperating Income (Expense)

Net nonoperating income was $144.6 million in 2005 compared to $59.2 million in 2004. Interest income increased $6.4 million due primarily to improved returns and a slightly larger average marketable securities portfolio in 2005, offset by a larger interest payment in 2004 related to the navigation fee refund. Interest expense increased $11.1 million due to interest rate increases on our variable-rate debt and the changes to some of our variable-rate debt agreements to slightly higher fixed-rate agreements. Capitalized interest increased $7.2 million from $1.7 million in 2004 to $8.9 million in 2005. This increase is due to the significant increase in deposits for future flight equipment resulting from our new aircraft purchase agreements for Boeing 737-800 and Bombardier Q400 aircraft.

Fuel hedging gains include $112.2 million in gains from fuel hedging contracts settled in 2005 compared to $28.6 million in 2004. In addition, fuel-hedging gains include net mark-to-market gains on unsettled hedge contracts, net of the reclassification of previously recorded mark-to-market gains for settled hedges, of $61.7 million in 2005 and $56.9 million in 2004.

Consolidated Income Tax Expense (Benefit)

Our consolidated effective income tax rate on pre-tax income before the cumulative effect of the accounting change for 2005 was 38.4% compared to an effective income tax rate of 25.7% on a pre-tax loss in 2004. Due to

the magnitude of nondeductible expense, such as employee per diem costs, relative to a marginal pre-tax profit or loss, a relatively small change in pre-tax results may cause a significant change in the effective tax rate. We applied our 2005 marginal rate of 37.5% to the cumulative effect of the accounting change.

2004 Compared with 2003

Our consolidated net loss for 2004 was $15.3 million, or $0.57 per share, versus net income of $13.5 million, or $0.51 per share, in 2003. The 2004 results include four significant items that impact the comparability to 2003. These items are discussed in the Results of Operations: 2005 Compared with 2004 section beginning on page 27. Our 2003 results also include $71.4 million ($52.8 million for Alaska and $18.6 million for Horizon, or a combined $44.3 million, net of tax) received related to assistance from the government under the Emergency Wartime Supplemental Appropriations Act.

Our consolidated operating loss for 2004 was $79.8 million compared to a loss of $17.5 million for 2003. Our consolidated pre-tax loss for 2004 was $20.6 million compared to pre-tax income of $29.0 million for 2003.

Alaska Airlines Revenues

Operating revenues increased $205.6 million, or 10.1%, during 2004 as compared to the same period in 2003. The increase in revenues resulted from an 11.5% increase in passenger traffic, offset by a 1.4% decline in ticket yields. For the year ended December 31, 2004, capacity increased 7.1% as compared to 2003. The capacity increases are primarily due to the annualization and expansion of our transcontinental flying, including service from Seattle to Chicago and Los Angeles to Reagan National in Washington D.C. The traffic increase of 11.5% outpaced the capacity increase of 7.1%, resulting in an increase in load factor from 70.0% to 72.9%. The decline in yield per passenger mile was a result of continued industry-wide pricing pressure, particularly in the fourth quarter where yield declines were more substantial, dropping 5.8% compared to the fourth quarter of 2003.

Freight and mail revenues increased $9.1 million, or 11.8%, because of a new mail contract we have in the State of Alaska offset by lower freight revenues.

Other-net revenues increased $13.3 million, or 12.1%, due largely to revenues from service to Dutch Harbor, which is operated by a third party, that began in January of 2004 and higher Mileage Plan revenues.

Alaska Airlines Expenses

For the year ended December 31, 2004, total operating expenses increased $271.6 million, or 13.3%, as compared to the same period in 2003. Operating expenses per ASM increased 5.8% from 9.84 cents in 2003 to 10.41 cents in 2004. The increase in operating expenses per ASM is due largely to significant increase in fuel costs, our restructuring charges, the impairment charge related to our Boeing 737-200 fleet, higher wages and benefits, contracted services costs and landing fees and other rental costs offset by declines in selling expenses and the navigation fee

recovery. Operating expense per ASM excluding fuel, the navigation fee recovery, restructuring and impairment charges decreased 5.0% to 7.92 cents per ASM compared to 8.34 cents per ASM in 2003. Explanations of significant period-over-period changes in the components of operating expenses are as follows:

Wages and benefits increased $18.2 million, or 2.3%, during 2004. Approximately two-thirds of the increase reflects higher pilot wages, substantially all of which were due to the 4% wage rate increase in May 2004. Wages were favorably impacted by the restructuring initiatives announced in August and September. During 2004, there were 9,968 FTEs, which was down by approximately 70 FTEs from 2003 on a 7.1% increase in capacity.

Benefits costs were favorably impacted by a $7.3 million reduction in workers compensation expense resulting from positive workers compensation claims experience at Alaska and a related reduction to ultimate loss estimates recorded in December totaling $6.6 million. In total, benefits costs were flat year over year.

Contracted services increased $14.9 million, or 18.3%, 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 and higher security costs, partially offset by $8.6 million from the recovery in 2004 of disputed Mexico navigation fees paid in 2002 and 2003.

Aircraft fuel increased $159.9 million, or 51.2%, due to a 43.9% increase in the GAAP fuel cost per gallon and a 5.2% increase in fuel gallons consumed. The increase in aircraft fuel expense is inclusive of $14.6 million of gains from settled hedges. During 2004, Alaska also realized $25.2 million of hedge gains, which are recorded in other non-operating income. After including all hedge gains recorded during the year, our economic fuel expense increased $140.1 million, or 45.7%, over 2003. Our economic fuel cost per gallon increased 38.6% from $0.91 cents to $1.26.

Aircraft maintenance decreased $7.6 million, or 5.0%, due largely to fewer engine overhauls during 2004 and a change in the mix of heavy maintenance versus routine maintenance.

Aircraft rent decreased $10.4 million, or 8.4%, due to lower rates on extended leases and fewer leased aircraft in 2004 compared to 2003.

Selling expenses decreased $15.8 million, or 10.7%, due to a decline in the incentive payments made to Horizon offset by increases in booking fees, credit card fees, and commissions. Incentive payments to Horizon are eliminated in consolidation. In 2004, 38.0% of Air Group ticket sales were made through traditional travel agents, compared to 43.0% in 2003. In 2004, 30.4% of the ticket sales were made through Alaska s Internet web site compared to 27.4% in 2003.

Depreciation and amortization increased $8.6 million, or 7.2%, reflecting accelerated depreciation on the planned retirement of the Boeing 737-200C fleet, an increase in depreciation resulting from one aircraft purchased in 2004, and the full year depreciation on aircraft acquired in 2003, and additional provisions for inventory obsolescence.

Landing fees and other rentals increased $14.2 million, or 11.1%. The higher rates primarily reflect higher joint-use and exclusive rental fees at Seattle, Portland, Los Angeles and Oakland, combined with modest volume growth.

Other expense increased $8.3 million, or 5.9%, primarily reflecting a $6.3 million increase in professional services costs, higher moving expenses associated with our restructuring initiatives, higher passenger remuneration costs, and supplies costs.

Restructuring charges totaled $53.4 million during 2004. This charge includes wages and other benefits that will be paid as a result of our restructuring initiatives announced in August and September of 2004.