PACIFIC AIR LINES TWENTY-SEVENTH ANNUAL REPORT 1966

DIRECTORS

MATTHEW E. McCARTHY, *Chairman of the Board, President and Chief Executive Officer, Member of the Executive Committee*

DAVID R. GRACE, *Director and Member of the Executive Committee*
General Partner, Sterling, Grace & Co., New York

RICHARD E. LANG, *Director and Member of the Executive Committee*
Chairman of the Board of Lang & Co., Seattle

H. PETER KRIENDLER, *Director*
Managing Director, "21 Club," New York

JOSEPH MARTIN, JR., *Director*
Partner in the Law Firm of Miller, Groezinger, Pettit, Evers & Martin, San Francisco

LLOYD W. MARTIN, *Director*
President of Reed & Martin, Honolulu

C. A. MYHRE, *Director, Executive Vice President and General Manager, Pacific Air Lines*

ROBERT SETRAKIAN, *Director*
President of Setrakian and Company, San Francisco
Chairman of the Board of the Valley National Bank

IAN G. THOMSON, *Director*
President of The Chartered Bank of London, San Francisco

HARRY S. WHITE, *Director*

MAX H. WYMAN, *Director*
Partner, M. A. Wyman Lumber Co., Seattle

PACIFIC AIR LINES 1966 ANNUAL REPORT

San Francisco International Airport

OFFICERS

MATTHEW E. McCARTHY, *President*

C. A. MYHRE, *Executive Vice President & General Manager*

R. E. COSTELLO, *Vice President—Traffic*

R. C. COUK, *Vice President—Flight Operations*

H. W. SWENSON, *Vice President—Finance*

J. C. O'CALLAHAN, *Vice President—Economic Research & Planning*

J. W. STEFFEN, *Vice President—Engineering & Maintenance*

W. H. LEVINGS—*Secretary*

DAVID R. GRACE—*Assistant Treasurer*

RICHARD E. LANG—*Assistant Treasurer*

MAX H. WYMAN—*Assistant Secretary*

CONTENTS

Mr. Matthew E. McCarthy, left, Chairman of the Board and President and Mr. C. A. Myhre, Executive Vice President and General Manager.

TO OUR STOCKHOLDERS:

The year 1966 produced gross revenues of $16,773,105 compared to $14,684,589 in 1965. Net operating and other costs for 1966 were $16,622,389 compared to $13,984,252 in 1965, resulting in a net income of $150,716 compared to $700,337 in 1965.

Your company placed in service in midsummer 1966 two leased Boeing 727s, and in September purchased one Boeing 727 for delivery in March 1967. Two additional Boeing 737s were purchased in September 1966 which, when added to the four Boeing 737s previously purchased, places six of these planes on order with deliveries starting in November 1967. This necessary investment in jet equipment to insure Pacific's future involves large transition costs in upgrading our departments to handle pure jet equipment and large introductory costs in placing these planes in service on our route system.

In 1966, new office and maintenance buildings were substantially completed and occupancy of the facilities was commenced in January 1967. Installed therein is the latest in computers—the IBM 360 model 30. The new buildings and computer will mean greater efficiency and cost control.

Plans were completed to erect, in 1967, a training center on our 16-acre complex at San Francisco. This training center will house a Boeing 737 simulator which will reduce pilot training costs and will contain necessary classrooms and equipment for training our stewardesses, sales, reservation, mechanics, and other personnel.

The forty-two day strike against five major airlines affected our general revenues, due to the loss of interline traffic. In November 1966 our mechanics, dissatisfied with the settlement reached by the five major trunk airlines, struck our company for six days. Final agreement was reached in the general area of the trunk line settlement. These strikes were costly to your company.

Previous to the time Pacific received its Boeing 727 aircraft in July and August 1966, the California Public Utilities Commission permitted PSA, an intra-state carrier, to enter our San Jose-Los Angeles non-stop market for which our Boeing 727s were intended. This also adversely affected our revenues. The Civil Aeronautics Board, in response to this action by the California Public Utilities Commission, granted your company four new non-stop routes, i.e., Burbank-Oakland, Burbank-San Francisco, Burbank-San Diego, and Burbank-Sacramento. Pacific has exemption applications now pending before the Civil Aeronautics Board to fly the following non-stop routes: San Francisco-Los Angeles, Burbank-Las Vegas, Burbank-Portland, and Burbank-Palm Springs.

Your company, in keeping with its present and future growth, has appointed three new vice presidents: Juan C. O'Callahan, Economic Research and Planning; John W. Steffen, Engineering and Maintenance; and Harry W. Swenson, Finance.

Plans are firm to operate our new non-stop routes as of May 1, 1967, and management feels confident that your company's growth in 1967 will be enhanced.

Matthew E. McCarthy

MATTHEW E. McCARTHY,
Chairman of the Board and President

OPERATIONAL REVIEW

MARKETING

Seated around a conference table (at right) are key members of the Marketing Department, under the direction of Acting Vice President Walter A. Rollins (center).

The group, along with their Marketing associates, are planning new and exciting advertising programs to coincide with the expanded April 30 schedules. New advertising and promotional campaigns are being initiated in conjunction with Stan Freberg, one of the country's foremost creative and performing personalities.

The Marketing Department has been strengthened with the addition of (seated around table) Alfred Kay, Director—Press Relations and Advertising; Warren W. Lauer, Director—Reservations; Ralph A. Johansen, Director—Sales; and Chief Stewardess Carolyn Ward.

INDUSTRIAL RELATIONS

A six-day strike by the airline mechanics was settled in November, and a contract with the union was drawn to expire on March 1, 1969. Other union contracts with Pacific's pilots, stewardesses, dispatchers and station personnel extend beyond 1967. Director—Industrial Relations, William H. Levings, is shown in photograph (at right) interviewing new personnel.

GROUND OPERATIONS

Ground operations, under the supervision of Eric J. Wilson (lower right on opposite page) is currently engaged in a program to improve the handling of passengers, baggage and ticketing; and throughout Pacific's 37 stations in three Western states is a new sense of co-ordination and dedication.

Contributing to the efforts is Lincoln F. Stock, who here checks the catering service, always important to both passenger and airline.

ROUTE DEVELOPMENT

Raymond E. Costello (shown in photo at the bottom of this page) is Vice President —Traffic, and his principal duties are concerned with route development. The work of Mr. Costello, conducted in conjunction with other company officers, can be seen on the route map on inside back cover. Numerous applications for new routes and new authority are on file with the Civil Aeronautics Board.

MAINTENANCE AND ENGINEERING

John W. Steffen, Vice President—Maintenance and Engineering (top left) sums up the objectives of his department in this way: "We are here to provide airplanes that are reliable and available—and when put to use in the sky will continue that reliability and availability. The planes must be safe for the passenger and economical for the company."

Pacific's new base has made this objective a reality; man-hours have been reduced and the maintenance work is being done even better. New cost-controls have been initiated, as well, with the aid of an IBM computer system.

TRAINING

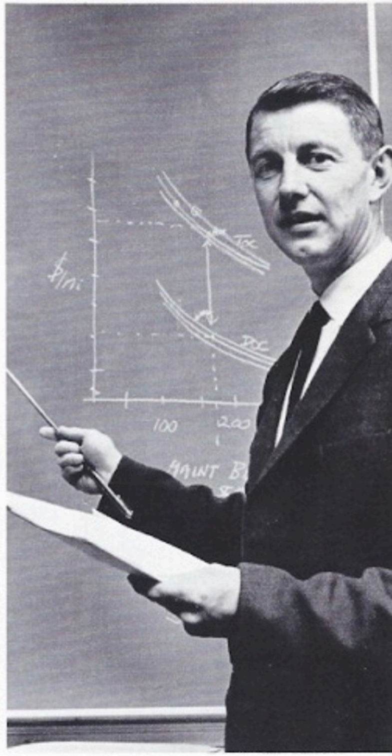
A new Training center will be constructed in 1967 within Pacific's 16-acre complex, and a 737 flight simulator will be installed there. For the first time, all training activities will be carried out under one roof—training programs for pilots, stewardesses, mechanics, reservations and sales personnel, etc. These programs, in convenient and efficient classrooms, will produce an even higher degree of proficiency and productivity among Pacific's personnel.

RESEARCH

Juan O'Callahan, Vice President—Economic Research and Planning (top right photo on the following page), is engaged

RESEARCH (Con't.)

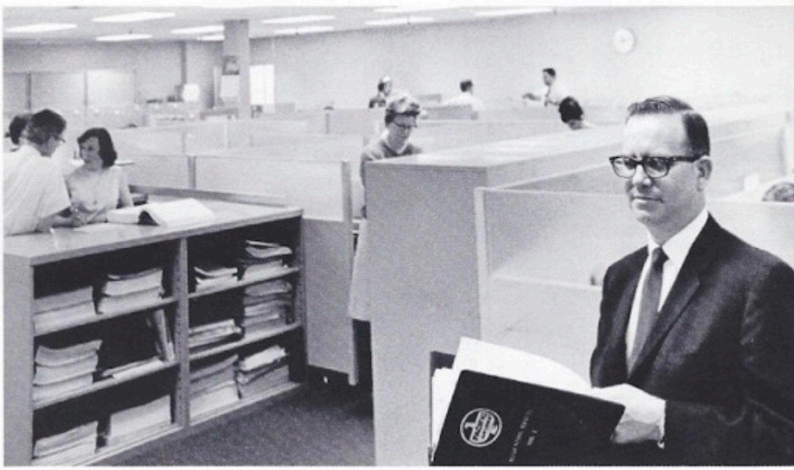
in an exacting project that will project Pacific's general needs, routes and equipment over a five-year period. His department has just completed a study concerning Pacific's system and the expanding Hollywood-Burbank airport area.



FLIGHT OPERATIONS

Rudy C. Couk, Vice President—Flight Operations, has under his direction the company's pilots, co-pilots, flight engineers, and the departments of flight control and crew scheduling. Each demands specific attention for their specific tasks, but all are co-ordinated into an efficient whole.

Couk (in photo at right) is further assured of efficiency by the group concept of Pacific's new general office building. All personnel are now centered in one convenient and concentrated area. Within this area Couk and his associates are planning the training programs for the introduction of 737 jets.



FINANCE

Harry W. Swenson has recently been appointed Vice President—Finance, and utilizing fully the capabilities of Pacific's IBM Computer System 360 has brought rewarding innovations to his department.

All of the company's accounting activities are now being co-ordinated in a more effective manner. Information and guidance concerning budgets and cost-controls are being advanced to each of the departments, and paper work is being reduced to provide a more efficient operation. An integrated and flexible budget system will soon be introduced. Mr. Swenson appears in the photo at right.

FINANCIAL HIGHLIGHTS

FINANCIAL	1966	1965
Total revenues	$16,773,105	$14,684,589
Operating income	$ 286,953	$ 1,462,036
Net income	$ 150,716	$ 700,337
Income per share—based on the weighted average of the number of shares outstanding during the year	$ 0.12	$ 0.65*(a)*
Long-term debt	$ 4,608,614	$ 2,518,405
Working capital	$ 270,270	$ 837,833
Stockholders' equity	$ 6,255,246	$ 6,237,502
Shares outstanding at end of year	1,305,110	1,186,580
Book value per share	$ 4.79	$ 4.78*(a)*

(a) Adjusted to reflect 10% stock dividend April 15, 1966

STATISTICAL	1966	1965
Revenue miles flown	6,937,094	6,302,180
Available seat miles (000)	336,023	261,311
Revenue passenger miles (000)	171,544	138,379
Revenue passengers	835,062	695,131
Passenger load factor	51.1%	53.0%
Passenger revenues per passenger mile	7.2¢	7.3¢
Number of airports served	30	30
Number of aircraft	18	18
Number of employees at end of year	969	802

ASSETS

	December 31 1966	December 31 1965
CURRENT ASSETS:		
Cash (including time deposits, 1966 and 1965—$1,000,000, pledged in 1966)	$ 1,381,756	$ 2,230,168
Accounts receivable:		
United States Government:		
Mail, passenger and other	876,641	614,807
Refundable federal income taxes	273,000	
Traffic and agents	685,258	475,396
Refundable advances for construction of building *(Note 6)*	1,275,186	
Insurance claims and miscellaneous, less allowance for doubtful accounts (1966 and 1965—$8,000)	317,518	60,270
Expendable parts and supplies, at approximate cost less reserves	550,308	545,745
Prepaid expenses	137,120	193,222
Total current assets	5,496,787	4,119,608
PROPERTY AND EQUIPMENT, at cost— pledged under notes payable *(Note 2)*:		
Flight equipment	12,538,461	11,780,154
Ground and other equipment	1,285,770	1,124,358
	13,824,231	12,904,512
Less—Accumulated depreciation and amortization	5,986,922	5,296,604
	7,837,309	7,607,908
Advance payments on flight equipment *(Note 6)*	2,061,078	288,855
	9,898,387	7,896,763
OTHER ASSETS:		
Route extension and development expense, less amortization	208,021	120,323
Preoperating cost of new flight equipment, less amortization	665,488	65,977
Other	94,390	62,638
	967,899	248,938
	$16,363,073	$12,265,309

LIABILITIES

	December 31 1966	December 31 1965
CURRENT LIABILITIES:		
Notes payable to bank—current instalments *(Note 2)*	$ 647,690	$ 986,448
Accounts payable	3,273,263	1,224,401
Taxes collected or withheld from others	187,437	238,049
Accrued expenses	849,774	316,080
Unearned transportation revenue	268,353	211,265
Federal income taxes		178,754
6½% convertible subordinated debentures, redeemed in January 1966		126,778
Total current liabilities	5,226,517	3,281,775
LONG-TERM DEBT:		
Notes payable to bank *(Note 2)*	1,582,376	2,518,405
Advances under long-term loan commitment (secured by $1,000,000 in time deposits) *(Note 6)*	3,000,000	
Equipment contracts payable	26,238	
	4,608,614	2,518,405
FEDERAL INCOME TAXES DEFERRED TO FUTURE YEARS	272,696	227,627
STOCKHOLDERS' EQUITY *(Notes 1, 2 and 4):*		
Common stock:		
Authorized, 2,000,000 shares of 50¢ par value per share Outstanding, 1966—1,305,110; 1965—1,186,580 shares	652,555	593,290
Paid-in surplus	3,905,139	2,438,079
Earned surplus, per accompanying statement	1,697,552	3,206,133
	6,255,246	6,237,502
COMMITMENTS AND CONTINGENT LIABILITIES *(Note 6)*		
	$16,363,073	$12,265,309

STATEMENT OF INCOME AND EARNED SURPLUS

	Year ended December 31	
	1966	*1965*
Operating revenues:		
Passenger	$12,274,373	$10,134,450
Mail	298,278	266,622
Express, freight and excess baggage	435,358	394,977
Other	169,510	193,857
	13,177,519	10,989,906
Public service revenue	3,595,586	3,694,683
	16,773,105	14,684,589
Operating expenses:		
Flying operations	4,326,112	3,364,356
Maintenance	3,456,121	2,983,030
Passenger service	648,867	506,538
Aircraft and traffic servicing	3,790,570	3,038,357
Promotion and sales	1,852,581	1,316,260
General and administrative	1,273,622	969,663
Depreciation	1,068,425	1,016,967
Amortization of preoperating and route development costs	69,854	27,382
	16,486,152	13,222,553
Operating income	286,953	1,462,036
Other expenses:		
Interest (less interest income, 1966—$68,765; 1965—$64,465)	121,792	258,718
Loss on disposition of assets	14,844	8,398
Other	26,491	19,583
	163,127	286,699
Income before federal income taxes and extraordinary item	123,826	1,175,337
Federal income taxes, exclusive of taxes related to extraordinary item:		
Provision (refund) for current year (after investment credit, 1966—$55,000; 1965—$94,000)	(126,000)	414,000
Deferred to future years	147,000	61,000
	21,000	475,000
Income before extraordinary item (per share: 1966—$.08; 1965—$.65)	102,826	700,337
Gain realized on disposition of Martin aircraft, less related income taxes of $44,000 (per share $.04)	47,890	
Net income for the year (per share: 1966—$.12; 1965—$.65) *(Notes 3 and 7)*	150,716	700,337
Earned surplus:		
Balance, beginning of year	3,206,133	2,505,796
Provision for vacation pay as of January 1, 1966, less related federal income taxes of $113,521 *(Note 3)*	(122,982)	
Transferred to common stock and paid-in surplus at time of stock dividend	(1,536,315)	
Balance, end of year	$ 1,697,552	$ 3,206,133

	Year ended December 31	
	1966	1965
Source of funds:		
From operations:		
Net income for the year	$ 150,716	$ 700,337
Expenses which did not require cash outlay:		
Depreciation and amortization	1,138,279	1,044,349
Provision for overhaul of aircraft	685,569	636,506
Provision for taxes deferred to future years	147,000	61,000
	2,121,564	2,442,192
Advances under long-term loan commitment	3,000,000	
Net proceeds from sales of equipment, less 1966 gain of $91,890 (included in net income for the year)	237,351	24,410
	5,358,915	2,466,602
Application of funds:		
Long-term debt paid or maturing currently	909,791	1,213,726
Additions to flight and ground equipment (including two Boeing 727 jet engines in 1966)	1,432,088	192,457
Advances on purchase of flight equipment	1,772,223	288,855
Overhaul costs of airframes and engines	788,658	684,757
Preoperating costs of aircraft	652,461	30,430
Route development	104,602	97,999
Provision for vacation pay as of January 1, 1966, less related federal income tax	122,982	
Other, net	143,673	24,138
	5,926,478	2,532,362
Net decrease in working capital	$ 567,563	$ 65,760
Working capital:		
Beginning of year	$ 837,833	$ 903,593
End of year	270,270	837,833
Net decrease in working capital	$ 567,563	$ 65,760

NOTES TO FINANCIAL STATEMENTS - DECEMBER 31, 1966

Note 1—*Change of state of incorporation:*

On July 14, 1966 Pacific Air Lines, Inc., an Arizona corporation, was merged into the Company for the purpose of changing its state of incorporation from Arizona to Delaware. In connection therewith the number of shares of common stock authorized was changed from 40,000,000 to 2,000,000.

Note 2—*Notes payable to bank:*

	December 31	
	1966	*1965*
5¼% note payable in monthly instalments of \$38,550 to April 1967, and thereafter in monthly instalments of \$5,550 to February 1969	\$ 292,090	\$ 754,690
5¾% note payable in monthly instalments of \$38,000 to March 1971	1,937,976	2,750,163
Total	2,230,066	3,504,853
Less—Instalments due within one year	647,690	986,448
Instalments due after one year	\$1,582,376	\$2,518,405

The Company's turbo-prop aircraft and related spare parts are pledged as security under chattel mortgages for the loans.

Under the terms of the loan agreements, the Company has agreed that (1) it will not, without the prior consent of the bank, pay any dividends (except in stock) or purchase, redeem or otherwise acquire for value any of its outstanding shares, and (2) it will maintain current assets at least equal to current liabilities (excluding the current portion of notes payable).

Note 3—*Accrued vacations:*

As of January 1, 1966 the Company adopted the practice of accounting for vacation pay on an accrual basis and the accrued liability, less related income taxes, has been charged to earned surplus as of that date. As a result of this change net income for 1966 is approximately \$29,000 less than it would have been under the method previously followed. The effect of this change on net income for the year 1965 was not material.

Note 4—*Paid-in surplus:*

Balance, December 31, 1965	$2,438,079
Excess of market value over par value of 118,470 shares of common stock issued as a 10% stock dividend on April 15, 1966 (after deducting expenses of issuance)	1,466,070
Excess of amount received over par value of 60 shares of common stock sold in connection with incorporation in the State of Delaware	990
Balance, December 31, 1966	$3,905,139

Note 5—*Pension plans:*

The Company has two pension plans for pilot personnel and one pension plan for non-pilot personnel. Of the pilots' pension plans, one has been non-contributory since 1962 and the other, a variable benefit plan, became non-contributory in August 1966. The non-pilot pension plan has been contributory since its inception. During 1966, earnings were charged with $286,638 representing the Company's share of current and past service pension costs.

At December 31, 1966 unfunded past service costs under the plans amounted to $482,000 which will be funded over future years at a rate which should accumulate sufficient funds to meet pension obligations to employees as they retire.

Note 6—*Commitments and contingent liabilities:*

As of December 31, 1966 the Company had aggregate lease commitments of $3,029,000 payable as follows: 1967—$832,000; 1968—$516,000; 1969—$128,000; 1970 through 1979—$929,000; and 1980 through 1990—$624,000. These leases relate to land, terminal facilities and aircraft and include the following major lease commitments: (a) lease of two Boeing 727 jet aircraft delivered in 1966 and (b) lease of certain land at the San Francisco International Airport for a new maintenance base and office building which the Company occupied in January 1967. The Company has arranged to finance the new building facilities, which were contracted for at an approximate cost of $1,700,000, by means of a sale and leaseback arrangement with a non-profit organization. At December 31, 1966, $1,275,186 had been expended for construction costs of the new building facilities and is included in current assets in the accompanying balance sheet. The sale and leaseback is subject to the non-profit organization's obtaining a favorable ruling from the Internal Revenue Service regarding its income. The proposed lease provides for approximately equal semiannual payments from September 1967 to March 1986 and the unpaid rental balance in March 1986. The lease also contains two options to extend the term for ten years each to a terminal date of November 2005. If these options are exercised the unpaid rental balance at March 1986 would be payable in approximately equal semiannual payments over the extended term.

The Company is committed to purchase six Boeing 737 and one Boeing 727 jet aircraft at an approximate aggregate cost of $30,000,000, including spare parts. The Boeing 727 jet aircraft was delivered March 10, 1967, and the six Boeing 737 jet aircraft are scheduled for delivery during the latter part of 1967 through early 1969. The jet aircraft are to be financed by means of long-term bank loans of which $16,000,000 has been arranged to date. In connection with this financing the presently outstanding notes payable to bank are to be retired.

At December 31, 1966 $3,000,000 has been advanced by the Bank under the long-term commitment. The new long-term bank loan, when executed, is to be secured by chattel mortgages on the Company's jet and turbo-prop aircraft and related spare parts.

On March 3, 1967 the Company entered into a lease-purchase agreement for a Model 737 digital flight simulator, delivery to be made within twelve months. The term of the lease is twenty-five months from the date of delivery at a monthly rental of $15,000. The agreement contains an obligation to purchase at a varying purchase price, from $988,000 at the date of delivery decreasing to $784,816 at the end of the lease period. In the event of cancellation by Pacific prior to April 17, 1967, the Company is obligated to pay $60,000 to the lessor. After April 17, 1967, the agreement is non-cancellable.

On March 18, 1967 the Company completed arrangements to lease three additional Fairchild F-27 turbo-prop aircraft. One lease is for a period of two years at an annual rental of $198,000; the remaining two leases are for a period of five years at an annual rental of $192,000 each. The leases contain an option to renew under terms similar to the original terms of the lease or under other mutually agreeable terms and an option to purchase upon thirty days' written notice by Pacific. If the Company exercises the purchase option a portion of the rental payments made (as specified in the Agreement) will apply to the purchase price of approximately $900,000 per aircraft.

The Company has been named defendant in several lawsuits resulting from the crash in May 1964 of one of its Fairchild F-27 turbo-prop aircraft. In the opinion of Company officials any liability that may result from claims for passenger fatality as a result of the crash should be adequately covered by insurance.

Note 7—*Net income for the year:*

In accordance with a recent pronouncement of the Accounting Principles Board of The American Institute of Certified Public Accountants, an extraordinary item has been included in the determination of net income for the year.

Per share data are based on the weighted average of the number of shares outstanding during the respective periods, retroactively adjusted for the 10% stock dividend issued in 1966.

PRICE WATERHOUSE & CO.
120 MONTGOMERY STREET
SAN FRANCISCO 94104

March 20, 1967

To the Board of Directors and Stockholders of
Pacific Air Lines, Inc.

In our opinion, the accompanying balance sheet, the related statement of income and earned surplus and the statement of source and application of funds present fairly the financial position of Pacific Air Lines, Inc., at December 31, 1966, the results of its operations and the supplementary information on funds for the year, in conformity with generally accepted accounting principles, applied on a basis consistent with that of the preceding year, except for the change (which we approve) in the method of accounting for vacation pay described in Note 3 to the financial statements. Our examination of these statements was made in accordance with generally accepted auditing standards and accordingly included such tests of the accounting records and such other auditing procedures as we considered necessary in the circumstances. It was not practicable to obtain confirmation of certain receivables from the United States Government by direct correspondence, but we satisfied ourselves as to these amounts by application of other auditing procedures.

Price Waterhouse & Co.

TRANSFER AGENTS

BANK OF AMERICA N. T. & S. A.
300 Montgomery Street
San Francisco, California

BANK OF NEW YORK
48 Wall Street
New York, New York

REGISTRARS

WELLS FARGO BANK
450 Mission Street
San Francisco, California

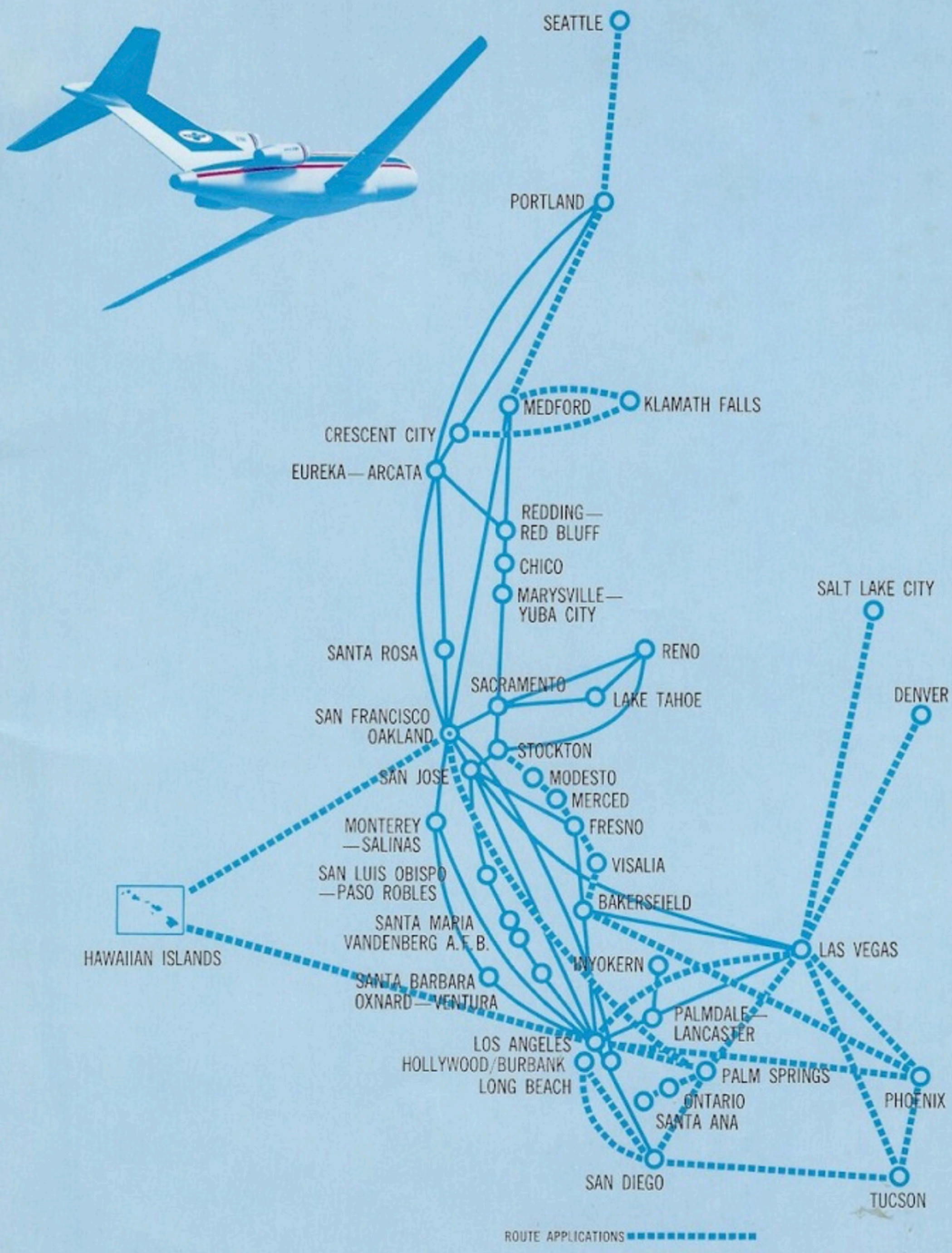
IRVING TRUST COMPANY
One Wall Street
New York, New York

ANNUAL MEETING

May 8, 1967, 11 o'clock (E.D.T.)
in the morning

No. 100 West Tenth Street
Wilmington, Delaware

Pacific Air Lines introduced its distinctive new stewardess uniforms this month. They were designed by Saks Fifth Avenue, New York City.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MEDFORD
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REDDING—
RED BLUFF
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