Work Hard. Fly Right.

CONTINENTAL AIRLINES 1997 ANNUAL REPORT

SUCCESS IN 1997

Fly to Win

We achieved operating income of $716 million, $191 million more than last year

Continental grew faster internationally (23.6%) than any other carrier

Our domestic Revenue per Available Seat Mile exceeded industry average (104.6%)

We had the highest load factor (70.9%) of any year in Continental history

Virgin Atlantic Airways became our alliance partner

We announced and began significant expansion projects at each of our underdeveloped hubs

OnePass won six of nine Freddie Awards, including Program of the Year and Best Elite-Level Program

Fund the Future

Our net interest expense was 36% less than 1996

We ordered new aircraft, including new-generation 737s, 767s and 777s

Our new aircraft will reduce our average fleet age to 7.2 years by 1999

We completed $2.7 billion of new financings primarily for airplanes and facilities at an average interest rate of 7%

Make Reliability a Reality

We won an unprecedented, second consecutive J.D. Power Award

Air Transport World named us "Airline of the Year"

We were the most improved company of the 1990s on *Fortune* magazine's annual Most Admired Companies list

We added reliable GTE telephones throughout our fleet

Working Together

We paid our employees $126 million in profit sharing and on-time bonuses

Our key people measures improved substantially over pre-turnaround 1994, including:

- Sick time declined 29%
- Employee turnover declined 45%
- On-the-job injuries declined 58%

We committed to bring employees to industry standard wages in the next 30 months

Front cover: Jeff Reeder, Captain, 20 years; Julia Hull, Continental Express Flight Attendant, 6 years; Jim Hicks, Customer Service Representative, 26 Years; and Gina Kearney, Customer Service Agent, 2 Years

FINANCIAL HIGHLIGHTS AND OPERATING STATISTICS

(In millions of dollars, except per share data)

	Reorganized Company					Predecessor Company
	Year Ended December 31,				Period from Reorganization (April 28, 1993 through December 31,	Period from January 1, 1993 through April 27,
	1997	1996	1995	1994	1993)	1993
Operating Revenue	$ 7,213	$ 6,360	$ 5,825	$ 5,670	$ 3,910	$ 1,857
Total Operating Expenses	6,497	5,835	5,440	5,681	3,815	1,971
Operating Income (Loss)	716	525	385	(11)	95	(114)
Income (Loss) Before Income Taxes, Minority Interest, Extraordinary Loss and Special Items[1]	640	556	202	(204)	(52)	(159)
Income (Loss) Before Extraordinary Gain (Loss)	389	325	224	(613)	(39)	(979)
Net Income (Loss)	385	319	224	(613)	(39)	2,640
Income (Loss) Applicable to Common Shares	$ 383	$ 314	$ 215	$ (619)	$ (42)	$ 2,640
Earnings (Loss) per Common Share	$ 6.65	$ 5.75	$ 4.07	$ (11.88)	$ (1.17)	N.M.*
Earnings (Loss) per Common Share Assuming Full Dilution	$ 4.99	$ 4.17	$ 3.37	$ (11.88)	$ (1.17)	N.M.*

Results prior to April 28, 1993 reflect the consolidated activities of Continental Airlines Holdings, Inc. or its predecessor because their activities correspond more closely to those of the current Continental Airlines, Inc.

*N.M. — Not meaningful — Historical per share data for the Predecessor Company is not meaningful since the Company was recapitalized and adopted fresh start reporting as of April 27, 1993.

[1]Special items include a fleet disposition charge of $128 million in 1996, a gain on the sale of System One of $108 million in 1995, a nonrecurring charge of $447 million in 1994, and reorganization items of $818 million in the period ended April 27, 1993.

OPERATING STATISTICS

(Jet Operations Only)

	1997	1996	1995	1994	1993
Revenue passengers (thousands)	41,210	38,332	37,575	42,202	38,628
Revenue passenger miles (millions) (a)	47,906	41,914	40,023	41,588	42,324
Available seat miles (millions) (b)	67,576	61,515	61,006	65,861	67,011
Passenger load factor (c)	70.9%	68.1%	65.6%	63.1%	63.2%
Breakeven passenger load factor (d)	60.0%	60.7%	60.8%	62.9%	63.3%
Passenger revenue per available seat mile	9.19¢	8.93¢	8.20¢	7.22¢	7.17¢
Operating cost per available seat mile (e)	9.07¢	8.77¢	8.36¢	7.86¢	7.90¢
Average yield per revenue passenger mile (f)	12.96¢	13.10¢	12.51¢	11.44¢	11.35¢
Average price per gallon of fuel	62.91¢	60.92¢	55.02¢	53.52¢	59.26¢
Fuel gallons consumed (millions)	1,357	1,228	1,203	1,349	1,333
Actual aircraft in fleet at end of period (g)	337	317	309	330	316

(a) The number of scheduled miles flown by revenue passengers.
(b) The number of seats available for passengers multiplied by the number of scheduled miles those seats are flown.
(c) Revenue passenger miles divided by available seat miles.
(d) The percentage of seats that must be occupied by revenue passengers in order for the airline to breakeven on income before income taxes, excluding nonrecurring charges, nonoperating items and other special items. This statistic excludes Express operations.
(e) Operating expenses divided by available seat miles. 1996 excludes fleet disposition charge totaling $128 million.
(f) The average revenue received for each mile a revenue passenger is carried.
(g) 1997 excludes six all-cargo 727 CMI aircraft and two 737-100's that were removed from service in 1997 and three DC-10-30 Continental aircraft that were delivered in 1997, but were not placed into service until 1998. 1996 excludes four all-cargo 727 aircraft at CMI, three A300 and one 747 Continental aircraft that were removed from service in 1995 and four DC-10-30 Continental aircraft that were delivered in 1996, but were not placed into service until 1997.

TO OUR CO-WORKERS, CUSTOMERS AND STOCKHOLDERS:

1997 was Continental Airlines' best year ever.

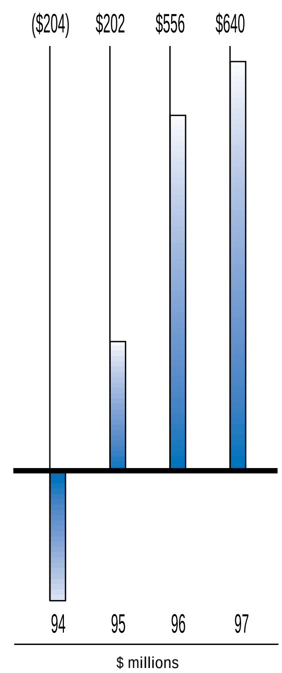
The highlight in a third straight year of "firsts" was the recognition by customers that Continental is once again the top-performing airline. In May 1997, customers surveyed by J.D. Power and Associates and *Frequent Flyer* magazine voted and awarded Continental, for an unprecedented second straight year, the coveted J.D. Power Award for customer satisfaction for flights 500 miles or more. In 1996, Continental became the first company in any industry to go from worst to first in the J.D. Power rankings, and in 1997 Continental became the first airline ever to win the award in back-to-back years. All U.S. airlines compete vigorously for this award because most customers, particularly connecting passengers, have many choices as to which airline they will fly. We are proud our co-workers have delivered the consistent, reliable service necessary to win back-to-back titles.

In January 1997, *Air Transport World*, our industry's leading publication, evaluated the world's 300-plus air carriers and awarded Continental "Airline of the Year." In March 1997, *The Wall Street Journal's Smart Money Magazine* named Continental's BusinessFirst service the best trans-Atlantic business class service of any U.S. airline, calling Continental the "Cinderella of the Skies." In January 1998, our industry-leading OnePass frequent flyer program dominated *Inside Flyer* magazine's prestigious Freddie Awards. The Freddie Awards are voted on by frequent flyers, and OnePass captured six of the nine awards, including Program of the Year and Best Elite-Level Program.

These honors are concrete evidence that we have the two essential elements of long-term success — a product we are proud to deliver and people who like coming to work everyday. We continue to show the trophies around our system so that our co-workers who earned them can enjoy them.

Three years ago we started with a basic understanding that "what gets measured and rewarded gets done." This led to the development of a strategy implemented in January 1995 that we call the Go Forward Plan. While the Go Forward Plan has

Pre-Tax Income *(loss)*



note: excludes special gains and charges

Fly To Win

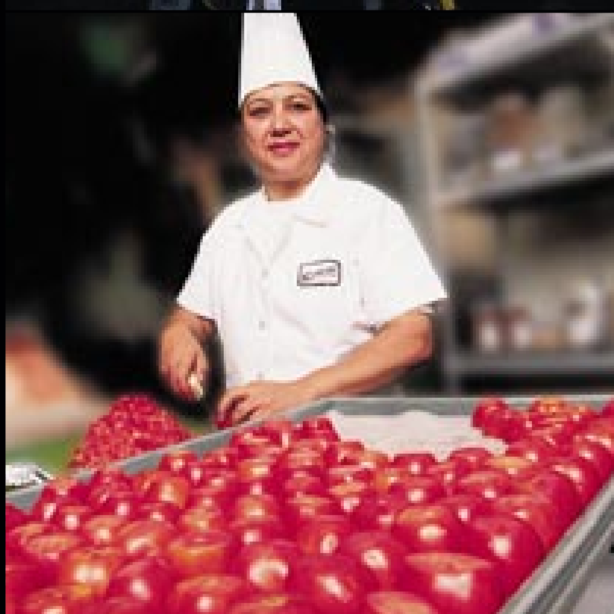
Roberto Montenegro, Airport Sales Agent, 1 year

Achieve top-quartile industry margins. Grow the airline where it can make money, and improve the mix of "coats and ties" versus "backpacks & flip-flops." Expand international-airline alliances and continue eliminating non-value-added costs.

Barry Walze, Lead Technician, 10 Years

▼ Danny Paulino, Lead Technician, 9 Years

Connie McAlister, Customer Service Agent, 2 Years ▼



▲ Juana Barriga, Chelsea Representative, 12 Years

Isabel Conceicao, Lead Presidents Club Representative, 10 Years ▲

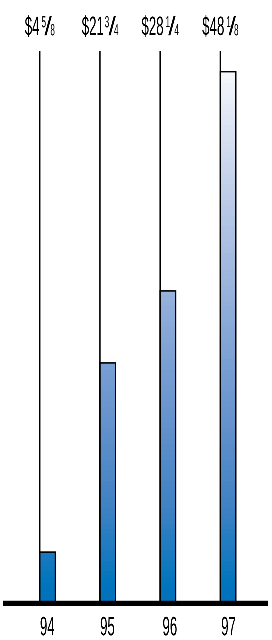
evolved, it has served as our foundation from 1995-1997 and will continue for the future. Its four cornerstones — Fly to Win, Fund the Future, Make Reliability a Reality and Working Together — are practical, measurable, flexible and, most importantly, make sense to our co-workers.

Financially, 1997 was a banner year for us. We achieved a record $640 million pre-tax profit in spite of the fact that the federal government reinstated a 10% ticket tax in 1997 that was not present for the majority of 1996. The $640 million pre-tax profit in 1997 compares to a $556 million pre-tax profit in 1996, a $202 million pre-tax profit in 1995, and a $204 million pre-tax loss in 1994, special charges and gains excluded.

In addition to record profitability, we delivered what we promised in 1997: margins which were near the top of our industry and the fastest growth of any major hub carrier. Once again, we ended the year with over $1 billion in cash. We now have the financial stability to weather the storms and provide our co-workers careers, not just jobs!

As always, we continue to focus on the values that our customers measure: on-time arrivals, baggage handling, fewest complaints, and fewest involuntary denied boardings, as measured by the U.S. Department of Transportation. Our performance on each of these measures improved in 1997 over 1996. Our consistent operational performance is primarily what won us our second consecutive J.D. Power Award.

Closing Stock Price



CAI.B closing prices

Once again, we accomplished all of this by Working Together. Our co-workers received $126 million in on-time bonuses and profit sharing. On average, each employee received bonuses equal to approximately 9% of their base pay. Our pay-for-performance strategy has clearly worked. It is good for our co-workers, customers and stockholders.

As a result of our performance, our stock continued to climb — rising from $28.25 per share on December 31, 1996 to $48.13 per share on December 31, 1997 — a whopping 70.4% increase. In January 1995 our stock traded as low as $3.25 per share. Continental employees have worked together to add more than $3 billion in stockholder value over the past three years.

That is our 1997. No matter how you measure us, we clearly remain at the top of our industry and we are carrying a lot of momentum into 1998.

We began 1998 by announcing an innovative alliance with Northwest Airlines that will benefit customers for years to come. By aligning with Northwest and our joint alliance partners, we can provide customers with the largest seamless network in the world, spanning Asia, Europe, and North, Central and South America. Customers will earn OnePass miles anywhere in the world, businesses can expect volume discounts for using the combined network, and our travel agent partners will be able to sell a network which rivals any of our competitors. We have a great deal of respect for our counterparts at Northwest and are proud to be their partners.

GO FORWARD PLAN

Tremendous results occur when 40,000 people focus on the same objectives for three straight years. Like a championship football team, everyone is in our huddle before every play. We communicate constantly. We are proud coaches as we watch our team work together to successfully execute the game plan time after time. Let's review what our team did in 1997 and what we plan to do in 1998.

FLY TO WIN

In 1995 we told you we were going to stop doing things that lose money … and we did. In 1996 we told you that we were going to achieve a 10% operating margin before we started expanding … and we did. In 1997 we promised rapid growth of 3-6% domestically and much faster internationally while maintaining a 10% operating margin.

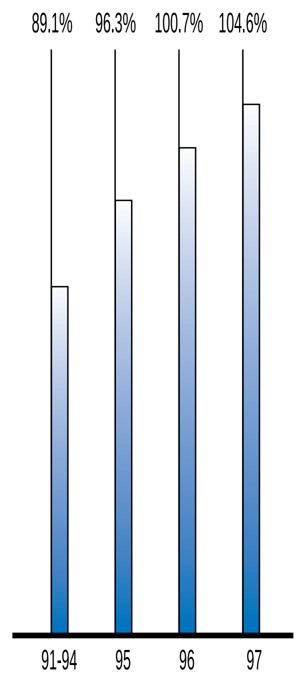
How did we do?

We accomplished our 1997 goals as well. We grew our seat miles 4.5% domestically and 23.6% internationally, the fastest of any major hub carrier, while finishing the year with a 10% operating margin.

How did we accomplish this?

We entered 1997 with every part of our Company working like a Swiss watch. All of our aircraft were deployed to our franchise hubs in Houston, New York/Newark, Cleveland and Guam with a profitable core schedule. Serving as the hub carrier in these four markets has increased the size and, most importantly, predictability of our

Revenue Premium



Domestic revenue per available seat mile versus the industry average (length of haul adjusted)

Fund the Future

Larry Kellner, Executive Vice President and Chief Financial Officer, 3 Years; Jeff Smisek, Executive Vice President and General Counsel, 3 Years

Reduce interest expense, develop our franchise hubs and lay the foundation for future growth. Focus on the fleet plan and develop hub real estate. Generate strong cash flow and improve financial flexibility.

Kevin Bruno, Customer Service Agent, 8 Years

Antwon Warden, Customer Service Agent, 10 Years

Sandy Paeste, Promotions Coordinator, 3 Years

Rafael Iturbide, Corporate Sales Manager, 1 Year

Doug Albasi, Technician, 10 Years

profits. Due to years of neglect, our domestic hubs are all undersized compared to our competitors. This affords us the profitable growth opportunities other carriers took advantage of years ago. Our consistent and reliable product continues to attract increasing numbers of business customers. While we value all customers, our business customers pay more for the convenience of booking our perishable seat inventory at the last minute and changing plans without penalty. The percent of our revenue from business customers has increased steadily from 32.2% in 1994, 38.3% in 1995, 42.8% in 1996 and 43.8% in 1997.

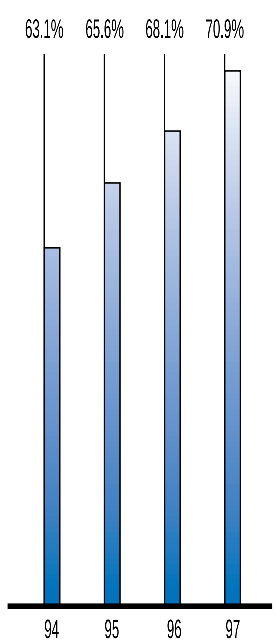
We expect continued improvement in 1998. The Northwest alliance will help provide us with the network necessary to reach our goal of having 50-55% of our revenue come from business customers, resulting in approximately $200 million of incremental pre-tax income.

Our load factor has also improved. In 1997, our load factor increased to 70.9% from 68.1% in 1996, 65.6% in 1995 and 63.1% in 1994. The significant increase in both local and flow traffic through our hubs is enabling us to very profitably add larger airplanes and more frequencies to existing markets and to enter new markets.

We have made significant progress in developing our international route and alliance network. Our European route system has grown from four destinations in 1994 to 13 by the summer of 1998. We now serve more European destinations out of the New York area than all but one carrier. The Air France, Alitalia and CSA Czech alliances we discussed last year are producing results that have far exceeded our expectations. We implemented our new relationship with Virgin Atlantic Airways in early 1998 and look forward to adding KLM. We are confident we have alliance partners throughout Europe that will allow Continental to grow and prosper.

In Latin America, we were the second-largest carrier in terms of destinations served in 1997. Over the past two years we have added a profitable operation throughout South America from our Houston and New York/Newark hubs to complement the strong position we have long held in Mexico and Central America. We are well underway in developing an alliance network in Latin America in spite of the anti-competitive actions a competitor continues to take in this part of the world. We expect an alliance

Load Factor Improvement



with ACES of Colombia to come on line in 1998, and we continue in discussions with several other carriers as we broaden our participation in this market in 1998.

In Asia, we plan to add service from New York/Newark and Houston to Tokyo in late 1998 and early 1999, respectively. Our new alliance with Northwest will augment our existing alliance with EVA to give us a significant presence in the trans-Pacific market for the first time.

Our alliances with America West, Sky West, Gulfstream and China Airlines continue to do well.

Fly to Win in 1998 will mirror 1997. We plan to grow approximately 6% domestically and 20-25% internationally while maintaining an operating margin near the top of our industry. We have entered into projects to expand each of our under-developed hubs, including expanding into Terminal B in Houston; a new regional jet facility in Cleveland; and new terminals, a longer runway and direct train service from Manhattan in Newark. These projects will become operable over the next several years.

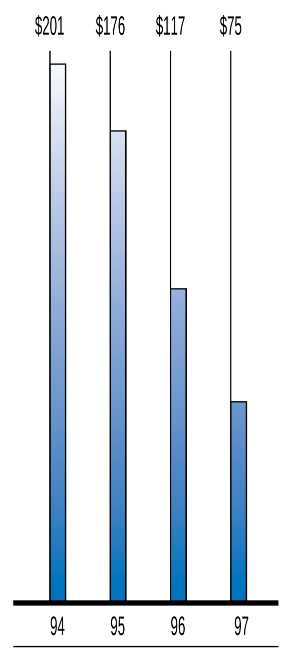
We will begin rapidly implementing our alliance with Northwest. In 1998, expect reciprocal frequent flyer programs and club memberships, Continental codes on certain Northwest flights feeding Continental's Latin American service, Continental codes on Northwest flights to Japan, and joint travel agent and business discount programs.

We will continue to make Continental's presence as New York/New Jersey's only hub carrier better known in the New York metropolitan area. Our Newark hub is clearly Continental's most leverageable asset. We intend to take full advantage of our position in the nation's largest market by offering a superior product to our customers and "getting the word out."

FUND THE FUTURE

With our credibility in the financial markets established, we spent 1997 refinancing our high-interest loans of the past with more traditional lenders at normal interest rates, financing our new aircraft and hub facilities at very attractive long-term interest rates, and eliminating non-value-added costs.

Net Interest Expense



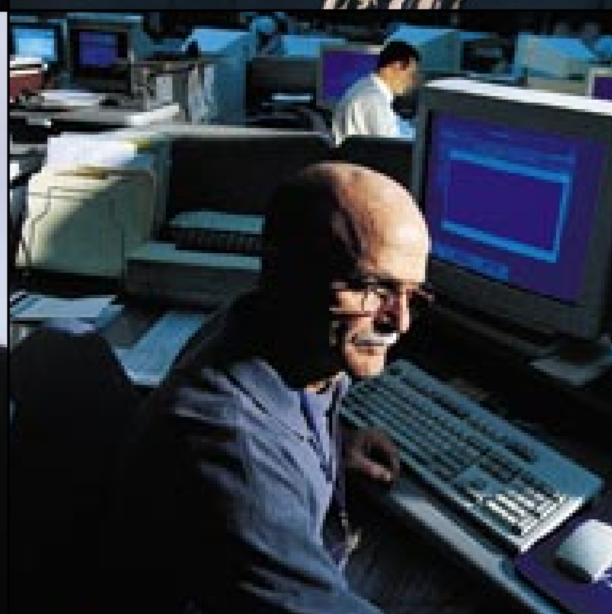
Make Reliability a Reality

Steve Hermann, Lead Technician, 11 Years

Have an industry-leading product we are proud to sell. Rank at the top of our industry in the four key D.O.T. measurements: on-time, baggage, complaints, and involuntary denied boardings. Keep polishing the company's image and improving the product.

▼ Elizabeth Greer, Customer Service Agent, 1 Year; Louis Ortiz, Customer Service Agent, 1 Year

Beverly Thompson, Reservations Quality Development Counselor and Trainer, 12 Years ▼



▲ Jeff Counts, Flight Attendant, 11 Years

Trista Gotlin, Flight Attendant, 11 Years

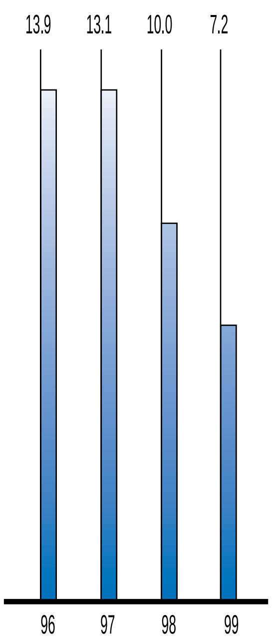
Dave Harvey, Director System Operations, 35 Years ▲

Our refinancing is clearly paying big dividends. Compared to 1994, we have saved over $126 million in annual net interest expense and $20 million in aircraft leases.

We placed several major aircraft orders. The net effect of these orders is to provide our customers with a much better product at a much lower cost to Continental. The orders were placed in a manner that allows Continental to adjust its growth over a five-year period from zero to 7% to meet market demand and to adjust the size of its aircraft. These orders include Boeing 737-500 (104 seats), the newer, faster 737-700 (124 seats), 737-800 (155 seats), 737-900 (167 seats), and 757 (185 seats) aircraft to replace our aging DC-9s, 737-100s and -200s, and 727s before the government-mandated noise modification of those old airplanes is required in 2000. We also ordered the new 767-400s and 777s to augment, and eventually replace, our DC-10 fleet. We inducted into service the new fast, quiet, 50-seat Embraer 145 regional jets. We expect to transition to an all-jet fleet in the regional market in the next five years.

By 1999, Continental's jet fleet age will drop from an average of 13.2 years currently to about 7.2 years, one of the youngest in the industry. The number of aircraft types in Continental's core fleet will be reduced from nine at the beginning of 1995 to five by the end of 1999, saving on maintenance, inventory and training.

Average Jet Fleet Age



Average age in years; excludes Continental Micronesia, includes ExpressJet

We have made great progress in financing the fleet. $2.2 billion of the $4.2 billion required debt financing through 1999 has been completed at an average interest rate around 7%, well below the rate at which most of our competitors have financed their recent fleet purchases.

All the 1998 aircraft deliveries have been substantially pre-financed. In addition to reducing costs by refinancing high-cost debt and acquiring new airplanes at a lower total cost than our current fleet, in 1998 we have tasked the organization with reducing non-value-added costs by $100 million. These are costs which do not affect our product, such as the reduction of normal ticket processing through the use of electronic ticketing and the reduction in aircraft insurance costs. Our unit cost increases should track inflation as these cost reductions substantially offset wage-rate increases.

We expect to generate significant cash flow from both operations and the sale of non-strategic assets in 1998.

MAKE RELIABILITY A REALITY

Continental is consistently clean, safe and reliable. This cornerstone is vital to our success; it's who we are and what we do, more than 2,000 flights every day. It's the basics of our business — on-time arrivals, few customer complaints, great baggage delivery and the lowest involuntary denied boardings.

To make sure we Make Reliability a Reality, all our departments work with flight scheduling to continually refine our flight schedule. We continue to operate our 1-800 hotlines, manned by pilots, flight attendants and others to solve operational problems. Our airplanes and airports all have a consistent Continental image and are cleaned frequently. In key markets we've "Latinized" our airports, offering more Spanish signage and staffing.

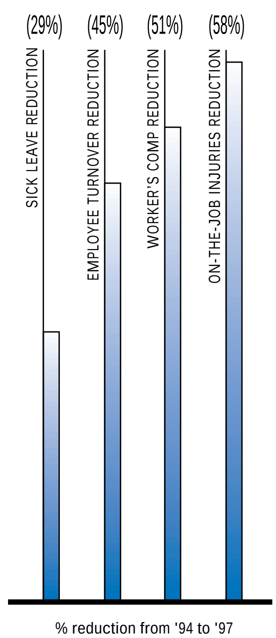
We serve appropriate food on the airplane when the customers want it. We are working hard to provide product enhancements and select services that our customers want, such as GTE phones on all of our aircraft, new Presidents Clubs in key cities and state-of-the-art entertainment systems on our new long-range aircraft. It's the product and service we provide that keep Continental ahead of the competition.

WORKING TOGETHER

Working Together worked again! Everyone in our Company knows that the airline business is the biggest team sport in the world. We all win together or lose together. Every year, we know when we set our goals, we need all 40,000 of our co-workers to be 100% committed to achieve them. Continental is a fun place to work today because we treat each other with the dignity and respect each member of this championship team deserves. We communicate openly and honestly, and we listen to each other. Everyone has a job to do, and they do it without interference or second guessing by management. Each of us is accountable and rewarded for our performance.

It is easy to measure our progress in Working Together. Every key employee satisfaction measure has increased every year for the last three years. In 1997, compared to 1994, our employee turnover is down 45%, we have more job applications than we can

Working Together Indicators



Working Together

Susan Oliver, Flight Attendant, 11 Years; Debra Collins, Flight Attendant, 15 Years; Pratt Sherer, First Officer, 14 Years; Sherri Klein, Flight Attendant, 12 Years; and Ken Robertson, Captain, 21 Years

Have a company where employees enjoy coming to work every day and are valued for their contributions. Treat each other with dignity and respect. Focus on safety, make employee programs easy to use, and keep improving communication. Pay compensation which is fair to employees and fair to the company.

First Quarter Earned pre-tax income of $124 million, a 51% increase over first quarter 1996. Handed out $68 million in profit sharing to employees. Named "Airline of the Year" by *Air Transport World*.

Second Quarter Became the first airline in history to win the *Frequent Flyer*/J.D. Power Award for two consecutive years. Announced expansion at Cleveland Hopkins International Airport. Inaugurated Lisbon, Portugal service.

Third Quarter Highest quarterly load factor (73.7%) in company's history. Gave eight brand-new Ford Explorers to employees with perfect attendance. Launched new service to Brazil.

Fourth Quarter Eleventh consecutive period of record quarterly profits. RASM rose 4.8%. Launched new service to Caracas, Venezuela. Announced new service to Ireland and Scotland.

handle, workers' compensation claims are down 51%, our sick leave is down 29% and the sales of Continental-logo merchandise at our Company store are up 400%.

All of our employees have received healthy pay increases over the last three years and, in 1997, we promised all of our employees that we will phase in industry-standard wages over the next 30 months. "Industry standard" is defined as the other nine carriers we compete with in the Department of Transportation rankings. The phase-in of industry-standard wages corresponds to the refinancing and pay down of above-market debt and aircraft leases. Why are we doing this? Because it is the right thing to do. We simply do not believe in financing the Company on the backs of our co-workers. We sometimes have differences as we debate what is fair, but we respect each other and have always resolved our differences amicably.

Today we have *careers*, not just jobs, at the best airline in the world.

Working Together is the major difference between a dysfunctional airline with a $175 million market value in 1995 and a two-time J.D. Power Award winner with more than a $4 billion market value today. Working Together has made us winners, and we plan to keep it up.

We know we need to work just as hard to stay successful as we did to achieve success. We will not relax. We are committed to significant returns for our stockholders while improving the environment in which we work.

Our solid performance this year once again proves we have changed the fundamentals of our Company. We are repeat champions both operationally and financially. We have no intention of stopping now.

We commit to you that all of our co-workers at Continental will continue to Work Hard and Fly Right.

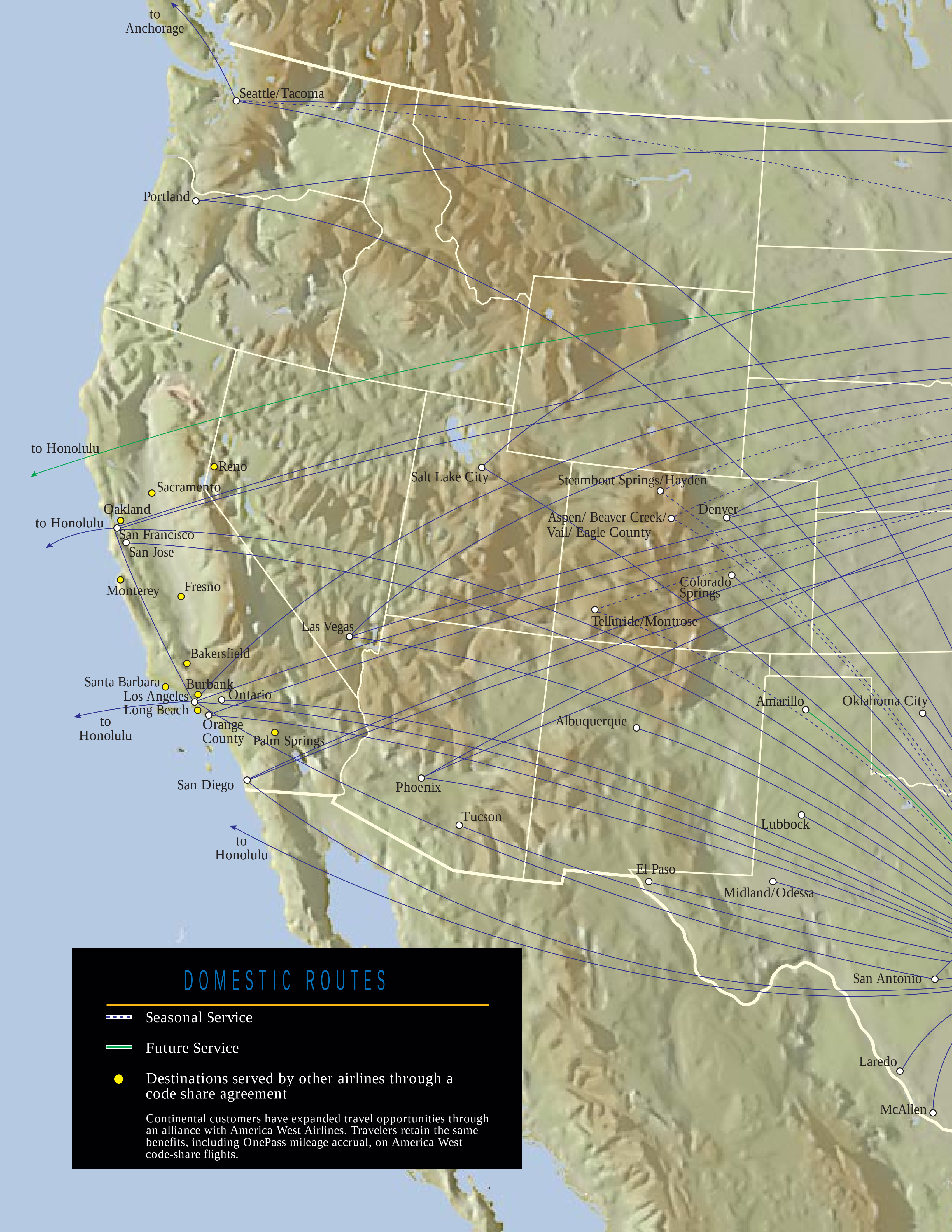
Thank you for choosing us.

Gordon

Gordon Bethune
Chairman of the Board and Chief Executive Officer

Greg

Greg Brenneman
President and Chief Operating Officer


to Anchorage
Seattle/Tacoma
Portland
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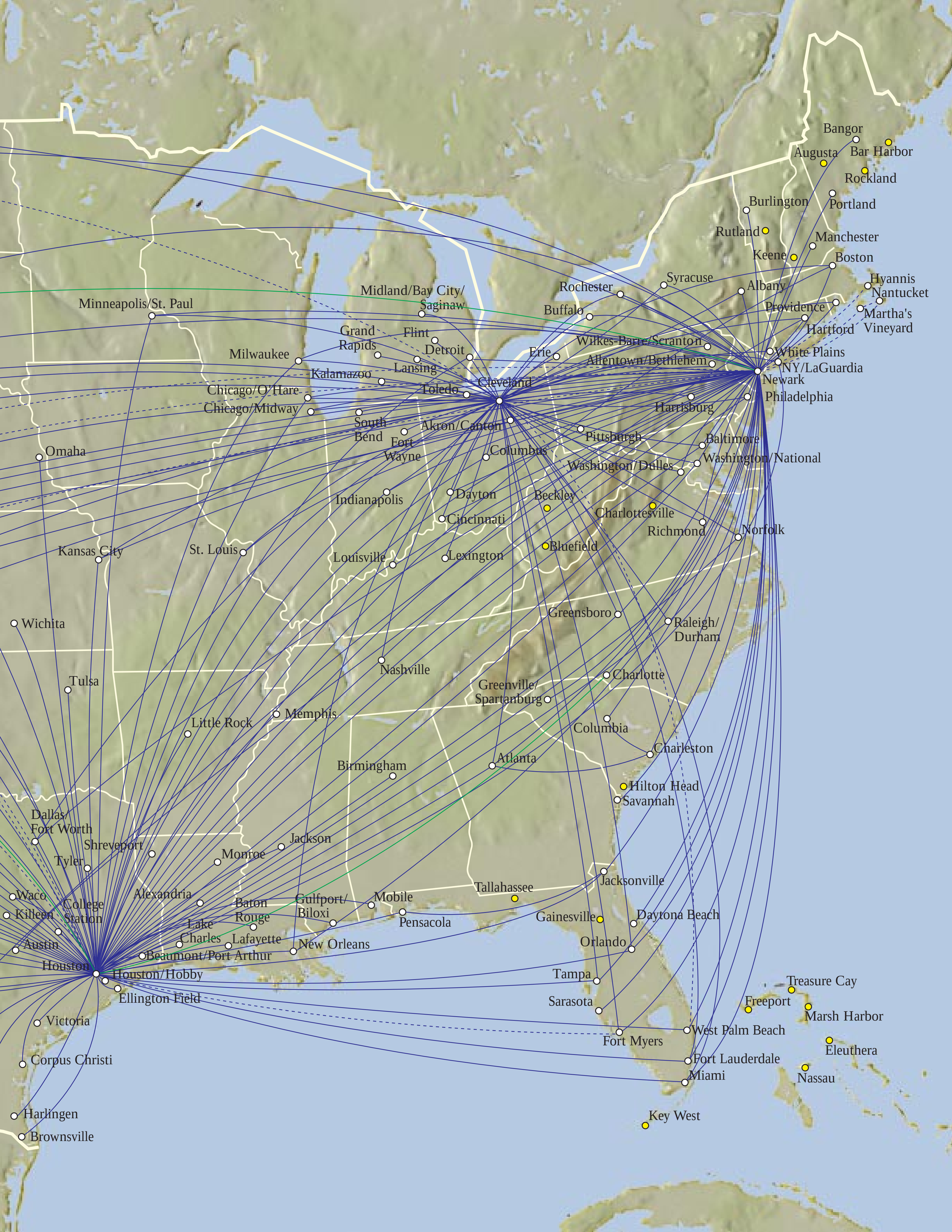
Reno
Sacramento
Oakland
to Honolulu
San Francisco
San Jose
Monterey
Fresno
Salt Lake City
Steamboat Springs/Hayden
Aspen/ Beaver Creek/ Vail/ Eagle County
Denver
Colorado Springs
Telluride/Montrose
Las Vegas
Bakersfield
Santa Barbara
Burbank
Los Angeles
Ontario
Long Beach
to Honolulu
Orange County
Palm Springs
San Diego
Phoenix
Tucson
to Honolulu
Albuquerque
Amarillo
Oklahoma City
Lubbock
El Paso
Midland/Odessa
San Antonio
Laredo
McAllen
DOMESTIC ROUTES
Seasonal Service
Future Service
Destinations served by other airlines through a code share agreement
Continental customers have expanded travel opportunities through an alliance with America West Airlines. Travelers retain the same benefits, including OnePass mileage accrual, on America West code-share flights.



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Bar Harbor
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Rockland
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Burlington
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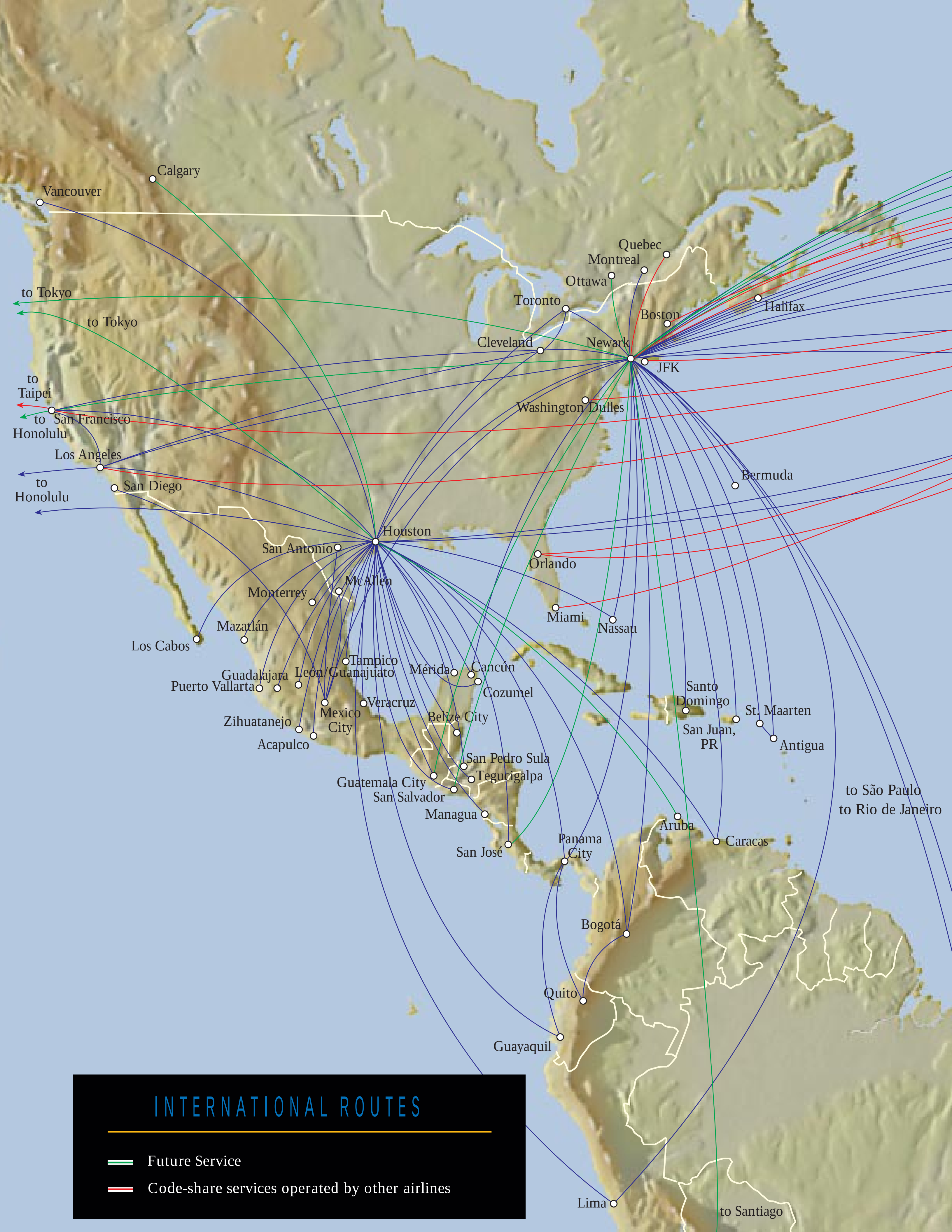
Manchester
Keene
Boston
Syracuse
Hyannis
Nantucket
Rochester
Albany
Martha's Vineyard
Providence
Buffalo
Hartford
Midland/Bay City/Saginaw
Minneapolis/St. Paul
Grand Rapids
Flint
Wilkes-Barre/Scranton
Erie
White Plains
Detroit
Milwaukee
Lansing
Allentown/Bethlehem
NY/LaGuardia
Kalamazoo
Cleveland
Newark
Toledo
Chicago/O'Hare
Philadelphia
Harrisburg
Chicago/Midway
South Bend
Akron/Canton
Fort Wayne
Pittsburgh
Baltimore
Omaha
Columbus
Washington/National
Washington/Dulles
Dayton
Beckley
Indianapolis
Charlottesville
Cincinnati
Richmond
Norfolk
Kansas City
St. Louis
Bluefield
Louisville
Lexington
Greensboro
Wichita
Raleigh/Durham
Nashville
Tulsa
Charlotte
Greenville/Spartanburg
Memphis
Little Rock
Columbia
Charleston
Atlanta
Birmingham
Hilton Head
Savannah
Dallas/Fort Worth
Shreveport
Jackson
Monroe
Tyler
Tallahassee
Jacksonville
Waco
Alexandria
Mobile
Gulfport/Biloxi
College Station
Baton Rouge
Killeen
Gainesville
Daytona Beach
Pensacola
Lake Charles
Lafayette
Austin
Orlando
New Orleans
Beaumont/Port Arthur
Houston
Houston/Hobby
Tampa
Treasure Cay
Ellington Field
Freeport
Sarasota
Marsh Harbor
Victoria
West Palm Beach
Fort Myers
Eleuthera
Corpus Christi
Fort Lauderdale
Miami
Nassau
Harlingen
Key West
Brownsville



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Quebec
Montreal
Ottawa
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Boston
Halifax
to Tokyo
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Newark
JFK
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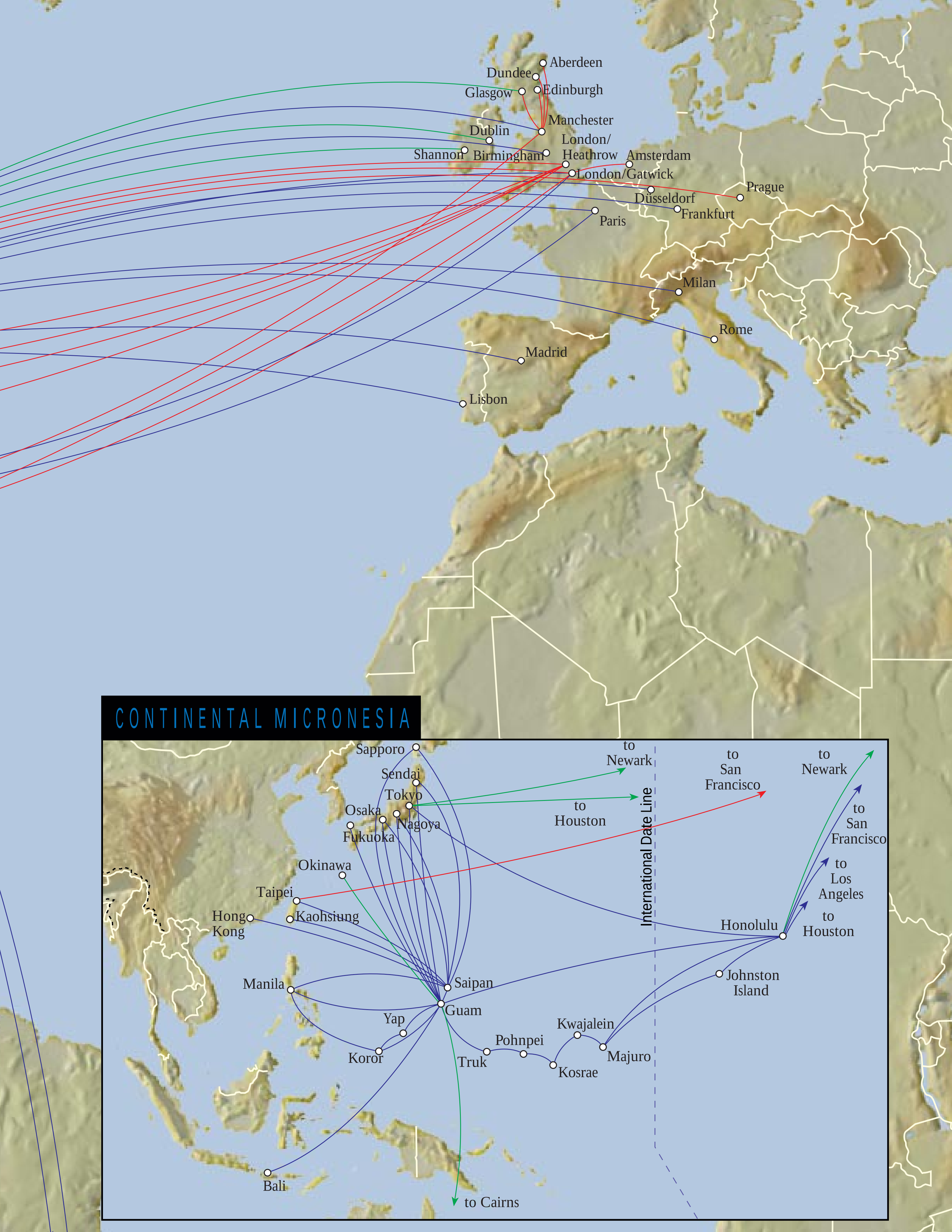
to San Francisco
Honolulu
Washington Dulles
Los Angeles
to
Honolulu
San Diego
Bermuda
Houston
San Antonio
Orlando
McAllen
Monterrey
Miami
Nassau
Mazatlán
Los Cabos
Tampico
Guadalajara
León/Guanajuato
Mérida
Cancún
Puerto Vallarta
Cozumel
Santo
Domingo
Veracruz
Mexico
City
St. Maarten
Zihuatanejo
Belize City
San Juan,
PR
Antigua
Acapulco
San Pedro Sula
Tegucigalpa
Guatemala City
San Salvador
to São Paulo
to Rio de Janeiro
Managua
Aruba
Panama
City
Caracas
San José
Bogotá
Quito
Guayaquil
INTERNATIONAL ROUTES
Future Service
Code-share services operated by other airlines
Lima
to Santiago



Aberdeen
Dundee
Edinburgh
Glasgow
Manchester
Dublin
London/
Heathrow
Shannon
Birmingham
Amsterdam
London/Gatwick
Prague
Düsseldorf
Frankfurt
Paris
Milan
Rome
Madrid
Lisbon
CONTINENTAL MICRONESIA
Sapporo
Sendai
Tokyo
Osaka
Nagoya
Fukuoka
Okinawa
Taipei
Kaohsiung
Hong
Kong
Manila
Saipan
Guam
Yap
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Truk
Pohnpei
Kosrae
Kwajalein
Majuro
Johnston
Island
Honolulu
Bali
to Cairns
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Houston
International Date Line
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Houston

FINANCIAL INFORMATION

MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS

The following discussion may contain forward-looking statements. In connection therewith, please see the cautionary statements contained in Continental Airlines, Inc.'s Annual Report on Form 10-K for the year ended December 31, 1997, which identifies important factors that could cause actual results to differ materially from those in the forward-looking statements. Hereinafter, the terms "Continental" and the "Company" refer to Continental Airlines, Inc. and its subsidiaries, unless the context indicates otherwise.

Results of Operations

The following discussion provides an analysis of the Company's results of operations and reasons for material changes therein for the three years ended December 31, 1997.

Comparison of 1997 to 1996. The Company recorded consolidated net income of $385 million and $319 million for the years ended December 31, 1997 and 1996, respectively, including a $128 million fleet disposition charge ($77 million after taxes) in 1996 and after-tax extraordinary losses relating to the early extinguishment of debt of $4 million and $6 million in 1997 and 1996, respectively. Management believes that the Company benefitted in the first three quarters of 1996 and in the first quarter of 1997 from the expiration of the aviation trust fund tax (the "ticket tax") on December 31, 1995 and December 31, 1996, respectively. The ticket tax was reinstated on August 27, 1996 and again on March 7, 1997. Management believes that the ticket tax has a negative impact on the Company, although neither the amount of such negative impact directly resulting from the reimposition of the ticket tax, nor the benefit realized by its expiration, can be precisely determined. Additionally, the Company benefitted in the first six months of 1996 from the recognition of previously unbenefitted post-reorganization net operating loss carryforwards ("NOLs").

Passenger revenue increased 13.4%, $789 million, during 1997 compared to 1996. The increase was due to a 14.3% increase in revenue passenger miles on capacity growth of 9.9% offset by a 1.1% decrease in yield.

Cargo revenue increased 13.6%, $21 million, during 1997 compared to 1996 due to an increase in cargo capacity, primarily in international markets.

Mail and other revenue increased 12.8%, $43 million, from 1996 to 1997 primarily as a result of an increase in mail volumes (principally in international markets) and an increase in other revenue related to frequent flyer mileage credits sold to participating partners in the Company's frequent flyer program ("OnePass").

Wages, salaries and related costs increased 16.3%, $236 million, during 1997 as compared to 1996 due in part to a 9.6% increase in the average number of full-time equivalent employees from approximately 34,300 for the year ended December 31, 1996 to 37,600 for the year ended December 31, 1997. Wages and salaries also increased in 1997 due to a $29 million accrual for the impact of the tentative collective bargaining agreement with the pilots.

Employee incentives increased 29.9%, $29 million, from 1996 to 1997 as a result of an increase in employee profit sharing of $37 million offset by a decrease in on-time bonuses of $8 million.

Aircraft fuel expense increased 14.3%, $111 million, from 1996 to 1997 primarily due to a 10.5% increase in the quantity of jet fuel used from 1.228 billion gallons during 1996 to 1.357 billion gallons during 1997, resulting from increased flying. In addition, the average price per gallon, net of fuel hedging gains of $65 million in 1996, increased 3.3% from 60.9 cents in 1996 to 62.9 cents in 1997.

Commissions expense increased 11.2%, $57 million, in 1997 compared to 1996, primarily due to increased passenger revenue.

Aircraft rentals increased 8.3%, $42 million, from 1996 to 1997, primarily as a result of the delivery of new aircraft throughout 1997, net of retirements.

Maintenance, materials and repairs increased 16.5%, $76 million, during 1997 as compared to 1996, principally due to the volume and timing of engine overhauls, increase in component costs and routine maintenance as part of the Company's ongoing maintenance program. Aircraft maintenance expense was reduced by $16 million in 1997 due to the reversal of reserves that are no longer required as a result of the acquisition of 10 aircraft previously leased by the Company.

Other rentals and landing fees increased 12.9%, $45 million, during 1997 compared to 1996 due to higher facilities rentals and landing fees resulting from increased operations.

During the third quarter of 1996, the Company recorded a fleet disposition charge of $128 million ($77 million after taxes), related primarily to (i) the writedown of Stage 2 aircraft inventory to its estimated fair value; and (ii) a provision for costs associated with the return of leased aircraft at the end of their respective lease terms.

Other operating expense increased 14.9%, $194 million, in 1997 as compared to 1996, primarily as a result of increases in passenger services, advertising and publicity, reservations and sales expense and other miscellaneous expense.

Interest capitalized increased $30 million in 1997 compared to 1996 as a result of higher average purchase deposits for flight equipment resulting from the pending acquisition of new aircraft.

Interest income increased 30.2%, $13 million, in 1997 compared to the prior year principally due to an increase in the average invested balance of cash and cash equivalents.

Other nonoperating income (expense) for the year ended December 31, 1996 included an $18 million gain related to the sale of America West Airlines, Inc. ("America West") common stock and warrants.

The income tax provision for the year ended December 31, 1997 and 1996 of $237 million and $86 million, respectively, consists of federal, state and foreign income taxes. During the second quarter of 1996, the Company had fully utilized previously unbenefitted post-reorganization NOLs, and began accruing income tax expense.

Comparison of 1996 to 1995. The Company recorded consolidated net income of $319 million and $224 million for the years ended December 31, 1996 and 1995, respectively, including a $128 million fleet disposition charge ($77 million after taxes) and a $6 million after-tax extraordinary loss relating to the early extinguishment of debt in 1996. Continental's financial and operating performance improved significantly in 1996 compared to 1995, reflecting, among other things, continued implementation of the Company's strategic program to enhance the fundamentals of its operations, rationalize capacity, improve customer service and employee relations and strengthen its balance sheet and liquidity. Management believes that the Company benefitted significantly from the expiration of the ticket tax on December 31, 1995, although the amount of any such benefit directly resulting from the expiration of the ticket tax cannot precisely be determined. The ticket tax was reinstated on August 27, 1996, and expired again on December 31, 1996.

Implementation of the Company's route realignment and capacity rationalization initiatives increased capacity by 0.8% in 1996 as compared to 1995. This increase in capacity, combined with a 4.7% increase in traffic, produced a 2.5 percentage point increase in load factor to 68.1%. This higher load factor, combined with a 4.7% increase in the average yield per revenue passenger mile, contributed to a 10.7% increase in passenger revenue to $5.9 billion in 1996.

Mail and other revenue decreased 11.4%, $43 million, from 1995 to 1996 primarily as a result of a series of transactions entered into with a former subsidiary, System One Information Management, Inc. ("System One") (which were effective April 27, 1995). See Note 11 of Notes to Consolidated Financial Statements. Partially offsetting such decrease was an increase in other revenue resulting from a wet lease agreement with Alitalia, an agreement with DHL International to operate a sorting and distribution hub in Manila and an increase in revenue related to frequent flyer mileage credits sold to participating partners in the Company's OnePass program.

Wages, salaries and related costs increased 5.1%, $71 million, during 1996 as compared to 1995 due in part to an increase in the average number of full-time equivalent employees from approximately 33,700 for the year ended December 31, 1995 to approximately 34,300 for the year ended December 31, 1996. The increase is also attributable to pay increases effective July 1, 1996 for Continental's jet pilots and substantially all of its non-unionized employees and an increase in base wages and per diem payments for flight attendants resulting from the Company's collective bargaining agreement with the International Association of

Machinists and Aerospace Workers ("IAM") representing Continental's flight attendants.

Employee incentives increased $46 million from 1995 to 1996 primarily due to an increase in employee profit sharing of $37 million and an increase in on-time bonuses of $9 million.

Aircraft fuel expense increased 13.7%, $93 million, from 1995 to 1996. The average price per gallon, net of fuel hedging gains of $65 million in 1996, increased 10.7% from 55.0 cents in 1995 to 60.9 cents in 1996. In addition, there was a 2.1% increase in the quantity of jet fuel used from 1.203 billion gallons during 1995 to 1.228 billion gallons during 1996, principally reflecting increased capacity.

Commissions expense increased 4.3%, $21 million, in 1996 compared to 1995, primarily due to a 10.7% increase in passenger revenue, partially offset by a decrease in the percentage of commissionable revenue.

Aircraft rentals increased 2.4%, $12 million, from 1995 to 1996, primarily as a result of the delivery of new aircraft throughout 1996. Such increase was partially offset by retirements of certain leased aircraft and refinancings of certain leased aircraft.

Maintenance, materials and repairs increased 7.5%, $32 million, during 1996 as compared to 1995, principally due to the volume and timing of engine overhauls as part of the Company's ongoing maintenance program.

During the third quarter of 1996, the Company made the decision to accelerate the replacement of 30 DC-9-30 aircraft, six DC-10-10 aircraft, 31 727-200 aircraft, 13 737-100 aircraft and 17 737-200 aircraft between August 1997 and December 1999. As a result of its decision to accelerate the replacement of these aircraft, the Company recorded a fleet disposition charge of $128 million ($77 million after taxes). The fleet disposition charge relates primarily to (i) the write-down of Stage 2 aircraft inventory, which is not expected to be consumed through operations, to its estimated fair value; and (ii) a provision for costs associated with the return of leased aircraft at the end of their respective lease terms.

Interest expense decreased 22.5%, $48 million, from 1995 to 1996, primarily due to principal reductions of long-term debt and capital lease obligations as a result of the Company's refinancing initiatives.

Interest income increased 38.7%, $12 million, in 1996 compared to 1995, principally due to an increase in the average invested balance of cash and cash equivalents.

The Company's other nonoperating income (expense) for the year ended December 31, 1996 includes a $13 million gain related to the sale of approximately 1.4 million shares of America West common stock, a $5 million gain related to the sale of the America West warrants and foreign currency gains and losses (primarily related to the Japanese yen and the British pound).

Nonoperating income (expense) for the year ended December 31, 1995 primarily consisted of a pre-tax gain of $108 million from the System One transactions. Additionally in 1995, the bankruptcy court approved a settlement resolving certain claims filed by the Company for the return of certain aircraft purchase deposits. As a result of the settlement, the Company recorded a $12 million gain in 1995, included in other nonoperating income (expense). These gains were partially offset by an additional provision of $14 million for underutilized airport facilities and other assets (primarily associated with Denver International Airport) and a $5 million pretax charge which represented a waiver fee to a major creditor of the Company.

The income tax provision for the year ended December 31, 1996 of $86 million consists of federal, state and foreign income taxes. During 1996, the Company utilized previously unbenefitted NOLs, created subsequent to the Company's 1993 emergence from bankruptcy, and began accruing income tax expense in the second quarter. A provision for federal income taxes was recorded for the year ended December 31, 1995 related to the System One transactions. No additional provision was recorded in 1995 due to the previously incurred NOLs for which a tax benefit had not previously been recorded.

Certain Statistical Information

An analysis of statistical information for Continental's jet operations, excluding regional jets operated by Continental Express, for each of the three years in the period ended December 31, 1997 is as follows:

	1997	Net Increase/ (Decrease) 1997-1996	1996	Net Increase/ (Decrease) 1996-1995	1995
Revenue passenger miles (millions) (1)	47,906	14.3%	41,914	4.7%	40,023
Available seat miles (millions) (2)	67,576	9.9%	61,515	0.8%	61,006
Passenger load factor (3)	70.9%	2.8 pts.	68.1%	2.5 pts.	65.6%
Breakeven passenger load factor (4), (11)	60.0%	(0.7)pts.	60.7%	(0.1)pts.	60.8%
Passenger revenue per available seat mile (cents) (5)	9.19	2.9%	8.93	8.9%	8.20
Total revenue per available seat miles (cents) (6)	10.09	3.0%	9.80	8.6%	9.02
Operating cost per available seat mile (cents) (7), (11)	9.07	3.4%	8.77	4.9%	8.36
Average yield per revenue passenger mile (cents) (8)	12.96	(1.1)%	13.10	4.7%	12.51
Average fare per revenue passenger	$150.63	5.1%	$143.27	7.6%	$133.21
Revenue passengers (thousands)	41,210	7.5%	38,332	2.0%	37,575
Average length of aircraft flight (miles)	967	7.9%	896	7.2%	836
Average daily utilization of each aircraft (hours) (9)	10:13	2.3%	9:59	4.7%	9:32
Actual aircraft in fleet at end of period (10)	337	6.3%	317	2.6%	309

Continental has entered into block space arrangements with certain other carriers whereby one or both of the carriers is obligated to purchase capacity on the other carrier. One such arrangement began in June 1997 pursuant to which the other carrier is sharing Continental's costs of operating certain flights by committing to purchase capacity on such flights. The tables above exclude 738 million available seat miles in 1997, as well as the related revenue passenger miles and enplanements, which were purchased and marketed by the other carrier.

(1) The number of scheduled miles flown by revenue passengers.

(2) The number of seats available for passengers multiplied by the number of scheduled miles those seats are flown.

(3) Revenue passenger miles divided by available seat miles.

(4) The percentage of seats that must be occupied by revenue passengers in order for the airline to break even on an income before income taxes basis, excluding nonrecurring charges, nonoperating items and other special items.

(5) Passenger revenue divided by available seat miles.

(6) Total revenue divided by available seat miles.

(7) Operating expenses divided by available seat miles.

(8) The average revenue received for each mile a revenue passenger is carried.

(9) The average number of hours per day that an aircraft flown in revenue service is operated (from gate departure to gate arrival).

(10) Excludes six and four all-cargo 727 CMI aircraft in 1997 and 1996, respectively.

(11) 1996 excludes fleet disposition charge totaling $128 million.

Liquidity and Capital Resources

During 1997 and early 1998, the Company completed a number of transactions intended to strengthen its long-term financial position and enhance earnings:

In March 1997, Continental completed an offering of $707 million of pass-through certificates to be used to finance (through either leveraged leases or secured debt financings) the debt portion of the acquisition cost of up to 30 new aircraft from The Boeing Company ("Boeing") scheduled to be delivered to Continental through April 1998.

In April 1997, Continental entered into a $160 million secured revolving credit facility to be used for the purpose of making certain predelivery payments to Boeing for new Boeing aircraft to be delivered through December 1999.

In April 1997, Continental redeemed for cash all of the 460,247 outstanding shares of its Series A 12% Cumulative Preferred Stock held by an affiliate of Air Canada for $100 per share plus accrued dividends thereon. The redemption price, including accrued dividends, totaled $48 million.

In June 1997, Continental purchased from Air Partners, L.P. ("Air Partners") for $94 million in cash warrants to purchase 3,842,542 shares of Class B common stock of the Company.

In June 1997, Continental completed an offering of $155 million of pass-through certificates which were used to finance the acquisition of 10 aircraft previously leased by the Company.

In July 1997, Continental entered into a $575 million credit facility, including $350 million of term loans, $275 million of which was loaned by Continental to its wholly owned subsidiary Air Micronesia, Inc. ("AMI"), reloaned by AMI to its wholly owned subsidiary, Continental Micronesia, Inc. ("CMI") and used by CMI to repay its existing secured term loan. The facility also includes a $225 million revolving credit facility.

In July 1997, the Company (i) purchased (a) the right of United Micronesia Development Association's ("UMDA") to receive future payments under a services agreement between UMDA and CMI and (b) UMDA's 9% interest in AMI, (ii) terminated the Company's obligations to UMDA under a settlement agreement entered into in 1987, and (iii) terminated substantially all of the other contractual arrangements between the Company, AMI and CMI, on the one hand, and UMDA on the other hand, for an aggregate consideration of $73 million.

In September 1997, Continental completed an offering of $89 million of pass-through certificates which were used to finance the debt portion of the acquisition cost of nine Embraer ERJ-145 ("ERJ-145") regional jets.

In October 1997, the Company completed an offering of $752 million of pass-through certificates to be used to finance (through either leveraged leases or secured debt financings) the debt portion of the acquisition cost of up to 24 new Boeing aircraft scheduled to be delivered from April 1998 through November 1998.

In February 1998, the Company completed an offering of $773 million of pass-through certificates to be used to finance (through either leveraged leases or secured debt financings) the debt portion of the acquisition cost of up to 24 aircraft scheduled to be delivered from February 1998 through December 1998.

In addition, during 1997 and the first quarter of 1998, Continental completed several offerings totaling approximately $291 million aggregate principal amount of tax-exempt special facilities revenue bonds to finance or refinance certain airport facility projects. These bonds are payable solely from rentals paid by Continental under long-term lease agreements with the respective governing bodies.

The cash proceeds from the pass-through certificate transactions are deposited with a depositary bank for the benefit of the certificate holders and enable the Company to finance (through either leveraged leases or secured debt financings) the debt portion of the acquisition cost of new aircraft. As of March 18, 1998 approximately $1.6 billion of the proceeds remain on deposit. If any funds remain as deposits at the end of the specified delivery periods, such funds will be distributed back to the certificate holders.

As of December 31, 1997, Continental had approximately $1.9 billion (including current maturities) of long-term debt and capital lease obligations, and had approximately $1.2 billion of Continental-obligated mandatorily redeemable preferred securities of subsidiary trust and common stockholders' equity, a ratio of 1.6 to 1. As of December 31, 1996, the ratio of long-term debt and capital lease obligations (including current maturities) to minority interest, Continental-obligated mandatorily redeemable preferred securities of subsidiary trust, redeemable preferred stock and common stockholders' equity was 2.1 to 1.

As of December 31, 1997 the Company had $1.0 billion in cash and cash equivalents (excluding restricted cash), compared to $985 million as of December 31, 1996. Net cash provided by operating activities increased $129 million during the year ended December 31, 1997 compared to the same period in the prior year principally due to an improvement in operating income. Net cash used by investing activities for the year ended December 31, 1997 compared to the same period in the prior year increased $406 million, primarily as a result of higher capital and fleet-related expenditures in 1997 and lower purchase deposits refunded in connection with aircraft delivered in 1996. Net cash used by financing activities increased $80 million primarily due to (i) a decrease in payments on long-term debt and capital lease obligations, (ii) a decrease in proceeds received from the issuance of long-term debt and (iii) an increase in warrants purchased in 1997.

Continental has general lines of credit and significant encumbered assets.

Deferred Tax Assets. The Company had, as of December 31, 1997, deferred tax assets aggregating $1.1 billion, including $631 million of NOLs. The Company recorded a valuation allowance of $617 million against such assets as of December 31, 1997. Realization of a substantial portion of the Company's remaining NOLs will require the completion by April 27, 1998 of transactions resulting in recognition of built-in gains for federal income tax purposes. In the fourth quarter of 1997, the Company determined that it would be able to recognize an additional $155 million of NOLs attributable to the Company's pre-bankruptcy predecessor. This benefit, $62 million, was used to reduce reorganization value in excess of amounts allocable to identifiable assets. To the extent the Company were to determine in the future that additional NOLs of the Company's pre-bankruptcy predecessor could be recognized in the consolidated financial statements, such benefit would also reduce reorganization value in excess of amounts allocable to identifiable assets. If such reorganization value is exhausted, such benefit would decrease other intangibles. The Company may consummate one or more additional built-in gain transactions by April 28, 1998.

As a result of NOLs, the Company will not pay United States federal income taxes (other than alternative minimum tax) until it has recorded approximately an additional $515 million of taxable income following December 31, 1997. Section 382 of the Internal Revenue Code ("Section 382") imposes limitations on a corporation's ability to utilize NOLs if it experiences an "ownership change." In general terms, an ownership change may result from transactions increasing the ownership of certain stockholders in the stock of a corporation by more than 50 percentage points over a three-year period. In the event that an ownership change should occur, utilization of Continental's NOLs would be subject to an annual limitation under Section 382 determined by multiplying the value of the Company's stock at the time of the ownership change by the applicable long-term tax exempt rate (which was 5.23% for

February 1998). Any unused annual limitation may be carried over to later years, and the amount of the limitation may under certain circumstances be increased by the built-in gains in assets held by the Company at the time of the change that are recognized in the five-year period after the change. Under current conditions, if an ownership change were to occur, Continental's annual NOL utilization would be limited to approximately $147 million per year other than through the recognition of future built-in gains transactions.

Based on information currently available, the Company does not believe that the Air Partners agreement to dispose of its interest in the Company to an affiliate of Northwest Airlines, Inc. will result in an ownership change for purposes of Section 382. See "Management's Discussion and Analyses — Liquidity and Capital Resources — Other."

Purchase Commitments. In March 1998, Continental announced the conversion of 15 Boeing 737 option aircraft to 15 Boeing 737-900 firm aircraft and the addition of 25 option aircraft. As of March 18, 1998, Continental had firm commitments with Boeing to take delivery of a total of 154 jet aircraft (including the Boeing 737-900 aircraft described above) during the years 1998 through 2005 with options for an additional 61 aircraft (exercisable subject to certain conditions). These aircraft will replace older, less efficient Stage 2 aircraft and allow for growth of operations. The estimated aggregate cost of the Company's firm commitments for the Boeing aircraft is approximately $6.7 billion. As of March 18, 1998, Continental had completed or had third party commitments for a total of approximately $1.6 billion in financing for its future Boeing deliveries, and had commitments or letters of intent from various sources for backstop financing for approximately one-third of the anticipated remaining acquisition cost of such Boeing deliveries. The Company currently plans on financing the new Boeing aircraft with a combination of enhanced equipment trust certificates, lease equity and other third party financing, subject to availability and market conditions. However, further financing will be needed to satisfy the Company's capital commitments for other aircraft and aircraft-related expenditures such as engines, spare parts, simulators and related items. There can be no assurance that sufficient financing will be available for all aircraft and other capital expenditures not covered by firm financing commitments. Deliveries of new Boeing aircraft are expected to increase aircraft rental, depreciation and interest costs while generating cost savings in the areas of maintenance, fuel and pilot training.

In September 1996, Continental Express, Inc. ("Express") placed an order for 25 firm ERJ-145 regional jets, with options for an additional 175 aircraft exercisable through 2008. In June 1997, Express exercised its option to order 25 of such option aircraft and expects to confirm its order for an additional 25 of its remaining 150 option aircraft by August 1998. Neither Express nor Continental will have any obligation to take such aircraft that are not financed by a third party and leased to the Company. Express took delivery of 18 of the aircraft through December 31, 1997 and will take delivery of the remaining 32 aircraft through the third quarter of 1999. The Company expects to account for all of these aircraft as operating leases.

Continental expects its cash outlays for 1998 capital expenditures, exclusive of fleet plan requirements, to aggregate $211 million, primarily relating to mainframe, software application and automation infrastructure projects, aircraft modifications and mandatory maintenance projects, passenger terminal facility improvements and office, maintenance, telecommunications and ground equipment. Continental's capital expenditures during 1997 aggregated $118 million, exclusive of fleet plan requirements.

The Company expects to fund its future capital commitments through internally generated funds together with general Company financings and aircraft financing transactions. However, there can be no assurance that sufficient financing will be available for all aircraft and other capital expenditures not covered by firm financing commitments.

Year 2000. The Company uses a significant number of computer software programs and embedded operating systems that are essential to its operations. As a result, the Company implemented a Year 2000 project in early 1997 to ensure that the Company's computer systems will function properly in the year 2000 and thereafter. The Company anticipates completing its Year 2000 project in early 1999 and believes that, with modifications to its existing software and systems and/or conversions to new software, the Year 2000 Issue will not pose significant operational problems for its computer systems.

The Company has also initiated communications with its significant suppliers and vendors with which its systems interface and exchange data or upon which its business depends. The Company is coordinating efforts with these parties to minimize the extent to which its business will be vulnerable to their failure to remediate their own Year 2000 issues. The Company's business is also dependent upon certain governmental organizations or entities such as the Federal Aviation Administration ("FAA") that provide essential aviation industry infrastructure. There can be no assurance that the systems of such third parties on which the Company's business relies (including those of the FAA) will be modified on a timely basis. The Company's business, financial condition or results of operations could be materially adversely affected by the failure of its systems or those operated by other parties to operate properly beyond 1999. To the extent possible, the Company will be developing and executing contingency plans designed to allow continued operation in the event of failure of the Company's or third parties' systems.

The total cost (excluding internal payroll costs) of the Company's Year 2000 project is currently estimated at $12 million and will be funded through cash from operations. The cost of the Company's Year 2000 project is limited by the substantial outsourcing of its systems and the significant implementation of new systems following its emergence from bankruptcy in 1993. The costs of the Company's Year 2000 project and the date on which the Company believes it will be completed are based on management's best estimates and include assumptions regarding third-party modification plans. However, in particular due to the potential impact of third-party modification plans, there can be no assurance that these estimates will be achieved and actual results could differ materially from those anticipated.

Bond Financings. In April 1997, the City of Houston completed the offering of $190 million aggregate principal amount of tax-exempt special facilities revenue bonds (the "IAH Bonds") payable solely from rentals paid by Continental under long-term lease agreements with the City of Houston. The IAH Bonds are unconditionally guaranteed by Continental. The proceeds from the IAH Bonds are being used to finance the acquisition, construction and installation of certain terminal and other airport facilities located at Continental's hub at George Bush Intercontinental Airport, including a new automated people mover system linking Terminals B and C and 20 aircraft gates in Terminal B into which Continental intends to expand its operations. The expansion project is expected to be completed by the summer of 1999.

In December 1997, Continental substantially completed construction of a new hangar and improvements to a cargo facility at Continental's hub at Newark International Airport. Continental expects to complete the financing of these projects in April 1998 with $25 million of tax-exempt bonds. Continental is also planning a facility expansion at Newark which would require, among other matters, agreements to be reached with the applicable airport authority.

The Company is building a wide-body aircraft maintenance hangar in Honolulu, Hawaii at an estimated cost of $25 million. Construction of the hangar, anticipated to be completed by the second quarter of 1998, is being financed by tax-exempt special facilities revenue bonds issued by the State of Hawaii. In connection therewith, the Company has entered into long-term leases providing for the Company to make rental payments sufficient to service the related tax-exempt bonds.

Continental has announced plans to expand its facilities at its Hopkins International Airport hub in Cleveland, which expansion is expected to be completed in the third quarter of 1999. The expansion, which will include a new jet concourse for the regional jet service offered by Express, as well as other facility improvements, is expected to cost approximately $156 million and will be funded principally by the issuance of a combination of tax-exempt special facilities revenue bonds (issued in March 1998) and general airport revenue bonds (issued in December 1997) by the City of Cleveland. In connection therewith, Continental has entered into a long-term lease with the City of Cleveland under which rental payments will be sufficient to service the related bonds.

Employees. In April 1997, collective bargaining agreement negotiations began with the Independent Association of Continental Pilots ("the IACP") to amend both the Continental Airlines pilots' contract (which became amendable in July 1997) and Express pilots' contract (which became amendable in October 1997). In February 1998, a five-year collective bargaining agreement with the Continental Airlines pilots was announced by the Company and the IACP. In March 1998, Express also announced a five-year collective bargaining agreement with its pilots. These agreements are subject to approval by the IACP board of directors and ratification by the Continental and Express pilots. The Company began accruing for the increased costs of a tentative agreement reached in November 1997 in the fourth quarter of 1997. The Company estimates that such accrual will be approximately $113 million for 1998. The Company's mechanics and related employees recently voted to be represented by the International Brotherhood of Teamsters (the "Teamsters"). The Company does not believe that the Teamsters' union representation will be material to the Company. In September 1997, Continental announced that it intends to bring all employees to industry standard wages (the average of the top ten air carriers as ranked by the Department of Transportation excluding Continental) within 36 months. The announcement further stated that wage increases will be phased in over the 36-month period as revenue, interest rates and rental rates reached industry standards. Continental estimates that the increased wages will aggregate approximately $500 million over the 36-month period.

Other. As a result of the continued weakness of the yen against the dollar, a weak Japanese economy and increased fuel costs, CMI's operating earnings have declined during 1996 and 1997, and are not expected to improve materially absent a significant improvement in these factors.

In addition, the Company has entered into petroleum option contracts to provide some short-term protection against a sharp increase in jet fuel prices, and CMI has entered into average rate option contracts to hedge a portion of its Japanese yen-denominated ticket sales against a significant depreciation in the value of the yen versus the United States dollar.

On January 26, 1998, the Company announced that, in connection with an agreement by Air Partners, L.P. to dispose of its interest in the Company to an affiliate of Northwest Airlines, Inc. ("Northwest"), the Company had entered into a long-term global alliance with Northwest.

The Company estimates that the alliance with Northwest, when fully phased in over a three-year period, will generate in excess of $500 million in additional annual pre-tax operating income for the carriers, and anticipates that approximately 45% of such pre-tax operating income will accrue to the Company.

In February 1998, Continental began a block space arrangement whereby it is committed to purchase capacity on another carrier at a cost of approximately $147 million per year. This arrangement is for 10 years. Pursuant to other block space arrangements, other carriers are committed to purchase capacity on Continental.

On March 3, 1998, the Company announced that its Board of Directors had authorized the expenditure of up to $100 million to repurchase the Company's common stock or convertible securities. No time limit was placed on the duration of the repurchase program. Subject to applicable securities laws, such purchases will be at times and in amounts as the Company deems appropriate. As of March 17, 1998, 200,000 shares had been repurchased.

Management believes that the Company's costs are likely to be affected in the future by (i) higher aircraft rental expense as new aircraft are delivered, (ii) higher wages, salaries and related costs as the Company compensates its employees comparable to industry average, (iii) changes in the costs of materials and services (in particular, the cost of fuel, which can fluctuate significantly in response to global market conditions), (iv) changes in governmental regulations and taxes affecting air transportation and the costs charged for airport access, including new security requirements, (v) changes in the Company's fleet and related capacity and (vi) the Company's continuing efforts to reduce costs throughout its operations, including reduced maintenance costs for new aircraft, reduced distribution expense from using Continental's electronic ticket product ("E-Ticket") and the Internet for bookings, and reduced interest expense.

QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK

Market Risk Sensitive Instruments and Positions

The Company is subject to certain market risks, including commodity price risk (i.e., aircraft fuel prices), interest rate risk, foreign currency risk and price changes related to investments in equity securities. Following is a discussion of the adverse effects of potential changes in these market risks. The sensitivity analyses presented do not consider the effects that such adverse changes may have on overall economic activity nor do they consider additional actions management may take to mitigate the Company's exposure to such changes. Actual results may differ. See the notes to the consolidated financial statements for a description of the Company's accounting policies and other information related to these financial instruments.

Aircraft Fuel. The Company's results of operations are significantly impacted by changes in the price of aircraft fuel. During 1997, aircraft fuel accounted for 14% of the Company's operating expenses. Based on the Company's 1998 projected fuel consumption, a one cent change in the average annual price per gallon of aircraft fuel would impact the Company's annual aircraft fuel expense by approximately $15 million. In order to provide short-term protection (generally three to six months) against sharp increases in aircraft fuel prices, the Company has entered into petroleum call options. As of December 31, 1997, the Company had hedged approximately 24% of its projected 1998 fuel requirements, including 100% related to the first quarter.

Foreign Currency. The Company is exposed to the effect of exchange rate fluctuations on the U.S. dollar value of foreign currency denominated operating revenue and expenses. The Company's largest exposure comes from the Japanese yen. The result of a uniform 10% strengthening in the value of the U.S. dollar from December 31, 1997 levels relative to the yen is estimated to result in a decrease in operating income of approximately $25 million for 1998. However, the Company has mitigated the effect of certain of these potential foreign currency losses by purchasing foreign currency average rate option contracts that effectively enable it to sell Japanese yen expected to be received from yen-denominated ticket sales over the next nine to twelve months at specified dollar amounts. As of December 31, 1997, the Company had purchased average rate options to hedge approximately 100% of its projected 1998 net yen-denominated cash flows.

Interest Rates. The Company's results of operations are affected by fluctuations in interest rates (e.g., interest expense on debt and interest income earned on short-term investments).

The Company had approximately $714 million of variable-rate debt as of December 31, 1997. If average interest rates increased by 0.5% during 1998 as compared to 1997, the Company's projected 1998 interest expense would increase by approximately $3 million. The Company has mitigated its exposure on certain variable-rate debt by entering into an interest rate cap (notional amount of $142 million as of December 31, 1997) which expires in July 2001. The interest rate cap limits the amount of potential increase in the Eurodollar or Prime rate component of the floating rate to a maximum of 9% over the term of the contract.

As of December 31, 1997, the fair value of $793 million (carrying value) of the Company's fixed-rate debt was estimated to be $803 million, based upon discounted future cash flows using current incremental borrowing rates for similar types of instruments or market prices. Market risk, estimated as the potential increase in fair value resulting from a hypothetical 0.5% decrease in interest rates, was approximately $18 million as of December 31, 1997. The fair value of the remaining fixed-rate debt (with a carrying value of $162 million and primarily relating to aircraft modification notes and various loans with immaterial balances) was not practicable to estimate due to the large number and small dollar amounts of these notes.

If 1998 average short-term interest rates decreased by 0.5% over 1997 average rates, the Company's projected interest income from short-term investments would decrease by approximately $4 million during 1998.

Preferred Securities of Trust. As of December 31, 1997, the fair value of Continental's 8½% Convertible Trust Originated Preferred Securities was estimated to be $514 million using market prices, which exceeded the carrying value of these securities by $272 million. Market risk is estimated as the potential increase in fair value resulting from a hypothetical 10% increase in market prices and was estimated to be $51 million as of December 31, 1997.

Investment in Equity Securities. Continental's investment in America West Holdings Corporation at December 31, 1997, which was recorded as its fair value of $9 million and includes unrealized gains of $4 million, has exposure to price risk. This risk is estimated as the potential loss in fair value resulting from a hypothetical 10% adverse change in prices quoted by stock exchanges and amounts to $1 million.

The Company also has an investment in AMADEUS which is also subject to price risk. However, since a readily determinable market value does not exist for AMADEUS (it is privately held), the Company is unable to quantify the amount of price risk sensitivity inherent in this investment.

CONSOLIDATED STATEMENTS OF OPERATIONS

(In millions, except per share data)

	Year Ended December 31,		
	1997	1996	1995
Operating Revenue:			
Passenger	$6,660	$5,871	$5,302
Cargo	175	154	145
Mail and other	378	335	378
	7,213	6,360	5,825
Operating Expenses:			
Wages, salaries and related costs	1,688	1,452	1,381
Employee incentives	126	97	51
Aircraft fuel	885	774	681
Commissions	567	510	489
Aircraft rentals	551	509	497
Maintenance, materials and repairs	537	461	429
Other rentals and landing fees	395	350	356
Depreciation and amortization	254	254	253
Fleet disposition charge	—	128	—
Other	1,494	1,300	1,303
	6,497	5,835	5,440
Operating Income	716	525	385
Nonoperating Income (Expense):			
Interest expense	(166)	(165)	(213)
Interest capitalized	35	5	6
Interest income	56	43	31
Gain on System One transactions	—	—	108
Other, net	(1)	20	(7)
	(76)	(97)	(75)
Income before Income Taxes, Minority Interest and Extraordinary Loss	640	428	310
Income Tax Provision	(237)	(86)	(78)
Income before Minority Interest and Extraordinary Loss	403	342	232
Minority Interest	—	(3)	(6)
Distributions on Preferred Securities of Trust, net of applicable income taxes of $8, $8 and $0, respectively	(14)	(14)	(2)
Income before Extraordinary Loss	389	325	224
Extraordinary Loss, net of applicable income taxes of $2 and $4, respectively	(4)	(6)	—
Net Income	385	319	224
Preferred Dividend Requirements and Accretion to Liquidation Value	(2)	(5)	(9)
Income Applicable to Common Shares	$ 383	$ 314	$ 215
Earnings per Common Share:			
Income before Extraordinary Loss	$ 6.72	$ 5.87	$ 4.07
Extraordinary Loss	(0.07)	(0.12)	—
Net Income	$ 6.65	$ 5.75	$ 4.07
Earnings per Common Share Assuming Dilution:			
Income before Extraordinary Loss	$ 5.03	$ 4.25	$ 3.37
Extraordinary Loss	(0.04)	(0.08)	—
Net Income	$ 4.99	$ 4.17	$ 3.37

The accompanying Notes to Consolidated Financial Statements are an integral part of these statements.

CONSOLIDATED BALANCE SHEETS

(In millions, except for share data)

Assets	December 31, 1997	December 31, 1996
Current Assets:		
Cash and cash equivalents, including restricted cash and cash equivalents of $15 and $76, respectively	$1,025	$1,061
Accounts receivable, net of allowance for doubtful receivables of $23 and $27, respectively	361	377
Spare parts and supplies, net of allowance for obsolescence of $51 and $47, respectively	128	111
Deferred income taxes	111	—
Prepayments and other assets	103	85
Total current assets	1,728	1,634
Property and Equipment:		
Owned property and equipment:		
Flight equipment	1,636	1,199
Other	456	338
	2,092	1,537
Less: Accumulated depreciation	473	370
	1,619	1,167
Purchase deposits for flight equipment	437	154
Capital leases:		
Flight equipment	274	396
Other	40	31
	314	427
Less: Accumulated amortization	145	152
	169	275
Total property and equipment	2,225	1,596
Other Assets:		
Routes, gates and slots, net of accumulated amortization of $270 and $212, respectively.	1,425	1,473
Reorganization value in excess of amounts allocable to identifiable assets, net of accumulated amortization of $71 and $60, respectively	164	237
Investments	104	134
Other assets, net	184	132
Total other assets	1,877	1,976
Total Assets	$5,830	$5,206

Liabilities and Stockholders' Equity	December 31, 1997	December 31, 1996
Current Liabilities:		
Current maturities of long-term debt	$ 243	$ 201
Current maturities of capital leases	40	60
Accounts payable	781	705
Air traffic liability	746	661
Accrued payroll and pensions	158	149
Accrued other liabilities	317	328
Total current liabilities	2,285	2,104
Long-Term Debt	1,426	1,368
Capital Leases	142	256
Deferred Credits and Other Long-Term Liabilities:		
Deferred income taxes	435	75
Accruals for aircraft retirements and excess facilities	123	188
Other	261	331
Total deferred credits and other long-term liabilities	819	594
Commitments and Contingencies		
Minority Interest	—	15
Continental-Obligated Mandatorily Redeemable Preferred Securities of Subsidiary Trust Holding Solely Convertible Subordinated Debentures (1)	242	242
Redeemable Preferred Stock	—	46
Common Stockholders' Equity:		
Class A common stock — $.01 par, 50,000,000 shares authorized; 8,379,464 and 9,280,000 shares issued and outstanding, respectively	—	—
Class B common stock — $.01 par, 200,000,000 shares authorized; 50,512,010 and 47,943,343 shares issued and outstanding, respectively	1	—
Additional paid-in capital	639	693
Retained earnings (accumulated deficit)	276	(109)
Other	—	(3)
Total common stockholders' equity	916	581
Total Liabilities and Stockholders' Equity	$5,830	$5,206

(1) The sole assets of the Trust are convertible subordinated debentures with an aggregate principal amount of $249 million, which bear interest at the rate of 8½% per annum and mature on December 1, 2020. Upon repayment, the Continental-Obligated Mandatorily Redeemable Preferred Securities of Subsidiary Trust will be mandatorily redeemed.

The accompanying Notes to Consolidated Financial Statements are an integral part of these statements.

CONSOLIDATED STATEMENTS OF CASH FLOWS

(In millions)

	Year Ended December 31, 1997	1996	1995
Cash Flows From Operating Activities:			
Net income	$ 385	$ 319	$ 224
Adjustments to reconcile net income to net cash provided by operating activities:			
Depreciation and amortization	254	254	253
Provision for aircraft and facilities	—	128	14
Deferred income taxes	212	72	71
Gain on sale of America West stock and warrants	—	(18)	—
Gain on System One transactions	—	—	(108)
Other, net	34	11	27
Changes in operating assets and liabilities:			
Increase in accounts receivable	(1)	(42)	(21)
Increase in spare parts and supplies	(38)	(43)	(8)
Increase in accounts payable	71	103	48
Increase (decrease) in air traffic liability	85	82	(5)
Other	(42)	(35)	(176)
Net cash provided by operating activities	960	831	319
Cash Flows from Investing Activities:			
Capital expenditures, net of returned purchase deposits in 1996 and 1995	(417)	(198)	(67)
Purchase deposits paid in connection with future aircraft deliveries	(409)	(116)	(15)
Deposits refunded in connection with aircraft transactions	141	20	97
Other	28	43	60
Net cash provided (used) by investing activities	(657)	(251)	75
Cash Flows From Financing Activities:			
Net proceeds from issuance of long-term debt	517	797	9
Payments on long-term debt and capital lease obligations	(676)	(975)	(318)
Net proceeds from issuance of preferred securities of trust	—	—	242
Purchase of warrants	(94)	(50)	(14)
Other	(25)	30	13
Net cash used by financing activities	(278)	(198)	(68)
Net Increase in Cash and Cash Equivalents	25	382	326
Cash and Cash Equivalents Beginning of Period (1)	985	603	277
Cash and Cash Equivalents End of Period (1)	$1,010	$ 985	$ 603

	Year Ended December 31, 1997		
	1997	1996	1995
Supplemental Cash Flows Information:			
Interest paid	$ 156	$ 161	$ 179
Income taxes paid, net	$ 12	$ 4	$ 11
Financing and Investing Activities Not Affecting Cash:			
Capital lease obligations incurred	$ 22	$ 32	$ 10
Property and equipment acquired through the issuance of debt	$ 207	$ 119	$ 92
Reduction of capital lease obligations in connection with refinanced aircraft	$ 97	$ —	$ —
Investment in AMADEUS acquired in connection with System One transactions	$ —	$ —	$ 120
Issuance of convertible secured debentures in connection with the aircraft settlements	$ —	$ —	$ 158

(1) Excludes restricted cash of $15 million, $76 million, $144 million and $119 million at December 31, 1997, 1996, 1995 and 1994, respectively.

The accompanying Notes to Consolidated Financial Statements are an integral part of these statements.

CONSOLIDATED STATEMENTS OF REDEEMABLE PREFERRED STOCK AND COMMON STOCKHOLDERS' EQUITY

(In millions)

	Redeemable Preferred Stock	Additional Paid-In Capital	Retained Earnings (Accumulated Deficit)	Other
Balance, December 31, 1994	$ 53	$ 778	$ (652)	$ (23)
Net Income	—	—	224	—
Purchase of Warrants	—	(51)	—	—
Accumulated Dividends:				
8% Cumulative Redeemable Preferred Stock	2	(2)	—	—
12% Cumulative Redeemable Preferred Stock	2	(2)	—	—
Series A 12% Cumulative Preferred Stock	2	(2)	—	—
Issuance of Note in Exchange for				
Series A 8% Cumulative Preferred Stock	(18)	(3)	—	—
Additional Minimum Pension Liability	—	—	—	(1)
Unrealized Gain on Marketable Equity Securities	—	—	—	20
Other	—	15	—	4
Balance, December 31, 1995	41	733	(428)	—
Net Income	—	—	319	—
Purchase of Warrants	—	(50)	—	—
Accumulated Dividends:				
Series A 12% Cumulative Preferred Stock	5	(5)	—	—
Additional Minimum Pension Liability	—	—	—	6
Unrealized Gain on Marketable Equity Securities, net	—	—	—	4
Sale of America West Stock and Warrants	—	—	—	(18)
Other	—	15	—	5
Balance, December 31, 1996	46	693	(109)	(3)
Net Income	—	—	385	—
Purchase of Warrants	—	(94)	—	—
Accumulated Dividends on Series A 12%				
Cumulative Preferred Stock	2	(2)	—	—
Redemption of Series A 12% Cumulative Preferred Stock	(48)	—	—	—
Additional Minimum Pension Liability	—	—	—	(4)
Other	—	42	—	7
Balance, December 31, 1997	$ —	$ 639	$ 276	$ —

CONSOLIDATED STATEMENTS OF REDEEMABLE PREFERRED STOCK AND COMMON STOCKHOLDERS' EQUITY

(Number of Shares)

	Redeemable Preferred Stock	Class A Common Stock	Class B Common Stock	Treasury Stock
Balance, December 31, 1994	471,000	12,602,112	40,747,024	60,000
Cancellation of 8% and 12% Cumulative Redeemable Preferred Stock	(471,000)	—	—	—
Issuance of Series A 8% and 12% Cumulative Preferred Stock	589,142	—	—	—
Issuance of Note in Exchange for Series A 8% Cumulative Preferred Stock	(202,784)	—	—	—
Forfeiture of Restricted Class B Common Stock	—	—	(55,000)	55,000
Reissuance of Treasury Stock	—	—	115,000	(115,000)
Preferred Stock In-kind Dividend	11,590	—	—	—
Issuance of Common Stock pursuant to Stock Plans and Awards	—	—	863,978	—
Other	—	—	1,185,546	—
Balance, December 31, 1995	397,948	12,602,112	42,856,548	—
Conversion of Class A to Class B Common Stock by Air Canada	—	(3,322,112)	3,322,112	—
Forfeiture of Restricted Class B Common Stock	—	—	(60,000)	60,000
Purchase of Common Stock	—	—	(133,826)	133,826
Reissuance of Treasury Stock	—	—	193,826	(193,826)
Preferred Stock In-kind Dividend	49,134	—	—	—
Issuance of Common Stock pursuant to Stock Plans and Awards	—	—	1,764,683	—
Balance, December 31, 1996	447,082	9,280,000	47,943,343	—
Conversion of Class A to Class B Common Stock	—	(900,536)	900,536	—
Purchase of Common Stock	—	—	(154,882)	154,882
Reissuance of Treasury Stock pursuant to Stock Plans	—	—	154,882	(154,882)
Issuance of Preferred Stock Dividends on Series A 12% Cumulative Preferred Stock	13,165	—	—	—
Redemption of Series A 12% Cumulative Preferred Stock	(460,247)	—	—	—
Issuance of Common Stock pursuant to Stock Plans	—	—	1,646,419	—
Conversion of Trust Originated Preferred Securities into Common Stock	—	—	21,712	—
Balance, December 31, 1997	—	8,379,464	50,512,010	—

Continental Airlines, Inc. (the “Company” or “Continental”) is a major United States air carrier engaged in the business of transporting passengers, cargo and mail. Continental is the fifth largest United States airline (as measured by 1997 revenue passenger miles) and, together with its wholly owned subsidiaries, Continental Express, Inc. (“Express”), and Continental Micronesia, Inc. (“CMI”), each a Delaware corporation, serves 191 airports worldwide. Continental flies to 125 domestic and 66 international destinations and offers additional connecting service through alliances with domestic and foreign carriers. Continental directly serves 10 European cities and is one of the leading airlines providing service to Mexico and Central America, serving more destinations there than any other United States airline. Continental currently flies to seven cities in South America. Through its Guam hub, CMI provides extensive service in the western Pacific, including service to more Japanese cities than any other United States carrier.

As used in these Notes to Consolidated Financial Statements, the terms “Continental” and “Company” refer to Continental Airlines, Inc. and, unless the context indicates otherwise, its subsidiaries.

Note 1 — Summary of Significant Accounting Policies

(a) Principles of Consolidation —

The consolidated financial statements of the Company include the accounts of Continental and its operating subsidiaries, Express, CMI, and prior to April 27, 1995, System One Information Management, Inc. (“System One”). See Note 11. All significant intercompany transactions have been eliminated in consolidation.

(b) Use of Estimates —

The preparation of financial statements in conformity with generally accepted accounting principles requires management to make estimates and assumptions that affect the amounts reported in the financial statements and accompanying notes. Actual results could differ from those estimates.

(c) Cash and Cash Equivalents —

Cash and cash equivalents consist of cash and short-term, highly liquid investments which are readily convertible into cash and have a maturity of three months or less when purchased. Approximately $15 million and $76 million of cash and cash equivalents at December 31, 1997 and 1996, respectively, were held in restricted arrangements relating primarily to payments for workers’ compensation claims and in accordance with the terms of certain other agreements.

(d) Spare Parts and Supplies —

Flight equipment expendable parts and supplies are valued at average cost. An allowance for obsolescence for flight equipment expendable parts and supplies is accrued to allocate the costs of these assets, less an estimated residual value, over the estimated useful lives of the related aircraft and engines.

(e) Property and Equipment —

Property and equipment were recorded at fair market values as of April 27, 1993; subsequent purchases were recorded at cost and are depreciated to estimated residual values (10% of cost) over their estimated useful lives using the straight-line method. Estimated useful lives for such assets are 25 years and 18 years from the date of manufacture for all owned jet and turboprop aircraft, respectively; up to 25 years, depending on the lease period, for aircraft acquired under long-term capital leases; and two to 25 years for other property and equipment, including airport facility improvements.

(f) Intangible Assets —

Routes, Gates and Slots

Routes are amortized on a straight-line basis over 40 years, gates over the stated term of the related lease and slots over 20 years. Routes, gates and slots are comprised of the following (in millions):

	Balance at December 31, 1997	Accumulated Amortization at December 31, 1997
Routes	$ 892	$ 115
Gates	407	115
Slots	126	40
	$1,425	$ 270

Reorganization Value In Excess of Amounts Allocable to Identifiable Assets

Reorganization value in excess of amounts allocable to identifiable assets, arising from Continental's emergence from bankruptcy reorganization in 1993, is amortized on a straight-line basis over 20 years. The carrying value of this intangible asset is reviewed if the facts and circumstances suggest it may be impaired. If this review indicates that this intangible asset will not be recoverable, as determined based on the undiscounted cash flows over the remaining amortization periods, the carrying value is reduced by the estimated shortfall of cash flows.

(g) Air Traffic Liability —

Passenger revenue is recognized when transportation is provided rather than when a ticket is sold. The amount of passenger ticket sales not yet recognized as revenue is reflected in the accompanying Consolidated Balance Sheets as air traffic liability. The Company performs periodic evaluations of this estimated liability, and any adjustments resulting therefrom, which can be significant, are included in results of operations for the periods in which the evaluations are completed.

Continental sponsors a frequent flyer program ("OnePass") and records an estimated liability for the incremental cost associated with providing the related free transportation at the time a free travel award is earned. The liability is adjusted periodically based on awards earned, awards redeemed and changes in the OnePass program.

The Company also sells mileage credits to participating partners in the OnePass program, such as hotels, car rental agencies and credit card companies. The resulting revenue, net of the estimated incremental cost of the credits sold, is recorded as other operating revenue in the accompanying Consolidated Statements of Operations during the period in which the credits are sold.

(h) Passenger Traffic Commissions —

Passenger traffic commissions are recognized as expense when the transportation is provided and the related revenue is recognized. The amount of passenger traffic commissions not yet recognized as expense is included in Prepayments and other assets in the accompanying Consolidated Balance Sheets.

(i) Deferred Income Taxes —

Deferred income taxes are provided under the liability method and reflect the net tax effects of temporary differences between the tax basis of assets and liabilities and their reported amounts in the financial statements.

(j) Maintenance and Repair Costs —

Maintenance and repair costs for owned and leased flight equipment, including the overhaul of aircraft components, are charged to operating expense as incurred.

(k) Advertising Costs —

The Company expenses the costs of advertising as incurred. Advertising expense was $98 million, $76 million and $94 million for the years ended December 31, 1997, 1996 and 1995, respectively.

(l) Stock Plans and Awards —

Continental has elected to follow Accounting Principles Board Opinion No. 25 — "Accounting for Stock Issued to Employees" ("APB 25") in accounting for its employee stock options and its stock purchase plans because the alternative fair value accounting provided for under Statement of Financial Accounting Standards No. 123 — "Accounting for Stock-Based Compensation" ("SFAS 123") requires use of option valuation models that were not developed for use in valuing employee stock options or purchase rights. Under APB 25, since the exercise price of the Company's employee stock options equals the market price of the underlying stock on the date of grant, no compensation expense is recognized. Furthermore, under APB 25, since the stock purchase plans are considered noncompensatory plans, no compensation expense is recognized.

(m) Recently Issued Accounting Standards —

In June 1997, the Financial Accounting Standards Board (the "FASB") issued Statement of Financial Accounting Standards No. 130 — "Reporting Comprehensive Income" ("SFAS 130") and Statement of Financial Accounting Standards No. 131 — "Disclosure About Segments of an Enterprise and Related Information" ("SFAS 131"). Both SFAS 130 and SFAS 131 are effective for Continental beginning in the first quarter of 1998.

SFAS 130 establishes standards for the reporting and display of comprehensive income and its components in a full set of financial statements. Comprehensive income is defined as the change in equity during a period from transactions and other events and circumstances from non-owner sources. Upon adopting the new standard, Continental will report and display comprehensive income which includes net income plus non-owner changes in equity such as the minimum pension liability and unrealized gains or losses on investments in marketable equity securities.

SFAS 131 changes the way segment information is presented from an industry segment approach to a management approach. Under the management approach, segments are determined based on the operations regularly reviewed by the chief operating decision maker to make decisions about resources to be allocated to the segment and assess its performance. The Company believes that it will report only one segment and certain additional geographic disclosures.

In February 1998, the Financial Accounting Standards Board issued Statement of Financial Accounting Standards No. 132 — "Employers' Disclosures about Pensions and Other Postretirement Benefits" ("SFAS 132") that revises the disclosure requirements of Statement of Financial Accounting Standards No. 87 — "Employers' Accounting for Pensions") and Statement of Financial Accounting Standards No. 106 — "Employers' Accounting for Postretirement Benefits Other than Pensions". The Company will adopt SFAS 132 in 1998. SFAS 132 is not expected to have an impact on the Company's results of operations or financial position.

(n) Block Space Arrangements —

Continental has entered into block space arrangements with certain other carriers whereby one or both of the carriers is obligated to purchase capacity on the other carrier. To the extent the other carrier is financially committed to purchase such capacity on Continental's flights, such payments to Continental by the other carrier are recorded as a reduction in the respective operating expenses in the accompanying Consolidated Statements of Operations. During 1997, Continental recorded a reduction of approximately $43 million of such operating expenses. To the extent that Continental is financially committed to purchase capacity on other carriers, such payments to other carriers are recorded as a reduction in other revenue. No such payments were made in 1997. See Note 13.

(o) Reclassifications —

Certain reclassifications have been made in the prior years' financial statements to conform to the current year presentation.

Note 2 — Earnings Per Share

In the fourth quarter of 1997, the Company adopted the FASB's Statement of Financial Accounting Standards No. 128 — "Earnings per Share" ("SFAS 128") which specifies the computation, presentation and disclosure requirements for earnings per common share ("EPS"). SFAS 128 replaces the presentation of primary and fully diluted EPS pursuant to Accounting Principles Board Opinion No. 15 — "Earnings per Share" with the presentation of basic and diluted EPS. Basic EPS excludes dilution and is computed by dividing net income available to common stockholders by the weighted average number of common shares outstanding for the period. Diluted EPS reflects the potential dilution that could occur if securities or other obligations to issue common stock were exercised or converted into common stock or resulted in the issuance of common stock that then shared in the earnings of the entity. All prior-period EPS data have been retroactively restated and reflect the application of SFAS 128.

The following table sets forth the computation of basic and diluted earnings per share (in millions, except per share data):

	1997	1996	1995
Numerator:			
Income before extraordinary loss	$389	$325	$224
Extraordinary loss, net of applicable income taxes	(4)	(6)	—
Net income	385	319	224
Preferred stock dividends	(2)	(5)	(9)
Numerator for basic earnings per share — income available to common stockholders	383	314	215
Effect of dilutive securities:			
Series A convertible debentures	—	1	4
Preferred Securities of Trust	14	15	2
6¾% convertible subordinated notes	11	8	—
	25	24	6
Other	(4)	(3)	(1)
Numerator for diluted earnings per share — income available to common stockholders after assumed conversions	$404	$335	$220
Denominator:			
Denominator for basic earnings per share — weighted-average shares	57.6	54.6	52.8
Effect of dilutive securities:			
Employee stock options	1.6	2.2	1.3
Warrants	3.5	5.9	3.6
Restricted Class B common stock	0.4	0.8	0.7
Preferred Securities of Trust	10.3	10.3	0.9
6¾% convertible subordinated notes	7.6	5.8	—
Series A convertible debentures	—	0.7	5.9
Dilutive potential common shares	23.4	25.7	12.4
Denominator for diluted earnings per share — adjusted weighted-average and assumed conversions	81.0	80.3	65.2

Warrants to purchase 11,120,002 weighted average shares of the Company's Class B common stock, par value $.01 per share ("Class B common stock") were not included in the computation of diluted earnings per share in 1995 because the warrants' exercise price was greater than the average market price of the common shares and, therefore, the effect would have been antidilutive.

Note 3 — Long-Term Debt

Long-term debt as of December 31 is summarized as follows (in millions):

	1997	1996
Secured		
Notes payable, interest rates of 5.84% to 9.97%, payable through 2019	$ 325	$ 218
Credit facility, floating interest rate of LIBOR or Eurodollar plus 1.125%, payable through 2002	275	—
Floating rate notes, interest rates of Prime plus 0.5% to 0.75%, LIBOR plus 0.75% to 3.75% or Eurodollar plus 0.75% to 1.0%, payable through 2006	204	187
Revolving credit facility, floating interest rates of LIBOR or Eurodollar plus 1.125%, payable through 1999	160	—
Notes payable, interest rates of 7.13% to 7.15% payable through 1999 and floating rates thereafter of LIBOR plus 2%, payable through 2011	91	97
Floating rate note, interest rate of LIBOR or Eurodollar plus 1.375%, payable through 2004	75	—
Notes payable, interest rates of 10.0% to 14.00%, payable through 2005	54	178
Floating rate notes, interest rates of Eurodollar plus 1.75% to 2.0% or Prime plus 0.75% to 1.0% payable through 2003	—	320
Other	2	4
Unsecured		
Senior notes payable, interest rate of 9.5%, payable through 2001	250	250
Convertible subordinated notes, interest rate of 6.75%, payable through 2006	230	230
Notes payable, interest rates of 8.38% to 12%, payable through 2001	2	78
Other	1	7
	1,669	1,569
Less: current maturities	243	201
Total	$1,426	$1,368

As of December 31, 1997 and 1996, the Prime, LIBOR and Eurodollar rates associated with Continental's indebtedness approximated 8.5% and 8.3%, 5.8% and 5.6%, 5.8% and 5.6%, respectively.

A majority of Continental's property and equipment is subject to agreements securing indebtedness of Continental.

In July 1997, Continental entered into a $575 million credit facility (the "Credit Facility"), including a $275 million term loan, the proceeds of which were loaned to CMI to repay its existing $320 million secured term loan. In connection with this prepayment, Continental recorded a $4 million after tax extraordinary loss relating to early extinguishment of debt. The Credit Facility also includes a $225 million revolving credit facility with a commitment fee of 0.25% per annum on the unused portion, and a $75 million term loan commitment with a current floating interest rate of Libor plus 1.375%. At December 31, 1997, no borrowings were outstanding under the $225 million revolving credit facility.

The Credit Facility is secured by substantially all of CMI's assets (other than aircraft subject to other financing arrangements) but does not contain any financial covenants relating to CMI other than covenants restricting CMI's incurrence of certain indebtedness and pledge or sale of assets. In addition, the Credit Facility contains certain financial covenants applicable to Continental and prohibits Continental from granting a security interest on certain of its international route authorities and domestic slots.

In April 1997, Continental entered into a $160 million floating rate secured revolving credit facility (the "Facility"). The revolving loans made under the Facility are used to make certain predelivery payments to The Boeing Company ("Boeing") for new Boeing aircraft to be delivered through December 1999. As of December 31, 1997, the Facility had been fully drawn.

At December 31, 1997, under the most restrictive provisions of the Company's debt and credit facility agreements, the Company had a minimum cash balance requirement of $600 million, a minimum net worth requirement of $613 million and was restricted from paying cash dividends in excess of $350 million.

In March 1996, the Company issued $230 million of 6¾% Convertible Subordinated Notes (the "Notes"). The Notes are convertible into shares of Class B common stock prior to their maturity date, April 15, 2006, at a conversion price of $30.20 per share. The Notes are redeemable at the option of the Company on or after April 15, 1999, at specified redemption prices.

Maturities of long-term debt due over the next five years are as follows (in millions):

Year ending December 31,	
1998	$ 243
1999	159
2000	152
2001	394
2002	170

Note 4 — Leases

Continental leases certain aircraft and other assets under long-term lease arrangements. Other leased assets include real property, airport and terminal facilities, sales offices, maintenance facilities, training centers and general offices. Most leases also include renewal options, and some aircraft leases include purchase options.

At December 31, 1997, the scheduled future minimum lease payments under capital leases and the scheduled future minimum lease rental payments required under aircraft and engine operating leases that have initial or remaining noncancellable lease terms in excess of one year are as follows (in millions):

	Capital Leases	Operating Leases
Year ending December 31,		
1998	$ 55	$ 658
1999	52	593
2000	41	582
2001	41	564
2002	15	482
Later years	26	3,007
Total minimum lease payments	230	$5,886
Less: amount representing interest	48	
Present value of capital leases	182	
Less: current maturities of capital leases	40	
Long-term capital leases	$ 142	

Not included in the above operating lease table is $236 million in annual minimum lease payments relating to non-aircraft leases, principally airport and terminal facilities and related equipment.

Continental is the guarantor of $325 million aggregate principal amount of tax-exempt special facilities revenue bonds. These bonds, issued by various airport municipalities, are payable solely from rentals paid by Continental under long-term agreements with the respective governing bodies.

The Company's total rental expense for all operating leases, net of sublease rentals, was $787 million, $719 million and $720 million in 1997, 1996 and 1995, respectively.

During 1997, the Company acquired 10 aircraft previously leased by it. Aircraft maintenance expense in the second quarter of 1997 was reduced by approximately $16 million due to the reversal of reserves that are no longer required as a result of the transaction.

Note 5 — Financial Instruments and Risk Management

As part of the Company's risk management program, Continental uses or used a variety of financial instruments, including petroleum call options, foreign currency average rate options, and interest rate swap and interest rate cap agreements. The Company does not hold or issue derivative financial instruments for trading purposes.

Notional Amounts and Credit Exposure of Derivatives

The notional amounts of derivative financial instruments summarized below do not represent amounts exchanged between parties and, therefore, are not a measure of the Company's exposure resulting from its use of derivatives. The amounts exchanged are calculated based upon the notional amounts as well as other terms of the instruments, which relate to interest rates, exchange rates and other indices.

The Company is exposed to credit losses in the event of non-performance by counterparties to these financial instruments, but it does not expect any of the counterparties to fail to meet its obligations. To manage credit risks, the Company selects counterparties based on credit ratings, limits its exposure to a single counterparty under defined guidelines, and monitors the market position with each counterparty.

Fuel Price Risk Management

The Company has entered into petroleum call option contracts to provide some short-term protection against a sharp increase in jet fuel prices. The petroleum call option contracts generally cover the Company's forecasted jet fuel needs for three to six months.
Gains, if any, on these option contracts are recognized as a component of fuel expense when the underlying fuel being hedged is used (deferral method). At December 31, 1997, the Company had petroleum call option contracts outstanding with an aggregate notional amount of $200 million. The fair value of the Company's call option contracts at December 31, 1997, representing the amount the Company would receive if the option contracts were closed, was immaterial. During the year ended December 31, 1996, the Company recognized gains of approximately $65 million under this risk reduction strategy.

Foreign Currency Exchange Risk Management

CMI purchases foreign currency average rate option contracts that effectively enable it to sell Japanese yen expected to be received from yen-denominated ticket sales over the next nine to twelve months at specified dollar amounts. The option contracts have only nominal intrinsic value at the time of purchase. These contracts are designated and effective as hedges of probable monthly yen-denominated sales transactions, which otherwise would expose the Company to foreign currency risk. Gains, if any, on these average rate option contracts are deferred and recognized as a component of passenger revenue when the related sale is recognized (deferral method). At December 31, 1997, CMI had average rate option contracts outstanding with a notional value of $266 million; the related fair value, representing the amount CMI would receive to terminate the agreements, was immaterial. During the year ended December 31, 1997, the Company recognized gains of approximately $10 million under these option contracts.

Interest Rate Risk Management

The Company entered into an interest rate cap agreement to reduce the impact of potential increases in interest rates on a floating rate bank financing. The interest rate cap agreement has a notional value of $142 million and is effective through July 31, 2001. The interest rate cap limits the amount of potential increase in the Eurodollar or Prime rate component of the floating rate to a maximum of 9% over the term of the contract. The fair value is immaterial. Payments to be received as a result of the cap agreement are accrued as a reduction in interest expense (accrual method).

Fair Value of Other Financial Instruments

(a) Cash equivalents —

Cash equivalents consist primarily of commercial paper with original maturities of three months or less and approximate fair value due to their short maturity.

(b) Investment in Equity Securities —

Continental's investment in America West Holdings Corporation ("America West") is classified as available-for-sale and carried at an aggregate market value of $9 million and $8 million at December 31, 1997 and 1996, respectively. Included in stockholders' equity at December 31, 1997 and 1996 is a net unrealized gain of $4 million.

Since a readily determinable market value does not exist for the Company's investment in AMADEUS (see Note 11), the investment is carried at cost.

(c) Debt —

The fair value of the Company's debt with a carrying value of $1.49 billion and $1.36 billion as of December 31, 1997 and 1996, respectively, estimated based on the discounted amount of future cash flows using the current incremental rate of borrowing for a similar liability or market prices, approximates $1.47 billion and $1.37 billion, respectively. The fair value of the remaining debt (with a carrying value of $179 million and $209 million, respectively, and primarily relating to aircraft modification notes and various loans with immaterial balances) was not practicable to estimate due to the large number and small dollar amounts of these notes.

(d) Preferred Securities of Trust —

As of December 31, 1997, the fair value of Continental's 8½% Convertible Trust Originated Preferred Securities ("TOPrS") (with a carrying value of $242 million), estimated based on market prices, approximates $514 million. The carrying value of the TOPrS was $242 million and the fair value approximated $332 million as of December 31, 1996. See Note 6.

Note 6 — Preferred Securities of Trust

Continental Airlines Finance Trust, a Delaware statutory business trust (the "Trust") with respect to which the Company owns all of the common trust securities, had 4,986,500 and 4,997,000 8½% TOPrS outstanding at December 31, 1997 and 1996, respectively. The TOPrS have a liquidation value of $50 per preferred security and are convertible at any time at the option of the holder into shares of Class B common stock at a conversion rate of 2.068 shares of Class B common stock for each preferred security (equivalent to $24.18 per share of Class B common stock), subject to adjustment in certain circumstances. Distributions on the preferred securities are payable by the Trust at the annual rate of 8½% of the liquidation value of $50 per preferred security and are included in Distributions on Preferred Securities of Trust in the accompanying Consolidated Statements of Operations. The proceeds of the private placement, which totaled $242 million (net of $8 million of underwriting commissions and expense) are included in Continental-Obligated Mandatorily Redeemable Preferred Securities of Subsidiary Trust Holding Solely Convertible Subordinated Debentures in the accompanying Consolidated Balance Sheets.

The sole assets of the trust are 8½% Convertible Subordinated Deferrable Interest Debentures ("Convertible Subordinated Debentures") with an aggregate principal amount of $249 million issued by the Company and which mature on December 1, 2020. The Convertible Subordinated Debentures are redeemable by Continental, in whole or in part, on or after December 1, 1998 at designated redemption prices. If Continental redeems the Convertible Subordinated Debentures, the Trust must redeem the TOPrS on a pro rata basis having an aggregate liquidation value equal to the aggregate principal amount of the Convertible Subordinated Debentures redeemed. Otherwise, the TOPrS will be redeemed upon maturity of the Convertible Subordinated Debentures, unless previously converted.

Taking into consideration the Company's obligations under (i) the Preferred Securities Guarantee relating to the TOPrS, (ii) the Indenture relating to the Convertible Subordinated Debentures to pay all debts and obligations and all costs and expenses of the Trust (other than U.S. withholding taxes) and (iii) the Indenture, the Declaration relating to the TOPrS and the Convertible Subordinated Debentures, Continental has fully and unconditionally guaranteed payment of (i) the distributions on the TOPrS, (ii) the amount payable upon redemption of the TOPrS, and (iii) the liquidation amount of the TOPrS.

The Convertible Subordinated Debentures and related income statement effects are eliminated in the Company's consolidated financial statements.

Note 7 — Redeemable Preferred, Preferred and Common Stock

Redeemable Preferred and Preferred Stock

During the years ended December 31, 1997 and 1996, the Company's board of directors declared and issued 13,165 and 49,134 additional shares, respectively, of Series A 12% Cumulative Preferred Stock ("Series A 12% Preferred") in lieu of cash dividends. In April 1997, Continental redeemed for cash all of the 460,247 shares of its Series A 12% Preferred then outstanding for $100 per share plus accrued dividends thereon. The redemption price, including accrued dividends, totaled $48 million.

Redeemable preferred stock consisted of 1,000,000 authorized shares of Series A 12% Preferred with 447,082 shares issued and outstanding at December 31, 1996.

Continental had 10 million shares of authorized preferred stock, none of which were outstanding as of December 31, 1997 or 1996.

Common Stock

Continental has two classes of common stock issued and outstanding, Class A common stock, par value $.01 per share ("Class A common stock") and Class B common stock. Holders of shares of Class A common stock and Class B common stock are entitled to receive dividends when and if declared by the Company's board of directors. Each share of Class A common stock is entitled to 10 votes per share and each share of Class B common stock is entitled to one vote per share. In addition, Continental has authorized 50 million shares of Class D common stock, par value $.01 per share, of which none were outstanding.

The Company's Certificate of Incorporation permits shares of the Company's Class A common stock to be converted into an equal number of shares of Class B common stock. During 1997 and 1996, 900,536 and 3,322,112 shares of the Company's Class A common stock, respectively, were so converted.

Warrants

As of December 31, 1997, the Company had outstanding 3,039,468 Class A Warrants and 308,343 Class B Warrants (collectively, the "Warrants"). As of such date, all of the Class A Warrants were held by Air Partners, L.P. ("Air Partners"), and all of the Class B Warrants were held by a limited partner of Air Partners. The Warrants entitle the holder to purchase one share of Class A common stock or Class B common stock as follows: (i) 2,298,134 Class A Warrants and 186,134 Class B Warrants have an exercise price of $7.50 per share, and (ii) 741,334 Class A Warrants and 122,209 Class B Warrants have an exercise price of $15 per share. The Warrants expire on April 27, 1998.

On June 2, 1997, the Company purchased for $94 million from Air Partners warrants to purchase 3,842,542 shares of Class B common stock (representing a portion of the total warrants held by Air Partners). The purchase price represented the intrinsic value of the warrants (the difference between the closing market price of the Class B common stock on May 28, 1997 ($34.25) and the applicable exercise price).

On November 21, 1996, Air Partners exercised its right to sell to the Company, and the Company subsequently purchased, for $50 million, Warrants to purchase 2,614,379 shares of Class B common stock (representing a portion of the total Warrants held by Air Partners) pursuant to an agreement entered into earlier in 1996 with the Company.

On September 29, 1995, Continental purchased 2,735,760 Class A Warrants and 9,699,510 Class B Warrants for an aggregate purchase price of $56 million (including a waiver fee of $5 million paid to a major creditor of the Company).

Note 8 — Stock Plans and Awards

Stock Options

On May 16, 1997, the stockholders of the Company approved the Continental Airlines, Inc. 1997 Stock Incentive Plan, as amended (the "97 Incentive Plan") under which the Company may grant options to purchase shares of Class B common stock to non-employee directors of the Company and employees of the Company or its subsidiaries. Subject to adjustment as provided in the 97 Incentive Plan, the aggregate number of shares of Class B common stock that may be issued under the 97 Incentive Plan may not exceed 2,000,000 shares, which may be originally issued or treasury shares or a combination thereof. The maximum number of shares of Class B common stock that may be subject to options granted to any one individual during any calendar year may not exceed 200,000 shares (subject to adjustment as provided in the 97 Incentive Plan). The total shares remaining available for grant under the 97 Incentive Plan at December 31, 1997 was 604,000. Stock options granted under the 97 Incentive Plan generally vest over a period of three years and have a term of five years.

Under the Continental Airlines, Inc. 1994 Incentive Equity Plan, as amended (the "94 Incentive Plan"), key officers and employees of the Company and its subsidiaries received stock options and/or restricted stock. The 94 Incentive Plan also provided for each outside director to receive on the day following the annual stockholders' meeting options to purchase 5,000 shares of Class B common stock. The maximum number of shares of Class B common stock that may be issued under the 94 Incentive Plan will not in the aggregate exceed 9,000,000. The total remaining shares available for grant under the 94 Incentive Plan at December 31, 1997 was 141,671. In 1995, the 94 Incentive Plan was amended to provide for the exchange and repricing of substantially all the outstanding stock options for new options bearing a shorter exercise term and generally exercisable at a price lower than that of the cancelled options, subject to certain conditions. The exercise price for the repriced options equaled the market value per share on the date of grant ($8.00). As a result of the repricing, stock options generally vest over a period of three years and have a term of five years.

Under the terms of the 97 and 94 Incentive Plans, a change of control would result in all outstanding options under these plans becoming exercisable in full and restrictions on restricted shares being terminated (see Note 17).

The following table summarizes stock option transactions pursuant to the Company's 94 and 97 Incentive Plans (share data in thousands):

	1997		1996		1995	
	Options	Weighted-Average Exercise Price	Options	Weighted-Average Exercise Price	Options	Weighted-Average Exercise Price
Outstanding at Beginning of Year	5,809	$17.37	4,769	$ 8.41	3,443	$10.19
Granted*	1,968	$29.34	3,307	$25.07	4,322	$ 8.43
Exercised	(1,582)	$11.72	(1,747)	$ 8.23	(361)	$ 9.25
Cancelled	(195)	$22.49	(520)	$14.83	(2,635)	$10.58
Outstanding at End of Year	6,000	$22.62	5,809	$17.37	4,769	$ 8.41
Options exercisable at end of year	1,235	—	656	—	1,079	—

*The option price for all stock options is equal to 100% of the fair market value at the date of grant.

Options granted during 1995 include the grant of repriced options; options cancelled during 1995 include the cancellation of the higher priced options.

The following tables summarize the range of exercise prices and the weighted average remaining contractual life of the options outstanding and the range of exercise prices for the options exercisable at December 31, 1997 (share data in thousands):

Options Outstanding

Range of Exercise Prices	Outstanding	Weighted Average Remaining Contractual Life	Weighted Average Exercise Price
$3.88–$8.00	1,178	3.10	$7.54
$8.19–$22.38	389	3.91	$16.59
$22.56–$23.00	1,328	3.12	$22.99
$23.25–$27.88	467	3.82	$25.63
$27.94–$48.88	2,638	4.08	$29.53
$3.88–$48.88	6,000	3.64	$22.62

Options Exercisable

Range of Exercise Prices	Exercisable	Weighted Average Exercise Price
$3.88–$8.00	287	$7.63
$8.19–$22.38	186	$16.55
$22.56–$23.00	359	$22.99
$23.25–$27.88	77	$25.05
$27.94–$48.88	326	$30.53
$3.88–$48.88	1,235	$20.57

Restricted Stock

The 97 Incentive Plan permits awards of restricted stock to participants, subject to one or more restrictions, including a restriction period, and a purchase price, if any, to be paid by the participant. In connection with the plan, 100,000 shares have been authorized for issuance as restricted stock (subject to adjustment as provided in the 97 Incentive Plan). As of December 31, 1997, no awards of restricted stock had been made.

The 94 Incentive Plan also permitted awards of restricted stock to participants, subject to one or more restrictions, including a restriction period, and a purchase price, if any, to be paid by the participant. In connection with the plan, 600,000 shares were authorized for issuance as restricted stock. As of December 31, 1997, 35,000 shares were available for grant as restricted stock.

Additionally, on March 4, 1994, the Board approved a one-time grant of 2,014,000 shares of restricted stock to substantially all employees at or below the manager level. These shares were issued at no cost to the employees and vest in 25 percent increments on each of January 2, 1995, 1996, 1997 and 1998.

Employee Stock Purchase Plans

On May 16, 1997, the stockholders of the Company approved the Continental Airlines, Inc. 1997 Employee Stock Purchase Plan (the “97 Stock Purchase Plan”). Under the 97 Stock Purchase Plan, all employees of the Company, including CMI and Express, may purchase shares of Class B common stock of the Company at 85% of the lower of the fair market value on the first day of the option period or the last day of the option period. Subject to adjustment, a maximum of 1,750,000 shares of Class B common stock are authorized for issuance under the 97 Stock Purchase Plan. During 1997, 148,186 shares of Class B common stock were issued at prices ranging from $23.38 to $29.33.

Under the Continental Airlines, Inc. 1994 Employee Stock Purchase Plan, as amended (the “94 Stock Purchase Plan”), which terminated on December 31, 1996, substantially all employees of the Company could purchase shares of Class B common stock at 85% of the lower of the fair market value on the first or last business day of a calendar quarter. Subject to adjustment, a maximum of 8,000,000 shares of Class B common stock were authorized for purchase under the 94 Stock Purchase Plan. During 1997, 70,706 shares were issued at a price of $19.55 per share that related to contributions made in the fourth quarter of 1996. During 1996 and 1995, 191,809 and 518,428 shares, respectively, of Class B common stock were issued at prices ranging from $15.81 to $23.96 in 1996 and $4.31 to $10.63 in 1995 in connection with the 94 Stock Purchase Plan.

Pro Forma SFAS 123 Results

Pro forma information regarding net income and earnings per share has been determined as if the Company had accounted for its employee stock options and purchase rights under the fair value method of SFAS 123. The fair value for these options was estimated at the date of grant using a Black-Scholes option pricing model with the following weighted-average assumptions for 1997, 1996 and 1995, respectively: risk-free interest rates of 6.1%, 5.8% and 6.2%; dividend yields of 0%; volatility factors of the expected market price of the Company's common stock of 34% for 1997 and 39% for 1996 and 1995; and a weighted-average expected life of the option of 2.5 years, 2.6 years and 2.3 years. The weighted average fair value of the stock options granted in 1997, 1996 and 1995 was $7.87, $7.55 and $2.35, respectively. The fair value of the purchase rights under the Stock Purchase Plans was also estimated using the Black-Scholes model with the following weighted-average assumptions for 1997, 1996 and 1995, respectively: risk free interest rates of 5.2%, 5.2% and 5.8%; dividend yields of 0%; expected volatility of 34% for 1997 and 39% for 1996 and 1995; and an expected life of 0.33 years for 1997 and 0.25 years for 1996 and 1995. The weighted-average fair value of those purchase rights granted in 1997, 1996 and 1995 was $7.38, $5.75 and $1.89, respectively.

The Black-Scholes option valuation model was developed for use in estimating the fair value of traded options which have no vesting restrictions and are fully transferrable. In addition, option valuation models require the input of highly subjective assumptions including the expected stock price volatility. Because the Company's employee stock options and purchase rights have characteristics significantly different from those of traded options, and because changes in the subjective input assumptions can materially affect the fair value estimate, in management's opinion, the existing models do not necessarily provide a reliable single measure of the fair value of its employee stock options and purchase rights.

Assuming that the Company had accounted for its employee stock options and purchase rights using the fair value method and amortized the resulting amount to expense over the options' vesting period net income would have been reduced by $11 million, $9 million and $5 million for the years ended December 31, 1997, 1996 and 1995, respectively. Basic EPS would have been reduced by 18 cents, 17 cents and 10 cents for the years ended December 31, 1997, 1996 and 1995, respectively, and diluted EPS would have been reduced by 14 cents, 11 cents and 6 cents for the same periods, respectively. The pro forma effect on net income is not representative of the pro forma effects on net income in future years because it did not take into consideration pro forma compensation expense related to grants made prior to 1995.

Note 9 — Employee Benefit Plans

The Company has noncontributory defined benefit pension and defined contribution (including 401(k) savings) plans. Substantially all domestic employees of the Company are covered by one or more of these plans. The benefits under the active defined benefit pension plan are based on years of service and an employee's final average compensation. For the years ended December 31, 1997, 1996 and 1995, total pension expense for the defined benefit plans was $41 million, $45 million and $40 million, respectively. Total expense for the defined contribution plans was $6 million, $7 million and $6 million, for 1997, 1996 and 1995, respectively.

Net periodic pension cost of the Company's defined benefit plans for 1997, 1996 and 1995 included the following components (in millions):

	1997	1996	1995
Service cost – benefits earned during the year	$ 38	$ 38	$ 30
Interest cost on projected benefit obligations	51	45	40
Loss (return) on plan assets	(83)	(63)	(79)
Net amortization and deferral	35	25	49
Net periodic pension costs	$ 41	$ 45	$ 40

The following table sets forth the defined benefit plans' funded status amounts as of December 31, 1997 and 1996 (in millions):

	1997		1996	
	Accumulated Benefits Exceed Assets	Assets Exceed Accumulated Benefits	Accumulated Benefits Exceed Assets	Assets Exceed Accumulated Benefits
Actuarial present value of benefit obligations:				
Vested	$603	$ 83	$308	$ 91
Non-vested	17	1	96	3
Accumulated benefit obligations	620	84	404	94
Effect of projected future salary increases	141	—	107	—
Projected benefit obligation	761	84	511	94
Plan assets at fair value	529	103	393	115
Projected benefit obligation in excess of (less than) plan assets	232	(19)	118	(21)
Unrecognized prior service costs	(9)	—	(9)	—
Unrecognized net gain (loss)	(96)	3	42	7
Additional minimum liability	9	—	2	—
Accrued (prepaid) pension liability	$136	$(16)	$153	$(14)

In accordance with Statement of Financial Accounting Standards No. 87 —"Employers' Accounting for Pensions," an additional minimum pension liability for certain plans, representing the excess of accumulated benefits over plan assets and accrued pension costs, was recognized at December 31, 1997 and 1996. A corresponding amount was recognized as a separate reduction to stockholders' equity.

Plan assets consist primarily of equity securities (including 50,000 and 100,000 shares of Class B common stock) as of December 31, 1997 and 1996, respectively, long-term debt securities and short-term investments.

The weighted average discount rate used in determining the actuarial present value of the projected benefit obligation was 7.25%, 7.75% and 7.25% for 1997, 1996 and 1995, respectively. The expected long-term rate of return on assets (which is used to calculate the Company's return on pension assets for the current year) was 9.25% for each of 1997, 1996 and 1995. The weighted average rate of salary increases was 4.9% for each of 1997, 1996 and 1995. In 1997, Continental changed from the 1984 Unisex Pensioners Mortality Table to the 1983 Group Annuity Mortality Table which affects the comparability of benefit obligations. The unrecognized net gain (loss) is amortized on a straight-line basis over the average remaining service period of employees expected to receive a plan benefit.

Continental's policy is to fund the noncontributory defined benefit pension plans in accordance with Internal Revenue Service ("IRS") requirements as modified, to the extent applicable, by agreements with the IRS.

The Company also has a profit sharing program under which an award pool consisting of 15.0% of the Company's annual pre-tax earnings, subject to certain adjustments, is distributed each year to substantially all employees (other than employees whose collective bargaining agreement provides otherwise or who otherwise receive profit sharing payments as required by local law) on a pro rata basis according to base salary. The profit sharing expense included in the accompanying Consolidated Statements of Operations for the years ended December 31, 1997, 1996 and 1995 was $105 million, $68 million and $31 million, respectively.

Note 10 — Income Taxes

The reconciliations of income tax computed at the United States federal statutory tax rates to income tax provision for the years ended December 31, 1997, 1996 and 1995 are as follows (in millions):

	Amount			Percent		
	1997	1996	1995	1997	1996	1995
Income tax provision at United States statutory rates	$ 224	$150	$109	35.0%	35.0%	35.0%
State income tax provision	9	6	5	1.4	1.4	1.6
Reorganization value in excess of amounts allocable to identifiable assets	4	5	20	0.6	1.2	6.5
Meals and entertainment disallowance	9	7	6	1.4	1.6	1.9
Net operating loss not benefitted	(15)	(88)	(67)	(2.3)	(20.5)	(21.6)
Other	6	6	5	1.0	1.4	1.6
Income tax provision, net	$ 237	$ 86	$ 78	37.1%	20.1%	25.0%

The significant component of the provision for income taxes for the year ended December 31, 1997, 1996 and 1995 was a deferred tax provision of $220 million, $80 million and $71 million, respectively. The provision for income taxes for the period ended December 31, 1997, 1996 and 1995 also reflects a current tax provision in the amount of $17 million, $6 million and $7 million, respectively, as the Company is in an alternative minimum tax position for federal income tax purposes and pays current state income tax.

Deferred income taxes reflect the net tax effects of temporary differences between the carrying amounts of assets and liabilities for financial reporting purposes and the related amounts used for income tax purposes. Significant components of the Company's deferred tax liabilities and assets as of December 31, 1997 and 1996 are as follows (in millions):

	1997	1996
Spare parts and supplies, fixed assets and intangibles	$ 639	$ 635
Deferred gain	63	62
Capital and safe harbor lease activity	49	34
Other, net	39	34
Gross deferred tax liabilities	790	765
Accrued liabilities	(370)	(370)
Revaluation of leases	(16)	(34)
Net operating loss carryforwards	(631)	(804)
Investment tax credit carryforwards	(45)	(45)
Minimum tax credit carryforward	(21)	(10)
Gross deferred tax assets	(1,083)	(1,263)
Deferred tax assets valuation allowance	617	694
Net deferred tax liability	324	196
Less: current deferred tax (asset) liability	(111)	121
Non-current deferred tax liability	$ 435	$ 75

At December 31, 1997, the Company has estimated net operating loss carryforwards ("NOLs") of $1.7 billion for federal income tax purposes that will expire through 2009 and federal investment tax credit carryforwards of $45 million that will expire through 2001. As a result of the change in ownership of the Company on April 27, 1993, the ultimate utilization of the Company's net operating losses and investment tax credits could be limited. Reflecting this possible limitation, the Company has recorded a valuation allowance of $617 million at December 31, 1997.

In the fourth quarter of 1997, the Company determined that it would be able to recognize an additional $155 million of NOLs attributable to the Company's pre-bankruptcy predecessor. This benefit, $62 million, was used to reduce reorganization value in excess of amounts allocable to identifiable assets. To the extent the Company were to determine in the future that additional NOLs of the Company's pre-bankruptcy predecessor could be recognized in the accompanying consolidated financial statements, such benefit would also reduce reorganization value in excess of amounts allocable to identifiable assets. If such reorganization value is exhausted, such benefit would reduce other intangibles.

The deferred tax valuation allowance decreased from $694 million at December 31, 1996 to $617 million at December 31, 1997. This decrease is related to the realization of deferred tax assets associated with net operating losses that had not previously been benefitted.

Approximately $359 million of the Company's net operating losses can only be used to offset the separate parent company taxable income of Continental Airlines, Inc. Approximately $13 million of the Company's investment tax credits can only be used to offset the separate parent company tax liability of Continental Airlines, Inc.

Note 11 — Nonoperating Income (Expense)

In February 1996, Continental sold approximately 1.4 million of the 1.8 million shares it owned in America West, realizing net proceeds of $25 million and recognizing a gain of $13 million. In May 1996, the Company sold all of its 802,860 America West warrants, realizing net proceeds of $7 million and recognizing a gain of $5 million. The gains are included in Other, net in the accompanying Consolidated Statements of Operations.

Continental and its former System One subsidiary entered into a series of transactions on April 27, 1995 whereby a substantial portion of System One's assets (including the travel agent subscriber base and travel-related information management products and services software), as well as certain liabilities of System One, were transferred to a newly formed limited liability company, System One Information Management, L.L.C. ("LLC"). LLC is owned equally by Continental CRS Interests, Inc. ("Continental CRS") (formerly System One, which remains a wholly owned subsidiary of Continental), Electronic Data Systems Corporation ("EDS") and AMADEUS, a European computerized reservation system ("CRS"). Substantially all of System One's remaining assets (including the CRS software) and liabilities were transferred to AMADEUS. In addition to the one-third interest in LLC, Continental CRS received cash proceeds of $40 million and an equity interest in AMADEUS valued at $120 million, and outstanding indebtedness of $42 million of System One owed to EDS was extinguished. In connection with these transactions, the Company recorded a pretax gain of $108 million, which amount was included in Nonoperating Income (Expense) in the accompanying Consolidated Statements of Operations for the year ended December 31, 1995. The related tax provision totaled $78 million (which differs from the federal statutory rate due to certain nondeductible expenses), for a net gain of $30 million. System One's revenue, included in Cargo, mail and other revenue, and related net earnings were not material to the consolidated financial statements of Continental.

Note 12 — Accruals for Aircraft Retirements and Excess Facilities

During 1996, the Company made the decision to accelerate the replacement of certain aircraft between August 1997 and December 1999. As a result of its decision to accelerate the replacement of these aircraft, the Company recorded a fleet disposition charge of $128 million. The fleet disposition charge related primarily to (i) the writedown of Stage 2 aircraft inventory, which is not expected to be consumed through operations, to its estimated fair value; and (ii) a provision for costs associated with the return of leased aircraft at the end of their respective lease terms. The majority of the aircraft are being accounted for as operating leases and therefore the Company will continue to recognize rent and amortization expenses on these aircraft until they are removed from service.

During 1994, the Company recorded a $447 million provision associated with (i) the planned early retirement of certain aircraft ($278 million) and (ii) closed or underutilized airport and maintenance facilities and other assets ($169 million).

The following represents the activity within these accruals during the three years ended December 31, 1997 (in millions):

	1997	1996	1995
Total accruals at beginning of year	$ 205	$ 220	$ 443
Net cash payments:			
Aircraft related	(25)	(52)	(59)
Underutilized facilities and other	(13)	(17)	(20)
Decrease in accrual for grounded aircraft	(16)	—	—
Fleet disposition charge for cost of return of leased aircraft	—	54	—
Issuance of the Convertible Secured Debentures	—	—	(158)
Increase in accrual for underutilized facilities	—	—	14
Total accruals at end of year	151	205	220
Portion included in accrued other liabilities	(28)	(17)	(45)
Accrual for aircraft retirements and excess facilities	$ 123	$ 188	$ 175

The remaining accruals relate primarily to anticipated cash outlays associated with (i) underutilized airport facilities (primarily associated with Denver International Airport), (ii) the return of leased aircraft and (iii) the remaining liability associated with the grounded aircraft. The Company has assumed certain sublease rental income for these closed and underutilized facilities and grounded aircraft in determining the accrual at December 31, 1997. However, should actual sublease rental income be different from the Company's estimates, the actual charge could be different from the amount estimated. The remaining accrual represents cash outlays to be incurred over the remaining lease terms (from one to 13 years).

Note 13 — Commitments and Contingencies

In March 1998, Continental announced the conversion of 15 Boeing 737 option aircraft to 15 Boeing 737-900 firm aircraft and the addition of 25 option aircraft.

As of March 18, 1998, Continental had firm commitments with Boeing to take delivery of a total of 154 jet aircraft (including the Boeing 737-900 aircraft described above) during the years 1998 through 2005 with options for an additional 61 aircraft (exercisable subject to certain conditions). These aircraft will replace older, less efficient Stage 2 aircraft and allow for the growth of operations. The estimated aggregate cost of the Company's firm commitments for the Boeing aircraft is approximately $6.7 billion. As of March 18, 1998, Continental had completed or had third party commitments for a total of approximately $1.6 billion in financing for its future Boeing deliveries, and had commitments or letters of intent from various sources for backstop financing for approximately one-third of the anticipated remaining acquisition cost of such Boeing deliveries. The Company currently plans on financing the new Boeing aircraft with a combination of enhanced equipment trust certificates, lease equity and other third party financing subject to availability and market conditions. However, further financing will be needed to satisfy the Company's capital commitments for other aircraft and aircraft-related expenditures such as engines, spare parts, simulators and related items. There can be no assurance that sufficient financing will be available for all aircraft and other capital expenditures not covered by firm financing commitments. Deliveries of new Boeing aircraft are expected to increase aircraft rental, depreciation and interest costs while generating cost savings in the areas of maintenance, fuel and pilot training.

In September 1996, Express placed a firm order for 25 Embraer ERJ-145 regional jets, with options for an additional 175 aircraft exercisable through 2008. In June 1997, Express exercised its option to order 25 of such option aircraft and expects to confirm its order for an additional 25 of its remaining option aircraft by August 1998. Neither Express nor Continental will have any obligation to take such aircraft that are not financed by a third party and leased to Continental. Express took delivery of 18 of the aircraft through December 31, 1997 and will take delivery of the remaining 32 aircraft through the third quarter of 1999. Continental expects to account for all of these aircraft as operating leases.

Continental expects its cash outlays for 1998 capital expenditures, exclusive of fleet plan requirements, to aggregate $211 million primarily relating to mainframe, software application and automation infrastructure projects, aircraft modifications and mandatory maintenance projects, passenger terminal facility improvements and office, maintenance, telecommunications and ground equipment.

Continental remains contingently liable until December 1, 2015, on $202 million of long-term lease obligations of US Airways, Inc. ("US Airways") related to the East End Terminal at LaGuardia Airport in New York. If US Airways defaulted on these obligations, Continental could be required to cure the default, at which time it would have the right to reoccupy the terminal.

In April 1997, collective bargaining agreement negotiations began with the Independent Association of Continental Pilots ("IACP") to amend both the Continental pilots' contract (which became amendable in July 1997) and Express pilots' contract (which became amendable in October 1997). In February 1998, a five-year collective bargaining agreement with the Continental Airlines pilots was announced by the Company and the IACP. In March 1998, Express also announced a five-year collective bargaining agreement with its pilots. These agreements are subject to approval by the IACP board of directors and ratification by the Continental and Express pilots. In September 1997, Continental announced that it intends to bring all employees to industry standard wages (the average of the top ten air carriers as ranked by the DOT excluding Continental) within 36 months. The announcement further stated that wage increases will be phased in over the 36-month period as revenue, interest rates and rental rates reached industry standards.

In February 1998, Continental began a block space arrangement whereby Continental is committed to purchase capacity on another carrier at a cost of approximately $147 million per year. This arrangement is for 10 years.

Legal Proceedings

The Company and/or certain of its subsidiaries are defendants in various lawsuits, including suits relating to certain environmental claims, the Company's consolidated Plan of Reorganization under Chapter 11 of the federal bankruptcy code which became effective on April 27, 1993, the Company's long-term global alliance agreement with Northwest Airlines, Inc. ("Northwest") entered into in connection with Air Partners' disposition of its interest in Continental to an affiliate of Northwest (see Note 16) and proceedings arising in the normal course of business. While the outcome of these lawsuits and proceedings cannot be predicted with certainty and could have a material adverse effect on the Company's financial position, results of operations and cash flows, it is the opinion of management, after consulting with counsel, that the ultimate disposition of such suits will not have a material adverse effect on the Company's financial position, results of operations or cash flows.

Note 14 — Related Party Transactions

The following is a summary of significant related party transactions that occurred during 1997, 1996 and 1995, other than those discussed elsewhere in the Notes to Consolidated Financial Statements.

In connection with certain synergies agreements, Continental paid Air Canada $30 million, $16 million and $38 million for the years ended December 31, 1997, 1996 and 1995, respectively, and Air Canada paid Continental $16 million, $17 million and $16 million in 1997, 1996 and 1995, respectively, primarily relating to aircraft maintenance.

The Company and America West, in which David Bonderman holds a significant interest, entered into a series of agreements during 1994 related to code-sharing and ground handling that have created substantial benefits for both airlines. Mr. Bonderman is a director of the Company and holds a significant interest in the Company. The services provided are considered normal to the daily operations of both airlines. As a result of these agreements, Continental paid America West $16 million, $15 million and $11 million in 1997, 1996 and 1995, respectively, and America West paid Continental $23 million, $22 million and $14 million in 1997, 1996 and 1995, respectively.

On July 27, 1995 and August 10, 1995, Air Partners purchased from the Company an aggregate of 308,226 and 657,320 shares of Class B common stock, respectively, at purchase prices of $7.93 per share (with respect to a total of 710,660 shares) and $6.70 per share (with respect to a total of 254,886 shares). Of the total, 316,640 shares were purchased pursuant to the exercise of antidilution rights granted to Air Partners under the Certificate of Incorporation and the remaining 648,906 shares were purchased pursuant to the exercise of antidilution rights granted to Air Canada under the Certificate of Incorporation (which rights were purchased by Air Partners immediately prior to their exercise on August 10, 1995).

In May 1996, Air Canada converted all of its 3,322,112 shares of Class A common stock into Class B common stock (pursuant to certain rights granted to it under the Company's Certificate of Incorporation) and sold, on the open market, 4,400,000 shares of the Company's common stock pursuant to the Secondary Offering.

On November 21, 1996, Air Partners exercised its right to sell to the Company, and the Company subsequently purchased, for $50 million, Warrants to purchase 2,614,379 shares of Class B common stock (representing a portion of the total warrants held by Air Partners) pursuant to an agreement entered into earlier in 1996 with the Company.

In April 1997, Continental redeemed for cash all of the 460,247 outstanding shares of its Series A 12% Preferred held by an affiliate of Air Canada for $100 per share plus accrued dividends thereon. The redemption price, including accrued dividends, totaled $48 million.

On June 2, 1997, the Company purchased for $94 million from Air Partners warrants to purchase 3,842,542 shares of Class B common stock (representing a portion of the total warrants held by Air Partners). The purchase price represented the intrinsic value of the warrants (the difference between the closing market price of the Class B common stock on May 28, 1997 ($34.25) and the applicable exercise price).

In July 1997, the Company purchased the rights of United Micronesia Development Association, Inc. ("UMDA") to receive future payments under a services agreement between UMDA and CMI (pursuant to which CMI was to pay UMDA approximately 1% of the gross revenues of CMI, as defined, through January 1, 2012, which payment by CMI to UMDA totaled $1 million, $6 million and $6 million in 1997, 1996 and 1995, respectively) and UMDA's 9% interest in AMI, terminated the Company's obligations to UMDA under a settlement agreement entered into in 1987, and terminated substantially all of the other contractual arrangements between the Company, AMI and CMI, on the one hand, and UMDA on the other hand, for an aggregate consideration of $73 million.

In connection with the Company's $320 million secured term loan financing, entered into in 1996, CMI paid UMDA a dividend of approximately $13 million in 1996.

Note 15 — Foreign Operations

Continental conducts operations in various foreign countries. Operating revenue from foreign operations are as follows (in millions):

	Year Ended December 31, 1997	1996	1995
Pacific	$ 648	$ 699	$ 742
Atlantic	778	494	390
Latin America	532	372	311
	$1,958	$1,565	$1,443

Note 16 — Subsequent Events

The Company announced on January 26, 1998 that Air Partners, the holder of 5,263,188 shares of Continental's Class A common stock and warrants to purchase 3,039,468 shares of Class A common stock, which represent, assuming exercise of the warrants, approximately 14% of the Company's common stock equity and approximately 51% of its outstanding voting power, had entered into an agreement to dispose of its interest in the Company to an affiliate of Northwest (the "Air Partners Transaction"). The Air Partners Transaction is subject to, among other matters, governmental approval and expiration of applicable waiting periods under the Hart-Scott-Rodino Antitrust Improvements Act of 1976. The agreement also extends to an affiliate of Air Partners a right of first offer to purchase certain shares of Class A common stock to be acquired by Northwest or its affiliates if such entities intend to dispose of those securities prior to the fifth anniversary of the closing of the Air Partners Transaction. Upon completion of the Air Partners Transaction, a change of control will result under the 97 and 94 Incentive Plans and all outstanding options and restricted stock under these plans will become fully vested. The Company also announced on January 26, 1998, that in connection with the Air Partners Transaction, the Company had entered into a long-term global alliance with Northwest.

Note 17 — Quarterly Financial Data (Unaudited)

Unaudited summarized financial data by quarter for 1997 and 1996 is as follows (in millions, except per share data):

	Three Months Ended			
	March 31	June 30	September 30	December 31
1997				
Operating revenue	$1,698	$1,786	$1,890	$1,839
Operating income	146	231	207	132
Nonoperating income (expense), net	(22)	(23)	(21)	(10)
Net income	74	128	110	73
Earnings per common share:				
Income before extraordinary loss (a)	$ 1.28	$ 2.22	$ 1.97	$ 1.26
Extraordinary loss, net of tax	—	—	(0.07)	—
Net income (a)	$ 1.28	$ 2.22	$ 1.90	$ 1.26
Earnings per common share assuming dilution:				
Income before extraordinary loss (a)	$ 0.96	$ 1.63	$ 1.48	$ 0.97
Extraordinary loss, net of tax	—	—	(0.04)	—
Net income (a)	$ 0.96	$ 1.63	$ 1.44	$ 0.97
1996				
Operating revenue	$1,489	$1,639	$1,671	$1,561
Operating income	120	229	77	99
Nonoperating income (expense), net	(25)	(23)	(30)	(19)
Net income	88	167	17	47
Earnings per common share:				
Income before extraordinary loss (a)	$ 1.60	$ 3.05	$ 0.42	$ 0.82
Extraordinary loss, net of tax	—	—	(0.12)	—
Net income (a)	$ 1.60	$ 3.05	$ 0.30	$ 0.82
Earnings per common share assuming dilution:				
Income before extraordinary loss (a)	$ 1.19	$ 2.09	$ 0.34	$ 0.62
Extraordinary loss, net of tax	—	—	(0.08)	—
Net income (a)	$ 1.19	$ 2.09	$ 0.26	$ 0.62

(a)The sum of the four quarterly earnings per share amounts does not agree with the earnings per share as calculated for the full year due to the fact that the full year calculation uses a weighted average number of shares based on the sum of the four quarterly weighted average shares divided by four quarters.

During the third quarter of 1997, in connection with the prepayment of certain indebtedness, Continental recorded a $4 million after tax extraordinary loss relating to early extinguishment of debt.

During the first quarter of 1996, the Company recorded a pretax gain of $12.5 million related to the sale of approximately 1.4 million shares of America West common stock.

During the second quarter of 1996, the Company recorded a $5 million gain related to the sale of the America West warrants.

During the third quarter of 1996, the Company recorded a fleet disposition charge of $128 million ($77 million after-tax) related to the Company's decision to accelerate the replacement of certain aircraft. In addition, in connection with the prepayment of certain indebtedness, Continental recorded a $6 million after tax extraordinary loss relating to early extinguishment of debt.

REPORT OF INDEPENDENT AUDITORS

The Board of Directors and Stockholders
Continental Airlines, Inc.

We have audited the accompanying consolidated balance sheets of Continental Airlines, Inc. (the "Company") as of December 31, 1997 and 1996, and the related consolidated statements of operations, redeemable preferred stock and common stockholders' equity and cash flows for each of the three years in the period ended December 31, 1997. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audits.

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

In our opinion, the consolidated financial statements referred to above present fairly, in all material respects, the consolidated financial position of the Company at December 31, 1997 and 1996, the consolidated results of its operations and its cash flows for each of the three years in the period ended December 31, 1997, in conformity with generally accepted accounting principles.

Ernst & Young LLP

Houston, Texas
February 9, 1998
except for Note 13, as
to which the date is
March 18, 1998

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Colony Advisors, Inc.

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Texas Pacific Group

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Materials Services

Janet P. Wejman
Senior Vice President and Chief Information Officer

James B. Ream
President, Continental Micronesia, Inc., and
Senior Vice President – Asia

David N. Siegel
President, Continental Express, Inc.

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Transfer Agent and Registrar
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311 West Monroe
P.O. Box A3504
Chicago, IL 60690-3504
Attn: Shareholder Services

Common Stock
Continental Airlines, Inc.'s Class B and Class A common stock trade on the New York Stock Exchange under the symbols CAI.B and CAI.A. As of March 11, 1998, there were 50,951,663 shares of Class B and 8,379,464 shares of Class A common stock outstanding, with approximately 17,956 holders of record of Class B and 3,133 holders of record of Class A.

Holders of Class B common stock are entitled to one vote per share, and holders of Class A common stock are entitled to ten votes per share, on all matters submitted to a vote of common stockholders, subject to restrictions governing voting rights of holders who are not United States citizens. Shares of Class A common stock are convertible at any time into an equal number of shares of Class B common stock. The Company has not paid cash dividends on its common stock and has no current intention to do so. Certain of the Company's credit agreements and indentures restrict the ability of the Company and certain of its subsidiaries to pay cash dividends.

Following are the high and low sales prices for the stocks as reported on the New York Stock Exchange for 1997 and 1996:

CAI.B and CAI.A Stock Prices for 1997 and 1996

	Class B				Class A			
	1997		1996		1997		1996	
	High	Low	High	Low	High	Low	High	Low
First Quarter	$33⅝	$27	$28 3/16	$19 7/16	$33¾	$27	$27	$19⅛
Second Quarter	$35⅞	$29½	$31 7/16	$26 9/16	$36¾	$30⅛	$31 1/16	$25⅞
Third Quarter	$41⅜	$34	$31⅛	$21⅛	$41 7/16	$34	$31	$21
Fourth Quarter	$50 3/16	$38⅝	$30¾	$22⅝	$50½	$38½	$30⅝	$22

1996 prices have been restated to reflect a 2-for-1 stock split effected in July 1996.

Continental
Airlines