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ALK - Q3 2014 Alaska Air Group Inc Earnings Call

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OVERVIEW:

Co. reported 3Q14 adjusted net income of $200m or $1.47 per share.

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PRESENTATION

Operator

Good morning my name is Tiffany and I will be your conference operator today. At this time I would like to welcome everyone to the Alaska Air Group third-quarter 2014 earnings conference call. Today's call is being recorded and will be accessible for future playback at www.AlaskaAir.com.

(Operator Instructions)

I would now like to turn the call over to Alaska Air Group's Managing Director, Lavanya Sareen.

Lavanya Sareen - *Alaska Air Group - Managing Director*

Thanks, Tiffany. Hi, everyone good morning. Thank you for joining us for Alaska Air Group's third-quarter 2014 earnings call. On the call today are CEO Brad Tilden, CFO Brandon Pedersen and our Senior Vice President of Planning and Revenue Management, Andrew Harrison who will provide highlights from the third quarter and our outlook for the fourth quarter. Several members of our senior management team are also on hand to help answer your questions.

Our comments today will include forward-looking statements regarding our future expectations which may differ significantly from actual results. Information on risk factors that could affect our business can be found in our SEC filings.

We will refer to certain non-GAAP financial measures such as adjusted earnings and unit costs excluding fuel. We have provided a reconciliation between the most directly comparable GAAP and non-GAAP measures in our earnings release. This morning Alaska Air Group reported a third-quarter GAAP profit of $198 million excluding the impact of mark-to-market adjustments related to our fuel hedge portfolio, Air Group reported a record adjusted net income of $200 million or $1.47 per share. This compares to our first call mean estimate of $1.42 per share and to last year's adjusted net income of $157 million or $1.11 per share.

Additional information about cost expectations, capacity plans, fuel hedging, capital expenditures and other items can be find in our investor update included in our form 8-K issued this morning and available on our website at www.AlaskaAir.com. And with that I'll turn the call over to Brad.

Brad Tilden - *Alaska Air Group - CEO*

Thanks Lavanya and good morning everyone. Lavanya just shared the numbers I thought I'd provide a little context on our performance and then talk for a bit about we're looking at 2015. I thought this was a very good quarter and almost all fronts.

It starts with the flight schedule and our folks in planning and revenue management continue to do an excellent job of letting in capacity in places where it's most appropriate based on underlying demand and of defending and protecting our route network. As you know this group of people is nimble and they move quickly.

Employees across our system did a great job growing and creating new demand for our service by continuing to run a great operation and by doing the little things for customers that make us who we are. Our folks in marketing and external relations in particular have done a terrific job getting our name out in the communities where we fly and building loyalty.

Andrew will share some impressive loyalty numbers with you in just a moment. And our folks throughout the operation did a great job with very high volumes, much higher than in the prior year and our folks in finance are making sure that all of this performance translates into this stock being a great investment for our owners. They're also doing a good job keeping our team focused on the things we need to do in 2015 to keep our cost going down and to keep this machine running smoothly.

Our $320 million pretax profit resulted in a pretax margin of 21.8% which is 340 basis points higher than last year. It may be that this result leads the industry. Our ROIC for the trailing 12 months is 17.2% and that performance was driven by four factors. Strong revenues, very strong non-fuel cost performance, lower fuel prices and increasingly by the benefit of much more fuel-efficient aircraft which are coming online. This is shaping up to be a year of record profitability despite increased competition.

Pretax income for the first nine months of the year is $716 million about 15% higher than our full-year result last year. I think our results over the last couple of years demonstrates that we're building a business model that works through the cycle. Finance and operations are humming along well, and customer service is at an all-time high.

New competition is making us reach higher and is creating an imperative for us to challenge ourselves and make necessary changes to achieve more. And we've got a fantastic group of front-line employees who are fully engaged and a talented and dedicated leadership team that's working together and providing great direction to our folks.

I think it's right to point out that a lot of airlines are putting out great numbers this demonstrates that the airline industry is evolving into a return focused industry. The airlines as a group are performing much better on many many fronts than we were just a few years ago.

For some time now you've heard Brandon compare our results and encourage you to compare our results not just other airlines but to other high-quality industrial companies. If you look at our balance sheet, our operational performance, our earnings, our consistency, you might conclude that he is right to do so.

Year-to-date cash flow from operations is just shy of $900 million which is enabling us to both reinvest in the business and return cash to shareholders. On the reinvestment side we firmed up options for 10 737-900ERs, bringing our firm order to 37 aircraft over the next three years. We're very excited about the economics of these aircrafts which Brandon will elaborate more on in just a moment and about the improved experience they provide for our customers.

On the returning cash to shareholders side of things, we repurchased $159 million worth of stock in the third quarter, an amount that represents 2.5% of the Company. When combined with dividends we're clearly on track to hit our target of $350 million in returns to shareholders this year.

Operationally the third quarter was challenging with additional capacity in some of our markets, but our people did a great job rising to the challenge and running a strong operation. Almost 87% of our flights in the first eight months of the year arrived on time and that was the highest percentage amongst the eight largest airlines.

If we look at our performance by hub, LAX was strong up six points from last year while Seattle struggled a bit with the high volumes and was down one and a half points from last year. Customer satisfaction was very strong. Alaska continued to exceed our 2014 target of 82% with a score of 84.4% for the quarter. The score is a blend of three questions we ask our customers. September's score of 85.7% is the highest we've achieved since we started tracking this in 2007 and it's about 15 points higher than our score from 2007.

Our launch of Alaska Listens, our online customer feedback form has been instrumental in raising scores. We survey about 50,000 customers a month and follow-up on many comments and on all negative comments within 72 hours. The follow-up is done by front-line management at the station or division responsible for the relevant area. The feedback we're are receiving has been very powerful in helping us recognize great employees and in helping us change policies and practices or coach employees where needed.

I think we talked with you in the past about Flight Path which was a series of workshops we ran with our 13,000 employees to talk about how we're doing and where we're headed together. It has had a positive impact on our alignment an on our service.

And finally we also believe that Gear Up, a series of training sessions we have recently done with our leadership team has contributed to the sense of ownership that our supervisors, managers and directors feel. From a network perspective, we are growing profitably. We had an 8% capacity and carried 8.1% more passengers during the quarter. Our total operating revenue was up 7%. Our Seattle figures for both passengers and revenues were virtually identical to our system averages. I thought it was a very solid revenue performance given the capacity headwinds both load factors and yields were down just a touch.

We launched three new markets in the third quarter from Seattle to Albuquerque, Baltimore and Detroit, and they're performing very well. With those we have 13 new markets year-to-date that will continued to diversify our revenue stream. We now serve 79 of our roughly 100 cities from Seattle giving our Seattle customers tremendous schedule utility. We believe that our success with this growth and with the total of 50 new markets we've added over the last three years has been driven by our three elements of competitive advantage. Which are low fares and low costs, a very reliable operation and most importantly great customer service.

On the labor front we reached an agreement in concept with our flight attendants on October 9. I want to thank our flight attendants for continuing to provide great service throughout the negotiations. We believe it's a fair agreement that recognizes the great work that our 3300 flight attendants do every day. Assuming this becomes a TA and ratifies we will have long-term agreements in place through 2016 and in most cases 2018 or 2019 with all of our larger work groups.

I'd like to talk for a minute about the 2015 plan which we're just putting the finishing touches on. We'll share details of this with you at our investor day in New York City on December 4. What I'll say now is that there's a huge emphasis in 2015 on projects that directly impact our customers, a huge emphasis on projects that are going to be completed within the next 12 to 18 months and with respect to execution we're putting a big emphasis on continuing to move our culture to one of high performance.

As I close I'd like to thank our employees for just a terrific quarter. I want to specifically call out our flight crews, our people on the ground in Mexico, LA and elsewhere and our folks in our SOC for incredible response to hurricane Odile in Los Cabos. As I think you all know we operated 12 humanitarian relief flights to rescue 2000 stranded passengers, we were one of the first airlines back when the airport reopened on October 8. With that I'll turn the call over to Andrew.

Andrew Harrison - *Alaska Air Group - SVP of Planning and Revenue Management*

Thanks Brad, good morning everyone. Our revenue performance for the third quarter was very strong given some competitive capacity in our markets, it was up 9%. Passenger revenue increased 7% on 8% capacity growth while PRASM was down 1.1% underlying demand was solid. PRASM was flat in July down 1.7% in August and down 1.4% in September.

We knew summer was going to be strong but we were particularly pleased with the September shoulder period as PRASM performance was down less than in August. The upgauging of our fleet with the 737-900ERs has helped drive unit costs down while growing total revenue. We were able to make extensive use of our new ERs during the peak summer months with many of these aircraft deployed into Hawaii and transcontinental markets. We ended the quarter with 22 of these impressive airplanes and they allowed us to generate up to 15% more capacity on high load factor routes without additional frequency.

In addition and without compromising passenger comfort, our seat retrofit program is allowing us to add seats on our 737-800s the backbone of our mainline fleet. We've completed 55 of 61 aircraft and we expect to complete the remaining 6 aircraft before year's end. The seats retrofit program should provide an incremental benefit of about $25 million next year.

We continue to make changes to our network and revenue management network practices. Earlier this year we added a new booking class to our first-class pricing structure. These fares are lower than our full first-class fares and allow us to stimulate demand in the first-class cabin as well as remain competitive with other carriers during weaker demand periods.

We've been very pleased with the results today. For the third quarter total first-class revenue was up 9% or $14 million by 4.4% increase in capacity. This translates to a 4.6% unit revenue increase for the front cabin with paid first-class traffic up 7 points versus last year. And we've only rolled out our new first-class pricing structure to about 50% of our markets. We expect to roll out the remaining markets in the first quarter of 2015 when we upgrade our revenue management system.

With respect to our network, we saw interline and codeshare revenue with Delta declined 53% or $38 million for the quarter. However we were able to recapture 85% of this revenue through our own distribution channels and generating higher codeshare and interline revenues from other airlines. Overall interline and codeshare revenue for the quarter is only down 5%.

Total revenues for the quarter increased 7.3% or $100 million on a year-over-year basis and continues to be helped by ancillary revenue which was up 18.7% or 10% per passenger.

The benefits of our modified agreement with Bank of America annualized during the third quarter, however we expect to continue to see benefits from our initiative to increase the number of members in our loyalty program. Our loyalty marketing team has done an outstanding job as active mileage plan members are up over 10% this year on a 6.2% increase in passengers, the largest increase we have ever seen. In addition both credit card miles sold and the number of cardholders continues to increase, both were up approximately 10% for the quarter. We appreciate our customers' loyalty and will continue to work hard to earn their business.

Now looking ahead Alaska's fourth-quarter capacity is expected to be up 10%, half of which is driven by efficient gauge and paid plan changes. This brings our full-year capacity growth to 7% which is consistent with what we have been guiding to all year. And bookings are holding up well for the seasonally slower fourth quarter. Advance book load factor is down 0.5 points for October up 3 points for November and down 1.5 points for December.

As some of you have asked whether ebola is negatively impact bookings and if lower oil prices are an indicator of softening demand. From what we see today the answer is no to both these questions. When we last spoke to you we expected other airline capacity in the fourth quarter of 2014 and Q1 of 2015 to be up 12% and 22% respectively. But as we look at published schedules today we now expect Q4 to be up 9%, that's a 3 point reduction and Q1 of 2015 to be up 17% and that's a 5 point reduction.

Now many of these reductions are coming out of key markets in Seattle and Portland. But notwithstanding this downward revision this is still a large amount of capacity in our markets and we continue to make the necessary changes to our business in order to successfully address these pressures.

We have a laser focus on building our loyalty base of customers in the Pacific Northwest especially here in Seattle. An important foundation of earning customer loyalty is making sure we provide the best schedule utility to customers out of our hubs. As Brad just mentioned we started three new markets out of Seattle this quarter, and we've launched or announced a total of nine new nonstop markets from Seattle since the beginning of last year. We expect these markets to add over $100 million of revenue annually when fully developed. And of the nine markets, eight have already launched and they generated a pretax margin of 11% in the third quarter.

We believe our return on invested capital of over 17% warrants continued investment our business and therefore we expect to grow between 7% and 8% on a consolidated basis in 2015. Now to put this growth in perspective, if all of this growth was our transcon markets it would be equivalent to eight daily round trips from Seattle to New York.

We continue to invest in our network and our product while driving unit costs lower which Brandon will talk about in a moment. We are confident that we can offer customers a great product at a reasonable price. We will provide further details on our 2015 plan which includes changes to our network and our revenue strategy at our upcoming investor day on December 4. And with that I'll turn the call over to Brandon.

Brandon Pedersen - *Alaska Air Group - CFO*

Thanks Andrew, and good morning everybody. Air Group's adjusted net profit improved by 27% and our earnings per share improved by 32%. The trailing 12 months fully cash ROIC of 17.2% was 420 basis points higher than at this point last year. On an adjusted pretax basis we earned $320 million, a nearly $70 million increase.

As Andrew said revenues grew by $100 million, these revenue gains were offset by a $31 million increase in nonfuel expenses, slightly higher total economic fuel costs and lower net nonoperating costs. As Brad said pretax margin improved by 340 basis points to 21.8%. We think pretax margin is a better metric than operating margin when comparing ALK to other airlines given the substantial net interest expense incurred by others.

Consolidated nonfuel unit costs were down 3.6% on the 8.1% increase in capacity. Some of that can be attributed to having two quarter's worth of increase in pilot wages in Q3 of last year, giving the timing of ratification of that contract and the high port of Seattle lease costs that we were occurring in Q3 last year. But notwithstanding those items, cost control continues to be really solid. In fact if you factor out the one-time items that distort the comp, unit costs were down 2%.

Productivity continues to be an important part of the story, it was up another 2.2% this quarter on a passengers per FTE basis. Across all our divisions at both companies we're seeing a focus on productivity and I want to thank everyone for it especially Ben Minicucci, Alaska's COO and Dave Campbell the new leader of Horizon and their entire operating teams for the productivity gains.

Technology is helping too. Our great website and mobile tools contributed to a 2.1% increase in the share bookings that go through AlaskaAir.com. Today nearly 70% of passengers check-in on the web or using their mobile device.

We expect nonfuel unit costs to decrease, about 2.5% in the fourth quarter on the 10% capacity increase. The net result is a unit cost reduction for the year of just over 1%, making 2014 the fifth year in a row of cost reduction. We'll end 2014 with our lowest exfuel cost structure ever.

Air Group has real and durable competitive advantages over our larger rivals and our cost structure is one of them. Lower cost will also make growth in new markets more attractive. Right now we're finalizing our 2015 budget. We're not ready to share guidance on next year's unit costs yet but we are working on a plan that leverages the 7% to 8% capacity growth that Andrew mentioned and know that directionally we need to keep cost coming down further. We'll share more color on expected 2015 cost at our investor day in December, stay tuned.

Moving to fuel, total expense grew by 1.8% on a 5.1% increase in consumption. But here's more interesting point. Our fuel burn on an ASM per gallon basis improved by another 2.8% and it will continue to just get better as we phase out the 737 classics and take 900ERs. We've taken delivery of 10 of these fantastic airplanes so far this year and have 35 more coming by the end of 2017 that will help us transition out of the 27 737-400s left in the fleet. With fuel representing about a third of total airline operating costs, fuel efficiency gains add to our competitive structural cost advantage.

Let me tell you why we like these airplanes so much. The 900ERs have the 37 more seats than a 400 but burn about the same amount of fuel. They're more reliable and have much lower maintenance cost. The customer feedback has been great too because they have Recaro seats with power at every seat. We look forward to 11 more joining the fleet in 2015.

We're also making other investments to improve the fuel efficiency of our fleet. Today we've installed split scimitar winglets on 23 airplanes and expect to have 45 aircraft completed by year-end. These winglets should save us another about 1.5% or so.

We also saw the benefit of the changes we've been making to our fuel hedge program over the last couple of years through lower hedge costs per gallon in our economic fuel number. We've also spent less than $2.5 million on new hedges this year. As a reminder we only hedge with call options to cap the price we pay for fuel so we are fully participating in the recent decline in jet fuel prices which is reflected in our Q4 guidance of $2.77 per gallon. The steep decline is providing a nice tailwind to our profit outlook.

During the first nine months we generated just shy of $900 million in operating cash flows an increase of about $70 million over the first nine months of last year. For the trailing 12 months operating cash flow was close to $1.1 billion. Our adjusted debt-to-cap stands at 31% today. We're in a 300, excuse me, $238 million net cash position. Some investors have asked if we're under levered are concerned that our low leverage increases our weighted average cost-to-capital. I totally get that question but believe we're in a place of strength.

Our investment grade balance sheet rivals other high-quality industrials and puts us in an excellent position to defend the franchise we have created in the Pacific Northwest and to withstand any other shock that we might face, whether pandemic or weakening to global demand which as Andrew said we aren't seeing.

With after-tax ROIC well above our cost-to-capital, investing in our business is the right thing to do in order to create long-term value for owners. To that end we recently exercised options for 10 Boeing 737-900ER aircraft and so we now expect full-year CapEx to be $685 million.

Our aggressive program to return capital through the dividend and share repurchases underscores our long-term commitment to ensuring our owners get an appropriate return. During the first nine months of the year we paid out $51 million in dividends. We've also repurchased 5.3 million shares of our common stock for $242 million. We took advantage of the pullback in our stock price to accelerate repurchase activity in Q3 repurchasing $159 million compared to $83 million in the first half the year.

As Brad said our Q3 repurchases equated to about 2.5% of the Company and our year-to-date purchases equate to more than 3.5% of the Company. But taking a longer-term perspective back to the start of 2009 we've repurchased more than 18% of the shares that were outstanding at that time. Combining the dividend and the buyback we now expect to substantially exceed the $350 million capital return that we've been talking about for much of the year.

With no more deleveraging required, plenty of cash on hand, with pensions fully funded, and CapEx very manageable, all of our substantial free cash flow is available to return to our owners next year.

Before I close I want to recognize our treasury team. They recently finalized a three-year extension of one of our $100 million lines of credit. I want to congratulate them in an outstanding outcome with a lower interest rate and a lower commitment fee. We can achieve great results like this because of our investment grade balance sheet. And with that I'll turn the call back to Brad.

Brad Tilden - *Alaska Air Group - CEO*

Thanks very much Brandon. So to recap we run a safe operation, a reliable operation, we offer low fares, we have award winning service and we have terrific customer loyalty.

We've got one of the youngest and most fuel efficient fleets in the industry, we have an investment grade balance sheet and we're returning cash to shareholders. We bought back 2.5% of the outstanding stock this quarter.

We look forward to seeing you all in New York on December 4. It looks like you're going to have a busy first part of December with at least two other investor days in New York but we're looking forward to that time to share more with you about our 2015 plan.

And now we do want to move to Q&A. As we do that I want to introduce three new members of our team. First, Dave Campbell who comes to us. He's running Horizon Air as our President. A long career at American Airlines and some time at Jet Blue. Very excited to have Dave aboard. Curtis Kopf is here. Curtis has been with the Company for four years. He runs our customer innovation group and he is the interim head of marketing. And then finally Herman Wacker is with -- he's been with Alaska Air group for seven years and recently succeeded Keith Loveless as General Counsel.

So we're all here, available to answer questions operator if you want to queue them up.

QUESTIONS AND ANSWERS

Operator

(operator instructions) Your first question comes from the line of Savi Syth with Raymond James. Your line is open.

Savi Syth - *Raymond James & Associates, Inc. - Analyst*

Hi, good morning.

Brad Tilden - *Alaska Air Group - CEO*

Good morning.

Savi Syth - *Raymond James & Associates, Inc. - Analyst*

Just you have been performing really well and to your point I think September, especially versus how August performed did very well. I'm just wondering in your markets that you're growing and some of is in competitive response, some of it is just the opportunity, how is the unit revenue performing between those two categories?

Andrew Harrison - *Alaska Air Group - SVP of Planning and Revenue Management*

Hi Savi, it's Andrew. What I would say is obviously where there's heavier competitive capacity coming into our markets they tend to marginally underperform our system average, but what we have been finding especially as we looked at the third quarter,the largest areas of growth which was Midcon, mountain and Transcon their unit revenues were all actually above the system average so we are actually finding meaningful benefit for the maturing of these new revenues streams that we're building on.

Savi Syth - *Raymond James & Associates, Inc. - Analyst*

Got it and then on the ancillary revenue front it was up 10% per passenger I believe. How much of that is from the revenue initiative and what's the ongoing trend?

Andrew Harrison - *Alaska Air Group - SVP of Planning and Revenue Management*

Most of the increase in ancillary revenues was the bag fee and the change fees we made last year and they will annualize in the first quarter but as we go into 2015 we're going to be continuing to look for ways to maintain that ancillary revenue growth.

Savi Syth - *Raymond James & Associates, Inc. - Analyst*

All right perfect I'll get back ion the queue, thanks.

Operator

Your next question comes from the line of John Godyn with Morgan Stanley, your line is open.

John Godyn - *Morgan Stanley - Analyst*

Hi, thank you for taking my question here. I appreciated, Andrew, the commentary about competitive capacity trends looking still not good but better than maybe some of the numbers that had been recorded earlier. One of the things that is a little bit uncertain though as we keep seeing schedules that look out a little bit further, the first quarter instead of the fourth quarter it always seems like the worst is still in front of us. I wonder if the team has a sense of what quarter things are sort of as bad as they can get or at what point can we sort of look at results and sound the all clear and we just sort of know that those numbers reflect more of a steady state competitive environment?

Andrew Harrison - *Alaska Air Group - SVP of Planning and Revenue Management*

Hi John it's Andrew yes you know I think as you look at the booking schedule as I do all we know is what we see today and to your point as we go into the first quarter that is a high watermark. Honestly what we're doing is focusing completely on how we're going to continue to change and evolve our business and as you've the last four quarters even though our unit revenues have lagged for the last 20 months we've been able to grow, we've been able to expand margins, expand our absolute profit and expand our ROIT and for 2015 we are squarely continuing to work on plans to continue our momentum.

John Godyn - *Morgan Stanley - Analyst*

Got it, okay, that's very helpful. And Brandon if we could talk a little bit about the buyback, the amount that was bought back this quarter was fantastic it was tremendous versus the authorization that you have out there. If I remember correctly when you put out that authorization you didn't really put a clear timeline around it. You did offer some comments here that future free cash flow would continue to go to capital returns in one form or another. I was hoping that we could revisit the authorization timeline a little bit, maybe you could talk about the appetite to continue to accelerate the buyback here as the stock by many people's argument is still depressed by the Delta threat.

Brandon Pedersen - *Alaska Air Group - CFO*

Well good morning John it's Brandon. Thanks for your comments we really appreciate it. You're right we did accelerate the buyback in Q3 and we took advantage of the pull back in the share price to do that. As you guys know we have the flexibility to do that and this shows that we will exercise that flexibility. In terms of looking forward I don't think we're going to give anything more today on how fast we think we're going to use the existing share authorization. I think you can look back at our track record and say man Alaska's done a pretty nice job managing the buyback, using it appropriately when the timing is right, being in the market I can tell you we're in the market every single day and we're continuing to do the right thing.

John Godyn - *Morgan Stanley - Analyst*

Got it fair enough.

Operator

Your next question comes from Helane Becker with Cowen, your line is open.

Helane Becker - *Cowen Securities LLC - Analyst*

Thank you very much operator I appreciate the time. Hi everybody. I have a couple of questions as we think about the aircraft that you're taking delivery of next year should we think about that as going into owned aircraft or do you think you would use the opportunity to add more leverage back to the balance sheet?

Brandon Pedersen - *Alaska Air Group - CFO*

Good morning Helene it's Brandon. You know at this point we kind of divorce those questions a little bit I think we would own the airplane and then we'll separately manage the capital structure. We have strong bias toward ownership, we like it for a lot of reasons and as I said we'll flex the capital structure as necessary.

Helane Becker - *Cowen Securities LLC - Analyst*

Okay and then I don't want necessarily for you to give away any, you know I don't know what the right word is, but cities that you might think about flying to going forward but maybe you could just talk about the opportunities you have to expand out of either Seattle or Portland or both over the next year and a half or so. Maybe into markets internationally or further east, in the eastern part of the United States.

Andrew Harrison - *Alaska Air Group - SVP of Planning and Revenue Management*

Hi Helane, good morning, it's Andrew. What I would say as I shared a little bit earlier what's especially exciting is as we continue to grow this Company and as a unit costs continue to come down and we get these new fuel-efficient ER aircraft we're finding more opportunities given our cost structure and our network that we can look to fly. So I think the opportunity is being created by the way we're running the business. The other thing I would point to is obviously we're getting the MAX in 2017, looks to be a fantastic airplane as well and we're just beginning to look at all the cool options that might become available to us as we look at the range of that aircraft, its cost structure and where we want our Company to be by the time we actually receive that airplane.

Helane Becker - *Cowen Securities LLC - Analyst*

Okay, can I follow with one last question just about Seattle and the fact that I think somebody mentioned that there was congestion at the airport. Is the airport authority doing anything to help you out there and I think you guys are having some construction on the North terminal so how will that affect on-time performance as that continues? Thanks.

Ben Minicucci - *Alaska Airlines - COO and EVP Operations*

Hi Helane, it's Ben. Yes, we did have some congestion this summer and it is more a time of day and a summer phenomenon so we're putting a lot of work right now modeling day of week, time of year and it also depends what flow of the airports in north flow and south flow which make an impacts so we are working with the airport with ATC, we're working with network scheduling to make sure that where we see the constraints at the time of day that we're going try to move flights maybe add a bit of block time. Our on-time performance for the summer although was lower was at about 84% for July and August which is better than most but it's below where we want to be, still fairly strong, so we are working hard and we will have plans in place by March to mitigate any of that impact.

Helane Becker - *Cowen Securities LLC - Analyst*

Great, thanks everybody, thanks for the time.

Brad Tilden - *Alaska Air Group - CEO*

Thanks Helane.

Operator

Your next question comes from Hunter Keay of Wolfe Research your line is open.

Hunter Keay - *Wolfe Research - Analyst*

Good morning everybody.

Brad Tilden - *Alaska Air Group - CEO*

Hi Hunter.

Hunter Keay - *Wolfe Research - Analyst*

Two questions for you so has Alaska ever in its history evaluated a wide body strategy to Asia giving that you would have such dominant share of that market from Seattle and if you did evaluate it did you not do it because of the cost, mostly did you not do it because of the cost complexity it would introduce or because of a concern over the amount of local demand to Asia?

Brad Tilden - *Alaska Air Group - CEO*

Hey Hunter good morning. You know I don't know that we'll talk a lot about that. What I will say is that we love the strategy that we have today as we moved Alaska to all 737s and this is maybe a direct answer your questions, we moved to Alaska to all 737s, Horizon and all Q400s, we have just seen tremendous economies as we sort of become we think best in class at operating these two airplane types. Alaska's got -- you're familiar with all the benefit there, it's easier pilot training cost, the pilot reserves, there's a fewer number of reserves that you have with the 737s we're upgauging so we're getting tremendous economies with fuel and owner maintenance and so forth. Horizon, you've seen a massive turnaround at that company as we move from maybe three fleet types a few years ago to one now and it's has gone from basically a breakeven operation to reducing $100 million a year of pretax income so we love the simplicity, we love the focus that a single fleet type brings us and that's our answer.

Hunter Keay - *Wolfe Research - Analyst*

Okay understand thank you. And then you talked about how 70% of your passengers are checking in on their own right now so is the number of kiosks that you use down 70%, and why not maybe give that final push, get rid of some kiosks, get rid of your footprint, because presumably that 30% of passengers that are not checking in on their own are customers who's loyalty you have to worry about the least and I can suggest a way to get that 70% up a lot higher if you want.

Brad Tilden - *Alaska Air Group - CEO*

(Laughter). I would love to talk about how to get the 70% higher but you're exactly right, we're seeing explosive growth in check-in via mobile and in fact customers who check-in via mobile are also happier about the whole process. And the secondly we're seeing web check-in continue to grow and we're seeing kiosk check-in steadily decline, so I do think we will see that trend over time, it may not be immediate but I think you're right.

Ben Minicucci - *Alaska Airlines - COO and EVP Operations*

Hi Hunter, it's Ben. I think what you're seeing is a shift of how people are checking in, so there's a lot of opportunities for us at the airport to look at really changing the customer experience and what you'll see us do in 2015 is put some initiatives in place that really transforms what we're thinking about the lobby areas so it will have a lot of benefits that I hope we can share with you in the next few calls.

Brad Tilden - *Alaska Air Group - CEO*

And Hunter, even though they're using their mobile phone to check-in, they're still using the kiosk to print bag tags and that's where we're looking to go with this technology.

Hunter Keay - *Wolfe Research - Analyst*

Okay, thank you very much.

Brad Tilden - *Alaska Air Group - CEO*

Thank you Hunter.

Operator

Jamie Baker with JPMorgan your line is open.

Jamie Baker - *JPMorgan - Analyst*

Hi good morning everybody. I just can't sit here and resist calling out Hunter, Alaska did in fact order the 747 though I appreciate how nugget might have slipped by (Laughter)Following up on John's question you know you mentioned the recent schedule filings even with some slight trims the Delta overlap in your current market's rises considerably this quarter and into the first as well the total OA impact is challenging. I know you guys don't want to provide quarterly guidance but can you at least remind us of any sort of year-on-year comparisons unique to your own flying that might provide some benefit year on year, things that we should consider in potentially offsetting what appears to be just really really nasty headwinds as we move towards yearend and beyond?

Andrew Harrison - *Alaska Air Group - SVP of Planning and Revenue Management*

Yes thanks Jamie. You know I think there's a couple ways that we are working hard to address, the obvious pressures that will come in into the first quarter is again continuing to capitalize on our seasonality and we're going to do that in two ways. A number of the capacity adds are in our Pacific Northwest to Hawaii which is more of a winter season for us and of course, deploying all those ERs and those fuel-efficient aircraft to the islands where we can is going to be helpful and we continue to be very surgical and try to be really smart about the day of week cuts and when we fly when we don't fly. So those are the things we continue to work on as well as the new markets even in the stop the demand periods continue to mature and get stronger so those are three areas of water level that we hope to continue to rise and offset some of the revenue pressures.

Jamie Baker - *JPMorgan - Analyst*

Got it okay appreciate that color thanks everybody.

Brad Tilden - *Alaska Air Group - CEO*

Thanks Jamie.

Operator

Your next question comes from the line of Michael Linenberg with Deutsche Bank your line is open.

Michael Linenberg - *Deutsche Bank - Analyst*

Good morning, everyone. Brandon, going back to the aircraft that you're going to add over the next 3 years, I think you said 37 aircraft, how should we think about the split between replacement versus growth would it be fair to say the majority of those airplanes are replacement airplanes?

Brandon Pedersen - *Alaska Air Group - CFO*

Yes, so right now I said 35 in my remarks there's 3,6 so we have 36 900ERs on order for 2015, 2016, and 2017 and we want to replace the remaining 27 400s. So on a net basis it does represent growth but it's not a huge amount of unit growth but it is a fair amount of ASM growth just because of the upgauging that you get and that's pretty efficient growth too.

Michael Linenberg - *Deutsche Bank - Analyst*

Definitely. And then my second question and maybe this is for Andrew when I look at some of the other markets that you're expanding into like for example you've been doing a nice job building out San Diego, when you make the decisions to add a route how important is it to have a codeshare partner involved in a new route to bring them on as a risk sharing partner and maybe sort of as a second half to that question is you know a large number of those San Diego flights, do they have say for example the American codeshare or for the most part are they being operated under the Alaska code only?

Andrew Harrison - *Alaska Air Group - SVP of Planning and Revenue Management*

Yes, you know I think history has taught me personally I think, the more dependent we are on ourselves and our own network I think the better we're going to be off in the long run. So the way I view the codeshare relationships is we never start a market purely based on what we might get from a codeshare, we do it based on our own economics, our own network and our own strategy and then what we hope to do once we've announced it, then we can legally go talk to codeshare partners and if codeshare makes sense to help the network and grow the pie then we'll do that, but pretty much we focus on what we can do with our aircraft.

Michael Linenberg - *Deutsche Bank - Analyst*

Okay very good thank you Andrew.

Brad Tilden - *Alaska Air Group - CEO*

Thank you Mike.

Operator

Your next question Duane Pfennigwerth with Evercore, your line is open.

Duane Pfennigwerth - *Evercore Partners - Analyst*

Good morning.

Brad Tilden - *Alaska Air Group - CEO*

Hi Dewayne.

Duane Pfennigwerth - *Evercore Partners - Analyst*

Just on ancillary revenue you know you mentioned you're round-tripping the credit card deal and I think you'll begin to round-trip some of the change fees in the fourth quarter so can you talk maybe broadly what levers you can pull to re-accelerates other revenue growth into 2015?

Andrew Harrison - *Alaska Air Group - SVP of Planning and Revenue Management*

Hi Duane, it's Andrew. You know what I will say is we've been spending a lot of time looking at what the industry does and you know as you know we're are about $13, $13.50 per passenger and some of the industry is up closer to $20 so we know where we can find value add opportunity for customers we're going to work hard at that and what I will tell you is we are looking at additional things that might provide opportunity for us and our customers in the ancillary revenue and that's probably as much as I would say right now.

Duane Pfennigwerth - *Evercore Partners - Analyst*

Okay fair enough, and one for Brandon could you help us with kind of where your cash tax rate stands you know this year versus last year and what your outlook for 2015 would be?

Brandon Pedersen - *Alaska Air Group - CFO*

Yes sure Duane, good morning. I think we'll be at a cash tax rate this year of about 35%. I think that's up about 10% from last year my recollection is that we were in the mid-20s in terms of cash effective rate and then as we look forward next year there is some question out there as to what happens to bonus depreciation but I would expect our cash rate and our effective rate on the book side would be pretty close to even.

Duane Pfennigwerth - *Evercore Partners - Analyst*

Okay great, thanks very much.

Brad Tilden - *Alaska Air Group - CEO*

Thanks Duane.

Operator

Glenn Engel with Bank of America, your line is open.

Glenn Engel - *BofA Merrill Lynch - Analyst*

Good morning. A few questions on the cost side. Much of you touched on this, wages were actually down 2%, did that reverse any of the flight attendants and would you expect that not be the case in the fourth quarter?

Chris Berry - *Alaska Air Group - Managing Director, Accounting and Alaska Air Group Controller*

No Glenn, this is Chris Berry, wages were down there's a lot of things going on in there, last year you might recall and Brandon mentioned it in his comment that we have the retro pilot pay as part of the agreement that they signed, that was about $6 million in the quarter last year. We also have year-over-year pension decline which is consistent throughout the quarter of $10 million and then there's a few other things but that's the majority of what's happening there's nothing in there with flight attendants this year.

Glenn Engel - *BofA Merrill Lynch - Analyst*

That surprised me because it was even down from the second quarter and you were certainly flying more in the third order than the second.

Chris Berry - *Alaska Air Group - Managing Director, Accounting and Alaska Air Group Controller*

There were other things, medical costs and a couple of things other true ups as well but for the majority it was really the pilot retro was in last year's and then as well as the continued benefit from pension expense.

Glenn Engel - *BofA Merrill Lynch - Analyst*

For the famous other line, that was down also 3% and down from the second quarter?

Chris Berry - *Alaska Air Group - Managing Director, Accounting and Alaska Air Group Controller*

The other line, the other operating costs line?

Glenn Engel - *BofA Merrill Lynch - Analyst*

Yes.

Chris Berry - *Alaska Air Group - Managing Director, Accounting and Alaska Air Group Controller*

Yes, there's a lot of noise in there but there were some decreases in property taxes this quarter from an assessment we got a favorable change to an assessment and in a couple of states we operate in as well as we had a couple of warranty claims that we were able to get in the quarter as well so that drove the year-over-year decline there.

Glenn Engel - *BofA Merrill Lynch - Analyst*

And utilization was down 1.8% yet you're showing great unit cost improvement? This utilization down is just the less off decline that Andrew was talking about?

Andrew Harrison - *Alaska Air Group - SVP of Planning and Revenue Management*

For which period you are referring to?

Glenn Engel - *BofA Merrill Lynch - Analyst*

Third quarter versus last year it looked like utilization was down.

Andrew Harrison - *Alaska Air Group - SVP of Planning and Revenue Management*

I might have to take that one off-line and take a look

Brandon Pedersen - *Alaska Air Group - CFO*

Glenn it's Brandon, we'll get back to you on that one.

Glenn Engel - *BofA Merrill Lynch - Analyst*

And finally the selling cost was up tons, selling expense?

Chris Berry - *Alaska Air Group - Managing Director, Accounting and Alaska Air Group Controller*

This is Chris again selling expenses were up mostly because of advertising that we're doing here locally as well as some other things and Curtis, do you want to add to that?

Curtis Kopf - *Alaska Air Group - VP, Customer Innovation*

Sure we have increased our advertising in Seattle in light of the competitive environment and we're seeing fantastic results on that. That said, we still spend less than similar sized airlines and we expect that spend to be flat going into next year.

Andrew Harrison - *Alaska Air Group - SVP of Planning and Revenue Management*

This is Andrew, we were having a brain freeze there, our COO just told me again. We're adding the extra row of seats and there's a couple of lines of aircraft that are in there getting modified and that's why we're down. In utilization we're flying the airplane harder but on a fleet basis that's was going on there.

Glenn Engel - *BofA Merrill Lynch - Analyst*

So these unit costs are coming down despite those high headwinds? Impressive. Thanks.

Operator

Bob McAdoo with Imperial Capital, your line is open.

Bob McAdoo - *Imperial Capital - Analyst*

Hi most of my questions answered just quickly when are you paying for fuel today?

Brad Tilden - *Alaska Air Group - CEO*

The raw price we're paying is $3.71 -- $2.71 sorry (Laughter).

Bob McAdoo - *Imperial Capital - Analyst*

$2.71? So the $2.77 that you've got, that you are telling us what are you assuming happens going out for the quarter?

Brad Tilden - *Alaska Air Group - CEO*

Yes, that includes $0.06 of hedging costs so $2.66 would be the all in economic cost of fuel.

Bob McAdoo - *Imperial Capital - Analyst*

So basically you're just assuming the base price straight out not making the assumption of the changes?

Brad Tilden - *Alaska Air Group - CEO*

It's right for the quarter.

Bob McAdoo - *Imperial Capital - Analyst*

All right very good.

Operator

Your next question comes from the line of Joe your line is open.

Joe DeNardi - *Stifel Nicolaus - Analyst*

Good morning.

Brad Tilden - *Alaska Air Group - CEO*

Hi Joe.

Joe DeNardi - *Stifel Nicolaus - Analyst*

Andrew, I'm wondering on the improvement and the competitive capacity trends you're seeing, could you walk us through who's pulling back relative to the last look there?

Andrew Harrison - *Alaska Air Group - SVP of Planning and Revenue Management*

Joe yes, it's mainly we've seen, it's really split between Seattle and Portland and we have United pulling down a fair bit of regional capacity. There from Portland we're also seeing some of the bigger carriers true up some their winter flying out of their hubs as well and then basically other than that it's spread across a number of pieces here and there so it's actually a mixed bag but I think it's people truing up schedules.

Joe DeNardi - *Stifel Nicolaus - Analyst*

Okay and then Brandon on the investment grade rating can you maybe help us walk us through kind of how that helps you guys maybe on the income statement are there areas that we wouldn't consider where that would help you out?

Brandon Pedersen - *Alaska Air Group - CFO*

Joe I'm going to let Mark answer that.

Mark Eliasen - *Alaska Airlines - VP Finance & Treasurer*

Hi Joe. It's Mark. It helps us in multiple ways as Brandon already said we renewed our lines of credit, we've gotten a lower margin and a lower fee for those lines that's one place. It helps us when we buy fuels in terms of credit terms. It helps us with pretty much anything any place where we're going in and getting credit whether it's operational credit or financial terms.

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Brandon Pedersen - *Alaska Air Group - CFO*

And when we do start financing again it will help us a lot there as well.

Joe DeNardi - *Stifel Nicolaus - Analyst*

Okay thanks.

Brandon Pedersen - *Alaska Air Group - CFO*

Sure

Brad Tilden - *Alaska Air Group - CEO*

Joe the hope would be that one day between the strength of the balance sheet and the investment grade rating which gives up low interest cost, the hope is one day we start to think of it as nonoperating line at just a net zero cost line, zero benefit, zero cost line which is an incredible thing for our business that's as capital intensive as ours.

Operator

Your next question comes from the line of Steve O'Hara with Sidoti Company, your line is open.

Stephen O'Hara - *Sidoti & Company - Analyst*

Hi good morning.

Brad Tilden - *Alaska Air Group - CEO*

Hi Steve.

Stephen O'Hara - *Sidoti & Company - Analyst*

I'm just curious about the 400s that are coming off are those unencumbered, are they encumbered, are they leased could you talk about that a little bit? And then maybe on the MAXs when you take those, what is your feeling in terms of your competitive position in the industry when you have those? Does it improve, does it stay the same you know based on the other orders you see out there?

Brad Tilden - *Alaska Air Group - CEO*

Well Steve I'm going to let Mark take the first part of that question.

Mark Eliasen - *Alaska Airlines - VP Finance & Treasurer*

Hi Steve, it's Mark Eliasen. 18 of our 400s are leased so those will be straightforward lease returns and then we do have the freighter and combis which we we own and we also own 3 of our passenger 400s. So the bulk of that fleet of 27 will just be returned as part of a lease.

Stephen O'Hara - *Sidoti & Company - Analyst*

Okay great.

Brad Tilden - *Alaska Air Group - CEO*

And on your second question in terms of the MAX, Andrew touched on it a little bit, we're super excited to get the MAX, we're excited for the efficiency gains that are going to come it, we're excited for the longer legs they provide, and the opportunity it gives us on the network, to the extent we're getting those earlier on that will certainly add to our fuel cost advantage that we already have.

Stephen O'Hara - *Sidoti & Company - Analyst*

Okay. And then I guess maybe a tougher question is what you see in terms of the industry doing as maybe their cost get better you know how much of that goes to the customer versus shareholders and then you know I guess you guys had talked previously about a brand update I'm just wondering where that processes is as well.

Brad Tilden - *Alaska Air Group - CEO*

I'd like to take the first part and we'll ask Curtis to do the brand. It's hard to say in term -- lower fuel cost and when they get tran -- I do think in an economy like our when costs go down over time a lot of that benefit does get competed away. Our job is just on a relative basis to have low-cost and capital and to have enough margin to cover the growth that we're doing. I don't know that we have a strong view on how lower fuel prices ultimately translate to revenues. Curtis on brand, do you want to update on that?

Curtis Kopf - *Alaska Air Group - VP, Customer Innovation*

Yes we are refreshing our brand look to be more consistent and more modern, and we've already started that and you'll see updates across all of our customer touch points like our website in the airports over the next 12 months.

Stephen O'Hara - *Sidoti & Company - Analyst*

Okay thank you.

Operator

Your next question comes from Dan McKenzie your line is open.

Dan McKenzie - *Buckingham Research Group - Analyst*

Yes, hi, good morning guys. I have been in and off the call here so I apologize if this has been answered, but what's the potential here for an expanded codeshare with American? Is it a dead opportunity is there potential opportunity looking ahead. Where are we at there potentially?

Andrew Harrison - *Alaska Air Group - SVP of Planning and Revenue Management*

Dan good morning it's Andrew as we've shared on previous calls we continue to enjoy a good solid relationship with the new American in fact even this quarter our codeshare and interline revenues were actually up 10% and again as we have anything more new to report as it relates to American we will do so.

Dan McKenzie - *Buckingham Research Group - Analyst*

Understood. And then following up on the new fare bucket for paid first-class, if I heard correct $14 million benefit in the quarter that was just 50% of the first-class opportunity you know so the implicit math roughly $100 million in incremental revenue annually based on the commentary but I would say it's all about the supply and demand dynamic and revenue management technique. What's really the right way to think about that on a potential annual run rate here?

Andrew Harrison - *Alaska Air Group - SVP of Planning and Revenue Management*

I may not agree with the $100 million it would be very nice but I think that $14 million was our overall performance in our first-class cabin. But a little bit to your point, we've only ever had one fare for our first-class cabin. And the opportunity we're seeing is to bring incremental paid passengers into that first-class cabin and also connecting traffic haven't received any benefit of this new fare yet so I think overall what I would be watching for is outperformance of unit revenues in our first-class cabin relative to our system and as we move forward on this we'll have a better view of how much it's actually going to be, but that's sort of where we are today.

Dan McKenzie - *Buckingham Research Group - Analyst*

Got it, can you remind us what percent of your revenues come from your say top 5% of your customers?

Andrew Harrison - *Alaska Air Group - SVP of Planning and Revenue Management*

I'm not sure we've really given that number before I think what we have shared before is probably about I think 10% or 12% of our revenues come in our highest classes, business first-class.

Dan McKenzie - *Buckingham Research Group - Analyst*

Okay thanks guys.

Brad Tilden - *Alaska Air Group - CEO*

Thanks Dan.

Operator

Your next question Michael Derchin with CRT capital Group. Your line is open.

Michael Derchin - *CRT Capital Group - Analyst*

Yes, hi. Along the nostalgia line I'm just curious how big of an opportunity is Salt Lake City? I remember when Western Airlines built it up and it was a pretty decent operation for them both as the local as well as connecting hub so I wonder how big that could be over time?

Andrew Harrison - *Alaska Air Group - SVP of Planning and Revenue Management*

Yes this is Andrew, good morning. You know I think like any new markets what we've found in generally with Salt Lake City is we'll perform much better when it's into our core Pacific Northwest hub you know the other West Coast key city flying, they're a little bit more challenging obviously we'll continue to work that. Our marketing group have gone out and got some fantastic contracts and corporate contracts, LDS contracts we're doing a lot of marketing the funny thing about Salt Lake City is that the folks there didn't really know who we were and we're starting to see that they're actually knowing who we are now and I think that's very rewarding for us.

Michael Derchin - *CRT Capital Group - Analyst*

Thank you.

Brad Tilden - *Alaska Air Group - CEO*

Thanks Michael.

Operator

Your next question comes from the line of Savi Syth with Raymond James. Your line is open.

Savi Syth - *Raymond James & Associates, Inc. - Analyst*

Hey thanks one quick question on the debt funds what's your latest thinking on where you want your debt levels to be and if you're thinking of increasing that or just containing current levels?

Brandon Pedersen - *Alaska Air Group - CFO*

Hi Savi, it's Brandon. You know we're very comfortable where we're at, I tried to address that my prepared comments we think it really gives us some gunpowder to do some things that fortifies our position here in the Pacific Northwest. Just to share some facts with you we've been comparing ourselves to high quality industrials and so if you look at the S&P 500 for example and you look at the industrials within the S&P 500, half of them roughly have debt-to-cap levels that are lower than 40% so that's really the sweet spot that we want to be in, we like that company a lot and so we think that that's a good place for us.

Savi Syth - *Raymond James & Associates, Inc. - Analyst*

Got it and then just next year are the biggest cash flow items just aircraft? Beyond operating cash levels.

Brandon Pedersen - *Alaska Air Group - CFO*

Yes for sure, debt repayments are extremely modest and as we alluded to with Helane's comment we're going to manage the capital structure I think a little bit yes it's really just CapEx and a lot of free cash flow beyond that.

Savi Syth - *Raymond James & Associates, Inc. - Analyst*

Perfect okay thanks guys.

Brad Tilden - *Alaska Air Group - CEO*

Thank you.

Operator

I would now like to turn the conference back over to Brad Tilden.

Brad Tilden - *Alaska Air Group - CEO*

Thanks everybody for joining us we'll be in New York City on December 4 for our investor day, we hope to see lots of you there. Thanks.

Operator

Thank you for participating in today's conference call. This call will be available for replay beginning at 12 PM Pacific time today to 11.59 PM Pacific time on November 23, 2014. The conference ID number for the replay is 17129742. The number to dial for the replay is 1-855-859-2056 or 1-404-537-3406. Also the call will be accessible for future playback at www.AlaskaAir.com. You may now disconnect.