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PRESENTATION

Operator

Good morning. My name is Michelle, and I will be our conference operator today. At this time, I would like to welcome everyone to the Alaska Air Group fourth-quarter and full-year 2014 earnings conference call. Today's call is being recorded and will be accessible for future playback at www.alaskaair.com.

All lines have been placed on mute to prevent any background noise. After the speakers' remarks, there will be a question-and-answer session for analysts and journalists. (Operator Instructions).

Thank you. I would now like to turn the call over to Alaska Air Group's Managing Director of Investor Relations, Lavanya Sareen. Please go ahead.

Lavanya Sareen - *Alaska Air Group, Inc. - Managing Director of IR*

Thanks, Michelle. Hey, good morning, everyone, and thank you for joining us for Alaska Air Group's fourth-quarter and full-year 2014 earnings call.

Before we get into the results for our fourth quarter, we hope you guys got a chance to see the results of a spectacular fourth-quarter turnaround by our other CFO, our Chief Football Officer Russell Wilson. Our entire team at Alaska congratulates the NFC Champion Seattle Seahawks on their win last Sunday, and we wish them all the luck for the Super Bowl next week.

For the earnings call today, our CEO Brad Tilden; our other CFO Brandon Pedersen, and our Senior VP of Planning and Revenue Management, Andrew Harrison, will provide highlights from the fourth quarter and our outlook for the first quarter and full year 2015. 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 fourth-quarter GAAP net profit of $148 million, excluding mark-to-market fuel hedge gains of $6 million and a $30 million benefit related to certain postretirement benefit plans and a one-time gain associated with a legal settlement. Air Group reported a record adjusted net profit of $125 million or $0.94 per diluted share. This result compares to First Call consensus of $0.93 per share and exceeds last year's adjusted net income of $77 million or $0.55 per diluted share.

For the full year, Air Group reported a record adjusted net profit of $571 million compared to $383 million in 2013. Adjusted earnings per share grew by 55% from $2.70 per share in 2013 to $4.18 per share.

Additional information about cost expectations, basket plans, fuel hedging, capital expenditures and other items can be found in our investor update included in our Form 8-K issued this morning and available on our website at alaskaair.com.

And now I'll turn the call over to Brad.

Brad Tilden - *Alaska Air Group, Inc. - President and CEO*

Thanks, Lavanya, and good morning, everyone. We are very happy to be talking with you again.

We had a record year on almost every front, even as we approach the end of the second year with much more competition in Seattle. We've got a fabulous group of folks here, folks that look at the outside world realistically and then get to work putting together plans that will work. Then we relentlessly focus on executing those plans. I could not be more proud of all of the people of Alaska and Horizon, together with the leadership team, who have risen to the occasion and produced some outstanding results.

Looking at the numbers, our pretax profit for the quarter was $206 million, and that was 67% higher than 2013. It helped us post record full-year pretax profits of $922 million, up 50% from 2013. We had a 17.2% pretax margin, which is almost 480 basis points higher than 2013, and our ROIC for the trailing 12 months is 18.6%, an improvement of 500 basis points.

Importantly, that improvement was driven by great earnings but also by reductions we made in the invested capital base through share repurchases.

Even excluding the tailwind from lower fuel costs, our full-year margins expanded by 300 basis points.

One of the distinguishing characteristics of high quality companies is the durability of their profits. 2014 was our fifth consecutive year of profitability in every quarter and our second year of profitability in every single month. In fact, in 2014 our monthly profit when compared to the same month in 2013 was higher in every single month. These results affirm that we've built a business that performs when challenged and that works well throughout the cycle.

Our cash flow from operations was over $1 billion, which has enabled us to reinvest in the business and return cash to shareholders. Brandon will talk more in a moment about our financial engine and about how growth in profits is enabling us to improve our balance sheet and our competitive positions.

As you know, given our belief in the sustainability of our results, we declared our first dividend in 21 years in July of 2013, and we increased it by 25% just six months later.

Today we are very pleased to announce that we are raising our dividend by 60% from $0.125 per share to $0.20 per share, and that's per quarter. With today's announcement, we've doubled our dividend in the 18 months since we announced it, and with today's announcement, our dividend yield is 1.2%, and our dividend payout ratio is 18%.

If we step back and look at our results over a longer period of time, say five years, we see that we've grown ASMs by the average of almost 8% per year. We've grown revenues by almost 11% per year. We've actually shrunk unit costs by 1.7% per year, and finally, we've grown both net income and cash flow from operations by $150 million per year.

From a financial perspective, this machine is working well, and at this point we are singularly focused on driving this performance higher.

As I said at the outset, these financial results were driven by the development of good plans and more importantly by great execution of those plans. As we do every year, we put out a call to action to our folks at the beginning of 2014, and I would like to report out on how our team did against those objectives.

Operationally, ALK leads the industry in reliability. Alaska was named the top US airline by Wall Street Journal's Annual Scorecard of Airline Service for the second year in a row. This is a quantitative analysis which is based on data collected from the DOT and other sources.

86% of our flights this year arrived on time, and we expect this to result in Alaska being the number one carrier in 2014 as ranked by flightstaff.com for the fifth year in a row.

Our completion factor of 99.5% was also the highest among the seven largest domestic carriers. From a customer perspective, we reached an internal customer satisfaction record in 2014. Our 84% blended satisfaction score is the best score we've received since we began collecting this data in 2007.

As you know, this internal data has been validated by JD Power and Associates, which ranked Alaska as the leading US airline for the seventh year in a row and by their first-ever survey of frequent flyer plans in 2014, which rated us number one.

From an employee perspective, I think we are doing reasonably well also. I think these results demonstrate that our folks are flat delivering every day. We've got a great group of folks, and our employee survey shows that employee engagement is at an all-time high. We spend a lot of time with our people listening to them and talking with them about where the industry is headed and where Alaska is going, and I think that's paying off.

On the labor front, our flight attendants approved a new five-year contract in December. With the flight attendant deal done, the weighted average duration of our agreements covering represented employees is almost four years. It's three years and nine months to be exact, and we believe that compares very favorably to the rest of the industry. I want to thank our flight attendants for not losing focus on our customers during a long and difficult negotiation.

Another reason Alaska is performing well is that we have great alignment with our employees. When the Company does well, our employees do well, and every one of our employees participates in the same gain sharing plan. Our programs, which we call PBP, paid close to the maximum for the fifth consecutive year. This is also the fifth consecutive year where our employees will get a full month's salary and performance bonuses.

Brandon will talk more about this in a bit. For me I'd just like to say that this alignment between shareholders and employees is powerful, and I also want to say that I'm proud of our employees for working hard and earning these payouts.

As we sit here today, we are very excited about the future. Airlines are managing capacity to match demand, and management teams across the industry are running airlines to create a better experience for customers, better jobs and more job security for our employees and, most importantly, real value for our shareholders. And lower fuel prices provide real opportunity in the near-term for owners. For Alaska these great results have come amidst unprecedented competition in our markets, and the folks throughout our Company are rising to the occasion to make us a great airline every day for our customers.

We think of this customer experience, together with our low fares and low costs, as a competitive advantage, or as an economic moat to borrow a term from Warren Buffett.

We have a whole host of initiatives that we are focusing on in 2015 to further widen this moat, and they range from working with our employees to further enhance our onboard service to investing in our onboard product and experience to further improving our mobile and other customer-facing technologies to maintain our leadership position.

We are excited about the future, and our entire team of 13,000 people is completely focused on achieving our plan so that we can continue to deliver strong results in the years to come.

With that, I'd like to turn the call over to Andrew.

Andrew Harrison - *Alaska Air Group, Inc. - SVP, Planning and Revenue Management*

Thanks, Brad, and good morning, everyone.

Our 2014 passenger revenue grew by 7.3% on 7.1% growth in capacity, resulting in a PRASM increase of 0.2%. Very strong performance considering competitive capacity grew 7% in our markets. Our total RASM outpaced PRASM and grew 0.9% as a result of ancillary revenue initiatives that we launched in 2014.

Looking at the fourth quarter, our revenue was up 8% on a capacity increase of 10.6%. PRASM was down 2.4% as a result of the 8% increase in competitive capacity and a 1.1% percent increase in system trip length.

That said, underlying demand continues to be robust, and we continue to work on improving the strength and profitability of our network in a number of ways.

First, we have the best scheduled utility for customers in Seattle and the Pacific Northwest, and our launch of 16 new markets over the last year brings our total North American destinations served from Seattle to 79 versus our closest competitor at 26. Our Seattle market share of 55% is 4 times our nearest competitor and ensures that we will continue to provide the greatest network utility for our customers.

Secondly, our growth has been incredibly efficient and margin-accretive. An important element of this has been our seat retrofit program, which has helped lower unit costs without compromising passenger comfort.

As of the end of December, we've completed the retro seat fit on all of our 737-800s and 737-900 aircraft. These improvements, combined with the delivery of 10 more 737-900ERs, accounted for 50% of the capacity growth in 2014.

In addition, the seat retrofit program should provide an incremental benefit of about $25 million in 2015 for a total run rate benefit of approximately [$50] million per year.

Third, as I shared at our Investor Day last month, the industry's move to revenue-based loyalty programs presents us with a unique opportunity to increase our membership base while evaluating the right structure for Alaska in the long run. Active mileage plan members are up over 11.4% this year, the largest increase we have ever seen on a 6.8% increase in passengers. In fact, the growth rate is almost double what we've observed on average over the last five years.

But perhaps even more impressive is our elite members on average flew 6% more segments on Alaska versus last year. The growing loyalty member base and fierce loyalty of our customers gives us confidence that we will continue to be successful in our core markets.

Finally, while fuels have been a nice tailwind in the fourth quarter, several of you have asked us if we are pricing to account for the lower fuel prices. And the answer is no. When pricing tickets, we look at the supply and demand in each of our markets and adjust prices to balance the two. Approximately 90% of our flying is in the United States domestic market, and the US economy continues to be strong.

Looking ahead, Alaska's first quarter capacity is expected to be up 11%, approximately 4 points of which is driven by efficient upgauging. Our full-year growth expectation for 2015 is 8%, and that's in line with previous guidance.

Other airline capacity in the first quarter of 2015 is expected to be up 15%. That's a 2 point reduction from three months ago and a 7 point reduction from published schedules six months ago.

While the demand environment is robust, there are some factors that will pressure unit revenues in Q1, especially January, and I'd like to point those out.

Firstly, the first quarter of last year was our lowest capacity growth quarter, up about 4.5%, where in 2015 it will be our highest capacity growth quarter as we sit here today, up 11%.

Second, our comps are tough. We had a 3.5% increase in PRASM last January. That was the highest of the year, helped by a significant amount of revenue we generated carrying traffic for other airlines that had high storm cancellations. For the first quarter last year, that was about a point of PRASM or $9 million, most of which was in January.

And finally, we have a special promotion going on right now where the first bag is free for members of our mileage plan through the month of January. New customer acquisition has far exceeded our expectations, but the forgone bag revenue could equate to nearly a point of RASM for the quarter.

As we look at 2015, underlying demand is strong. Competitive capacity, while high, has moderated versus previous expectations. Initiatives developed are working well. Members in our loyalty program are growing at unprecedented rate. And in general, new markets are exceeding our expectations. This gives us confidence that we are entering 2015 on a strong footing.

At our Investor Day, we shared some of the revenue initiatives we're undertaking to ensure we continue to perform well in 2015 and beyond. I wanted to give you some additional detail on a few fronts.

As you might recall, we added a discounted booking class to our first class fares and rolled that out to approximately 50% of our markets by year end. This increased our paid first class traffic by 7 points in the fourth quarter, and we are rolling this out to the remaining 50% of our system by the end of March.

First class PRASM in Q4 was up approximately 1% or 3 points above system PRASM performance. Second, we will launch the preferred seating product in the second quarter which allows customers to book an exit row or bulkhead seat for as little as $15 to $50 one way, depending on the stage length of the flight. We bundled this with a free drink and priority boarding to make this a compelling offer to our customers.

Initially we expect this to add around $15 million in revenue and margin on an annualized basis, but we anticipate growing these revenues over time.

Third, we are upgrading our revenue management system in the first quarter. While the underlying pricing algorithms are the same, the system will be able to optimize flights based on demand more regularly, which will help us optimize revenue. The upgrade will also help automate certain processes that are manual today in the system. A primary example of this are P fares I just talked about.

And finally, and personally for me, I'm very pleased to announce that John Kirby has joined Alaska as our Vice President of Capacity Planning, overseeing Alaska Air Group's network and scheduling functions. John will richly add to our team with over three decades of experience working at carriers of all sizes. We are confident that the 16 new markets we launched in 2014, combined with the 2014 initiatives and the additional projects we are rolling out in 2015, will help us continue to deliver strong results this year.

And with that, I'll turn the call over to Brandon.

Brandon Pederson - *Alaska Air Group, Inc. - EVP, Finance and CFO*

Thanks, Andrew, and good morning, everyone.

Air Group's adjusted net profit for the fourth quarter improved by 67%, and because of the reduction in shares outstanding, earnings-per-share improved by 71%. Full-year profit grew by 50%, and as Brad said, after-tax ROIC came in at 18.6%, 500 basis points higher than in 2013.

Our $206 million fourth-quarter pretax profit was $83 million higher than last year. Revenues grew by almost $100 million, and nonfuel expenses grew by $60 million. But those increases were offset by a $42 million reduction in the price of fuel.

I know the collapse of fuel prices is front and center in investors' minds right now, but I don't want that to overshadow the excellent cost performance we achieved both in the fourth quarter and in the full-year.

CASM ex-fuel for the quarter declined by 2.4% on a 10.6% ASM growth. Even with the reduction, there were a couple of noteworthy items that negatively impacted the quarter.

First, Q4 included the impact of the new agreement with Alaska's flight attendants. The signing bonus and new rates accounted for about $9 million of additional cost. And, as you might recall, last year in Q4 we recorded a final favorable trueup to Port of Seattle lease costs, making Q4 this year a very tough comp and explaining much of the 31% increase in landing fees and rents on the P&L.

For the full year, we lowered nonfuel unit costs by 1.3%, making this the fifth year in a row of nonfuel unit cost reduction and the 12th year out of the last 13 for the mainline operation. The reduction widens our cost gap versus larger rival network carriers, which is on average about 20% to 25% and which continues to be a source of important competitive advantage. We see excellent cost control in most -- we saw excellent cost control in most areas all year, and productivity continues to be a great story. Across Air Group, we increased passengers per FTE by another 2%.

We are proud to report that incentive pay increased by 10%. Our people earned a new record $116 million. About $14 million of that was earned under the Operational Performance Rewards Program for meeting monthly, on time and customer satisfaction targets. The other $102 million was earned through our PBP program. PBP is not a traditional profit-sharing plan, but rather has annual goals set by our board in four categories: safety, customer satisfaction, and nonfuel unit costs which each make up 10% of the total, and an Air Group profit goal which makes up the remaining 70%.

Employees at Alaska exceeded all of these goals and are receiving the maximum payout of 10% of base wages. Horizon employees missed the cost goal, but hit the maximum payouts for the other measures. As Brad said, PBP payouts will approximate a month's pay for nearly everyone.

We'll be paying PBP on Monday, almost a month earlier than normal thanks to the great efforts by our payroll and HR teams.

Turning the page to 2015, we expect nonfuel CASM to be about flat. At Investor Day, we told you that the expected nonfuel CASM -- we expected nonfuel CASM to decline about 0.5 point. In absolute terms, we ended with a budget that was very, very close to what we thought at the time. However, because we finished 2014 with better costs than we were expecting then, the comp is simply tougher.

Let me walk you through some of the larger cost drivers. First, a new flight attendant contract is expected to add about $25 million of structural expense in 2015, up about 19%, but adds about $15 million of incremental expense in 2015 after considering the signing bonus and additional wages already booked into Q4. The new contract does, however, include some important productivity enhancements.

Second, pension expense is expected to increase about $20 million or 150%, driven by lower discount rates and higher life expectancy assumptions. Even with the discount rate and required assumption changes, our pensions remained 93% funded with no required contributions.

Third, depreciation will be up 14% because of the significant investments we are making in the fleet. We took delivery of 10 Boeing 737-900ERs in 2014 and will get another 11 of those highly efficient aircraft in 2015. The 900ERs have 37 more seats than a 737-400, but burn about the same amount of fuel. They are more reliable, and customers like them better. We'll also take another Q400 earlier in the year.

Fourth, maintenance expense will increase about 12%, split about 60-40 between Alaska and Horizon. Much of our Q400 fleet is entering an engine overhaul cycle. And finally, as Brad mentioned, we are investing in things that customers will notice such as new in-flight entertainment and improved food offerings. The customer service workshops for more than 8000 of our customer-facing employees will cost us about $10 million, but this will be money very well spent much like the flightpath training that we had a few years ago was.

Now, fuel. The dramatic retreat in oil prices should translate into higher profitability and cash flows for all airlines. Having said that, and even at these oil prices, we are really focused on fuel efficiency in order to increase our all-out competitive advantage on the cost side.

In 2014, our fuel efficiency on an ASM per gallon basis improved by another 2.1%, bringing our fuel efficiency improvement over the last 10 years to 22%. We've now installed split scimitar winglets on 48 aircraft with more to go and look forward to phasing out the remaining 27 737-400 aircraft and replacing them with efficient 900ERs by the end of 2017.

The recent collapse in oil prices has put fuel hedging policies in the spotlight. Alaska's program is simple and straightforward. We buy call options that act as an insurance policy against sudden spikes and allow us to fully participate in fuel price declines with no risk of collateral calls.

Turning to cash flow and capital allocation, operating cash flow topped $1 billion in 2014 for the first time ever. Free cash flow was $344 million. Alaska's debt balance declined to $800 million as scheduled principal payments more than offset new financing. We ended the year with $1.2 billion in cash in a $260 million net cash position, even after factoring in our operating leases. We own 77% of our fleet, including 76 airplanes that are owned free and clear that are mostly high-value NGs. And we expect this to increase as we replace the 737-400s with new 900ERs.

Alaska's strong balance sheet compares favorably to other high quality industrials and the S&P 500. The credit rating agencies say Alaska is only one of two investment grade airlines in the US and only one of five worldwide. Access to high grade credit markets is another way Alaska differentiates itself and is a competitive advantage. This will give us more options when and if we want it to go to the debt market, and we'll be able to do it at a lower cost.

We invested $667 million into the business in 2014, bringing the total since the beginning of 2009 to nearly $2.8 billion. We are generating very strong returns on that investment and have created substantial value for our owners. At these return levels and even without the benefit of low fuel prices, which may very well be short-lived, Air Group, like any other high-quality industrial earning 10 percentage points above WAC, should be investing more into the business, and we are doing so. We are currently projecting CapEx for 2015 to be between $650 million and $700 million.

Brad noted that we repurchased 7.3 million shares of our common stock for $348 million, which equates to about 5% of the shares that were outstanding as of the beginning of the year. We also paid $68 million in dividends, bringing the total returns to shareholders to $416 million in 2014.

This exceeded our cumulative total returns in the preceding five years. Dating back to 2007, our share repurchase programs have allowed us to buy back 30% of our shares before dilution and 18% after. As we said at Investor Day, we expect to return more cash to shareholders in 2015 than we did in 2014.

2014 was a very good year for Air Group. Alaska has real and durable competitive advantages that will help us sustain these results going forward. We're safe. We run an excellent operation. We offer award-winning service, have really loyal customers, a great network, low costs, a modern fuel-efficient fleet, a strong balance sheet, and engaged employees.

I want to join Brad and thank them all for everything they did to produce these terrific results. And with that, we would like to open it up to questions that you may have.

QUESTIONS AND ANSWERS

Operator

(Operator Instructions) Savi Syth, Raymond James.

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

Just kind of curious on that. I appreciate all the color you gave on the unit revenue side. Just in December, I was wondering how much of the timing shifted note of Thanksgiving kind of hurt your December unit revenue?

Andrew Harrison - *Alaska Air Group, Inc. - SVP, Planning and Revenue Management*

Savi, this is Andrew. I don't have an exact number, but I think I'd put it around a point or so of that shift. And again, December was a very high capacity growth month at around 12% plus versus November.

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

Got it. That makes sense. Then the mileage plan, how long does that go through?

Andrew Harrison - *Alaska Air Group, Inc. - SVP, Planning and Revenue Management*

That actually ends for folks actually flying on an airplane January 31 at midnight. So for the full month of January, folks who have physically flown our airplanes who are mileage plan members will get a free bag.

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

All right. Great. And then if I might, just one last one on the CapEx side. I understand the fleet CapEx. I'm just wondering what the CapEx increase is on the non-aircraft side and what those investments are?

Brandon Pederson - *Alaska Air Group, Inc. - EVP, Finance and CFO*

Savi, it's Brandon. You caught me off guard on that one. Let me come back on the line and get you that answer.

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

All right. Sounds good. All right. Thanks.

Operator

Hunter Keay.

Brandon Pederson - *Alaska Air Group, Inc. - EVP, Finance and CFO*

Hunter, you there?

Operator

I'm sorry. He has jumped out of the queue, so we'll move on to your next question. Michael Linenberg, Deutsche Bank.

Michael Linenberg - *Deutsche Bank - Analyst*

Just two questions here. Brandon, historically I've liked how you have positioned yourself and how you hedge oil, and I'm just thinking with the curve having gone from backwardation into a fairly steep contango, I think if I look out over the next year, it seems like prices are $8.00 to $10 above where they are now. That combined with the increase in volatility, it would suggest that the call options are probably a bit pricier. Does that change or slow down the pace at which you have been building your positions, or is it just systematic? Do you just keep adding, or are you a bit more sensitive on some of the structural changes to the curve?

Brandon Pederson - *Alaska Air Group, Inc. - EVP, Finance and CFO*

Hey, Mike. It's Brandon. Good morning. I'm going to let Mark Eliasen take that one.

Mark Eliasen - *Alaska Air Group, Inc. - VP, Finance and Treasurer*

Yes, we are very systematic in it. We did take the approach that it's insurance, and when insurance rates go up slightly, you continue to buy insurance. So that's what we do.

Michael Linenberg - *Deutsche Bank - Analyst*

And then just my second question and this is to Andrew. Andrew, just the stats on mileage plus, I thought that was very interesting and the fact that employments were up I don't know about almost 7%, 6.8% your mileage plus members. I think you said up about 11%. What -- when you look at where you're getting the new mileage plus members from, is some of this coming from markets outside of Seattle?

So, for example, Salt Lake, that was a market where you had maybe three or four flights a day, and maybe for some time your penetration was low. But once you've moved to, say, 14 or 15 daily frequencies and the same with San Diego, you get to a tipping point where all the sudden it does make sense for that local passenger to move into the program, or are some of these customers coming from maybe some of your partner airlines where their programs have changed, and they are playing this arbitrage. How might -- which program or which carrier is going to give me better -- is going to get me more miles for what I'm purchasing?

Andrew Harrison - *Alaska Air Group, Inc. - SVP, Planning and Revenue Management*

All right. Michael, that's a lot of questions in there. Let me try and hit because I think it's very pertinent. So, our mileage plan loyalty program just on the growth side I think what's most encouraging for us is that it's across the board.

So we obviously have our largest bases in the Pacific Northwest and in California, and we've seen good, healthy growth in those areas. And then on the smaller areas whether it's sort of the Salt Lake City or some of these other key focus points, the growth has been off the charts, obviously on smaller bases. And so we've been very encouraged that this is across the system.

And an important thing and maybe some lessons learned here, we've been far more proactive about investing in our program, advertising our program, getting out there with our program than we have before, and we've seen big significant changes there.

And then lastly, I think is the question -- and it's early days yet on the industry's change to a revenue-based accrual process, and as we shared on Investor Day, a huge amount of our customers will be better off in our program. But more importantly, as you know, our program we have a big portfolio of both global and domestic carriers, and we think we bring a great proposition to the table. So all of those things combined we feel like we've got good momentum here that will continue.

Michael Linenberg - *Deutsche Bank - Analyst*

Okay. Great. Thank you.

Operator

Hunter Keay, Wolfe Research.

Hunter Keay - *Wolfe Research - Analyst*

So, I have a couple of questions maybe for Andrew about your state of Alaska business. Can you do your best to let us know sort of what percentage of your revenues are tied that you can tie directly to the oil markets, whether that's corporate or oil towns that you serve, known oil towns that you serve or anything like that? And also, Andrew let us know what your point-of-sale mix is with business up to Alaska? Like, for example, do you have people buying tickets, flying up to Alaska to take a cruise back down, you know, so there might not be an impact from lower oil prices? Help us understand what's going on with that market.

Andrew Harrison - *Alaska Air Group, Inc. - SVP, Planning and Revenue Management*

Yes, I think and maybe Joe might add here a little bit. But I think you know I don't want to give specifics about some of the items you have requested, but what I will tell you is that the state of Alaska we've seen be resilient over the years from booms and busts, and it's just had a steady as she goes marginal increase year after year.

We have a very big mix. So in the summertime, there is a huge amount of volumes of traffic for a vacation coming up through our network and up to the state of Alaska. To your point, there is huge oil and business, commercial business, and as you know, Hunter, we are the highways and byways of the state of Alaska. And so, a lot of that is just static that continues day in and day out.

So overall, the state of Alaska, we feel is way less volatile than probably other parts of our network.

Joe, did you have anything to add there?

Joe Sprague - *Alaska Air Group, Inc. - SVP, Communications and External Relations*

Hunter, Joe here. The only thing I would add is, in terms of oil towns in the state of Alaska, really Anchorage is the big oil town. The production activity happens up on the North Slope. We fly up there to Prudhoe Bay. Actually there's a fair bit of summer -- wintertime traffic that's counter seasonal because they do all the exploration work on the North Slope during the wintertime, and I think the oil companies, despite the low oil prices right now, a lot of those projects are to produce oil for two, three, 10 years from now. So they are continuing to explore and do their activities and we see the benefit of that in the wintertime.

Hunter Keay - *Wolfe Research - Analyst*

Okay. Thank you, guys. And Brandon, given the amount of just really incredible multiple compression we've seen with Alaska stock over the last couple of months as oil has collapsed. You guys have still only bought back about $2 million of shares per day. Why would you not really, really ramp up the buyback materially here given the fact that the market is really not giving you guys any credit or really any airlines for that matter for the decline in fuel prices? Do you have the type of flexibility that you need within the structure of your buyback to do something like that?

Brandon Pederson - *Alaska Air Group, Inc. - EVP, Finance and CFO*

Yes, absolutely. And by the way, good morning. We have a ton of flexibility. And I think you can see that if you look at our track record over 2014 where we bought back, I don't know rough order of magnitude $350 million of stock over the course of the year with probably two-thirds of that occurring in the back half. And we can do that in 2015 as well.

One of the things that we have always liked is kind of a steady as she goes approach. We love the benefits of dollar cost averaging. What I will say if I go into the market and buy $50 million this week, next week fuel will be $40, and so we just really like ratable. So we just really like ratable execution. And we stand by our commitment to return more capital to shareholders than we did in 2014, and we will do that as the year progresses.

Hunter Keay - *Wolfe Research - Analyst*

Thank you very much.

Operator

Helane Becker, Cowen and Company.

Helane Becker - *Cowen and Company - Analyst*

Thanks for the time. I just had a couple of questions. The first one is with respect to your business to Hawaii. You didn't talk about that this time, and I would have thought you would of given us an update on that business is.

Andrew Harrison - *Alaska Air Group, Inc. - SVP, Planning and Revenue Management*

It's Andrew. At a high level, we've, as you know, have been rapidly growing Hawaii. We're up about 8% in capacity for the quarter. Again, overall that business and region is doing well. I think for us the most exciting part there is, as we get these new 900ERs, we are able to increment capacity there in a nice way.

So, again just like many of our other regions, we haven't seen any material change in the environment there.

Helane Becker - *Cowen and Company - Analyst*

Okay. And then can I just ask an Alaska-related question? I think every year when the folks who live in Alaska get their dividend checks, you usually do a fair promotion program, and without commenting necessarily on pricing, this year those dividend checks may be lower than they've been in past years. Would you still consider a similar promotion?

Joe Sprague - *Alaska Air Group, Inc. - SVP, Communications and External Relations*

It's Joe, again. Just the way the Alaska residents permanent fund dividend program works, it's actually less tied to the oil prices and more tied to just what the overall markets are doing because it's a dividend off of their sort of their permanent fund, their sovereign wealth fund.

So it actually doesn't track exactly with what oil prices are doing, and the checks even in low years have been pretty healthy. Healthy enough that tapping into them in all different businesses and services up there tend to do permanent fund sales of some sort to tap into that inflow of cash to the state each fall.

Andrew Harrison - *Alaska Air Group, Inc. - SVP, Planning and Revenue Management*

And we've had that -- just in 2014, we had that in the fourth quarter, and we will look at it again in 2015.

Helane Becker - *Cowen and Company - Analyst*

Can I just ask -- thank you. Can I just ask one quick capacity question for the Super Bowl. I think I saw you guys were adding flights from Seattle to Phoenix for that weekend. So I guess that's what -- an end of January, beginning of February kind of thing? So, is that -- does that skew your capacity growth number for this month and next month at all?

Andrew Harrison - *Alaska Air Group, Inc. - SVP, Planning and Revenue Management*

Helane, Andrew. No, that's only a couple three flights, and it's completely immaterial to our capacity. Very important capacity (multiple speakers) very important Seahawks fares.

Helane Becker - *Cowen and Company - Analyst*

Okay. Well, thanks, guys.

Operator

Jamie Baker, JPMorgan.

Jamie Baker - *JPMorgan - Analyst*

Good morning, everybody. I was going to suggest you charge $50 not to sit in a bulkhead. I guess that's why I don't work at an airline.

Maybe I need the room for that mutant salmon you showed at Investor Day.

Back in early 2013, Delta started speaking somewhat aggressively about its desire to be added to the S&P 500. And obviously there's only so much a company can actually do. But clearly when they were added that autumn, it was to shareholders benefit. You meet the eligibility requirements. Is this something that you spend any time thinking about or have any sway over?

Brandon Pederson - *Alaska Air Group, Inc. - EVP, Finance and CFO*

Jamie, it's Brandon. Good morning. Let me ask Mark to answer that question.

Mark Eliasen - *Alaska Air Group, Inc. - VP, Finance and Treasurer*

Good morning, Jamie. To answer your question, we do think about being in indexes, and we -- as you know, we are in the S&P 400 right now, which is (multiple speakers)

Jamie Baker - *JPMorgan - Analyst*

Right, right.

Mark Eliasen - *Alaska Air Group, Inc. - VP, Finance and Treasurer*

We are one of the larger companies in the mid-cap index. So, we are promoting the case that we should graduate and move up to the large cap. As you say, we've (inaudible) for some time, and it would make sense for us to be there. Our performance certainly has been good.

So we are keeping an eye on that. We know we are eligible. And there isn't a lot of lobbying you can do for that, but I think just continuing to perform well and make sure that the committee understands that we are a quality candidate.

Brad Tilden - *Alaska Air Group, Inc. - President and CEO*

Yes, it is a goal of ours, though, Jamie, just to be really clear about that.

Jamie Baker - *JPMorgan - Analyst*

Got it. Got it. And second, with all the talk about the frequent flyer program this morning, both Southwest and United made some smallest changes in their accounting policies. Southwest as it relates to spoilage partner sales and United I think it was timing of revenue recognition. I'm not sure you've had time to even digest these changes. I'm just kind of wondering how your frequent flyer accounting might flesh out relative to whatever the industry norm is right now. Is it more conservative? Less conservative? In line? Any thoughts there?

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

Jamie, this is Chris. From an accounting standpoint, there are really no changes, unless you change your program. And so for our accounting, there is a mix in the industry on how mileage plan or how frequent flyer programs are accounted for. But we don't anticipate any changes, unless we make changes to the program itself, and then you have to consider certain accounting implications of that. But yes, there's nothing on the horizon right now.

Brandon Pederson - *Alaska Air Group, Inc. - EVP, Finance and CFO*

Jamie, Brandon. One other follow-up on that. I've always viewed ours as relatively conservative. If you look at our liability and you size adjust it to what other airlines have as liabilities, I've always viewed ours as being relatively conservative on that perspective or using that measure.

Jamie Baker - *JPMorgan - Analyst*

Perfect. I appreciate it. It's not a big issue, but it's one that's just all of a sudden kind of topical. So I appreciate the color. Thanks, guys.

Operator

Duane Pfennigwerth, ISI.

Duane Pfennigwerth - *Evercore ISI - Analyst*

Just a quick one here. With fuel at these levels, how do you think your relative hedge advantage impacts the competitive environment in Seattle? If at all?

Brandon Pederson - *Alaska Air Group, Inc. - EVP, Finance and CFO*

It's Brandon. I think Mark spent some time talking about what our hedging policy is, and to the extent that there is an advantage, I don't think we are looking at that as something that influences the fare environment necessarily. I think Andrew articulated our perspective on that. We set fares to equal or match supply and demand, and to the extent that we have a favorable hedge position or an insurance position that allows us to have a fuel price that looks a lot like the spot price, that's going to benefit the bottom line. But I don't think it impacts the pricing environment in Seattle.

Duane Pfennigwerth - *Evercore ISI - Analyst*

Maybe not for you but maybe for others. Any estimate for the value of that unencumbered fleet which you reminded us of, those 76 NGEs?

Brandon Pederson - *Alaska Air Group, Inc. - EVP, Finance and CFO*

None that we are going to share today, but I think you can do the math. One of the things we tried to do in the prepared remarks is help you with that by just giving you the number of unencumbered aircraft and then also alluding to the fact that the vast majority of those airplanes are really high value, high marketability NGEs that are pretty darn new. So whatever you want to estimate the value of a 737-900ER, you can do the math from there.

Duane Pfennigwerth - *Evercore ISI - Analyst*

Okay. Great. And then just could you remind us on the E175s when those are coming on this year, and from a network perspective, what capability do those give you either feet into Seattle or market types that you haven't historically had? And thanks for taking the questions.

Andrew Harrison - *Alaska Air Group, Inc. - SVP, Planning and Revenue Management*

Thanks, Duane. It's Andrew. The first three arrive this summer June. They will be on mid continent routes. These aircraft will be very valuable assets to our tool chest for a couple of reasons. They are going to have sort of the first class product because we're going to fly them at the longer trips.

They're going to be really powerful on the longer thin routes out of Seattle. And then the preferred seating product we talked about, this aircraft will also have seats where we'll be selling it on that. And then we have another four coming after that sort of late in 2015 and then early into 2016.

Duane Pfennigwerth - *Evercore ISI - Analyst*

Thank you.

Operator

Joe DeNardi, Stifel.

Joe DeNardi - *Stifel Nicolaus - Analyst*

Andrew, I think it looks like this is the first time in a couple of quarters that TRASM is more or less in line with PRASM, and it sounds like that will probably continue into first quarter given that the free bag in January. I'm just wondering as the preferred seating comes online in second quarter, is the hope that the TRASM starts to outpace PRASM?

Andrew Harrison - *Alaska Air Group, Inc. - SVP, Planning and Revenue Management*

Yes. Joe, yes, what you're seeing is really the annualization of the bag and change fees we've made over a year ago basically completely come down to net out.

So to your point, the next major driver here would be the preferred seating, which would probably start to roll out in the second quarter. Off the top of my head, I can't tell you what the differential drive will be, but the hope is is that our RASM will be a tad higher than our PRASM.

Brandon Pederson - *Alaska Air Group, Inc. - EVP, Finance and CFO*

Joe, it's Brandon. One thought on that, just it's not huge numbers in the grand scheme of things but maybe important to the modeling, is our TRASM includes the results of our cargo business, and cargo is about a $100 million business. That's probably a 2% or 3% growth business, so growing much less than ASMs, although certainly a factor or a part of that TRASM calculation. So, just to be aware of that.

Joe DeNardi - *Stifel Nicolaus - Analyst*

Okay. That's helpful. And then, Andrew, you also mentioned that the competitive capacity outlook has moderated a little bit. Can you quantify that just over the next couple of quarters?

Andrew Harrison - *Alaska Air Group, Inc. - SVP, Planning and Revenue Management*

Yes. So if you look at -- let's just see here, my little sheet. So if you look at the first quarter, our competitive capacity from other airlines is up 15 points. Our current schedules in the second quarter is 12, and in the third quarter, it is 12. So that's what we see today.

Again, as noted on the call, we've seen these come down as we get closer to launch date, and we see a lot of carriers as has been shared on calls taking a look at supply and demand, and we've seen carriers adjust their capacity given some of the changes going on in Seattle.

Joe DeNardi - *Stifel Nicolaus - Analyst*

Okay. Thank you.

Operator

Dan McKenzie, Buckingham Research.

Dan McKenzie - *Buckingham Research Group - Analyst*

I appreciate the commentary on the elite passengers, and I guess looking ahead what are your business travelers saying about their plans for business travel spend in 2015, and in particular should we expect the spend to grow in line with your growth in capacity, or would it likely lag?

Joe Sprague - *Alaska Air Group, Inc. - SVP, Communications and External Relations*

Thanks, Dan, for the question. This is Joe again. You know, actually the Seattle market with the growth that we have here is helpful in that regard because we're adding, as Andrew said, a lot of new flying to key various destinations, but some key business destinations, and really strengthening our Seattle network where we have, as you know, a ton of key corporate customers.

So I think on sort of the managed corporate travel business, it was up modestly in the fourth quarter -- and we would expect as we get into the beginning of the year here and those businesses have fresh travel budgets, that that growth would continue. And so we are looking for that to be reasonably strong as we move into 2015.

Dan McKenzie - *Buckingham Research Group - Analyst*

And then can you just remind us what percent of the revenues are tied to this aspect of the business?

Brandon Pederson - *Alaska Air Group, Inc. - EVP, Finance and CFO*

We can get you that. For us it's a relatively small amount because of the heavy amount of leisure destinations and just general leisure traffic that we have.

Brad Tilden - *Alaska Air Group, Inc. - President and CEO*

Dan, it's Brad. For managed business travel, it's not that -- especially if you comp us to other airlines, it's not that great of a percentage of the pie. If you look at business travel, we think it's 30%, 35% of total revenue.

Dan McKenzie - *Buckingham Research Group - Analyst*

Right. Understood. And then just one other final question here. Brandon, debt financing obviously is pretty cheap for you guys, and if I'm not mistaken, a higher debt level would lower your cost of capital. I'm just wondering if you can just give us what are the puts and takes at this point from your perspective on using debt financing to perhaps leverage the return of capital to the shareholders?

Brandon Pederson - *Alaska Air Group, Inc. - EVP, Finance and CFO*

Dan, it's Brandon. Maybe I'll take a stab at that, and Mark can jump in with any additional thoughts that he has. Totally get the math on using debt to increase the leverage in returns to equity holders, and we're obviously totally -- very aware of where the rates are today, and raising debt would be very attractive for us.

On the other hand, you need to have a need for the money, and I think if you look at the history of our Company over the last couple of years, we've been really trying hard now for a couple of years to position ourselves as a high-quality industrial, and we do a lot of things to emulate high-quality industrials, including where we set our capitalization level in the mix between debt and equity.

So, that's probably the primary driver of where we are in terms of the leverage level, and to the extent we need to use debt to go and manage the capital structure, we will do so. But I think it's a complicated question, and we are thinking about it a lot of different ways.

Mark Eliasen - *Alaska Air Group, Inc. - VP, Finance and Treasurer*

Dan, this is Mark. I was just going to add onto that that we could borrow today at under 3%, and we are aware of that. We can borrow unsecured or on a secured basis. Those are very attractive to us. But we have enough free cash flow right now to fund most of our return to shareholders out of just free cash flow. So, as Brandon said, we'll balance that out. We are aware. We do have a lot of options given our strong results and our strong balance sheet.

Dan McKenzie - *Buckingham Research Group - Analyst*

Very good. Thanks, guys.

Operator

Glenn Engel, Bank of America.

Glenn Engel - *BofA Merrill Lynch - Analyst*

Good morning. A question I have one on the competitive capacity numbers you gave. Does that exclude what Alaska is adding itself, and is that the big change in 2015, is that Alaska is adding a lot of competitive capacity on top of what everybody else is doing, too?

Andrew Harrison - *Alaska Air Group, Inc. - SVP, Planning and Revenue Management*

You know, Glenn, actually the numbers are sort of similar. So, as I said for the first quarter, it was up 15 points. The industry, which will include Alaska and our competitors, is up 14. So basically just looking at other airlines, capacity increases, and then if you add to ours, they are all within a point of each other. So they are very much interchangeable.

Glenn Engel - *BofA Merrill Lynch - Analyst*

And on aircraft utilization, if I looked at the numbers, 2014 was actually slightly down year over year. Why was that, and would we expect to see that number rise again?

Ben Minicucci - *Alaska Air Group, Inc. - COO and EVP, Operations*

Glenn, Ben Minicucci here. We had several modifications ongoing. The major one was the seat conversion program where we had our Recaro seats going in. So we had a couple of lines of modification going. That program is complete, so that's why you see the boost in utilization in 2015.

Brad Tilden - *Alaska Air Group, Inc. - President and CEO*

Hey, and Glenn, this is Brad. The guys here have told me you and I haven't had a chance to chat, but they tell me that you've been promoted, and we may not get to chat with you in the future. Just wanted to wish you well, and thank you for your coverage of Alaska over the years.

Glenn Engel - *BofA Merrill Lynch - Analyst*

Thank you. You guys have always been first class.

Operator

Darryl Genovesi, UBS.

Darryl Genovesi - *UBS Securities LLC - Analyst*

Not to beat a dead horse on the balance sheet, but fully understanding that you are comping yourself up against other high-quality industrials, but I think the way that the market will likely measure your leverage will be on some sort of interest coverage ratio basis or probably the adjusted net debt to EBITDAR basis. And given the earnings trajectory that you guys are on with lower fuel and the operational improvements that you've made, those metrics do suddenly look much more conservative.

And with regard to the use of -- with regard to the use of your cash, as Hunter brought up, your stock is relatively cheap. So, just wondering if maybe your framework is changing. I know historically you have sort of articulated your balance sheet goals to us with reference to a debt to capital ratio, but just wondering if maybe that view is evolving a little bit.

Brandon Pederson - *Alaska Air Group, Inc. - EVP, Finance and CFO*

Darryl, it's Brandon. Thanks for that. I would say our -- your question is absolutely not beating a dead horse. Our balance sheet is very alive, and it serves us very well.

I totally get your question, and we think about that stuff all the time. We talk with our board about that. I think to the extent that we are going to evolve our approach to that, it would be over a matter of quarters or even years.

We've had a fuel environment that looks like it does now for I think three months, and I don't think you would see Alaska pivot from a very purposeful strategy of capital allocation based on three months' fuel decline and the rosier cash flow outlook that that produces, but rather look and see what happens over a longer period of time and adjust accordingly. But I can assure you that we talk about this stuff all the time, both internally and with our board.

Darryl Genovesi - *UBS Securities LLC - Analyst*

Okay. Thanks for that. And then I guess over the last couple of years, you've really prided yourselves on having a pension fund that's fully funded. With the move down in rates during 2014, is the plan still fully funded on a GAAP basis? And to the extent it's not, should we expect a ramp up in the contributions that you guys would make to get to be fully funded on a GAAP basis?

Mark Eliasen - *Alaska Air Group, Inc. - VP, Finance and Treasurer*

Darryl, this is Mark. What drove our pension funding to drop from 104% down to about 94% was just the decline in long-term interest rates.

So, our investments are performing very well there. So we are comfortable -- pensions are, of course, a very, very long-term asset and liability. So we are comfortable kind of letting that ride. Substantially we are fully funded if you look at it. It will bounce around a little bit, but we are substantially fully funded. We don't anticipate making a huge contribution to the pensions. Nor do we need to.

Darryl Genovesi - *UBS Securities LLC - Analyst*

Okay. Thank you.

Lavanya Sareen - *Alaska Air Group, Inc. - Managing Director of IR*

Michelle, we have time for one more question.

Operator

Your final question will come from Dave Simpson from Barclays.

Dave Simpson - *Barclays - Analyst*

A quick one for Brandon just in the full-year CASM guide, how much of a -- or or if any PBP payout, how are you managing that? Is it assumed in there?

Brandon Pederson - *Alaska Air Group, Inc. - EVP, Finance and CFO*

That's a tough one every year, and it does periodically result in adjustments to CASM along the way as we progress through the year. We paid the max payout this year, and we would not expect to do that necessarily every year. So we budgeted something a little bit less than that. Less than what we spent in 2016.

Dave Simpson - *Barclays - Analyst*

Okay. That's very helpful. Thanks. And then just taking a step back, I mean you guys have been a smaller airline with very high returns, high returns relative so you've grown -- now your returns are only going higher presumably with lower fuel. How are you going to kind of look at low fuel in terms of your growth going forward obviously knowing oil is out?

Brandon Pederson - *Alaska Air Group, Inc. - EVP, Finance and CFO*

Yes, it's Brandon again. The thought I would say on that is that we are in a very low fuel environment. And, as I said in the prepared remarks, that's going to result in improved profitability and cash flows. But we are really not considering that in how we think about planning the long-term growth of the business.

As I look across the last seven years or so, just on a raw fuel price basis, I've seen everything from $1.85, which we guided to today up to $3.31. The simple average over the last seven years is $2.89, $2.90 a gallon, and that's more of where our head is from a planning standpoint. Big picture our planning standpoint or our planning mindset is let's put airplanes in capital where we can produce returns for our owners.

Dave Simpson - *Barclays - Analyst*

Okay. That's very helpful. I appreciate that.

Brandon Pederson - *Alaska Air Group, Inc. - EVP, Finance and CFO*

One other mop up, just before I lose everybody. I want to come back to Savi and her question about non-aircraft CapEx. Savi, I would encourage you to buy a lottery ticket today because I have a 1-inch book with about 50,000 numbers, all except that one.

It is a variety of things that are driving that increase. Some of it is leftover spending that we didn't quite get to in 2014. Some relates to the big IT capital projects that we have in place and that we've spoken to you about over the last couple of years. And some of it relates to a refresh that we are doing at many of our airports to try to make the Alaska presentation at a lot of our airports or most of our airports very, very consistent to improve the customer experience.

Brad Tilden - *Alaska Air Group, Inc. - President and CEO*

All right. And with that, thanks, everybody. We appreciate your interest in us, and we look forward to chatting with you next quarter. Thanks.

Operator

Thank you for participating in today's conference call. This call will be available for replay beginning 12:00 PM Pacific time today to 11:59 PM Pacific time on February 22, 2015. The number to dial for the replay is 1-855-859-2056 or 1-404-537-3406. And the conference ID number for the replay is 62357440.

Also, the call will be accessible for future playback at www.alaskaair.com.

Thank you, everyone. You may now disconnect.
