THOMSON REUTERS STREETEVENTS

EDITED TRANSCRIPT

ALK - Q2 2013 Alaska Air Group, Inc. Earnings Conference Call

EVENT DATE/TIME: JULY 25, 2013 / 3:30PM GMT

OVERVIEW:

Co. reported 2Q13 GAAP profit of $104m and adjusted earnings of $105m or $1.47 per share.

THOMSON REUTERS

CORPORATE PARTICIPANTS

Chris Berry *Alaska Airlines - Manager, IR*

Brad Tilden *Alaska Airlines - President, CEO*

Brandon Pedersen *Alaska Airlines - CFO*

Andrew Harrison *Alaska Airlines - VP, Planning and Revenue Management*

Benito Minicucci *Alaska Airlines - EVP, Operations, COO*

Joe Sprague *Alaska Airlines - VP, Marketing*

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

CONFERENCE CALL PARTICIPANTS

Hunter Keay *Wolfe Trahan & Co. - Analyst*

Savanthi Syth *Raymond James & Associates - Analyst*

Jamie Baker *JPMorgan Chase & Co. - Analyst*

Helane Becker *Cowen Securities - Analyst*

Mike Linenberg *Deutsche Bank - Analyst*

Duane Pfennigwerth *Evercore Partners - Analyst*

John Godyn *Morgan Stanley - Analyst*

Dave Fintzen *Barclays Capital - Analyst*

Steve O'Hara *Sidoti & Company - Analyst*

Dan McKenzie *Buckingham Research Group - Analyst*

Glenn Engel *BofA Merrill Lynch - Analyst*

PRESENTATION

Operator

Good morning, my name is Megan, and I will be your conference operator today. At this time, I would like to welcome everyone to the Alaska Air Group's second quarter 2013 earnings conference call. Today's call is being recorded, and will be accessible for future play back 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, Chris Berry.

Chris Berry - *Alaska Airlines - Manager, IR*

Thanks Megan. Good morning everyone, and thank you for joining us for Alaska Air Group's second quarter 2013 earnings call. I know it has been just a couple of weeks since we spoke to you last, so today's prepared remarks will be a bit briefer than usual. On the call today, Brad Tilden, our CEO, and Brandon Pedersen, our CFO, will provide some highlights from the quarter, and our outlook for the third quarter and the full year. Several members of our senior management team are also here to help answer your questions.

As usual, today's comments 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 available on our website. We will refer often to certain non-GAAP financial measures, such as adjusted earnings or unit cost excluding fuel, and 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 second quarter GAAP profit of $104 million, excluding the impact of mark-to-market adjustments related to our fuel hedge port portfolio, Air Group reported an adjusted net income $105 million, or $1.47 per share. This compares to a First Call mean estimate of $1.51 per share, and to last year's adjusted net income of $111 million, or $1.53 per share. Additional information about cost expectations, our capacity 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 will turn the call over to Brad.

Brad Tilden - *Alaska Airlines - President, CEO*

Thanks Chris. Good morning everybody. It is good to be talking with you again. Things are tracking along really well at Alaska, as we had a solid second quarter. We reported adjusted earnings of $105 million, or $1.47 per share as Chris said, and that represented a 13.5% pretax profit margin. This was our 17th consecutive quarterly profit. We continue to produce very solid cash flows from operations, and industry-leading returns on invested capital.

We have a long record of quarterly profits, and our belief in the sustainability of these profits provided the foundation for our announcement two weeks ago, that we will begin paying a quarterly dividend of $0.20 per share on August 22nd. This dividend represents a yield of 1.3%, and it is an affirmation of our commitment to providing shareholders with appropriate returns. The dividend is in addition to our $250 million share repurchase program.

Our adjusted profit fell from last year by $6 million, due to the negative impact on unit revenues from some additional capacity in our markets. Our capacity increased 7.5% this quarter, while total revenues increased 3%. Much of the unit revenue shortfall came in the state of Alaska, where over the years, we have seen airlines and flights come and go. Given the importance of the state, we obviously plan to staunchly defend our turf there. And given industry dynamics with respect to supply and demand, which are generally quite positive, we expect this capacity to normalize in the years ahead. We also have additional capacity in some of our north south markets on the West Coast and again, given the industry's more rational approach to supply and demand, we are optimistic that this will stabilize as we move forward.

Our profit was also impact by several unusual items on the cost side, that Brandon will talk more about in just a couple of minutes. In addition to capacity changes, we believe the changes we either announced or highlighted on our call two weeks ago will drive new revenue. Changes to our bag fees and ticket change fees which will be effective October 30th should bring in approximately $50 million per year of new revenue.

Our new agreement with Bank of America for our Affinity credit card, will result in an additional $55 million of cash flow per year. As you know, we are also upgrading the cabins of our 800 and 900 aircraft by adding Recaro seats with power. Because of the way these seats are designed, we will be able to add six new seats on the 800s, and nine new seats on the 900s, while also enhancing the onboard experience for our customers. Everything else being equal, we expect these seats will add approximately $47 million in revenue annually. Viewed differently, they will lower unit costs by 3.5% on the reconfigured airplanes, or 2.5% fleetwide.

Taken together and once fully implemented, we expect the annual cash flows from these three initiatives to be $150 million or more. This quarter's results were also impact by higher rates at Sea-Tac Airport that were retroactive to January 1st, and that were imposed on the airlines by the Port of Seattle. Subsequent to our quarter end close and our last call, we reached an agreement in principle with the Port on the major elements of a new long-term lease agreement. Along with the other airlines, we need to convert this agreement to a final lease and once we do, we will have lower rates than those imposed.

One positive result of the long negotiation is that we have a much better understanding of the airport rate making process, and are much better at influencing that process. This is important, considering that airport costs have risen from 5.5% of our nonfuel costs in 2000, to almost 10% today. I want to specifically thank Karen Gruen and her team in corporate real estate, for their diligence in achieving this new agreement in principle.

We also recently reported two other pieces of very good news. Our pilots at Alaska, and our flight attendants at Horizon have each ratified new five year agreements. Having long-term agreements puts us in a position to focus on running a great operation, taking care of our customers, and beating the competition. I want to thank everyone involved both union and management folks for their hard work in reaching these mutually beneficial deals. The one group we have that is currently past their contract amendable date is the Alaska flight attendants. We are in active negotiations there.

Before I turn the call over to Brandon, I want to thank all of our people for running an excellent operation and for starting our busy summer season off with such strong results. For the sixth year in a row, our customers honored us with the J.D. Power and Associates Award for the Highest in Customer Satisfaction Among Traditional North American Carriers. We are very proud of this honor and the credit for the award goes to our people at Alaska and Horizon.

We still have some work to do to reach our goal of having the best score of any carrier, traditional or low cost, but we feel very good about the progress we made this year after posting the largest point increase of any carrier. As I think you all know, our goal here has been to build a fundamentally strong business that is good for all of our stakeholders. We want to be safe, we want to operate well, we want to provide excellent service and good value to our customers, and we want to be a great place to work. Finally, we want Alaska Air Group to be a good place to invest, creating long-term real value for our shareholders. The concept is simple. The execution is not. We are working hard every day to get better at it.

Thank you for your attention to us, and with that, I will now turn the call over to Brandon.

Brandon Pedersen - *Alaska Airlines - CFO*

Thanks Brad. Good morning everybody. As Chris said, Air Group reported an adjusted net profit of $105 million, down slightly from the $111 million profit last year. However, our trailing 12-month after-tax return on invested capital improved to 13% up from 12.3% at the end of the second quarter last year. On an adjusted pretax basis, we earned $170 million for the quarter compared to $179 million last year. The $9 million decline was the product of a $42 million increase in revenue, offset by a $45 million increase in nonfuel costs, and an $8 million increase in economic fuel costs.

Revenues increased only 3%, even though capacity increased 7.6%. PRASM declined 3.8% largely on the well-advertised increase in competitive capacity in long haul Alaska flying, which represented about 12% of our ASMs. Yield fell 10% in those markets. System PRASM was also pressured by the 43% increase in Transcon capacity, in markets such as Seattle Philadelphia and San Diego Boston. These new markets have longer than average trip lengths, and are still in the development stage. Many of the factors that caused the second quarter unit revenues to be negative will still exist in the third. As a result, we expect unit revenues to decline again in Q3 on a year-over-year basis, although at a rate less than the 3.8% decline in Q2.

I do want to quickly elaborate on the modified Bank of America Affinity card deal. We will be required to apply some new accounting that is complex, and we expect to record a very large one-time favorable revenue item, perhaps in the neighborhood of $150 million to $200 million in the third quarter, that we are planning to call out as special. We are also finalizing our estimate of how much of the improved Affinity card deal will impact Q3 and Q4. We will provide more information in our next investor update, and in our 10-Q, although we don't expect the P&L benefit to be significantly different from the additional cash flow.

On the cost side, we did record the six-month impact of the port-imposed rates at Sea-Tac that Brad talked about. The $11.5 million charge that we recorded in June resulted in an uptick to our cost guidance in our final Q2 investor update. We do expect, however, a favorable true-up in Q3 based on the agreement reached subsequent to the end of the quarter.

Maintenance costs increased by $13 million or 24%, largely on the timing of planned activities, higher than expected costs at Horizon, and costs associated with leased aircraft that will be returned in the next three quarters. We expect maintenance costs to moderate considerably in the second half of the year. Despite the increase in airport and maintenance costs, our overall cost performance continues to be very good in nearly every operating division, and reflects the commitment by all of our people to achieve lower costs through higher productivity, and a tight focus on controlling the growth in overhead. It is notable that productivity improved by 5.5% this quarter, and 6.7% in June.

In our Investor update, we provided guidance that reflects our two new labor contracts, as well as the higher rates at Sea-Tac. Based on what we see today, we expect full-year mainline nonfuel unit cost to be about flat, and consolidated costs to be down slightly. We are working to manage costs down further though, so that we can maintain our multi-year track record of mainline unit cost reductions.

Moving to fuel, economic fuel was up $8 million, or 2.2% on the 6.6% increase in consumption. The biggest news is the change we recently announced to our hedging program. We are now buying options 18 months before planned consumption, down from 36 months. The shorter tenor will significantly reduce the amount we pay for hedges, yet remains true to our commitment to use a simple insurance-like program to protect our balance sheet from spikes in oil prices, and provide some additional certainty to our cash flows.

Turning to the balance sheet, we ended the quarter with $1.4 billion in cash and short-term investments. So far this year, we have generated $590 million of operating cash flow compared to $455 million last year. Capital spending was $260 million, as we took delivery of four 737-900ERs, and made predelivery payments on future 737s, and three Q400s that we will take later this year. As a result, we generated roughly $330 million of free cash flow during the first half of the year. We used to have free cash flow to pay off $109 million of long-term debt, improving our debt to cap ratio to 52%, and bringing our adjusted net debt to just over $300 million. We also repurchased over 900,000 shares of our common stock for $51 million.

As of June 30th, we were $60 million into our $250 million repurchase program, which we still expect to be completed by the end of 2014. We spent some time on the call a couple of weeks ago reviewing the powerful cash flow generation of this Company over the past several years. Let me recap that using second quarter numbers. We have generated nearly $2.9 billion of operating cash flow since the beginning of 2009. And we have used that capital in a thoughtful and balanced way.

First, we invested $1.8 billion building one of the youngest and fuel-efficient fleets in the industry. Second, we deleveraged the business by reducing debt and lease obligations by $1.2 billion. Third, we contributed $560 million to our pension plans, even though no funding was required. Our plans are now well-funded, and have no immediate funding requirement. And finally, we have returned $260 million to our shareholders in the form of share repurchases. As I said a couple of weeks ago, a dividend was the next logical step in our balanced capital allocation strategy.

With that, we would like to now open it up to questions that you might have.

QUESTIONS AND ANSWERS

Operator

(Operator Instructions). Please limit your question to one question and one follow-up. We will pause for a moment to compile the Q&A roster. Your first question comes from the line of Hunter Keay with Wolfe Research. Your line is open.

Hunter Keay - *Wolfe Trahan & Co. - Analyst*

Hi, good morning everybody.

Brad Tilden - *Alaska Airlines - President, CEO*

Good morning.

Brandon Pedersen - *Alaska Airlines - CFO*

Good morning, Hunter. I thought we had exhausted two years worth of questions.

Hunter Keay - *Wolfe Trahan & Co. - Analyst*

I know, I thought I would ask you about variable incentive pay. No. That is a joke. Let's talk about your codeshare as much as you can. I am curious to know has the decision-making progress unfolded, and when you announced service from Portland to DFW and Atlanta, when you make a decision like that, do you do it with the intention of how can we be complimentary to our existing codeshare partners into their fortress hubs, or is it more just simply a matter of, we think we can make money on this, and if we happen to have a codeshare benefit down the line, then that is great. How do you think about those specific routes to use, maybe we can extrapolate how to think about that for future decisions like this?

Andrew Harrison - *Alaska Airlines - VP, Planning and Revenue Management*

Hunter, it is Andrew. Good morning. A couple of things, we look at our network, and we make decisions about like a Portland, Dallas, as it stands alone on that route. I cannot, don't have discussions with any partner prior to making those decisions. Once we have made those decisions, we then go and talk to our partners to see if they would like to participate where we think it might be mutually beneficial. The big thing with American, as you know, is adjustments to their scope language has allowed us to with confidence, look at additional markets that before we knew full well they weren't going to be able to work with us on. Big picture, we look at it as a complimentary to our network, is it going to help build our hubs on the West Coast? It going to help us, our partners and overall mostly our customers? If the answer is yes, and it is economically healthy for us, then we will go do it.

Hunter Keay - *Wolfe Trahan & Co. - Analyst*

How does it actually work with the codeshare? You start flying and then the code goes on the flight? When can you start talking about that process with partners?

Andrew Harrison - *Alaska Airlines - VP, Planning and Revenue Management*

We will publicly announce a flight, get it in the schedule, start selling it, and then go ask the code.

Hunter Keay - *Wolfe Trahan & Co. - Analyst*

Alright, great. Thanks. Another question for you, maybe a little obscure. The $50 million benefit from the bag and change fees, I am curious what the breakdown is between bag and change? And also have you guys done any analysis or any work on the associated fuel savings, because we think it can be material, not just for you guys but bag fees in general, in terms of the weight savings you that get? I realize that some people just pack heavier on carry-ons. But have you done any analysis as part of the $50 million, for sort of unintended cost savings from those things? Or is that just a revenue number?

Brad Tilden - *Alaska Airlines - President, CEO*

Hunter, just on the fuel savings, what I can tell you, ever since the industry started charging for bags, we have seen a considerable number of lesser checked bags below, a significant amount. 30% to 40% less. What I can tell you is upstairs, when you fly, we have a very intricate process to manage carry-ons like we have never had before. Every space in the bin and under seat is taken up. When I look at payloads, for example, on our flights, payloads are pretty much the same as they were before. In fact, we have had to increase the ratio of passenger and a carry-on upstairs, relative to the total payload of the airplane. So I am not sure it is that significant.

Andrew Harrison - *Alaska Airlines - VP, Planning and Revenue Management*

How it is the split for the model purposes, is say $35 million for bag, and $15 million for the change.

Hunter Keay - *Wolfe Trahan & Co. - Analyst*

Awesome, thank you very much.

Brad Tilden - *Alaska Airlines - President, CEO*

Thanks, Hunter.

Operator

Your next question comes from the line of Savanthi Syth, Raymond James & Associates.

Savanthi Syth - *Raymond James & Associates - Analyst*

Good morning. On your last call, update call you mentioned having opened 19 markets, and 16 markets over the last two years, and then maybe you are slowing down that opening as we move forward. Just wondering what drove the number of new markets over the last couple of years and why, what is the thinking about slowing down going forward here?

Andrew Harrison - *Alaska Airlines - VP, Planning and Revenue Management*

It is Andrew. As you have seen, I think for the last three years, we have started 30 new markets. You will see a lot of them are Transcon and Midcon, and obviously a lot of Hawaii filling in capacity that was no longer there.

I think in the second quarter, we have 21 new markets that we are in our unit revenues this quarter. If you go back to the beginning of the second quarter of last year. Going forward, you are going to see that significantly come down. We are going to get about two new airplanes next year. That is about 6% growth give or take. And we may not start any new markets next year. We are going to digest and do better things with what we have. I will tell you on the Hawaii front, for instance, we have seen unit revenues stabilize. In fact, Hawaii now is in a positive unit revenue situation. In fact, in the third and fourth quarter, we continue to reduce capacity while not having exited one single market since we started this journey in 2007. So in short, we feel very confident about our new markets, the upside that is continuing to occur, and more of a dialing back of new market growth over the next 12 or so months.

Brad Tilden - *Alaska Airlines - President, CEO*

Savanthi, it is Brad. I think if you look, and the analysts that follow us like you know this, but if you look at us over a longer time period, Alaska has been really contrary. If you go back to 9/11, that was when a lot of the industry was contracting. That was the opportunity we found to fly to New York and Washington DC and Boston, and the East Coast. 2008 and 2009 is when we had another recession. AT and [LoI] pulled out of Hawaii. That was the moment that this Company chose to sort of open our growth into Hawaii. Hawaii, as you know we put in maybe 22% of the flying we have today.

Those two regions together are 40% of the flying for Alaska. I kind of think this notion of not pushing it when it is not there, but going for it in a big way when the opportunities are there has really served the Company and our owners well, and that is how we are thinking, so right now, we have done terrific with Hawaii. Andrew and his team have done some great adjustments to refine Hawaii and get it working better. But we don't have to push something that is not evident to us that is going to work out of the gate. So that is maybe sort of a longer term perspective of how we think about capacity growth.

Savanthi Syth - *Raymond James & Associates - Analyst*

Okay. That makes sense. Thanks for the color there. Just one follow-up then. You are moving to Q400s in the state of Alaska. I was wondering what the potential cost savings or positive impact to earnings could be from that change in fleet?

Andrew Harrison - *Alaska Airlines - VP, Planning and Revenue Management*

So right now, as you know, putting about three airplanes up there, which is small in the scheme of Air Group. That said, getting the right airplane in the right markets, the cost per departure for the routes we are going to fly is down 30%, and we will accommodate all of the same passengers. Our plan is to continue to work this and grow this, so I think in short, this will be very positive for Alaska Air Group as we continue to grow, and we are also doing this by increasing frequency. So I think is a win/win for customers, lower airfares, lower operating costs, right airplane in the right market, and we can redeploy mainline into growth markets, and not have to maybe buy another airplane or so as we do that.

Savanthi Syth - *Raymond James & Associates - Analyst*

Alright, great. Thanks so much, guys.

Brad Tilden - *Alaska Airlines - President, CEO*

Thank you.

Operator

Your next question comes from the line of Jamie Baker with JPMorgan. Your line is open.

Jamie Baker - *JPMorgan Chase & Co. - Analyst*

Hey, good morning everybody. I don't normally ask a lot of RASM questions on these calls but in fairness, every other cylinder in the Alaska engine seems to be firing with the exception of that one. I guess I will leave it to you whether you describe your operation as a V8 or a V12, or maybe a V6 with Ecoboost. But you cited better RASM in the third quarter than in the second. That is consistent with what other carriers are saying. Is it simply an improved, is it a rising tide phenomenon, or are there some specific shifts in the markets, where competitive dynamics have proved more aggressive?

Andrew Harrison - *Alaska Airlines - VP, Planning and Revenue Management*

Jamie, we like to think of ourselves as V-12s, but that might not be reality.

Jamie Baker - *JPMorgan Chase & Co. - Analyst*

Excellent.

Andrew Harrison - *Alaska Airlines - VP, Planning and Revenue Management*

That is coming from a 3% carrier here. So what I would say is that as Brandon mentioned, unit revenues in Alaska long haul were down, and our yield was down 10%. So competitive pressure thereto be certain.

We also had 13% unit revenue increase last year in Alaska because there was something like 3,000 military during this period who came back into the state with their families, so we had very strong unit revenues last year. The competition going forward, there are 7.5 extra flights this summer. By November, there will only be one. We see that abating significantly. I think the core of your question is that I personally believe we are going to see continued material improvement in the many, many new markets that we have started, that right now the industry just really doesn't have. And so the challenge for my team and our team is to get those markets matured, and we will be way back on par with the industry, I believe sooner rather than later.

Jamie Baker - *JPMorgan Chase & Co. - Analyst*

Okay. That is helpful. Second, just a question on consolidation. If you were to ever look at another airline, what would be on the short list in assessing the attractiveness of the dance partner and look, I am setting aside okay, it needs to be accretive. You will do what is in the best interest of shareholders, and all of that. But I am just thinking size and shape? Would you rather look at a larger carrier, or a smaller one than Alaska? Would you want to look at one that is already in an alliance, or all else being equal an unaligned carrier, one with a modern fleet, or perhaps one where you could do the refleeting and create some value. Just wondering what might make that attractive dance partner if ever was to sashay past you?

Brad Tilden - *Alaska Airlines - President, CEO*

Jamie, there are a lot of folks smiling around the table wondering how we are going to handle this question.

Jamie Baker - *JPMorgan Chase & Co. - Analyst*

Look, in fairness, I am deliberately asking it this way because I don't want to name names, and I don't want to put you in a position where you think I am trying to extract a name that you might be attracted to.

Brad Tilden - *Alaska Airlines - President, CEO*

I think it is a good question. It is obviously one that we are probably not going to talk a lot about. I mean, what we would say is that this Company is very focused on producing returns on invested capital. And that is what we want to do. We want to be known for building a great business that is safe, that operates well, that does good things for customers, brings in value, and kind of helping the industry move to a place where we begin to produce honest to gosh returns on invested capital for owners. So that would be a big factor in anything that we might ever look at. This isn't an area where we would never say never. The Company did two acquisitions in the mid to late 1980s. An important part of who the Company is today. This was Jet America and Horizon Air. But I think that by our actions over the last what is that, 30 years, or something like that, you can see that we haven't seen anything that quite meets our criteria. Good question. Probably not one that we can provide a lot of detail on. I think I have shared with you what our primary objectives are, and where our primary focus is.

Jamie Baker - *JPMorgan Chase & Co. - Analyst*

Perfect. I will let you move onto other folks. Thanks so much.

Brad Tilden - *Alaska Airlines - President, CEO*

Thanks Jamie.

Operator

Your next question comes from the line of Helane Becker with Cowen Securities. Your line is open.

Helane Becker - *Cowen Securities - Analyst*

Thanks very much. I have phone issues, so I think one of the questions might have been answered. On the Q400s, did you say what you are going to do with the cargos between the markets that they are going to fly?

Andrew Harrison - *Alaska Airlines - VP, Planning and Revenue Management*

Oh, hi, Helane. This is Andrew. Did you just say cargo?

Helane Becker - *Cowen Securities - Analyst*

Yes. Because, right, I think the issue with having the larger planes was to handle the cargo. You were going to smaller planes, so I didn't hear if you responded to that question?

Andrew Harrison - *Alaska Airlines - VP, Planning and Revenue Management*

Where we are putting them mainly obviously Anchorage, Fairbanks, where we still have mainline metal. I will tell you cargo has been front and center of the overall Q4 analysis going forward, and how we can grow, and we also, the Q400 has also seasonal bins that can add 800-pounds worth of baggage and cargo baggage that we are looking at. So we feel very good about increasing the cargo capacity of the Q400 going forward while utilizing the mainline fleet, our freighters, and our mainline frequencies. It is a little bit of challenge, but we think we have a path to making that successful.

Helane Becker - *Cowen Securities - Analyst*

Okay. Thank you. All of my other questions were mostly asked and answered. Thanks.

Brad Tilden - *Alaska Airlines - President, CEO*

Thanks Helane.

Operator

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

Mike Linenberg - *Deutsche Bank - Analyst*

Just a few here. I want to go back to the seating reconfiguration where you get the benefit of like a 2% CASM across the fleet and the $47 million on the revenue. When is that completed? How does that phase in? Do we see that by the end of this year, or is that 2014? What is the timing on that?

Benito Minicucci - *Alaska Airlines - EVP, Operations, COO*

Mike, it is Ben. The reconfiguration is this fall, and they will run to the end of 2014. So it will take us almost 18 months to get through the fleet. Two lines of mods working, and we are pretty excited about where we are going to be at the end of that.

THOMSON REUTERS

Andrew Harrison - *Alaska Airlines - VP, Planning and Revenue Management*

Mike, we will have half of them done before the summer and we think we are going to get about it $27 million-plus of benefit in 2014. And then at the run rate, you heard Brandon say $47 million. We are going to be halfway done before summer and selling those in this coming summer in 2014.

Mike Linenberg - *Deutsche Bank - Analyst*

Okay, great. Just my second question, I want to go back to the point I think Brad, you mentioned about airport costs going from 5% to 10%. I guess the question is, I mean, what is going on here? Are we seeing airports exercise their ability to monopoly price, or is there just other areas of cost inflation, maybe they are just not being, they are just not running these businesses like they should or maybe they are not being run like businesses.

I would say that when you think about a big cost for an airport, financing cost is a big chunk, but when you look at what their financing rates are today and what they have been over the last few years versus 10 or 15 years ago, it seems like those numbers have come down significantly. So what is going on here?

Benito Minicucci - *Alaska Airlines - EVP, Operations, COO*

Mike, it is Ben. I will be really honest. We learned a lot about airports and where costs get created in the airport world. And essentially, there are two big areas. One is how much money they borrow to build big capital projects, and the second is their own internal costs. So it varies airport by airport. But when they buildterminals and add runways, somebody has to pay for it, and it ends up on the backs of the airlines. Part of what you are seeing costs go up is infrastructure being put in, and in Sea-Tac, we saw the third runway. We are look at expansions in a new International FIS. We are looking at improvements on our sites. So all of the capital cost plus what they have spent in the past are coming to catch up, at least with us at Sea-Tac. That is part of the problem.

We have learned a lot. So there area bunch of other elements, in the least that can benefit us. And we have worked hard with the Port of Seattle. I think we have, our costs are going up. There was no way to get around it because of the capital spending that was done, and what is going to happen, but we have a lease structure that has some provisions that protect the airlines going forward, and it is our hub. We have got to make it work. We are pretty happy, like Brad said, we are happy with the team and the lease we have, and with every airport we have, we are going to make sure that we understand the capital projects that are being done, and we are going to make sure that we understand their O&M costs, so that we can contain these costs as best we can.

Mike Linenberg - *Deutsche Bank - Analyst*

Okay, great. Thank you.

Brad Tilden - *Alaska Airlines - President, CEO*

Thanks, Mike.

Operator

Your next question comes from the line of Duane Pfennigwerth with Evercore.

Duane Pfennigwerth - *Evercore Partners - Analyst*

Thanks, good morning. I may have missed it. You sounded pretty upbeat about demand improvement on your last call before earnings. What have you said about kind of the demand environment into the third quarter here, and should we be thinking about the same level of pressure on unit revenue near term?

Andrew Harrison - *Alaska Airlines - VP, Planning and Revenue Management*

Duane, it is Andrew. I think in Brandon's prepared remarks, we are still expecting unit revenues to be down in the third quarter, but certainly less than what you just saw in the second quarter. And then September is September obviously. It is a little ways out. So we can't really comment good or bad, but what I can say is for July and August, we continue to see yield improvement as we bring in summer, and the demand is very good for summer. We feel very good right now about how summer is shaping up.

Duane Pfennigwerth - *Evercore Partners - Analyst*

Thanks. And then your response to the capacity in your markets. I understand you are going to defend your turf, specifically state of Alaska. As you look across your entire network, has there been anything that you have pulled back on, and to what degree has what is occurring made you kind of reconsider the growth rate of the airline longer term? Thanks for taking the questions.

Andrew Harrison - *Alaska Airlines - VP, Planning and Revenue Management*

Most of our pullbacks have been within our own supply and demand world, if you will. So Hawaii, Transcon, and those sorts of things. Honestly with the state of Alaska already in June, I can personally see where we took the yield hits, where the passengers disappeared, which markets were from all over the country. We will be very well-positioned if this occurs again next summer to do a much better job. I think there is only upside from there. The rest of that, you have seen some West Coast actions. But again, we feel really good with our core network running high load factors, and again, with the changes in our business, that $150 million of undergirding of our economic model coming forward, and all of the things we are doing, we are just feeling quite optimistic looking out about our network, and the competition we are dealing with.

Duane Pfennigwerth - *Evercore Partners - Analyst*

And then I guess just a longer term question, has this series of events caused you to kind of reconsider the growth rate of the airline longer term?

Brad Tilden - *Alaska Airlines - President, CEO*

Duane, the only thing we might add to what Andrew has already said, is one of the phenomenons that we are dealing with right now, is I think Hawaii is kind of getting built out in terms of the capacity we are capable of putting in Hawaii. If you look at the Anchorage, Bellingham, Seattle, Portland, Hawaii is fully served. California, the market needs are largely satisfied. So that has been a big growth driver for this Company for five years now. And so not having the Hawaii opportunity, probably says growth is going to be a little bit slower in the next couple of years, than it has been in the last three or four years.

And as we kind of said in response to an earlier question, I think we kind of keep our head down, keep focusing on being safe, and running a good operation. A compelling proposition for customers, and low costs, and more opportunities will come our way. When they do, we will pounce on them. For now, maybe not for the near term, the next one, two, three years, maybe not the same level of opportunity that we saw in the last couple of years.

Duane Pfennigwerth - *Evercore Partners - Analyst*

Thanks. I will just sneak one more in. To the extent that you are done with deleveraging in 2014, does the initial dividend that you have put forth, should we view that as a starting position, or did that already contemplate you sort of being done with paying down debt? Thanks for taking the questions.

Brandon Pedersen - *Alaska Airlines - CFO*

Hey, Duane. It is Brandon. We said two weeks ago that we wanted to first do a dividend and we are almost there. A couple of weeks now until we make the payment. But we said that we had an interest in growing the dividend on some regular basis, and we want to design our business in a way that we can do that. You are right. We are getting to a point where we are probably done deleveraging, and that further positions us to change our capital allocation strategy, and return more to shareholders, whether it be through repurchase or dividend. That is our option.

Duane Pfennigwerth - *Evercore Partners - Analyst*

Thank you.

Brad Tilden - *Alaska Airlines - President, CEO*

Thanks, Duane.

Operator

Your next question comes from the line of John Godyn with Morgan Stanley.

John Godyn - *Morgan Stanley - Analyst*

Hey guys. Thanks for taking my questions. I wanted to follow up on this idea of fewer new routes next year. I don't think the stretch to imagine that the more mature markets operate at significantly higher profitability, it sounds like simplistically, holding macro constant, fuel interest rates, we should be expecting a nice bump in margins in 2014, just based on that factor alone. Is that the right framework, is that logical, or am I missing something?

Andrew Harrison - *Alaska Airlines - VP, Planning and Revenue Management*

John, I love the thought process, and I would embrace that answer. I think at the end of the day, you have actually capsulated ultimately the macro plan. There are a lot of things outside of our control obviously, and we are going to work it hard. But on a pure, theoretical basis, that would be the direction that I think we would like to head with this.

John Godyn - *Morgan Stanley - Analyst*

Okay. Excellent. And then maybe more practical, less theoretical, is there anything you can tell us about how the profitability of an immature route, or how the slope might look like? A year out, or something like that,versus a mature route? Is there anything you can help us think about the differential there?

Andrew Harrison - *Alaska Airlines - VP, Planning and Revenue Management*

A couple of things I can tell you and if you take a Ft. Lauderdale and a San Diego Orlando in the second quarter, they both ran about 88%, 89% load factor. We are moving both red eyes to prime time, daytime flights. We have seen continuing improvement there and I expect that to accelerate. As far as the new markets goes, what we are seeing is that especially in the first year, very significant profitability or let's just say, moving towards profitability in those first years. So I think by year two, we should have, in many of these markets, good results contributing to the business, and by year three, those that are not or even before that, they will be gone.

John Godyn - *Morgan Stanley - Analyst*

Okay. Great. Just one more follow-up on the topic. I can go and calculate this, but I am not sure if you have the number available. What percentage of your capacity approximately today is in new routes, or that you would consider new?

Brad Tilden - *Alaska Airlines - President, CEO*

That is a hard one.

Brandon Pedersen - *Alaska Airlines - CFO*

I can probably get back to you on that John.

John Godyn - *Morgan Stanley - Analyst*

Even if it is a general number.

Andrew Harrison - *Alaska Airlines - VP, Planning and Revenue Management*

You stumped me there. Depending on what is new, to be honest. And then a number of the new routes are like regional routes, so they are in the scheme of, the economics are much smaller.

John Godyn - *Morgan Stanley - Analyst*

Got it. No problem.

Brad Tilden - *Alaska Airlines - President, CEO*

All new Transcons, like a San Diego Boston or San Diego Orlando or a Seattle Philly, it is 4% or 5%, or 3% or 4%, something like that. But it is an easy number to run. We should do that.

Andrew Harrison - *Alaska Airlines - VP, Planning and Revenue Management*

Basically, the ASM growth, another way to look at it is essentially new markets, give or take.

John Godyn - *Morgan Stanley - Analyst*

Got it. That is helpful.

Brad Tilden - *Alaska Airlines - President, CEO*

Hawaii is actually down you were telling me for the fourth quarter.

Andrew Harrison - *Alaska Airlines - VP, Planning and Revenue Management*

Hawaii will be down 5.5% in Q3, and 11.5% in Q4.

John Godyn - *Morgan Stanley - Analyst*

Okay, great. Thanks, guys.

Operator

Your next question comes from the line of David Fintzen with Barclays. Your line is open.

Dave Fintzen - *Barclays Capital - Analyst*

Good morning everyone. Question, I think for Andrew. If I recall, I think it was you, Andrew, a couple of weeks, you said competitors come and competitors go in the state of Alaska. I mean obviously you see Seattle to Anchorage type stuff. I am curious when you look out beyond the Anchorages of the world, into Juneau, into the smaller cities, or the intra Alaska, is there something about airport facilities, or the difference in operating in a place like Alaska, where operating year round in Alaska, are there things that are different that we should be thinking about that would mean sort of, if somebody wanted to come try to replicate something more similar, it would be tougher than say replicating something in a city in the lower 48? I am curious just how to think about that?

Joe Sprague - *Alaska Airlines - VP, Marketing*

David, this is Joe Sprague from Marketing. I might take that one. It is a great question. I am not sure if you have been around to some of those other communities or not. They are pretty unique places obviously. We serve 19 cities in the state of Alaska with 737s, only three of which are actually connected to any sort of road system. So that it is a real sort of unique set-up, in terms of the way we serve the state of Alaska. The reason we are flying to these communities is because they are so isolated. They need air service to get just basic goods and services in and out of the community, then if somebody has got to go to the doctor or the dentist, they pretty much fly us to get into the major city for that service.

But as a result, those communities are pretty small. Much smaller than you would see for commercial service in the lower 48 for instance. They don't have facilities, a Juneau or a Fairbanks would have a more traditional municipal airport terminal building. But in a lot of the other communities, we are the terminal building. It is an Alaska Airlines building that serves sort of as the city airport terminal. So that is different. We have also invested a lot in those communities.

You mentioned Juneau specifically. That stands out in terms of our investment in the flight technology information technology, that allows to effectively serve those communities, so we have the special RNP approaches for Juneau, and several other communities in Alaska. They are not proprietary necessarily, but we are far and ahead of anyone else in terms of being able to operate those kinds of approaches. And given the weather and terrain, and so forth, that is a pretty unique advantage that Alaska Airlines has in serving those communities. So it is different, we have spent 80 years perfecting how we serve those communities. We have got improvement yet to make. That is why you see us doing things like bringing the Q400s to the state of Alaska. Overall, we feel very good about our position in the state of Alaska. We have Club 49, which helps to reinforce our loyalty with the residents of the state of Alaska. So on the customer front, the operations front, and even the facilities front, it is a lot of unique things that we do to set ourselves apart.

Dave Fintzen - *Barclays Capital - Analyst*

Just to quickly follow-up. In that next tier down from an Anchorage, like a Juneau or a Fairbanks, it has been a while since I have been to Fairbanks, but it didn't seem like it was an airport that was chock full. Is it fair to think they are fairly full airports, but there is space if somebody wanted it, or is it like you are struggling to find some space, particularly as you are ramping up frequency yourself?

Joe Sprague - *Alaska Airlines - VP, Marketing*

From a facilities standpoint, they don't have a lot of extra space. I think we have seen in the case of Fairbanks in particular, there have been some other airlines that have dipped their toe in the Fairbanks water during the busy summer tourist season, then when the temperature goes below zero, they retreat pretty quickly. If somebody wanted to come, I am sure the airports would try to find space for them. But that is sort of the way the set-up has worked.

Dave Fintzen - *Barclays Capital - Analyst*

Thank you. I appreciate it. I know it is a little bit unusual. Thanks for all of the color.

Brad Tilden - *Alaska Airlines - President, CEO*

It is a great question. The other thing about the Alaska market is that a lot of those folks do connect. Seattle Anchorage is a huge market for us. The last number I remember is something like 65% of the customers on that route are connecting on either the Alaska end or the Seattle end. Having this network into the smaller communities into Alaska really helps you make these flights work.

Dave Fintzen - *Barclays Capital - Analyst*

That makes sense. Great. Thanks for the color. I appreciate it.

Operator

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

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

Hi, good morning. I was wondering in terms of the impact from the seats, I didn't quite catch that. When do you start seeing that impact from the seats, and it seems like the ASMs per gallon are up, or improving fairly well in the third quarter. Is that part of that? Or not?

Brad Tilden - *Alaska Airlines - President, CEO*

The mod lines start in October, Steve. It will be two airplanes at a time, and once we have the prototypes, you will see them pop out a week at a time. You will start seeing airplanes, the extra seats starting in November. And then increasing from there. So by the end of 2014, Andrew just mentioned by the summer, we will have half our fleet reconfigured, then the rest will be by the end of 2014, just to give you a sense.

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

Okay. And then what is the, I think you mentioned the X fuel impact. What is the CASM impact? Is some of that offset by weight and depreciation? What is the full CASM impact?

Brandon Pedersen - *Alaska Airlines - CFO*

Steve, it is Brandon. On CASM impact, it is basically the same as the CASM X fuel impact. Brad used the number 2.5% on a fleetwide basis, about 3.3%, 3.5% on the airplanes being modified. You doget some incremental passenger-related costs when you fill the extra seats. There is the depreciation as you point out. You have a little bit of weight on the fuel, but in the grand scheme of things, as you think about those costs in relation to the $47 million of annual benefit that we are going to see, once we get the thing fully implemented, it is really, really small, and so I think those are probably fair percentages to apply on a CASM basis, or a CASM X fuel basis.

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

Okay. Thank you. And then just as a follow-up on the Q400s, do you see other opportunities for that type of move in other areas? Is there any desire to maybe increase the size of that fleet for that reason?

Andrew Harrison - *Alaska Airlines - VP, Planning and Revenue Management*

Steve, for start in the state of Alaska, we absolutely see more opportunities, and for now, we are very, very happy with the lower 48 deployment. If you look at our unit revenues and our regional business, you will see there are very impressive increases year-over-year and has been. For now, we are looking at the state of Alaska, and how we can maximize the use of these Q400s, and as the Alaska fleet gauge increases, the 400s and the 700s leave, the ERs come in, we need the Q400s to help feed these markets out of the Pacific Northwest, and we will use them for that.

Brandon Pedersen - *Alaska Airlines - CFO*

Hey, Steve, it is Brandon. One other thing that I might add to that, is that we think about the long-term Alaska fleet plan. We have a specific need in that we have to replace the five 737-400 Combi aircraft that we operate, that is slated to happen in a few years. But ultimately, the Q400 might be a very important part of that solution because those Combi airplanes fly into some of the smaller markets in the state of Alaska.

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

Alright. Thank you very much.

Operator

Your next question comes from the line of Dan McKenzie with Buckingham Research. Your line is open.

Dan McKenzie - *Buckingham Research Group - Analyst*

Good morning guys. Couple of questions here. I guess the first is really house cleaning. Very simple. The Recaro seats, are those going to be expensed or capitalized?

Brandon Pedersen - *Alaska Airlines - CFO*

Hi, Dan, it is Brandon. Welcome back. The Recaro seats will be capitalized.

Dan McKenzie - *Buckingham Research Group - Analyst*

Got it. Okay. And then second, you guys have all done a great job of keeping your codeshare partners happy. But as Delta continues to expand out of Seattle, it looks like it is increasingly bumping up against one world, so it looks like there could be a little friction. From your perspective, what is the trick to keeping both partners happy longer term, and do you think you can keep them happy longer term? I guess what I am really getting at here is possibly require further investment at Seattle, but perhaps bring even more value to both members?

Brad Tilden - *Alaska Airlines - President, CEO*

Yes, Dan, this is Brad. As Brandon said, welcome back. Good to have you covering us again. I think absolutely. I think both partners, both Delta and American understand our strategy of having alliance relationships with both Delta and American. Both are okay with that.

I do think that these alliances are complicated. And that once in a while, there are little skirmishes or little frictions that arise in them. What you need to have is a couple of things. You need to have a relationship where you sit down and talk and you understand each other's needs, and you work them out. You also need to have a natural reason for the relationship to exist. We have that with both American and Delta.

If you take Delta as an example, they really want to grow International wide body flights out of Seattle. They have gone from four or five wide bodies a few years ago, to I think to they announced Seattle Heathrow this week, they are at ten today maybe going to 11, or something like that. So anyway, that is a relationship where we do have natural opportunity to help Delta. And I think helping Delta will help Alaska as well. So I don't see any, I think it is a good strategy for Alaska Air Group to have deep relationships with both American and Delta. And I think that we are going to have to pay attention to this over time, and make sure that we are doing things that are kind of supporting both folks, and helping us grow the revenue pie, and that is going to take some work. But I am confident that we are going to get the work done, and that this is going to work out. This is a good, stable, long-term strategy for us.

Dan McKenzie - *Buckingham Research Group - Analyst*

Thanks. Appreciate that, Brad.

Brad Tilden - *Alaska Airlines - President, CEO*

Yes.

Operator

Your next question comes from the line of Glenn Engel with Bank of America. Your line is open.

Glenn Engel - *BofA Merrill Lynch - Analyst*

Good morning. Questions on fuel. When I look at your hedge book, I guess two things stand out to me. One, your WTI hedges which looked dumb earlier in the year now look brilliant. I don't really seem to see that in your fuel guidance, given at 101 I would have thought you would see a bigger drop. Two, you are refining crack spreads at $0.52 third quarter looked relatively high, and wanted to know when those stop hurting you?

THOMSON REUTERS

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

Yes, hey Glenn, this is Mark Eliasen. We have changed our hedging program over the last few years actually. We are confident in the long-term, like you said, some months it looks bad. Some months it looks brilliant, but over the long-term, it has served us very well. In terms of specifics, yes, we are starting to get in the money with the WTI hedges that we had in place. Those are performing just as expected. And on the crack side, the airline is benefiting a lot from LA jet prices coming down. So that's working the way we would expect as well.

Glenn Engel - *BofA Merrill Lynch - Analyst*

You are using a 106 average brand for fuel the third quarter, and yet half of your hedges are at 101. I am curious why you use such a high number for your jet fuel for the third quarter?

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

Yes, say that again?

Glenn Engel - *BofA Merrill Lynch - Analyst*

I thought you were 50% hedged at 101 WTI in the third quarter, and yet implicit in your third quarter estimate, the update says you are using 106 per barrel to get to the 325 forecast?

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

We have got $0.08 in as hedge cost. The hedges are benefiting us somewhat.

Chris Berry - *Alaska Airlines - Manager, IR*

Yes, that 106, Glenn, this is Chris, that 106 in the guidance on the fuel, that is a raw WTI. Then we split out the hedge benefit or cost separately. So that when you see what our guidance is, when we break out the components, it is always the raw cost, and then we put the hedge in sort of that separate $0.08 cost for the quarter.

Glenn Engel - *BofA Merrill Lynch - Analyst*

I guess that still seemed somewhat surprising to me given that at 101, you would think that the benefits of the hedge would be now more than offsetting the cost?

Chris Berry - *Alaska Airlines - Manager, IR*

Yes. They are in the money but not totally offsetting it.

Glenn Engel - *BofA Merrill Lynch - Analyst*

So what is going on. Is there a benefit from the crude oil hedge and the cost of the refining hedge?

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

There is a benefit in the crude oil, but it is not totally offsetting the cost of it.

Brad Tilden - *Alaska Airlines - President, CEO*

The cost of the refining hedge?

Glenn Engel - *BofA Merrill Lynch - Analyst*

The refining hedges hurt you how long? How much longer?

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

Just go out one quarter with those. Those are working their way through very rapidly.

Glenn Engel - *BofA Merrill Lynch - Analyst*

The third quarter Alaska, on the revenue side, the third quarter PRASM on Alaska, should I guess, hopefully get better in the fourth quarter, as the impact as the capacity comes out. Does the Seattle markets that you are seeing pressure on, do those get worse in the fourth quarter when you start moving in the off-peak?

Andrew Harrison - *Alaska Airlines - VP, Planning and Revenue Management*

As you know, we are always a little seasonal here. But we believe we have taken action to implement new, never been done before by us cuts, in a decent part of our capacity in transcontinental Hawaii, as we move into the fourth quarter that should help us going forward. I can't comment on what unit revenue will be in the fourth quarter. We have actions that we have put in place for the fourth quarter that we didn't have last year, and I think they are going to be good.

Glenn Engel - *BofA Merrill Lynch - Analyst*

But your full-year capacity really hasn't changed much with those cuts?

Brandon Pedersen - *Alaska Airlines - CFO*

Glenn, it is Brandon. If came down a little bit, if you look at our annual guidance on a consolidate basis I think it came down from 7.5 to 7 or so.

Glenn Engel - *BofA Merrill Lynch - Analyst*

Okay. Thank you.

Brandon Pedersen - *Alaska Airlines - CFO*

You are welcome.

Operator

There are no further questions at this time. I will turn the call back over to the presenters.

Brad Tilden - *Alaska Airlines - President, CEO*

Thanks Megan. Thanks everybody for being on the call this morning, and we look forward to talking with you next quarter.

Operator

Thank you for participating in today's conference. This call will be available for replay beginning at 5.00 PM Eastern Time today through to 11.59 PM Eastern on August 25th, 2013. The conference ID number for the replay is 37717448. The number to dial for the replay is 1-800-585-8367 or 404-537-3406. Also the call will be accessible for future play back at www.alaskaair.com. You may now disconnect.
