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ALK - Q2 2017 Alaska Air Group Inc Earnings Call

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OVERVIEW:

Co. reported 2Q17 GAAP net profit of $296m.

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PRESENTATION

Operator

Good morning, my name is Virgil, and I will be your conference operator today. At this time, I would like to welcome everyone to the Alaska Air Group Second Quarter Earnings Release Conference Call. Today's call is being recorded and will be accessible for future playback at www.alaskaair.com. (Operator Instructions) Thank you.

I would now like to turn the call over to Alaska Air Group's Managing Director of Investor Relations and Financial Planning and Analysis, Lavanya Sareen.

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

Thanks, Virgil, and good morning, everyone. Thank you for joining us for Alaska Air Group's Second Quarter 2017 Earnings Call. On the call today, our CEO, Brad Tilden, will provide an overview of the business and share progress on the Virgin America integration; and our Chief Commercial

Officer, Andrew Harrison, will share revenue results for the quarter; followed by Brandon Pedersen, our CFO, who will discuss our financial results and outlook for second half of 2017. Several members of our senior management team are also in the room to help answer your questions.

As a reminder, 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.

Moving to results. This morning, Alaska Air Group reported second quarter GAAP net profit of $296 million. Excluding merger-related costs and the impact of mark-to-market adjustments related to our fuel hedge portfolio, Air Group reported an adjusted net income of $312 million and earnings per share of $2.51, that's in line with the First Call consensus.

As we did last quarter, we have included certain unaudited supplementary data labeled, Combined Comparative Statistics, on Page 7 of our earnings release to help investors make meaningful comparisons to the combined results of both airlines and last year's second quarter. We think this provides investors better insights in how the overall business is performing. Additional information about cost expectations, 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'll turn the call over to Brad.

Bradley D. Tilden - *Alaska Air Group, Inc. - Chairman, CEO & President*

Thanks, Lavanya, and good morning, everybody. As Lavanya mentioned, we reported a net profit of $312 million for the second quarter and that represents an 18% increase in earnings when comparing to Alaska by itself last year and about a 1% increase in earnings if we include both Alaska and Virgin America in the base. This is our second full quarter owning Virgin America, and the combination has had a positive impact on earnings and is highly accretive to earnings per share. The Virgin operation, net of financing costs, generated more than $30 million of net profit for us this quarter.

Our quarterly profit -- or our quarterly revenue topped $2 billion for the first time in our history, and this growth has come at a healthy margin. Our trailing 12-month margin -- trailing 12-month pretax margin was about 20%.

As we head into the second half of the year, I want to share with you an update on how our business is performing and take stock of progress we've made on the integration. We're pleased on both fronts, but as I said on the last call, we are in execution mode right now and our team is working very hard to fulfill our purpose of creating an airline that people love.

At Alaska, we start everything we do with safety, so let's start there. Safety is job #1 for all of our 20,000 employees. Our commitment to operating safely was recently validated by our maintenance teams at Alaska and Horizon as they earned the FAA's prestigious AMT Diamond Award for maintenance, training and excellence for the 16th time. I want to congratulate both teams for this impressive accomplishment.

Turning to operations. To be direct, our operational performance has not met our expectation in the first half of the year, but we're on the road to recovery now. Air space and airport congestion are increasing across the country, but we're seeing big impacts in Seattle, San Francisco and Los Angeles. We're working now to develop a plan to reflect the new reality of the environment we operate in. Our team is working on a playbook that will standardize across the various parts of our operation and our customer communications organizations how we handle -- or how we're going to handle typical ground delay programs and irregular operations. The goal is to again deliver industry-leading operational reliability while avoiding expensive increases of block times.

Despite starting the year at the back of the entire pack, our team has rallied and we're now in the #2 spot in on-time performance among the 6 largest airlines in the United States. I'm proud of our team, but we have more work to do especially on improving our completion factor and time line adherence for our regional operation.

Our people have continued to provide excellent customer service. Despite our operational struggles and the fact that many parts of our airline are under construction, our second quarter customer satisfaction score is only 1 point lower than our all-time second quarter high. This commitment to our customers was recognized again this year with Alaska receiving the 10th consecutive J.D. Power award for customer service during the quarter and Virgin America being raised as the best U.S. Airline by Travel + Leisure in their annual readers' choice awards also for the 10th year in a row. And we just learned that just last week, Alaska Airlines was named 1 of the top 10 airlines in the world by TripAdvisor, receiving their first annual Traveler's Choice award for airlines. These awards are fantastic recognitions for our employees, and I want to congratulate them and thank them for everything they're doing to make this a great airline for our customers.

I know you have questions about the progress of our pilot negotiations, and I want to provide some detail on the process that you might find helpful. As you know, we are going to arbitration and we expect that process to begin at the end of August and we expect to have a decision by the end of October. I think you all know our underlying philosophy on compensation and what we're trying to achieve culturally here. Our philosophy is to pay all of our employees well, provide them with great benefits and stable growing careers and an ability to earn meaningful incentive pay through our performance-based plan when the company meets its goals. Brandon will share more information with you in a moment on the company's proposal.

I think you all know from watching the industry that there is a real shortage of pilots right now and very likely for the foreseeable future, and pilot wages are rising significantly. The cost of the proposal is substantial and I believe that many of you are expecting this.

With that, let me transition to the integration process more broadly. It's been 15 months now since the merger announcement and 7 months since the legal closing of the deal. There is an incredible amount of work that has to be done to integrate 2 airlines, and our team is doing great with this work. We realized a few months ago just how all-consuming the merger process would be, and we started to look for ways to accelerate integration so that we could give the airline back to the divisional leaders earlier and turn their full attention from the merger to running the best airline that we can possibly run.

As you know, what is probably the most significant gating item is the migration to a single passenger service system or PSS. Without a single PSS, we can't have a single airline code, a single set of flight numbers or a single system for sales, distribution and check-in. Having a single PSS system will effectively mean that we can operate our fleet as one fleet, so we'll have much greater flexibility to assign the right airplane to the right market. And finally, a single PSS kicks off a deliberate progression toward a single customer experience, encompassing fees, service, common liveries -- common cabin layouts, et cetera.

We originally expected to transition to a single PSS in the fourth quarter of 2018. But thanks to some fantastic work by our folks led by Shane Tackett and Sandy Stelling, we now expect to move up PSS integration to early in the second quarter. This effectively allows us to run Virgin America and Alaska as one airline and that will provide a whole host of operational, customer and financial benefits. Andrew will talk more about some of these in a moment.

In addition to PSS, we're making great headway with other systems. We expect to have a single loyalty program, a single payroll and HR system and a single financial system by January 1, 2018, and we expect to be operating a single operating certificate with the FAA sometime in the first quarter of 2018.

There is much to do, and I know that calling out only a few milestones oversimplifies the thousands of hours our team is spending in getting all of the necessary work done. I want to say now how much we all appreciate the talent and dedication of everyone working on the integration, and I want to note that it's really nice to see cutovers for a lot of these systems now happening in the next 2 to 3 quarters.

In summary, we are feeling great momentum with our merger and with our business. Our operation is improving after a tough first quarter, and our underlying business is very strong. We're under -- unlocking the value from the Virgin integration already, and our teams are working hard to help bring these 2 airlines together.

I want to close by thanking our fantastic people and our fantastic leadership team for everything they are doing to make this a successful merger and to create an airline that people love.

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

Andrew R. Harrison - *Alaska Airlines, Inc. - Chief Revenue Officer, Chief Commercial Officer and EVP*

Thanks, Brad, and good morning, everyone. I wanted to start off by taking a step back and talking about the importance of our growth. We've launched 120 new markets since 2010, and in aggregate, these markets represent about 1/4 of our revenues and profits today. This includes the 20 markets that we launched in the last 12 months, and 1/4 of our earnings per share would not exist today had it not been for these markets. And the reason I'm taking the time to reiterate this is because the acquisition of Virgin America provides the necessary platform upon which to continue this profitable growth.

We will be launching another 30 new markets over the next 6 months, and we fully expect these to add significantly to our revenue base and profits over time. In fact, of the 20 new markets launched in the last 9 months, 75% are already profitable with 60% of them earning well above our cost of capital.

Growth markets will help us activate the full potential of the Virgin America acquisition. This growth is foundational to utility, which in turn drives loyalty and sustainable returns to our shareholders.

To highlight our progress on utility. San Francisco has gone from 9% utility preacquisition to about 55% today and will reach just under 70% by the end of this year. By utility, we mean that we will fly nonstop to where 70% of the people out of San Francisco want to go in North America. This in turn builds our brand and guest loyalty. In our most recent brand health tracker for California, unaided awareness of Alaska Airlines in the past 6 months has increased 12 points and consideration increased 6 points. These are very significant increases for any brand and we expect to continue to build on this.

Further, 23% of Virgin America bookings in the second quarter came through alaskaair.com and there were days where this penetration reached nearly 30%. Membership in our frequent flyer program continues to grow at a healthy clip across the system.

Credit card growth program generated $460 million in cash for the first half of '17. Growth in both Mileage Plan and our card portfolio continues to outpace our capacity growth, and this underpins our confidence in meeting our loyalty revenue synergies. All of this to say is that our strategy is delivering results and that the Alaska brand is being embraced in California post acquisition of Virgin America.

The second quarter revenue results are a testament to what I've been talking about. Revenue increased $183 million or nearly 10%. Not only did our load factor outgrow the 5.8% capacity increase to a second quarter record of 86.8%, yields also grew a healthy 1.7%. This resulted in RASM growth of 3.5%, notwithstanding our increase in stage length resulting in downward unit revenue pressure of about 1 point. We outperformed industry RASM by 20 basis points and outgrew industry capacity by a ratio of 2:1.

Earlier this month, we began operating from one revenue management system. It is an unbelievable achievement within 6 months. This gives the RM team a solid platform from which to manage total network revenues going forward. I'm very proud of Kevin and the entire RM team in partnership with Troy and the e-commerce team.

Brad talked about PSS moving to early Q2. For the network and alliances teams, this means we can accelerate some of our revenue synergy initiatives like fleet optimization and driving greater international traffic from our partners, given our presence in 3 largest international gateways of the West Coast. We estimate that an early PSS launch will unlock $20 million of incremental profits in 2018.

Shifting to our capacity outlook. We expect competitive capacity in our markets to be up 2% in the third quarter and about 6% in the fourth quarter, that's significantly lower than for the same periods last year. We are lowering our full year capacity guidance from 8.5% to just under 8% given we finalized our schedules for 2017. We expect capacity to be up approximately 8% and 12% in Q3 and Q4, respectively.

In summary, the fundamentals, as Brad has shared, of our business is strong and we are continuing to grow revenue, our brand and loyalty in the midst of an integration, which will be substantially complete within the next 9 months. Commercially speaking, we will then be in a position to open up the throttle to full speed and bring to life all the synergies to our guests and shareholders.

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

Brandon S. Pedersen - *Alaska Air Group, Inc. - CFO, EVP - Finance, CFO - Alaska Airlines Inc and EVP - Finance - Alaska Airlines Inc*

Thanks, Andrew, and hey, everyone. After a profit decline in Q1, we were very pleased that we can once again report a year-over-year increase in profit even on a combined basis with Virgin America's results included last year.

Air Group's $505 million second quarter adjusted pretax profit represents a $12 million increase over the combined pretax of Q2 last year. We had really solid revenue performance, as Andrew said, with operating revenues up by more than $180 million, outpacing the increase in total operating costs despite the fact that economic fuel cost per gallon was up 13% from last year. Nonfuel unit cost increased by 3.3%, in line with our most recent investor guidance.

Generally speaking, I would characterize our cost performance as needs improvement. It's clear that the operational challenges and integration complexities have been driving some cost creep, but we're also not at peak performance applying the tight cost management practices that we've relied on for many years now. There are some bright spots, however, that are helping mitigate cost pressures.

For example, Virgin America's flight ops team increased productivity by 3.5% and the Alaska in-flight team raised productivity by more than 1 point. As Andrew noted, we've taken our full year capacity growth down a bit to just under 8%. The lower ASMs will pressure unit costs a bit. For Q3, we're currently forecasting CASMex fuel to increase by 1.5% and we expect fourth quarter unit costs to be down a little more than 1%, which would result in full year unit costs being up about 0.5 point.

As is our normal practice, our cost guidance does not include the impact of the arbitration decision with our pilots because we aren't certain of the amount or exact timing. One thing we can all agree on is that the market for pilot wages has increased substantially since our last contract was signed. Our arbitration proposal recognizes this reality, and we put total compensation for our pilots in a very competitive position versus others in the industry, especially when considering our much smaller size. As I believe most of you have already modeled, this is a very substantial cost increase for us.

Fully priced, our arbitration proposal will increase pilot costs by about $140 million annually. It represents a nearly 3% increase to consolidated CASMex fuel. It will reduce pretax margin by more than 1.5 points. And it will, by far, be the biggest increase ever for Air Group from a new labor agreement.

Back to costs broadly. We're in a transitional year and Alaska leaders are getting their arms around their new areas, that's to be expected. But as we enter the 2018 planning season, we'll be emphasizing the need to get back to much tighter costs and productivity management and ensuring the additional costs that we've been incurring this year don't get embedded into the long-term cost structure.

Cash flow for the first half of the year has been really strong. We ended the quarter with $1.9 billion of cash on hand, and we generated more than $1.1 billion of operating cash flow excluding merger-related expenses.

CapEx for the first half of the year was $500 million, leading to almost $600 million of free cash flow. We expect full year 2017 CapEx to be $1.2 billion, unchanged from previous guidance. And as we look to 2018, we now expect CapEx to be $1.3 billion, a bit lower than our last guidance.

We've made a number of very important decisions recently that have helped us firm up our CapEx plan. We told you at Investor Day about our plan to retrofit the Airbus aircraft to adopt the Alaska configuration. Besides having a consistent fleet, it will unlock Premium Class revenue and modestly increase the number of seats on the Airbus aircraft.

We've also finalized plans to install satellite across the entire mainline fleet, a project that should start in the first quarter of 2018.

One decision that hasn't been made yet is whether we'll operate an all-Boeing fleet in the future or stick with the mixed fleet as we have today. While we recognize there's a great deal of interest in this question, it's not urgent that we decide as the Airbus leases don't even start to expire until 2019.

And speaking of Airbus, we've taken 2 Airbus 321neos so far this year and we'll have 5 by the end of the year and we'll also take 5 more next year. We're using them in transcon markets now while the ETOPS certification gets finalized, and we hope to have them flying in Hawaii by the end of the third quarter.

We again made progress redeleveraging our balance sheet. Our debt-to-cap fell by another 1 point since the end of the first quarter to 55% and we expect to end the year at about 51% or 52%. Our portfolio of unencumbered aircraft is growing. We currently have 60 unencumbered planes including 36 next-generation 737s and 7 brand-new E175s.

Finally, I wanted to quickly cover an accounting change that will impact our debt-to-cap ratio. Effective January 1, 2018, Air Group will be required to implement the new revenue recognition standard. We'll provide a lot more disclosure in our SEC filings, but big picture, we'll no longer be able to use the incremental cost method to account for frequent flyer miles earned for travel. Very preliminarily, we estimate the transition will result in a reduction in book equity by as much as $250 million and increase debt-to-cap by about 2 points.

I'll stop there before we get too deep in the technical accounting standards and instead move right to your questions, which will be much more fun.

QUESTIONS AND ANSWERS

Operator

(Operator Instructions) Your first question comes from Savi Syth from Raymond James.

Savanthi Nipunika Syth - *Raymond James & Associates, Inc., Research Division - Airlines Analyst*

On the moving up of the PSS system transition, just kind of wondering how you're getting comfortable with doing that ahead of the summer season? And maybe how you'll handle that to lower the risks as we've seen maybe in some historical context?

Bradley D. Tilden - *Alaska Air Group, Inc. - Chairman, CEO & President*

Savi, we're going to get Shane Tackett who basically runs that whole area to answer this question.

Shane Tackett - *Alaska Airlines, Inc. - VP of Revenue Management*

Savi, thanks. I think a couple of things. One, we've tried to really derisk the scope of the project. A lot of the prior cutovers have included the data migration where you're actually taking ticket data out of one system, trying to transform it to look like the system that it's going into and then dump it in there and hope it all works the next morning. Our goal is to not do any of that. So a lot of the prework over the next few months is to get us really to avoid doing that. If we're successful, which we expect to be, it really just becomes a training process to make sure that the agents at the stations are ready with the sort of the new technology they have to use, then our operation systems back of the house need to make sure that they're able to talk to our Sabre partitions. So a lot of work, it's complicated, there's a lot of effort going into it now, but our goal is to be ready, sort of been feeling very confident well ahead of the actual cutover event and to really make this as much of a nonevent as possible.

Savanthi Nipunika Syth - *Raymond James & Associates, Inc., Research Division - Airlines Analyst*

And if I may also ask this. I think Horizon's had quite a few issues this summer. And just wondering if you could provide a little bit more color on what's happening there. And if with all the E175s coming here in the fourth quarter, if we might see kind of capacity getting adjusted lower again if some of those issues continue.

Bradley D. Tilden - *Alaska Air Group, Inc. - Chairman, CEO & President*

Savi, maybe we'll get Andrew to deal with the capacity question first and then Dave Campbell, Horizon CEO, can talk about the first half of the year.

Andrew R. Harrison - *Alaska Airlines, Inc. - Chief Revenue Officer, Chief Commercial Officer and EVP*

Yes. Savi, big picture just on overall capacity, any reductions in Horizon's line has been basically completely backfilled by either Alaska Mainline or SkyWest line. So from an overall regional capacity perspective, there's no changes there other than the operator. And Dave?

David L. Campbell - *Alaska Air Group, Inc. - CEO of Horizon Air Industries Inc and President of Horizon Air Industries Inc*

Yes. Thanks, Andrew. Savi, let me see if I can just give you a pretty -- a quick snapshot back. As you know, the industry's changed really fast in terms of pay. We got behind there. It took us about 9 months in order to deal with the pilots. We're able to get that done. We now have a competitive contract in place that will allow us to actually hire pilots. So we've actually gone out since June when we implemented the new LOI and we've been able to fill up all our requirements. A lot of what's happening this fall is really the ability to kind of slow it down, catch up where we actually haven't grown the airline dramatically and try to implement a new contract. So this is actually a reset for us. It's going to be painful for us to get through it in terms of the entire [fleet], but I feel really confident that we have a great competitive agreement. We have a good contract in place that allows us to be super productive, but it's just trying to really get back and focus on the operation.

Savanthi Nipunika Syth - *Raymond James & Associates, Inc., Research Division - Airlines Analyst*

So is that -- then does that get resolved by the end of the year? Or is it already -- has kind of the backlog been addressed?

David L. Campbell - *Alaska Air Group, Inc. - CEO of Horizon Air Industries Inc and President of Horizon Air Industries Inc*

I think so. I think by the time we get to the end of December, we should be caught back up on pilot hiring. We should be caught back up on the backlog in training. So I have a lot of confidence that we will -- this is a good reset for us, and we'll be back up operating here early January.

Bradley D. Tilden - *Alaska Air Group, Inc. - Chairman, CEO & President*

Yes. Savi, the current plan is that some Horizon flying is being covered by Alaska and SkyWest for the next 6 months and the hope is that we're done with that by January of next year.

Operator

Your next question comes from the line of the Joseph DeNardi from Stifel.

Joseph William DeNardi - *Stifel, Nicolaus & Company, Incorporated, Research Division - VP*

Maybe a question for Chris Berry if he's there since he's on the rev recognition task force. Just wondering if you could talk about -- Brandon, you mentioned the change to accounting for miles that are earned. Will the accounting change for the way that you handle miles that are sold? Will the deferral rate be impacted by the rev rec changes?

Christopher Michael Berry - *Alaska Air Group, Inc. - VP - Finance, Controller, VP - Finance for Alaska Airlines Inc & Controller of Alaska Airlines Inc*

That's pretty easy. This is Chris, Joe. That's a pretty easy answer. The revenue for the sold miles, which is the bulk of the miles that come into our program, does not really change much at all. So there won't be any significant change. It really is in just the flown miles where we're going to have to defer actual revenues as those miles are earned, but that revenue will get recorded later when those miles are used. So it's a timing on the revenue, no change on the sold miles.

Joseph William DeNardi - *Stifel, Nicolaus & Company, Incorporated, Research Division - VP*

Okay, great. And then, Andrew, if I just look at kind of bag and change fee revenues per passenger between you and Virgin, as they reported to the DOT, there's a pretty big discrepancy in Virgin's, quite a bit higher than you. Over the next couple of years, should I expect you to come up or Virgin to come down?

Andrew R. Harrison - *Alaska Airlines, Inc. - Chief Revenue Officer, Chief Commercial Officer and EVP*

Yes, I think what you should expect is, just from a baseline perspective, more of a normalization to Alaska. But that said, Shane and the team are actively working in as we're getting all our Premium seats and also putting more First Class seats in the Airbus cabins and Premium Class, to be frank, that overall revenue will go up. It may be in a different category, but it's going to go up.

Bradley D. Tilden - *Alaska Air Group, Inc. - Chairman, CEO & President*

Joe, it's Brad. I might just jump. We believe in our setup here in Alaska. We do try hard to build trust with our customers, we try to be generous with these policies and fees, give people generous upgrades into the Premium Class and into the First Class cabin. And in return, you get loyalty. And so I -- we're pretty optimistic that as we apply Alaska's policies and revenue management practices to more of the Virgin network, that RASM is going to go up, not down.

Joseph William DeNardi - *Stifel, Nicolaus & Company, Incorporated, Research Division - VP*

Yes. Just interesting, I guess, that Virgin was able to get the loyalty that they were able to with those -- with that of a fee structure, but thanks for the time.

Operator

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

Jamie Nathaniel Baker - *JP Morgan Chase & Co, Research Division - U.S. Airline and Aircraft Leasing Equity Analyst*

Question on San Francisco. The pro forma Alaska growth in the second half is pretty significant, you opined on that. It's even more significant when you layer on the competitive response that you're seeing in overlapped markets. So I know you're not going to share your San Fran-specific RASM expectations with us, but I presume whatever those expectations are, they're a bit worse now, now that we know what the competition is doing than they were earlier this year. My question is how much deterioration has there been in your San Francisco RASM plan? And what revisions to that plan can you point to that you've made as a result?

Andrew R. Harrison - *Alaska Airlines, Inc. - Chief Revenue Officer, Chief Commercial Officer and EVP*

Jamie, I'll take that. Obviously, I can't answer that specific question, but what I will share with you is that really as it relates to San Francisco, it's part of the whole ecosystem. It's basically what Alaska already had been and Virgin bringing those together, selling each other, the loyalty growth filling in some of these other markets. And at a big picture, when you combine Alaska and Virgin and you look at overall impact of competitive capacity on us as a bigger entity, it's significantly down. So while we always have pockets here or there, we still feel very confident in our plan, and I could argue that the environment is actually better than it was 12 months ago for us.

Jamie Nathaniel Baker - *JP Morgan Chase & Co, Research Division - U.S. Airline and Aircraft Leasing Equity Analyst*

Okay, that's helpful. If we turn to margins for a minute, your competitors have described this year as a "transition year". Basically asking for a pass from the market for the fact that margins are down year-on-year and kind of assuring or at least implying that margins are going to be expanding next year. I've not heard Alaska Group describe 2018 yet as a transition year. My question is, is whether you're confident that post pilots, and I know there are some assumptions around what that looks like, but post pilots, do you believe you can expand margins next year? Or should we assume that you inevitably come back to us asking for a pass sometime later this year, the way that other airlines have already done?

Brandon S. Pedersen - *Alaska Air Group, Inc. - CFO, EVP - Finance, CFO - Alaska Airlines Inc and EVP - Finance - Alaska Airlines Inc*

Jamie, it's Brandon, and maybe I'll start. I think 2018 is definitely a transition year. In all seriousness, I mean, we are focused on execution right now. We have a lot going on to put the 2 airlines together. You've heard about all the things that we're going to be accomplishing in 2018. I think, generally speaking, we feel really good about the business and where it's headed and the operating environment and the competitive advantages that we have. As you know, we don't do much in terms of margin expansion. And if you ask me and say, "Would you trade 1 point of margin decline for higher-margin dollars?" I, of course, would take the higher-margin dollar, so I'm not going to opine on what margins look like next year and I probably won't even do that in January of next year.

Bradley D. Tilden - *Alaska Air Group, Inc. - Chairman, CEO & President*

Brandon, I agree with you. I think we think the underlying operating conditions in the industry are good now and think they're going to be good next year.

Brandon S. Pedersen - *Alaska Air Group, Inc. - CFO, EVP - Finance, CFO - Alaska Airlines Inc and EVP - Finance - Alaska Airlines Inc*

Totally.

Operator

Your next question comes from the line of Rajeev Lalwani from Morgan Stanley.

Rajeev Lalwani - *Morgan Stanley, Research Division - Executive Director*

Brandon, a question for you. As far as the arbitration process, can you just walk me through how that's going to work from here? And then as it relates to that $140 million or so, should we think of that as sort of a lower bound as to what the increase could be when this is all said and done?

Benito Minicucci - *Alaska Air Group, Inc. - President of Alaska Airlines Inc and COO of Alaska Airlines Inc*

Rajeev, it's Ben Minicucci here. So the process, maybe just to go back a little bit, we were negotiating directly with ALPA. We went into mediation, then arbitration, so that process in front of 3 arbitrators begins in August and they'll probably take several weeks, and hopefully by sometime in September, early October, we'll have the decision. So that's basically the process. So the good thing is that this was a tight process that we negotiated in 2009, and I think it's good. In terms of lower bounds, upper bounds, I think what we'll say about that is the proposal we put in place really we've looked at it from a total compensation and total cost perspective. So when you take the pay rate and you add it to benefits with vacation, retirement and sick leave, that total compensation package puts our pilots at the upper end of the industry. So we feel really good about our proposal. It's pretty -- it's really solid and we'll leave it to the arbitrators to decide where the final decision lands.

Rajeev Lalwani - *Morgan Stanley, Research Division - Executive Director*

Okay. Andrew, a question for you, if I may. On your competitive capacity comments, I believe you said going up to 6% in 4Q. Can you just talk about where that capacity is showing up, if it's been in response to some of what you're doing? And then whether or not there's a potential for that to, I guess, maybe go down given that seems like schedules may be overloaded for someone like a Delta, for example.

Andrew R. Harrison - *Alaska Airlines, Inc. - Chief Revenue Officer, Chief Commercial Officer and EVP*

Yes. I debated internally with my team on the fourth quarter. I think, honestly, schedules are still in flux. We see what we call big netting still going on out there. So at the end of the day, airlines are doing what airlines are doing with their core networks. But I think at the end of the day, that actually may come down a tad, to be frank. So that's what I meant on that.

Rajeev Lalwani - *Morgan Stanley, Research Division - Executive Director*

Okay. I'm sorry, and the other part of the question was just where is it showing up assuming that 6% stays, I guess, more in the Bay Area, et cetera?

Andrew R. Harrison - *Alaska Airlines, Inc. - Chief Revenue Officer, Chief Commercial Officer and EVP*

As we see, the big carriers continue to strengthen their hubs to their spokes, which obviously affects us. And then of course, there's been some Hawaii growth in California from one carrier, so all of these things impact our comps.

Operator

Your next question comes from the line of Hunter Keay from Wolfe Research.

Hunter Kent Keay - *Wolfe Research, LLC - MD and Senior Analyst of Airlines, Aerospace & Defense*

I want to make sure I understand this because the market, I think, seems to like the commentary around the acceleration of the PSS cutover. Shane, what is this data migration? Is that the same thing as these airlines talking about like a drain down with regard to how the PSS handles the actual reservations? Are you talking about different data? And if it's different, are you taking a drain-down approach? Or sort of a nice edge cutover approach to mitigate risks. I don't know if those are the same things? Are they different? Can help us understand that?

Shane Tackett - *Alaska Airlines, Inc. - VP of Revenue Management*

Yes. Hunter, you've got the basics right, so all of our tickets are sitting in our Sabre partition. All of Virgin's tickets are sitting in theirs on different ticket stock. Our goal is to not to transfer any of their ticket stock partition. We want to show up on the cutover date with only Alaska tickets in circulation and we're going to basically do a drain down to get there. It's a little different than others have done, but it significantly reduces the risk of the transition itself and it cuts out a lot of the testing works that you have to do to get ready for that and lets us sort of focus on other readiness activities. So that's essentially what's going to happen.

Bradley D. Tilden - *Alaska Air Group, Inc. - Chairman, CEO & President*

So Shane, you stopped selling tickets beyond that certain date in the -- we're not saying we know exactly what the date is in the first quarter. You stopped selling today?

Shane Tackett - *Alaska Airlines, Inc. - VP of Revenue Management*

Yes. So we typically sell 330-day window, Virgin did as well. We're not selling 330 days on Virgin right now. I wouldn't necessarily construe that, that's the date. It's just a convenient end of a schedule and so we start to decide exactly when we're going to stop selling the 984-ticket stock, Virgin ticket stock on the future. But right now, we're not selling it beyond April of next year.

Hunter Kent Keay - *Wolfe Research, LLC - MD and Senior Analyst of Airlines, Aerospace & Defense*

So okay, so that's what changed. I just think we needed to make sure on this here because basically what Savi said was I totally agree with Savi. I mean, I think United rushed their cutover and it set them back by years. So while it's very enticing to talk about an incremental $20 million of profit from the cutover, you're introducing, I think, more risks here. So I guess, what you're saying today was that maybe if the drain down...

Shane Tackett - *Alaska Airlines, Inc. - VP of Revenue Management*

I'd actually say less risky because we're not doing the data migration. If you get the data migration wrong, it'd take a long time to unwind all of that. We do this right, we'll show up with no real sort of technology problem at the airport in terms of we don't know how to operate a Virgin-sold ticket on an Alaska-only network. We'll only have Alaska tickets to deal with. We deal with those every day obviously on the Alaska network.

Hunter Kent Keay - *Wolfe Research, LLC - MD and Senior Analyst of Airlines, Aerospace & Defense*

And in the event that things are not progressing as planned, this is my last question, if they're not progressing as planned, does that mean that this thing gets pushed out like 6 months and not 2 because you're probably not going to want to do this during peak summer travel? And like -- just to be clear like I think, all else equal, you'd be inclined here to get this right for the long term and not necessarily rush it. And if it doesn't happen in, say, in April, it's probably more like October. Is that fair?

Shane Tackett - *Alaska Airlines, Inc. - VP of Revenue Management*

I think it's like really premature to make that sort of prediction. It would really depend on like what factor that was driving us off sort of course is. I'm really, really confident in the ability of the airports to handle this transition the way we're doing it. But the big piece that we have to get right is at the back of the house, communications between our Sabre partition and the movement control system that handles the Virgin operation, which is where our IT group comes in and they're super good at this. We actually have a lot of folks who've been through this before that -- at our company within IT now. Just as a note, Hunter. We were planning on sort of reracking the communication protocol between Sabre partitions and the movement control on Virgin before the original PSS date anyway. So nothing's really changed timing-wise on that. I think we're in good shape here.

Operator

Your next question comes from the line of Michael Linenberg from Deutsche Bank.

Michael John Linenberg - *Deutsche Bank AG, Research Division - MD and Senior Company Research Analyst*

Just a couple of questions here. Just the Virgin royalty payments, are you still accruing for that? And if you are, is that -- where does that show up in the P&L? What's that amount?

Christopher Michael Berry - *Alaska Air Group, Inc. - VP - Finance, Controller, VP - Finance for Alaska Airlines Inc & Controller of Alaska Airlines Inc*

So the answer -- Mike, this is Chris, so the answer is, yes, it does. And I -- it's in other operating expenses on the P&L.

Benito Minicucci - *Alaska Air Group, Inc. - President of Alaska Airlines Inc and COO of Alaska Airlines Inc*

And we're paying -- accruing them and paying them.

Christopher Michael Berry - *Alaska Air Group, Inc. - VP - Finance, Controller, VP - Finance for Alaska Airlines Inc & Controller of Alaska Airlines Inc*

Yes.

Michael John Linenberg - *Deutsche Bank AG, Research Division - MD and Senior Company Research Analyst*

What's the magnitude of that? What is it -- I don't think it's a big number but...

Christopher Michael Berry - *Alaska Air Group, Inc. - VP - Finance, Controller, VP - Finance for Alaska Airlines Inc & Controller of Alaska Airlines Inc*

It's not a big number and I -- sorry, I don't know. We can get back to you on that.

Benito Minicucci - *Alaska Air Group, Inc. - President of Alaska Airlines Inc and COO of Alaska Airlines Inc*

(inaudible)

Christopher Michael Berry - *Alaska Air Group, Inc. - VP - Finance, Controller, VP - Finance for Alaska Airlines Inc & Controller of Alaska Airlines Inc*

Yes.

Michael John Linenberg - *Deutsche Bank AG, Research Division - MD and Senior Company Research Analyst*

Not a problem. And then just it looks like there are 5 more E175s coming from SkyWest in '18 and '19. Is that a new development? I wasn't aware of that.

Andrew R. Harrison - *Alaska Airlines, Inc. - Chief Revenue Officer, Chief Commercial Officer and EVP*

I don't know of a new development or not from what we've shared previously, but we think it's going to be at 25.

Bradley D. Tilden - *Alaska Air Group, Inc. - Chairman, CEO & President*

They are going from 20 to 25, Mike.

Michael John Linenberg - *Deutsche Bank AG, Research Division - MD and Senior Company Research Analyst*

Okay, okay. And then just, lastly, maybe this is for Andrew and Ben. Obviously, LAX and SFO feature prominently in kind of the new Alaska and there's been a lot going on at these airports. I mean, LA just had that big migration. I think you, for the most part, were able to sit still. You didn't have to move. How are the facilities now with respect to colocation? And I know there's been some complaints and gripes at LA in getting like INS facility or access. I mean, do you feel like you're 90% of the way there with your facilities -- with both those facilities, LAX and SFO? Or do we have a bit more work to do to get the operation where it needs to be?

Benito Minicucci - *Alaska Air Group, Inc. - President of Alaska Airlines Inc and COO of Alaska Airlines Inc*

Mike, it's Ben. No, just so what happened in LAX, Virgin America moved from Terminal 3 to Terminal 6 where Alaska is and I'd say, overall, the move went well. We did have some growing pains the first few months. We are tied on gates at LAX. When things get on schedule, we've got airplanes waiting for gates. We have some problematic gates, we've had to push airplanes out, so it's not -- we've got work to do with LAWA and we're working with them hopefully to smooth things out and make things better in LAX. But things are stabilizing what I'll say there. San Francisco is still a lot of work. As you know, we were on the international side. Virgin has just a gorgeous terminal in Terminal 2. We've moved a lot more of our flights to 2 and we're still operating in international. They are in -- like a lot of airports, they're in big construction in San Francisco. So before we get all in one terminal, Terminal 2, it's going to be a couple of years before that happens. So it's still going to be some hardstand operations, operating on international and T2. So it won't be smooth out in San Francisco for another couple of years.

Michael John Linenberg - *Deutsche Bank AG, Research Division - MD and Senior Company Research Analyst*

Ben, just based on your growth plans and what you've announced, do you -- when do think you hit a cap at LAX or SFO? I mean, do we run into like within the next 6 to 12 months you have to moderate your growth at those airports? Or do you have more runway than that?

Benito Minicucci - *Alaska Air Group, Inc. - President of Alaska Airlines Inc and COO of Alaska Airlines Inc*

What I tell Andrew is we work hand-in-hand with network. It's just a great relationship because what we do is we get really granular. We look at the time of day and if Andrew wants to put 10 pounds of stuff in a 5-pound bag, you go back and work with his team and say, "Look, you've got to slide this half an hour earlier, half an hour later." And what's happening now is we're filling up more of the entire day than we did in the past where we would operate out of the peak. So that what you're seeing us is filling out the entire day, which is happening in SFO, in LAX, in Seattle.

Operator

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

Helane Renee Becker - *Cowen and Company, LLC, Research Division - MD and Senior Research Analyst*

I just have 2, I think, 1 or 2 easy questions. The first question is as you think about your -- as we think about the growth that you're looking out over the next maybe 2 or 3 years, should we be thinking about more international growth into more Central America kind of locations? Or are you thinking more domestic U.S., more Midwest, East Coast cities?

Andrew R. Harrison - *Alaska Airlines, Inc. - Chief Revenue Officer, Chief Commercial Officer and EVP*

Helane, it's Andrew. I think really the only comment I would make on that, which we've been very public on from day 1 is we are focused on the West Coast of the United States where we've invested significantly with the purchase of Virgin America and our own traditional Alaskan networks. So that's where we're going to be focusing.

Helane Renee Becker - *Cowen and Company, LLC, Research Division - MD and Senior Research Analyst*

No, I understand. The route -- the flights are coming from there, but where are you thinking of these flights going to? That's what I'm trying to get at.

Andrew R. Harrison - *Alaska Airlines, Inc. - Chief Revenue Officer, Chief Commercial Officer and EVP*

Helane, we -- obviously, you could appreciate it is not in our best interest to share any of that information, but we have a 5-year plan that we're working towards.

Bradley D. Tilden - *Alaska Air Group, Inc. - Chairman, CEO & President*

Helane, I think what we can say is we're focused on providing utility for our customer base who lives in this important marketplace. That's what we're going to be looking at.

Helane Renee Becker - *Cowen and Company, LLC, Research Division - MD and Senior Research Analyst*

Okay. And then, I guess, the other thing to just follow up on one of Savi's questions about the Horizon pilot, I understand you're backfilling and you've adjusted the schedules. But is -- can you maybe quantify the cost impact or the cost impact in the second quarter of not operating some of those flight cancellations? I know you've tried to get ahead of the issues by adjusting the schedule, but I'm just trying to figure out the cost of that.

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

Helane, this is Lavanya. When we talk about costs, we look at sort of overall. So for overall system, the cost of our operations and using 2016 as a baseline is about $5 million in the second quarter.

Helane Renee Becker - *Cowen and Company, LLC, Research Division - MD and Senior Research Analyst*

Okay. And then given the changes you've made, we shouldn't extrapolate that out for the rest of the year, right?

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

That's fair.

Operator

Your next question comes from the line of Darryl Genovesi from UBS.

Darryl Genovesi - *UBS Investment Bank, Research Division - Director and Equity Research Analyst*

Brandon, I wanted to start off with perhaps a follow-up to Rajeev's question. I will avoid the words upper bound and lower bound. But you going to arbitration with a plan that would add $140 million to your cost base, presumably the pilots have their own plan. Have you seen it? And have you evaluated what that plan would add to your cost base?

Benito Minicucci - *Alaska Air Group, Inc. - President of Alaska Airlines Inc and COO of Alaska Airlines Inc*

Darryl, it's Ben. Yes, both proposals from have been sent to both parties, so we know what the ALPA proposal is. And so I think, Darryl, instead of talking about upper bound and lower bound, I think I just want to center us back to the proposal we put on the table. When you look at it from, again, a total cost, total comp puts our pilots on the upper end in the industry. So these proposals are going to go in front of 3 arbitrators. They're going to look at all the facts, us being the fifth largest airline compared to being 4 to 6x smaller than the other ones. They have to take all these facts together and decide what market is for Alaska and we'll let that decision -- we'll leave that decision to the arbitrators.

Darryl Genovesi - *UBS Investment Bank, Research Division - Director and Equity Research Analyst*

Okay. Andrew, thanks for the color on the competitive capacity. Couple of questions on that, the first is just a quick one. Would you just confirm what the competitive capacity number was by your measure for the second quarter?

Andrew R. Harrison - *Alaska Airlines, Inc. - Chief Revenue Officer, Chief Commercial Officer and EVP*

For -- as in this year?

Darryl Genovesi - *UBS Investment Bank, Research Division - Director and Equity Research Analyst*

That's right, the quarter just passed.

Andrew R. Harrison - *Alaska Airlines, Inc. - Chief Revenue Officer, Chief Commercial Officer and EVP*

We had -- it was only about 1 point.

Darryl Genovesi - *UBS Investment Bank, Research Division - Director and Equity Research Analyst*

Okay. So you go from 1 -- kind of 1 to 2 to 6. And then the 400-basis point step-up in the fourth quarter is kind of consistent with the numbers that we're looking at and it looks like at least half of that step up is related to accelerating growth out of Delta in Seattle. I guess, I was under the assumption that Delta had mostly maxed out its -- the Seattle airport capacity that was available to it, and I guess, Brad's prepared remarks would have also suggested that there's some congestion on the runway and in the pattern. So just wondering how much more of a runway do you think Delta has to continue growing in Seattle into 2018?

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Andrew R. Harrison - *Alaska Airlines, Inc. - Chief Revenue Officer, Chief Commercial Officer and EVP*

You'd have to ask Delta about that. I have no idea about their plans or whatever they're doing.

Operator

Your next question comes from the line of Andrew Didora from Bank of America.

Andrew George Didora - *BofA Merrill Lynch, Research Division - Director*

I guess, maybe, Andrew, can you just talk about what you are seeing from a broader pricing perspective early on here in 3Q? I know there are some fears out there domestic pricing has been weak, though we're seeing volumes continue to be holding up. Is it just too much capacity here in the summer months? Or are you seeing some more aggressive pricing actions from others in the market?

Shane Tackett - *Alaska Airlines, Inc. - VP of Revenue Management*

Andrew, this is Shane. I'd say it's actually very stable for us right now. We had a lot of activity this time last year, probably more so than the rest of the country is. We had sort of some of the low fares come into the West Coast that hadn't been here before. So we've lapped most out this summer. It's actually the pricing environment in terms of what's being filed is as stable as I've seen it since I've been in RM over the last 2.5 years. There's obviously some pockets of selling for activity that's pretty competitive, but that's normal and sort of healthy and not of any real concern. So right now it's a pretty stable environment for us. And the planes are full, so it's been pretty good.

Andrew George Didora - *BofA Merrill Lynch, Research Division - Director*

Great. And then just, lastly, for Brad, I know 1Q you obviously weren't pleased with the operation and completion factor, on-time arrivals obviously below where they have been in 2Q. Did any of this come about due to some integration teams? And did you take into any of these operational challenges -- did you take these operational challenges into account when you thought about lowering your capacity in the back half of the year?

Benito Minicucci - *Alaska Air Group, Inc. - President of Alaska Airlines Inc and COO of Alaska Airlines Inc*

Yes, I think it's a fair question. We have been -- as I said, we've been working hard on the integration and that probably does take your focus away from some other things. But no, I don't think the back half of the year changes everything that needs to do with some of the issues we've had operationally. I think our biggest thing operationally, we'll go back to it, but one, it does feel like over time, we've operate -- we changed from operating in airports that don't have a lot of congestions, don't have a lot of constraints to operating in airports that have a lot of ATC congestion and a lot of constraint. It's not only air space and long taxi times, but the airplane comes in and there's not a gate available. So this is just in -- and then we've got a lot more exposure to San Francisco and LA so -- and I said in my remarks that there's -- and we're going to get it, but we -- there's a new capability that we have to have as a company of how to operate in these constrained airports. So that's the biggest thing. On the Horizon side, I'll just say that there's a couple of things. One, we've got to be fantastic recruiters. We've got -- this is an incredible company. We've got to be great in going out and recruiting and bringing pilots in. But we also have to be great at knowing what the pilot capacity is going to be and I think we fell short there candidly. And that's something -- that's not a tough problem, but it's something that we have to get better at and I think we will get better at in short order. So that's my thoughts on the operation -- those are my thoughts on the operation.

Operator

Your next question comes from the line of Brandon Oglenski from Barclays.

Brandon Robert Oglenski - *Barclays PLC, Research Division - VP and Senior Equity Analyst*

Andrew, I wonder if you could go back to your prepared remarks. You talked about the amount of new markets in your capacity right now. In effect, I think you said 75% were profitable and 60% are earning above cost of capital. Given where you are on those routes, I mean, how is that progressing versus history? Is that above where you would expect them to be at this point?

Andrew R. Harrison - *Alaska Airlines, Inc. - Chief Revenue Officer, Chief Commercial Officer and EVP*

Yes, we've -- we used to talk about 2 to 3 years for maturity and that's not the reality anymore. The markets that we've been starting as we build the business reached maturity significantly faster.

Brandon Robert Oglenski - *Barclays PLC, Research Division - VP and Senior Equity Analyst*

And do you think that's just a function of where we are right now in the economy? Or is it something specific to what the team has learned over the years?

Andrew R. Harrison - *Alaska Airlines, Inc. - Chief Revenue Officer, Chief Commercial Officer and EVP*

I think I can only answer it from my vantage point, but I think that when you look at the depth and the breadth of our network today versus 5, 6, 7 years ago, when you look at a sustained GDP growth of 2% every year for the last 5 years and just the growth in demand, I just think that the environment is different than it has been historically. And we've got -- to be able to continue to keep our costs down with low fares, and that's created demand for our product.

Brandon Robert Oglenski - *Barclays PLC, Research Division - VP and Senior Equity Analyst*

Okay, appreciate the response. And Brandon, if I can ask one of you, appreciate the color on the pilot contractor potential impact from it. But how does that factor into your longer-term cost outlook? And I apologize if you highlighted that at the Investor Day, but I think you were calling for a flat or slightly up unit costs in the future. Does that change anything from here?

Brandon S. Pedersen - *Alaska Air Group, Inc. - CFO, EVP - Finance, CFO - Alaska Airlines Inc and EVP - Finance - Alaska Airlines Inc*

No, I don't -- hi, Brandon, it's Brandon. No, I don't think it changes our [pilot] unit costs. We did talk about the fact that new pilot contract would drive up our costs. And I, in my prepared remarks, said that it was going to drive up unit costs by 3%. But I don't think that changes our longer-term philosophy about what happens with unit costs, particularly when we're growing in the 6% to 8% range. I think that the mindset continues to be as we grow at that rate, we should be able to reduce costs modestly, maybe flat to down slightly. And over time, what that does is it creates a larger cost advantage versus airlines that are much larger than us that have costs going up.

Operator

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

Daniel J. McKenzie - *The Buckingham Research Group Incorporated - Research Analyst*

I actually had a similar question. If I could just follow up on that last question. I think, Brandon, you mentioned the cost structure needs an improvement. I'm just wondering if you could just clarify or tie that back to the Investor Day commentary around merger synergies. So first, obviously you've got labor cost pressures, I think you've got airport congestion. But are these cost pressures that are impacting the value of the merger synergies that you quantified for us? Or -- and I believe you've got some initiatives underway to address it. but I'm just wondering if you could just clarify that just a little bit further.

Brandon S. Pedersen - *Alaska Air Group, Inc. - CFO, EVP - Finance, CFO - Alaska Airlines Inc and EVP - Finance - Alaska Airlines Inc*

Sure. Dan, I don't think it's at all related to the cost synergy projections that we had given. I think we feel very good about those, and of course, we would hope to achieve those at the time -- in the time that we said and perhaps even exceed them. I think what you're just seeing is what I would call friction, a little bit of friction related to the operation, a little bit of friction to getting to know the Virgin business, a little bit of friction putting it all together, a little bit of friction with that because we don't understand our history, our budget reports. And all that does is just learning, it's part of transition and so my comments were really around just the dissatisfaction with how fast that process of learning is going. And we'll get better. It's a big part of the 2018 planning, but I don't think it's connected at all to lack of our ability to deliver on merger synergies.

Daniel J. McKenzie - *The Buckingham Research Group Incorporated - Research Analyst*

Okay. And then, I guess, my second question is for Andrew or Shane. And I'm just wondering how did Alaska respond to the basic economy rolled out in the second quarter? So I guess, where overlap existed, broad brush, what percent of the flying was Alaska able to capture some incremental revenue? Or I guess, maybe to ask that differently, what percent of the route are you matching the basic economy fare?

Shane Tackett - *Alaska Airlines, Inc. - VP of Revenue Management*

Yes, I'll take that. I think the question on the percent, I don't have it at my fingertips. It's been broadly rolled out by Delta, had been in many of our markets well before the United and American bringing it to market. United's pretty much system-wide as we see it. American's still sort of constrained to fewer markets. For the most part, the levels that were brought in were no different than had already existed. They just attached the more restrictive set of policies to the fares that already existed. So we really haven't seen again a lot of movement on the prices that have been filed in general in the markets. We saw it in the interesting sort of modest surge in demand in April, May, June, but I wouldn't necessarily correlate it to that. It was just coincidental with the timing. Obviously, we have, for the same price, a better product than the basic economy offering. So we're feeling really good about this. We don't see flights away from our -- our flights at all, in fact, we see a lot of demand. And as we said at Investor Day, our goal is to sort of keep it simple and easy for customers to understand low fares and sort of avoid the extreme ends. They have also segmentation or ultra-premium until they hit the sweet spot in the middle, which is a much bigger market.

Daniel J. McKenzie - *The Buckingham Research Group Incorporated - Research Analyst*

Okay. I guess if I could just -- I just wonder if I could clarify, but it seems to me because you're offering more than the basic economy, it seems like there should be, in effect, some de facto incremental revenue that you're be able to recognize. And is that a fair characterization that you're recognizing some incremental revenue where you weren't recognizing it previously?

Shane Tackett - *Alaska Airlines, Inc. - VP of Revenue Management*

Yes, we just haven't had a chance. It's so new to really put our finger on the number. We think that, that is happening, but we don't have it modeled or valued. And the one thing I'd also say, especially in a peak season, you can -- there's a risk of over indexing on the discount sort of end of the market. And we do want to be careful to make sure we've got room for middle-structured fares and high-yield fares as well. So I think until we get into more shoulder part of the year we won't really know if there's a lot of incrementality for us or not.

Operator

Your last question comes from Kevin Crissey from Citi.

Kevin William Crissey - *Citigroup Inc, Research Division - Director and Senior Analyst*

Brandon, quick one. Pilot pay increases, that's not merger-related special item, am I correct on that?

Brandon S. Pedersen - *Alaska Air Group, Inc. - CFO, EVP - Finance, CFO - Alaska Airlines Inc and EVP - Finance - Alaska Airlines Inc*

That is correct. To the extent that the pilot pay -- almost correct. To the extent that the pilot pay increase would have come earlier than the normal amendable day in May of 2018, we did include something for that. But generally speaking, no.

Kevin William Crissey - *Citigroup Inc, Research Division - Director and Senior Analyst*

Okay. And then maybe for Shane or Andrew on maybe a little bit more on the revenue trends. If you could talk about maybe corporate versus leisure trends. And maybe the puts and takes on RASM growth in Q3 versus Q2, whether there's holiday impact, that kind of thing?

Joseph A. Sprague - *Alaska Air Group, Inc. - SVP of Communications & External Relations - Alaska Airlines, Inc.*

Kevin, this is Joe Sprague. I'll just touch briefly on the corporate sales piece and simply to say that it's doing quite strong. Revenue in that area for the quarter was up about 12%. I would say in Seattle, in the Bay Area, we're especially strong. Probably no spreads there given the strength of the economy in those areas and we think this is outpacing the overall industry. And I would just say the one other thing that, I think, helps to set us apart in that area a little bit. Obviously, we don't have quite the same corporate sales reach some of our bigger competitors have, but we do have the hardest working sales team in the business and they really do have deep, strong relationships with these large corporate accounts.

Shane Tackett - *Alaska Airlines, Inc. - VP of Revenue Management*

You want me to answer that? On the RASM, yes, just in terms of the calendar, just recall that there was 1 point of impact to Q2 due to the Easter shift, mostly it was all in April, which we had mentioned I think on the Q1 call. Q3 is clean. We don't really have a calendar issue or a movement of holidays that's going to impact it much.

Operator

Your next question comes from the line of Hunter Keay from Wolfe Research.

Bradley D. Tilden - *Alaska Air Group, Inc. - Chairman, CEO & President*

Maybe we lost Hunter. We'd try to get one more question in, but it sounds like Hunter's not there. Okay, in that case, thank you, everybody, for joining in. We've enjoyed chatting with you -- Hunter's there?

Hunter Kent Keay - *Wolfe Research, LLC - MD and Senior Analyst of Airlines, Aerospace & Defense*

I'm sorry, I got a new headset. I don't know what's going on here. Can you hear me now?

Bradley D. Tilden - *Alaska Air Group, Inc. - Chairman, CEO & President*

Yes, we can hear you now.

Hunter Kent Keay - *Wolfe Research, LLC - MD and Senior Analyst of Airlines, Aerospace & Defense*

All right. Sorry about that. In terms of the arbitration, just real quick, can you just help us understand these detachable steps here. And you said it's going to be done by October, but just given you had a little bit of a unique transition agreement signed, pilots, just to be clear, this is binding arbitration. There's no appeal. Is there a vote? I don't think so, right? And then when will it be effective? Like Jan 1, 2018? Just help us understand sort of mechanical like sort of steps, that's all.

Benito Minicucci - *Alaska Air Group, Inc. - President of Alaska Airlines Inc and COO of Alaska Airlines Inc*

So this is will go out for both, Hunter. It's the arbitrator decision stands and it -- exact effective date, I'm going to say, is...

Bradley D. Tilden - *Alaska Air Group, Inc. - Chairman, CEO & President*

The arbitrator decides.

Benito Minicucci - *Alaska Air Group, Inc. - President of Alaska Airlines Inc and COO of Alaska Airlines Inc*

The arbitrator decides, yes. So hard to say right now when the exact date is.

Bradley D. Tilden - *Alaska Air Group, Inc. - Chairman, CEO & President*

All right. So in that case, thanks, Hunter, and thank you all for tuning in. We look forward to chatting with you next quarter.

Operator

Thank you for participating in today's conference call. This call will be available for future playback at www.alaskaair.com. You may now disconnect.