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# EDITED TRANSCRIPT

ALK - Q1 2013 Alaska Air Group, Inc. Earnings Conference Call

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**OVERVIEW:**

ALK reported 1Q13 GAAP profit of $37m, adjusted net profit (excluding impact of mark-to-market adjustments related to fuel hedge portfolio) of $44m and adjusted EPS of $0.62.





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**Hunter Keay** *Wolfe Trahan - Analyst*

**Helane Becker** *Cowen - Analyst*

**Savi Syth** *Raymond James - Analyst*

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**Glenn Engel** *Bank of America - Analyst*

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## PRESENTATION

**Operator**

Good morning, my name is Lorelle, and I'll be your conference operator today. At this time, I would like to welcome everyone to the Alaska Air Group first quarter 2013 earnings conference call. Today's call is being recorded and will be accessible for future playback at www.alaskaair.com. All lines have been placed on mute to prevent any background noise.

After the speaker's remarks, there will be a question-and-answer session for analysts and journalists. (Operator Instructions).

I would like now like to turn the call over to Alaska Air Group's Managing Director of Investor Relations, Chris Berry.

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**Chris Berry** - *Alaska Air Group - MD, IR*

Thanks, Lorelle. And good morning, everyone. And thank you for joining us today for Alaska Air Group's first quarter 2013 earnings call. Our CEO Brad Tilden and our CFO Brandon Pedersen will share on their thoughts on our first quarter financial results, our operations, and our outlook for the remainder of the year. Several members of our senior management team are also here to help answer your questions.

As is our normal practice, 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 findings, available on our website.

We will refer often to certain non-GAAP financial measures, such as adjusted earnings or unit costs excluding fuel. We have provided between a reconciliation between the most directly comparable GAAP and non-GAAP measures in our earnings release.

This morning, Alaska Air Group reported a first quarter GAAP profit of $37 million. Excluding the impact of mark to market adjustments related to fuel hedge portfolio, we reported a record adjusted first quarter net profit of $44 million, or $0.62 per share. This compares to first call mean estimate of $0.56 per share, and to last year's adjusted net income of $28 million, or $0.39 per diluted share. Additional information about our unit cost expectations, capacity plans, future fuel hedge positions, our 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.

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**Brad Tilden** - *Alaska Air Group - CEO*

Thanks, Chris, and good morning everyone. We're pleased to report our fourth consecutive first quarter profit, and we are also pleased that this was a record first quarter. In many of the 22 years that I've been here, we have posted sizeable losses in the first quarter that have required us to dig out of the hole in the second and third quarters. This quarter's results demonstrate the positive impact of the changes we have made at Alaska and Horizon over the past decade, and the nimbleness we've gained in tailoring our capacity to meet demand. It's notable that we earned a profit in each month of the quarter, and this is the first time that I have seen us post a profit in the month of January.

In a moment, I'll talk about a couple of the uncertainties that we're facing in the next few months, but I want to first highlight the strength of our results and the strength of our underlying business.

We have been a solidly profitable company for several years now, and we expect the same thing this year. Though we're facing some headwinds with unit revenues, we are hitting our aggressive cost-management objectives, and the decline in oil prices will help significantly. So overall, these excellent first quarter results put in a good position for the rest of the year.

For the quarter, our pre-tax margin was 6.3%. This represents a 1.9 point improvement from the first quarter last year and translates to a rolling 12 month ROIC of 13.4%, which compares to 11.6% from the end of last year's first quarter. Revenues grew 9% on an 8.7% increase in capacity. The capacity growth was driven by new mid-con and trans-con routes out of the Pacific Northwest and San Diego, and by the annualization of California to Hawaii flying added last year.

For the quarter, PRASM grew 0.3% on a slightly higher load factor and flight yields. Looking at the two operating businesses, mainline PRASM grew 0.4%, and regional PRASM grew 3.5%, the latter being largely a result of a 2.6 jump in load factor. Overall, we're generally pleased with our first quarter revenues.

The mainline PRASM increase of 0.4% compares to an industry PRASM increase of 3%. However, Alaska's result was based on a 9.5% increase in capacity, while the industry was based on 0.5% decline. Additionally, Alaska average stage length grew by 3.2%. On a sequential basis, PRASM was up 2% in January, and up 1.6% in February and down 2.1% in March.

We were disappointed by the March result, and it was impacted by three items. First, we had too much capacity in our California to Hawaii markets. We have made schedule reductions that will be effective in the next few days and additional reductions that will be effective in the fall. Second, new trans-con and mid-con routes are still in the developmental phase and are not yet producing system average revenues. And finally, we're seeing more competitive capacity in certain markets and some pricing actions by competitors that are negatively affecting close-in fares.

As we look forward today, we are seeing advance book load factors down about a point in April and flat in both May and June. From a unit revenue standpoint, April is the most difficult comp of the year, as PRASM in April 2012 was up about 7% from PRASM in 2011. The factors that I just mentioned pertaining to March, as well as potential demand impact from government sequestration, ATC-caused flight delays, and the shift in the timing of Easter are all pressuring April unit revenues, and will result in negative comps for the month, likely at levels exceeding the March decline.

We're taking steps now to improve yields and we're evaluating whether more changes to fall capacity is needed. We have a history of reacting appropriately to changes in demand and adjusting capacity. Our size allows us to be flexible and adapt quickly.

We have a very good cost story this quarter. Brandon will get into the details, but overall CASM ex fuel was down over 2%. The mainline had notable performance, with CASM ex fuel down 4%. I want to specifically thank all of our folks on our operating divisions at Alaska, who are led by Chief Operating Officer Ben Minicucci and have done a great job managing their aggressive cost and productivity goals. In fact, across air group, productivity, as measured by passengers per employee, improved by 4.3% from last year.

On Tuesday, we announced a major initiative to upgrade the cabins of the majority of our airplanes. We'll be retrofitting our 737-800 and 737-900 aircraft with the new slimmer Recaro seats that are already being used on our 900ERs and which are receiving great customer feedback. And we are also adding 110-volt and USB power at every seat, and will be investing in an improved in-flight entertainment system. The seats, power, in-flight entertainment and other cabin enhancement will help Alaska differentiate itself even further from our competitors.

With the new space saving design of the seat, we'll be able to add six seats on our 800s and nine seats on our 900s without sacrificing passenger comfort. This will drive additional revenue, especially in our high-demand, high-density markets, and it will lower unit costs. When we're through with the upgrade in late 2014, we'll have increased the number of seats in our fleet by 2.4%. We know that to grow successfully and compete with the LCCs, we need to keep bringing costs down. This investment will help us do that.

During the quarter, for the third consecutive year, we won the flightstats.com award for the best on-time performance in the United States, and this highlights the incredible performance of the Alaska and Horizon operations teams. One of the biggest drivers in customer preference is a safe and reliable operation. And our people are providing this consistently.

And speaking of customer preference, you may have seen our announcement last week, that Curtis Kopf has been promoted to the new position of Vice President of Customer Innovation. Many of you have heard us discuss our strategic plan, which we summarized as our five focus areas. One of these includes the goal to be the easiest airline to fly by 2017. The Customer Innovation Team, which will consolidate and streamline many of the activities and functions that are underway today, will help make this a reality. I am really looking forward to some of the new ideas that will be coming from this group and to see Alaska extend our leadership position with respect to customer facing technology.

Before I turn the call over to Brandon, I want to share my view that despite near-term pressure on revenues, 2013 should be a very good year for Air Group. We're confident in the strength of our brand and our network, a position that will only get stronger with the cabin upgrade project. And we're looking forward to another very good year in 2013.

I want to thank our employees for the incredible work this quarter to help us achieve these record results, and I also want to ask them for their continued focus and flexibility incident as we work together to deal with the increased competition in our markets.

With that, I'll now turn the call over to Brandon.

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**Brandon Pedersen** - *Alaska Air Group - CFO*

Thanks, Brad, and good morning, everyone. I'm fighting a cold and I apologize if I astound a little nasally today.

Air Group reported an adjusted net profit of $44 million, compared to $28 million last year. On a per share basis, adjusted earnings improved by 59%, on a 57% increase in net income and 2% reduction in diluted shares, and as Brad mentioned, this result brings our trailing 12-month after-tax return on invested capital to 13.4%, a 1.9 point improvement over the 12 months ended Q1 of last year, and well above our weighted average cost to capital.

On an adjusted pretax basis, we reported a $71 million profit, which is $25 million, or 54%, better than last year. The $94 million improvement in revenues more than offset a $40 million increase in non-fuel operating costs and a $30 million increase economic fuel costs.

Brad spent a fair amount of time talking about the revenue environment so I'll jump right into costs. Non-fuel operating costs increased 6% on the 8.7% increase in capacity. As a result, CASM ex fuel declined by 2.3% to $0.0862, quite a bit lower than our the initial guidance at the start of the quarter.

We were very pleased with the cost performance, and our leaders are doing a very good job managing the budgets. We did, however, also benefit from the deferral of certain projects, both IT and non-IT, to later this year. We saw a significant increase in maintenance expense, with roughly half of the increase attributable to a high number of engine events of Horizon, which we expect to subside in the second half of the year.

Looking to the second quarter, we are expecting unit costs ex fuel to be about flat on a 7.5% increase in ASMs. Maintenance, contracted services, and other expenses are expected to increase more than capacity, accounting for much of the flat cost performance.

In our investor update this morning, we lowered our full year guidance from CASM ex fuel down 1% to now down 1.5%, given the solid cost performance in the first quarter. However, as we have stated previously, our unit cost guidance doesn't provide for new contacts with several work groups.

There's growing uncertainty about our airport costs Seattle, given where we are with lease negotiations that could negatively impact our second quarter and full year costs. Our goal, however, is to get to a place where air group's costs are lower in the long run, but we may have short-term increases in our airport costs to get there.

Economic fuel costs were up $30 million, or 9%, on a 7% increase in consumption, and a 2% increase in economic price per gallon. We have seen a steady decline in jet prices recently, which is reflected in our $3.27 guidance for the quarter, compared to $3.40 per gallon in last year's and $3.48 in the first quarter of this year. The lower fuel prices should help offset some of the pressure Brad discussed.

The cost of hedges that settled in the first quarter, $12 million, or $0.11 a gallon. But it's notable that we only spent $4 million on new positions this past quarter, the lowest level in recent history. This reflects our shift last year to purchasing call options that are up to 20% out of the money.

Moving to our balance sheet, we ended the quarter with nearly $1.27 billion in cash and short-term investments, about equal to the year end total. We generated $212 million of operating cash flow in the first quarter, compared to $183 million last year. Capital spending was approximately $100 million as we took delivery of three 737-900 ERs, and made advance payments of future deliveries, resulting in over $100 million of free cash flow.

We repurchased 373,000 shares of our stock for $19 million, bringing our total purchases under our current $250 million authorization to $28 million at quarter end. And when you include repurchase activity since the end of the quarter, we're now at $37 million under this facility.

We also paid off approximately $88 million in debt, bringing our debt to cap ratio, adjusted for leases, down to 53%, which puts on pace to hit or fall below 50% by the end of third quarter. This is 28 points lower than where we were at the end of 2008 and reflects the very strong financial performance we have seen in the last four plus years.

It's worth reminding folks that since that time, we have generated $2.5 billion of operating cash flow, made significant investments in our business, while expanding ROIC, produced $870 million of free cash flow, lowered on- and off-balance sheet by $1.2 billion, and repurchased $227 million of our common stock.

We currently expect full year capex to be approximately $450 million based on our firm order book. That may increase somewhat, depending on what we do with our options later this year. We'll take one 900ER in the second quarter and then three more in the fourth quarter, bringing our total 900ER fleet to 13 by year end. As a reminder, the 900ER has unit costs that are 8% to 10% better than our 800s.

Today's capex guidance includes the enhancements we are making to the cabin with the Recaro seats and installation of power, which is expected to cost approximately $100 million. We expect $20 million of that to fall into 2013, and the balance into 2014. Because of the design of the Recaro seat, we'll be able to add about 475 seats to our 800 and 900 fleets, or the equivalent of about three 800s. This is a cost effective way to grow seat capacity, lower unit costs by more than 2%, and generate additional revenue. It will also give us the ability to slow capital investment to something less than what our option book would otherwise allow. We expect the cabin investment to have a two to 2.5 year pay back.

We again expect to generate free cash flow for our fourth consecutive year, and also expect to return a significant percentage of that to our shareholders as we continue to execute on our current buyback program.

Overall, we're very with the quarter, but mindful of the challenges ahead. We are committed to delivering returns, well in excess of cost to capital and being good stewards of our owners' money.

At this time, I'll turn over to Brad to kick off the Q&A.

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**Brad Tilden** - *Alaska Air Group - CEO*

Thanks very much, Brandon. And operator, we're now ready for questions from the analysts.

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## QUESTIONS AND ANSWERS

**Operator**

(Operator Instructions). Your first question is from John Godyn with Morgan Stanley. Your line is open.

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**John Godyn** - *MAATSKAAPY - Analyst*

Hi, everybody. Thank you for taking my question. I wanted to ask a question on capex longer-term, and the thought process there. I couldn't help but notice, in all of the prepared remarks, the focus on sort of product enhancements and things of that nature. And of course you've gone through a refleeting program, and you've always been a product-focused company.

And where I'm going with this, as you all know, sometimes investors like to parallel airlines to rails, and I've admittedly been a bit skeptical of that parallel, but I'm open minded. And if there's any airline that I feel like is closest to having those economics or that trend is you guys. And one of the things that we have seen in rail land over time is that as rails drove prices higher, actually their capex, as a percent of sales, continued to stay stable or go up, because as they drive price higher, they need to kind of increasingly make customer-focused enhancements to their product or service, to justify, in part, those higher prices.

When I take a step back, I sort of feel like I'm seeing a similar pattern with you guys, and it's working. It's sort of this virtuous cycle that's helpful to you. But I'm curious. Do you think of it that way? If we envision a world where consolidation leads to higher fares over the next few years, do we need to even step up our game further in terms of product and service as the fares go higher and the capex associated with that? How do you think about that?

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**Brad Tilden** - *Alaska Air Group - CEO*

John, great question. Here's a couple of thoughts about it. This upgrade that we're doing now is a $100 million upgrade. And granted, that's on a fleet that's got a value of $4 billion or something like that. And this is the first time I can remember us making a cabin upgrade in 10, 15, maybe 20 years. So I don't think this is the first of many things to come. This is something that's due, and it's time for it, and it's going to really benefit our customers. The in-seat power in particular is going to be great.

And it's really important to keep in mind that this is going to enable us to increase seat density and get us closer to some of the low-cost competition. So in the 800s, we're at 157 seats today, we go to 163, and that's maybe a more of a couple of the airlines, but Southwest has 175 seats on an 800. And that's how the thinking is. I don't think we're thinking of this as the first of many investments, but it's something that we need to do right now.

To your broader question, an objective we have had for many, many years was to begin to produce significant free cash flow. And we are doing that. I think Brandon shared some numbers earlier. We're excited about doing that. I don't know if we're getting to your question exactly, but I think our mindset is that if we're able to produce revenues and produce profits, to let some of that come through as free cash flow and not reinvesting it all. Is that getting to your question, or are you asking something different?

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**John Godyn** - *MAATSKAAPY - Analyst*

What I'm getting at a little bit more, as fares, as the fare environment goes up, and if that's the case, if that's the future that we should be predicting, to what extent does that force the airlines to make commensurate improvement in their products? Or do you think that product and service, or improvements in product and service and price are just disconnected enough that fares can go up multiple years without that?

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**Brad Tilden** - *Alaska Air Group - CEO*

John, I may need to think about it more, but my initial gut is the latter. I don't really see a connection. I think that as the industry does a better job with capacity, hopefully we have more pricing power. These changes to our product are good, but I don't, I'm not sitting here seeing repeated improvements or upgrades to the product.

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**John Godyn** - *MAATSKAAPY - Analyst*

Okay. So it sounds like it's more of a cost-centric decision, and maybe that can lead me to the second question, which is, when I think about your cost profile over the last few years, you guys have done an incredible job of outperforming inflation. And it sounds like, from your go-forward cost commentary that you would like to continue to do that for the next few years. I know up-gauging has played a big role here, but outside of up-gauging, how should we think about your normalized CASM ex fuel? And what levers do you have outside of up-gauging to keep that below inflation?

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**Brandon Pedersen** - *Alaska Air Group - CFO*

Good morning, John, it's Brandon. Maybe I'll take that one. You're right, up-gauging has been important to us. But I think the story beyond that bigger picture, we know that getting our costs lower is an important part of our success going forward. We're really proud of the work that we have done in the last decade or so. We have been able to reduce costs ten out of the last 11 years, and if we do it this year, it will be 11 out of 12.

Productivity enhancements continue to be an important part of the strategy going forward. We've shared with you over the last couple of calls some of the things that we're doing with self-service kiosks for example, we have web bag tags that are coming. There are lots of things going on that are both preferred by our customers -- not necessarily preferred, but that our customers like and help productivity. So the idea is to leverage growth in airplane size, leverage growth in stage length. But also couple that with really tight control over overhead and continue to focus on productivity and continue to manage costs down.

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**John Godyn** - *MAATSKAAPY - Analyst*

That's really helpful, thanks, guys.

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**Brad Tilden** - *Alaska Air Group - CEO*

Ciao John.

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**Operator**

Your next question comes from the line of Hunter Keay with Wolfe Trahan. Your line is open.

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**Hunter Keay** - *Wolfe Trahan - Analyst*

Thanks, everyone.

I'm going to be candid here, Brandon, the cost per gallon that you're paying for fuel on a percentage basis, above your unhedged competitors, going forward into the second quarter, is actually increasing. It's getting worse. It's actually twice as much as it has been in the last three years, based on what we have seen from the guidance so far. If you're hedging to reduce volatility, it's not working, fuel cost is just as volatile as it's ever been. And if you're hedging against temporary exogenous shocks, I don't see the point of why you need to hedge into 2016. So as you talk about the competitive capacity challenges that you're facing, it seems you're trying to run a race now with a weight around your neck, and it's becoming such a drag on your ability to drive margins, and I feel you're handicapping your RM guidance to drive the yields high enough to get to the point where they're expanding margins on a year over year basis.

So what does it take to reevaluate the strategy? You're in a net cash position on a balance sheet, you have billions of dollars of encumbered assets, and what does it take to really liquidate the hedge book at this point?

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**Brandon Pedersen** - *Alaska Air Group - CFO*

Hunter, I appreciate your candid comments.

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**Hunter Keay** - *Wolfe Trahan - Analyst*

I'm sure you do.

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**Brandon Pedersen** - *Alaska Air Group - CFO*

You know what? I think I'll let Mark Eliasen, our treasurer, handle that one.

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**Mark Eliasen** - *Alaska Air Group - VP, Finance*

Good morning, Hunter.

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**Hunter Keay** - *Wolfe Trahan - Analyst*

Hey, Mark.

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**Mark Eliasen** - *Alaska Air Group - VP, Finance*

I guess you know the fundamental problem we have as an airline, the customers buy tickets in advance and we buy fuel today. So while I respect your position, we look at hedging as insurance, and it has worked for us. If you look at the current quarter, you're right, we haven't used our hedging program, but if you look at the last 11 years, it has paid off nine of those 11 years, and it saved our shareholders and investors $367 million. So looking at one quarter at a time, while we do calculate that, and we are just as focused on fuel as anyone, we do take more of a long-term view of our program.

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**Hunter Keay** - *Wolfe Trahan - Analyst*

But comparing this industry to five years ago is pointless to some extent. And I understand that your customers buy tickets in advance, but no one is buying air tickets for 2016 right now. So at the very least, Brandon said it himself, your balance sheet has come in 40 percentage point on a debt to cash basis or net cash, and there's no reason to have the same risk profile from a cost management perspective now that you did eight years ago. I'm not telling you to stop hedging, let's stop there for a second. Why don't you only hedge for four months out, six months out, and even nine months out because that's when the customers are buying your tickets? Because if that's really what it's about, hedging to 2016 conceptually doesn't jive with that.

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**Brandon Pedersen** - *Alaska Air Group - CFO*

I think there's merit to what you're saying in terms of the industry changes, and the dynamics, the fundamentals being different. That's something that we're certainly lying to think about. But, as you know, we like to be a little bit thoughtful and deliberate on how we evaluate these kinds of changes. But I think your point has merit.

You know, the one thing I will say, if you look at the breakdown of our fuel costs, you probably noted in our investor update, the cost of hedging is $0.18 in guidance. Well, $0.12 of that is hedges coming through, which is of some cost because we bought those a couple of years ago, and $0.06 of it is because we swap into the crack spread. And to the extend we have $0.06 because we have swapped into the crack spread, what we have done is we have smoothed onto the downside, but to the extent that cracks go back up, we'll also be leading the industry, or, excuse me, we'll have a better position in the industry as we go back up. So $0.06 of it is the swap piece. But it is notable that we have only spent $4 million in the quarter on go-forward positions, which is much, much less than we have spent before and that's because we have changed our policy in the last six months ago.

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**Hunter Keay** - *Wolfe Trahan - Analyst*

I appreciate that, you guys are doing a good job. There is no doubt about it. Your stock is so cheap, you have phenomenal cash flows, you have great balance sheets, and there's so much low hanging fruit lying around that it feels like to me if you really wanted to, you could really compete with the big boys, I'm saying S&P 500, I'm sure, with the multiple that you get. I'm trying to figure out what's holding you guys back. That's all

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**Brandon Pedersen** - *Alaska Air Group - CFO*

We appreciate your candor.

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**Brad Tilden** - *Alaska Air Group - CEO*

Hunter, this is Brad. I think just to maybe make a long answer a little bit longer. I think you and some of the other analysts have been helpful, pushing us forward in this fuel-hedging, and that's why we have gone to 20% out of (inaudible) called. But I think the point you're making now really is about consolidation and better control over capacity, the industry's ability to pass on cost increases in the form of higher fares. That's worth us thinking about and do we need to be hedging as far out as we do? We're not the type to announce the change on a conference call, but it's a good challenge for this leadership team and it's something that we should think about.

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**Hunter Keay** - *Wolfe Trahan - Analyst*

Thanks a lot, guys. Thanks for all your time. Thanks for everything.

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**Brad Tilden** - *Alaska Air Group - CEO*

Sure.

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**Operator**

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

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**Helane Becker** - *Cowen - Analyst*

Thank you very much, operator. Hi, guys, thanks for the time. Just a couple of questions. Given the comments that I think you made, Brad, about March, and having maybe more than competitive capacity in some of your markets, or too much capacity in California-Hawaii, would you consider at all slowing your capacity growth? I think you've talked about 6% to 8% annually going forward, but would you consider bringing that down further?

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

Helane, this is Andrew. Right now, we're taking a hard look, given the industry conditions about the fall. There is real strength, as there always is, in the summer, and we believe have very decent Hawaii capacity cuts in the summer to take care of challenges there. In the near term, our crew files are down, we're selling them the planes, they're filling up. There doesn't appear to be any demand weakness in the next few months for sure. We have more of a yield challenge, so absolutely, we'll be looking at our capacity, but at this point, it's at the fall, and it's where we're focused on right now.

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**Brad Tilden** - *Alaska Air Group - CEO*

And Helane, the 48% was always profit-permitting. Absolutely, if we can't growing profitably, we shouldn't be growing, and that's another answer to your question.

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**Helane Becker** - *Cowen - Analyst*

Okay. All right. That's fine, and that was really my biggest question, and the rest is fine, thank you very much.

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**Brad Tilden** - *Alaska Air Group - CEO*

Thanks Helane.

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**Operator**

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

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**Savi Syth** - *Raymond James - Analyst*

Good morning, everyone. Just on the competitive issues that you're seeing, I was wondering if you could provide a little bit more detail, or at least some color on how much of your capacity is exposed to this action.

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**Brad Tilden** - *Alaska Air Group - CEO*

I'm sorry, Savi, which action are you referring to?

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**Savi Syth** - *Raymond James - Analyst*

Just the unusual fare discounting and the pressure that you mentioned that was causing you revenue pressure.

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

Just in March alone, one-third of our network was subject to 3% to 4% reduction in selling structured fares in the mid to lower buckets. And really, there's two drivers for that. Firstly, its' Hawaii. The industry right now, especially out of California, has fares $50-$60 lower, year-over-year, and at this point, they continue. So that's the first challenge. And you know, Hawaii is probably 20% of our network

And then the other area is California. And what we're seeing there is a number of low-cost carriers, having fares that are anywhere from $10-$20 lower, year-over-year, in bookings that occur seven to 13 days in advance of departure, which is a key booking period. So we're not seeing issues with demand, but the industry has some low fares in the marketplace that's putting pressure on our heels.

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**Savi Syth** - *Raymond James - Analyst*

Understood. You're seeing that letting up as you look forward? Or is that continuing?

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

You know, what we're doing right now is we're actively managing it from a revenue management perspective, calling on our strands. We're using the strength of our regional network, our feeds, our (inaudible). We're doing a lot of things to make sure that we come out in a solid place. But there are some pricing pressures.

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**Savi Syth** - *Raymond James - Analyst*

Okay, and just one last question. We're seeing the $100 million investment, and is it possible to disaggregate how much of that is for adding seats and just for the other upgrades you're doing in the cabin?

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**Brandon Pedersen** - *Alaska Air Group - CFO*

Hi, Savi. It's Brandon. We're not going to break out specifically, but it's safe to say that the majority of that is related to the seats.

**Savi Syth** - *Raymond James - Analyst*

Okay, great. Thanks guys.

**Brad Tilden** - *Alaska Air Group - CEO*

Thanks, savvy.

**Operator**

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

**David Fintzen** - *Barclays Capital - Analyst*

Hey, good morning, everyone.

**Brad Tilden** - *Alaska Air Group - CEO*

Hey, Dave.

**David Fintzen** - *Barclays Capital - Analyst*

Just quick, on the $100 million capex of the seats with the $20 million this year, I think that's what you said, Brandon, is that fairly proportional in terms of what might be going in in terms of ASM and how that might be flowing through CASM guidance? Or is that you catching the last couple days of the year with the seats where it doesn't affect your guidance in terms of ASMs or cost?

**Brandon Pedersen** - *Alaska Air Group - CFO*

It's more of the latter -- $20 million this year, as I said, $80 million, next. But in terms of new ASMs that have come in, or the impact on cost, I think very little of it actually gets into 2013. It's probably more rounding than anything else. We really start to see the benefit in 2014, and so you see some in 2014 and then just as you lap into 2015, you will see some benefit there too.

**David Fintzen** - *Barclays Capital - Analyst*

As we start to think about 2014 and the phasing of that, is that something that you're going to try to do in off-peaks?

**Brandon Pedersen** - *Alaska Air Group - CFO*

No, not necessarily. When we get this thing going later this year, we're going to work hard, just at a constant speed and get that fleet through as quickly as we absolutely can. This is an important investment, both from a customer standpoint and from a cost standpoint.

**David Fintzen** - *Barclays Capital - Analyst*

Okay, so sort of straight-lining it through next year with the bulk to appear next year when it comes. Okay. That's very helpful.

And then just coming back to the new markets that are developing. Particularly the non-Hawaii new markets. You just mentioned obviously, how's that going versus your expectations, is that tracking the sort of normal one to two year industry experience? Just a little color on how those markets are developing relative.

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

Most of those, David, the trans-con markets, and where we are today, many of those started in the past six months, some of them in the down periods. But on the whole, as I was looking at March results, just the last couple of days, I have an air of confidence about how they're starting to build and go into the summer. So they are maturing. That I can tell you. They're at lower yields than the rest of our network, but that's it. They're maturing and getting stronger and stronger each month, so we feel pretty good about them.

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**David Fintzen** - *Barclays Capital - Analyst*

And when you mention the lower pricing you're seeing on the low-cost carriers, is that in response to some of those new markets, or is that something that you're seeing in your broader, southern California network?

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

Most of those markets are trans-con, in which both the pricing structure and the capacity is fairly stable year-over-year. Where we are seeing the elevated pressure is on the California, west coast markets.

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**David Fintzen** - *Barclays Capital - Analyst*

Okay, so more of the same-store kind of markets.

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

Yeah.

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**David Fintzen** - *Barclays Capital - Analyst*

Okay, great, thank you very much. I appreciate the color.

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**Brad Tilden** - *Alaska Air Group - CEO*

Thanks, David.

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**Operator**

Your next question comes from Michael Linenberg with Deutsche bank. Your line is open.

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**Michael Linenberg** - *Deutsche Bank - Analyst*

Great. Just a couple questions. I guess, Andrew, to you, how does the competitive capacity look over the next few quarters? I know on the one hand, you've had, it looks like, maybe there are some seasonal reductions by Allegiant. Maybe they're not necessarily head-to-head markets with you, and they probably have some additional capacity for the West Coast/Hawaii that goes away. So maybe that's a plus, but just watching Delta put some moves in, I think, some markets, and I think that the markets are being characterized as seasonal or utilization flying, but nevertheless, seats going into your market. There's some stuff where you have JetBlue coming up the coast to Alaska, Virgin America, etc. You know, plus and minuses, what do you see, some reasons are different in the second and third quarter?

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

Sure, I think, net, it's somewhat of a high-level wash. But there are really two capacity stories. The first one is Hawaii. Going into the third quarter, obviously, which is important, the industry off the West Coast west coast where we fly is going to be down one point, and we're going to be down 6%, the same with the fourth quarter. On the Hawaii front, the actual seats or the ASMs going there is going to be down. On the other hand, the state of Alaska is our big challenge. In the second quarter, other airlines have increased their capacity by 22%. That grows to 35% in the third quarter. So we're seeing a lot of carriers bring their mettle into the state of Alaska this summer, which is going to be our challenge. Some of the others up and down the West Coast, which we deal with every day, but the main story is really the state of Alaska as we head into the peak.

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**Michael Linenberg** - *Deutsche Bank - Analyst*

Okay, great. And then just my second question. Brad, you threw the number out when you started talking about, you're characterizing the revenue, what the situation was, and what the outlook was, and you mentioned that March PRASM. I think you said it was down in Q1 -- was that consolidated or mainline? I know you said that April would be worse, and I didn't get the sense that you provided any sort of look on May and June, other than things tend to pick up as we moved into the summer. Additional color on that?

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**Brad Tilden** - *Alaska Air Group - CEO*

I don't know, Mike, that we provided a lot of color that we haven't said already. We did say that it was consolidated RASM for March was down. All we said was first quarter revenues were fine. March was not, March was down a little over 2%. April, we said we do expect it to be worse. May, June, we're not as booked out. I think kind of our thinking is we are in for a tougher second quarter. But summertime, most of the years I've had here, there is almost always been more demand than supply, so it should be okay, and fall, we're starting to think about the fall capacity. So we didn't give guidance for May or June, but maybe you're getting a sense of how we're thinking about it.

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**Michael Linenberg** - *Deutsche Bank - Analyst*

Okay, good, that's helpful, thank you.

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**Operator**

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

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**Duane Pfennigwerth** - *Evercore Partners - Analyst*

Thanks, good morning.

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**Brad Tilden** - *Alaska Air Group - CEO*

Good morning.

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**Duane Pfennigwerth** - *Evercore Partners - Analyst*

So you've been buying back stock for a while, which is positive. As you see moderation and yields, and perhaps less capacity required in the near term -- wondering if it causes you to evaluate your long-term capital plans? How do you think about taking the next aircraft from Boeing versus beginning to pay a dividend? It feels like with your debt reduction, which you have already got in the bag, and very positive free cash flow dividend, it would be really a layup for you.

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**Brandon Pedersen** - *Alaska Air Group - CFO*

Hi, Duane, it's Brandon. I'm not sure I get the question. It almost felt like there were two or three questions in there. Is it a question of would we do a dividend? Is it a question about would we slow the capex in the face of softening demand?

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**Duane Pfennigwerth** - *Evercore Partners - Analyst*

Just use of capital.

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**Brandon Pedersen** - *Alaska Air Group - CFO*

Just use the capital generally. I guess maybe the bigger picture is that, we're trying to be good stewards of shareholders' money and trying to do the right thing for capital allocation standpoint. I guess we'll divorce a little bit from the weakness that we are seeing in the second quarter and stay at the full year level.

And as Brad said, we're going to have a really good year. And as we think about the current repurchase authorization, we have got a lot left on it, but we're still looking at our commitment to exhaust that by the end of 2014, which would suggest $120 million repurchase activity this year. Of course, as we get to the point where we have the option to exercise -- excuse me, as we have the decisions around exercising new options, we'll consider all of the facts that are available at the time. Certainly, the seat project works into the equation.

And then the question about a dividend is, we'll see. We know that returning capital to shareholders is important. We know there are several tools at our disposal. To date, we prefer the repurchase path, but it doesn't say that we wouldn't do something different in the future after consideration of the environment we're in, the cash flow forecast that we have and what the board wants to do.

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**Duane Pfennigwerth** - *Evercore Partners - Analyst*

Appreciate that answer. You know, there's a larger competitor that has been alluding to capital return, and we'll see what they announce next month and if it's material, and how soon it is. But I think you've quietly led the industry from this perspective. Perhaps over time, the industry moves closer to it, but I think you have the opportunity to maintain your leadership in that regard.

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**Brandon Pedersen** - *Alaska Air Group - CFO*

Well, we appreciate that, and we're certainly mindful of what others are talking about, although we wouldn't view this as a race. We have to do what is best for our company. And I think we've demonstrated going back to 2007, we do think this is important.

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**Duane Pfennigwerth** - *Evercore Partners - Analyst*

Thank you very much.

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**Brad Tilden** - *Alaska Air Group - CEO*

Thanks, Duane.

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**Operator**

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

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**Glenn Engel** - *Bank of America - Analyst*

Good morning.

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**Brandon Pedersen** - *Alaska Air Group - CFO*

Hey, Glenn.

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**Glenn Engel** - *Bank of America - Analyst*

A couple of questions, and I think you might have answered it, but the cost of set-off hedges was $0.11 in the first quarter and your update was $0.18 in the second quarter. Was that the $0.06 you mentioned about the refining or is that something else?

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**Brandon Pedersen** - *Alaska Air Group - CFO*

No, that's basically it. It was $0.11 in the first quarter, but the guidance that we provided today had a cost of settled hedges of $0.18. Roughly $0.12 was the cost of the crude options that settle, and another $0.06 of that is just the swaps coming through, and that's the differential.

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**Glenn Engel** - *Bank of America - Analyst*

Does that come back down to $0.11 or $0.12, back again in the second half probably?

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**Brandon Pedersen** - *Alaska Air Group - CFO*

I think so. The swaps that we do are really really close in, and so as those swaps burn off, we should get back to what would be "normal" -- and then longer term, as we minimize cash outflow related to new options, you'll see that come down even further.

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**Glenn Engel** - *Bank of America - Analyst*

The interest expense was actually slightly higher in the second half, not much, but you've been paying down debts, and why is that?

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**Brandon Pedersen** - *Alaska Air Group - CFO*

This is Brandon, maybe I'll jump in on that. Part of it is the accounting around terminal 6 in LA. From an accounting perspective, that is debt on our books even though it's a typical lease arraignment, but since we funded the construction of the terminal, from a funding perspective, it's a big asset on our books, and what looks like debt. So we're required under the accounting rules to call some of the rent payments as interest expense almost as if we were amortizing a capital lease. Think of it that way, but it does maybe drive, maybe, $1 million or so a quarter.

**Mark Eliasen** - *Alaska Air Group - VP, Finance*

This is Mark, and the overall story is very good. We're reducing debt, which is costing us about 5%, so that's a good story. The yield has gone down a little bit on our temporary cash portfolio.

**Glenn Engel** - *Bank of America - Analyst*

And finally, can you give us an update on San Diego? How's it doing, and what's the plan over the next few quarters?

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

Glenn, this is Andrew, and as you know, we have had niche growth there with Hawaii. I think we're running now about 12 cities, 24 departures a day. So we're watching some of the new regional markets, as well as the San Diegos and the Orlandos and the Bostons, and we're starting San Diego-Lihue in the summer in June. We have been very pleased. It's not easygoing, but we're seeing good, promising signs, and we're just very pleased right now.

**Joe Sprague** - *Alaska Airlines - VP, Marketing*

Glenn, this is Joe from marketing, and I might add on the San Diego question. We have a lot offer marketing and advertising focus there, both to grow awareness of our new service from that market, but also to bring in new customers to our customer base. We have seen great success on that from. Our mileage plan membership in San Diego is up 10% year-over-year. And when we do a geographic focus from our alaskaair.com, both shoppers and bookers are seeing a big increases in terms of our alaskaair.com bookings from San Diego.

**Glenn Engel** - *Bank of America - Analyst*

Thanks.

**Brad Tilden** - *Alaska Air Group - CEO*

Thanks, Glenn.

**Operator**

Your next question comes from the line from Bob McAdoo with Imperial Capital. Your line is open.

**Bob McAdoo** - *Imperial Capital - Analyst*

Hi, folks, just a quick little question. Early on in the discussion today, you made comments about Hawaii capacity changing, and you made some reference to the next few days or something -- what was that? I didn't understand what you're doing in the next few days.

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

Bob, that reference there was that on the 29th, which is in the next few days, we will reduce our California-Hawaii capacity by the equivalent of two airplanes. So Kona and Lihue will be going from instead of daily to basically four times a week and that's permanent going forward. So the only point there, we have too much capacity there and that's coming out in the next couple of days.





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**Brad Tilden** - *Alaska Air Group - CEO*

And Andrew, that service from San Jose to Oakland to Kona and Lihue goes from daily to half daily.

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

Correct.

**Bob McAdoo** - *Imperial Capital - Analyst*

That's not something new, it has been in the system for a while, and it happens to be starting up this way is what you're saying?

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

Exactly.

**Bob McAdoo** - *Imperial Capital - Analyst*

Okay, I thought you were start doing new stuff in the next few days, and I couldn't figure what that could be at the last minute, that's all. Thanks a lot.

**Operator**

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

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

Hi, good morning.

**Brad Tilden** - *Alaska Air Group - CEO*

Steve.

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

Could you just talk about -- on one of the other conference calls, there was talk about I guess what I would call the fruits of consolidation in the industry. Where do you see the industry now versus the benefits of consolidation or kind of how you see consolidation playing out? It seems like there are other companies mired in the process. Do you see that helping the industry, and maybe Alaska, longer-term, more so than it already has?

**Brad Tilden** - *Alaska Air Group - CEO*

Steve, we have talked about this on other calls. I think that net-net, consolidation has been a really good thing for the industry. And it will be better. If you just go back to a different time, when the industry was a lot more fragmented with different players and everybody was more in a market share battle than actually trying to make their businesses successful and produce returns for owners, we many many times had way too much





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capacity in the given market. And now we have got four airlines with an excess of 80% of share of the industry, something like that, and I think across the board, much more responsible decisions are being made by the airlines.

I think it's good for the industry, and hopefully it's us getting through another cycle or two of deregulation and becoming a more mature industry. Candidly, I think it makes us, at Alaska, it makes us for the industry and about our own future.

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

Okay, and then second, in terms of the seat additions and the power option that you're adding, do you see yourself moving away from -- you know, maybe trying to emulate more of a low-cost carrier or some of the bigger guys that don't focus as highly on cost, I guess? Where do you see the trend going over the long-term? Do you want to try to get closer to the low-cost guys, or do you think that they have moved you want towards the industry average over time?

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**Brad Tilden** - *Alaska Air Group - CEO*

Steve, you know us. We're in an interesting spot out here on the West Coast. Flying up and down the west coast of the United States, the fares have always been low, yet Alaska has always had a differentiated product and catered to business travel and that part of the market. We have always straddled this a little bit. If we wanted to be an LCC, we would make a lot of changes and add a lot of seats. If we wanted to be just like the trunk carriers, the network airlines, we would go in a different place.

This is an incremental move that's going to give our customers a terrific seat, in-seat power, great in-flight entertainment system, maybe some other changes to the cabin as we go forward. But it is also going to make the company, it is going to put us in a position where we compete a little bit more effectively with the LCCs. It's hard to give you an absolute answer, but that's how we think about it. For what it's worth, that is the space we have been in for ten, 15, 20 years now out here on the West Coast.

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

Okay. All right. Thank you.

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**Brad Tilden** - *Alaska Air Group - CEO*

Yes.

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**Operator**

Your next question comes from the line of Tom Vance with KUOW Public Radio. Your line is open.

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**Tom Vance** - *Media - KUOW Public Radio*

Thank you. I have a quick question about this week's FAA controller furloughs, and wondered if that has any operational effect so far, any adjustments that you see the airline making in the short-term.

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**Ben Minicucci** - *Alaska Airlines - COO*

Tom, Ben Minicucci here. Yes, the FAA furloughs have definitely had an impact on us, across the country. But where we operate a lot of flights into Los Angeles, so we have seen a daily impact into Los Angeles. I would say one cancel per day on a Horizon flight, as well as five to six delays, ranging anywhere up to three hours. We have done a lot to take care of our customers, and we have communicated a lot. We have diverted a couple of flights onto another carrier where the delays have been excessive. We have had buses waiting to take customers back to Los Angeles. We are doing everything we can. We're on ATC calls constantly monitoring arrival rates and we adjust on the fly. I'm really proud of our ops team the way they're dealing with this. We're going to do the best that we can to mitigate it for customers. But we hope there's a solution from DC that puts an end to this, and we can get more normal operations.

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**Tom Vance** - *Media - KUOW Public Radio*

And if you could just wrap that up, how much advance word or planning ability do you have, based on what the FAA is communicating to you?

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**Ben Minicucci** - *Alaska Airlines - COO*

You know, they don't give us a lot of warning, Tom, just to be honest. You may have an hour to two hours when they change the arrival rate. What we have done in our planning process, we work the arrival rates to an operational plan. So if the arrival rate in Los Angeles drops by 30%, we know exactly which flights to move, to divert, to perhaps cancel, consolidate, do whatever we can to take excessive delays and bring them shorter. So we have developed a pretty quick playbook to manage this inconvenience.

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**Brad Tilden** - *Alaska Air Group - CEO*

And Tom, this is Brad. And I might just add that, at a time when our country sort of desperately needs it get our economy moving again, and we need to move closer to a balanced budget, it's kind of difficult to imagine. It's a little bit unfathomable that we're kind of impairing this critical part of our infrastructure. So I don't know, there are encouraging things in the last day or two, I think there's cause to be optimistic that we're going to get this problem behind us, but the sooner the better from our perspective. This is something that we desperately need fixed.

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**Tom Vance** - *Media - KUOW Public Radio*

Thank you.

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**Operator**

And your last question comes from the line of Hunter Keay with Wolfe Trahan. Your line is open.

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**Hunter Keay** - *Wolfe Trahan - Analyst*

Thanks for taking my follow up. New topic, I promise. Let's talk about change fees. You guys did about $26 million in change fees last year, and JetBlue did about $135 million in change fees, despite the fact that the revenue is about the same. I'm not asking you if you're going to adjust those change fees. I know you can't comment on that stuff. But can you explain why it was so much lower? It's about $0.90 a share that you're leaving off our P&L for that. It is an enforcement issue? Do restrictions need to be tightened? I'm just wondering why this discrepancy exists.

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**Brandon Pedersen** - *Alaska Air Group - CFO*

Hi, it's Brandon. Maybe Joe can answer the question in terms of the policy. But what were the numbers that you threw out again?

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**Hunter Keay** - *Wolfe Trahan - Analyst*

So I have you guys, according to DOT data we have estimated fourth quarter. But we had you guys $26 million in change fees, and we had JetBlue at about $135 million in change fees. If you assume that as pure margin, not to mention pure numerator in ROIC, but if you see it as pure margin, it's like $0.90 a share in earnings, roughly. But either those are the revenue numbers, $26 million versus $135 million.

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**Brandon Pedersen** - *Alaska Air Group - CFO*

$26 million for the quarter?

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**Hunter Keay** - *Wolfe Trahan - Analyst*

No, for the full year. That's DOT data. Is that wrong?

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**Brandon Pedersen** - *Alaska Air Group - CFO*

That is wrong.

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**Hunter Keay** - *Wolfe Trahan - Analyst*

DOT did it wrong? No! So what's your change fee revenue? Maybe that's a better question.

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**Brandon Pedersen** - *Alaska Air Group - CFO*

Um, I don't know that we have really broken that out. What we have talked about is big picture, change fee revenue on a per passenger basis is more like $12 just to use round numbers.

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**Joe Sprague** - *Alaska Airlines - VP, Marketing*

Total ancillary.

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**Brandon Pedersen** - *Alaska Air Group - CFO*

$12 per passenger total. Andrew, we have talked about the amount of revenue that's first bag fee revenue, which is $125 million a year or so, but we haven't given much color on the rest. Why don't we take up a few thousand feet -- Joe, you want to talk about how we think about that?

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**Joe Sprague** - *Alaska Airlines - VP, Marketing*

Well, Hunter, as Brandon said, our overall ancillary revenue for the first quarter was up, even on a per passenger basis, it was up slightly about $11.68. Bag fees, which have been trending down in the last three or four quarters, reversed and were actually up 8% in the first quarter. So you know, those are okay trends. They're not great in terms of growth, but at least its keeping pace with the rest of our growth.

I think beyond that, United announced a pretty interesting change to their change fees this week. At $75 per change for our change fees, we think that's, again, a good value proposition. We have -- we're trying to look at each of those different fees that we charge, make sure that they make sense for the customer, that they are simple to understand, but yet reflect a cost of what it does to make a change. And some of these where the change fee itself is of higher, it's tough to make that to the customer that it reflects the cost of the airline. I think we're feeling okay about that area, but as Brad and Brandon have said, these are things that we do spend a lot of time looking at and looking at the trends and making sure that's where we need to be.

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**Hunter Keay** - *Wolfe Trahan - Analyst*

Okay, thanks. I'll catch up with you offline, maybe share with you where I got that data. Thanks a lot.

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**Operator**

And as we have no further questions. I'll turn the call back over to Mr. Brad Tilden.

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**Brad Tilden** - *Alaska Air Group - CEO*

At this part, we'll just wrap up. Thanks everybody for tuning in, and we look forward to chatting with you again next quarter.

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**Operator**

Thank you for participating in today's conference call. This will be available for replay beginning at 5.00PM Eastern Standard Time today through 11.59PM Eastern Standard Time on May 24, 2013. The conference ID for the replay is 37717116. The number to dial for the replay is 1-800-585-8367 or 1-404-537-3406. Also, the call will be accessible for future play back at www.alaskaair.com. You may now disconnect.

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