

ALASKA AIR GROUP INC

Form PREC14A

March 21, 2008

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UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
Washington, D.C. 20549

SCHEDULE 14A

Proxy Statement Pursuant to Section 14(a) of the
Securities Exchange Act of 1934

Filed by the Registrant ☒ Filed by a Party other than the Registrant ☐

Check the appropriate box:

☒ Preliminary Proxy Statement

☐ **Confidential, for Use of the Commission Only (as permitted by Rule 14a-6(e)(2))**

☐ Definitive Proxy Statement

☐ Definitive Additional Materials

☐ Soliciting Material Pursuant to §240.14a-12

Alaska Air Group, Inc.

(Name of Registrant as Specified In Its Charter)

(Name of Person(s) Filing Proxy Statement, if other than the Registrant)

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NOTICE OF ANNUAL MEETING OF STOCKHOLDERS

P.O. Box 68947

Seattle, Washington 98168

To our Stockholders:

The Annual Meeting of Stockholders of Alaska Air Group, Inc. will be held at the Museum of Flight in Seattle, Washington at [] on Tuesday, May 20, 2008, for the following purposes:

1. To elect six directors, each for a one-year term;
2. To approve a new 2008 Performance Incentive Plan;
3. To consider and vote upon the three stockholder proposals described in the accompanying proxy statement, if those proposals are properly presented at the meeting; and
4. To transact such other business as may properly come before the meeting or any adjournment thereof.

Stockholders owning Company common stock at the close of business on March 14, 2008 are entitled to receive this notice and to vote at the meeting. All stockholders are requested to be present in person or by proxy. For the convenience of stockholders who do not expect to attend the meeting in person and wish to have their shares voted, a form of proxy and an envelope are enclosed. Stockholders may also vote by internet or telephone. Any stockholder who later finds that he or she can be present at the meeting, or for any reason desires to do so, may revoke his or her proxy at any time before it is voted.

Voting by the internet or telephone is fast and convenient and your vote is immediately confirmed and tabulated. By using the internet or telephone to vote, you help Alaska Air Group reduce postage and proxy tabulation costs.

To vote by internet, visit www.proxyvote.com.

To vote by telephone, call 1-800-690-6903.

We appreciate your participation, since a majority of the outstanding common stock entitled to vote at the meeting must be represented either in person or by proxy to constitute a quorum in order to conduct business.

By Order of the Board of Directors,

Keith Loveless

Corporate Secretary and General Counsel

April , 2008

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ANNUAL MEETING INFORMATION

The Board of Directors of Alaska Air Group, Inc. ("AAG" or the "Company") is soliciting proxies for this year's Annual Meeting of Stockholders. This proxy statement contains important information for you to consider when deciding how to vote on the matters brought before the meeting. Please read it carefully.

The Board set March 14, 2008 as the record date for the meeting. Stockholders who owned Company common stock on that date are entitled to vote at the meeting, with each share entitled to one vote. There were 36,575,476 shares of Company common stock outstanding on the record date.

Annual meeting materials, which include this proxy statement, a proxy card or voting instruction form, and our 2007 Annual Report, were delivered to stockholders on or about April 1, 2008. The Company's Form 10-K for the year ended December 31, 2007 is included in the 2007 Annual Report. It was filed with the Securities and Exchange Commission ("SEC") on February 20, 2008.

IMPORTANT NOTICE REGARDING THE INTERNET AVAILABILITY OF PROXY MATERIALS FOR THE STOCKHOLDER MEETING TO BE HELD ON MAY 20, 2008.

Stockholders may access, view and download this proxy statement and our 2007 Annual Report over the Internet on our website located at <http://www.alaskaair.com/company>

and by clicking on "Investor Information, Financial Reports" and "2007 Annual Report and 2008 Proxy Statement." Information on our website does not constitute part of this proxy statement.

QUESTIONS AND ANSWERS

Why am I receiving this annual meeting information and proxy?

You are receiving this annual meeting information and proxy from us because you owned shares of common stock in Alaska Air Group as of the record date for the annual meeting. This proxy statement describes issues on which you may vote and provides you with other important information so that you can make informed decisions.

You may own shares of Alaska Air Group common stock in several different ways. If your stock is represented by one or more stock certificates registered in your name, you have a stockholder account with our transfer agent, Computershare Trust Company, N.A., which makes you a stockholder of record. If you hold your shares in a brokerage, trust or similar account, you are the beneficial owner but not the stockholder of record of those shares. Employees of the Company who hold shares of stock in one or more of the Company's 401(k) retirement plans are beneficial owners.

What am I voting on?

You are being asked to vote on the election of six directors, the approval of a new 2008 Performance Incentive Plan ("2008 Plan") and, if properly presented, up to three stockholder proposals. When you sign and mail the proxy card or submit your proxy by telephone or the internet, you appoint each of William S. Ayer and Keith Loveless, or their respective substitutes or nominees, as your representatives at the meeting. (When we refer to the "named proxies," we are referring to Messrs. Ayer and Loveless.) This

way, your shares will be voted even if you cannot attend the meeting.

How does the Board of Directors recommend I vote on each of the proposals?

FOR each of the Board's six director nominees and FOR the approval of a new 2008 Performance Incentive Plan
(Proposals 1 and 2)
AGAINST the stockholder proposals (Proposals 3 through 5)

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How do I vote my shares?

Stockholders of record can vote by using the proxy card or by telephone or by the internet. Beneficial owners whose stock is held:

in a brokerage account can vote by using the voting instruction form provided by the broker or by telephone or the internet.

by a bank, and have the power to vote or to direct the voting of the shares, can vote using the proxy or the voting information form provided by the bank or, if made available by the bank, by telephone or the internet.

in trust under an arrangement that provides the beneficial owner with the power to vote or to direct the voting of the shares can vote in accordance with the provisions of such arrangement.

in trust in one of the Company's 401(k) retirement plans can vote using the voting instruction form provided by the trustee.

Beneficial owners, other than persons who beneficially own shares held in trust in one of the Company's 401(k) retirement plans, can vote at the meeting provided that he or she obtains a legal proxy from the person or entity holding the stock for him or her (typically a broker, bank, or trustee). A beneficial owner can obtain a legal proxy by making a request to the broker, bank, or trustee. Under a legal proxy, the bank, broker, or trustee confers all of its rights as a record holder (which may in turn have been passed on to it by the ultimate record holder) to grant proxies or to vote at the meeting.

Listed below are the various means—internet, phone and mail—you can use to vote your shares without attending the annual meeting.

You can vote on the internet.

Stockholders of record and beneficial owners of the Company's common stock can vote via the internet regardless of whether they receive their annual meeting materials through the mail or via the internet. Instructions for doing so are provided along with your proxy card or voting instruction form. If you vote on the internet, please do not mail in your proxy card (unless you intend for it to revoke your prior internet vote). Your internet vote will authorize the named proxies to vote your shares in the same manner as if you marked, signed and returned your proxy card.

You can vote by phone.

Stockholders of record and beneficial owners of the Company's common stock can vote by phone. Instructions for voting by phone are provided along with your proxy card or voting instruction form. If you vote by telephone, please do not mail in your proxy card (unless you intend for it to revoke your prior telephone vote). Your phone vote will authorize the named proxies to vote your shares in the same manner as if you marked, signed and returned your proxy card.

You can vote by mail.

Simply sign and date the proxy card or voting instruction form received with this proxy statement and mail it in the enclosed prepaid and addressed envelope. If you mark your choices on the card or voting instruction form, your shares will be voted as you instruct.

The availability of telephone and internet voting.

Broadridge Financial Solutions, Inc. (Broadridge) internet and telephone voting facilities for stockholders of record and beneficial holders will be available 24 hours a day, and will close at 11:59 p.m. Eastern Time on May 19, 2008. To allow sufficient time for voting by the trustee, voting instructions for 401(k) plan shares must be received no later than 11:59 p.m. on Thursday, May 15,

2008.

How will my shares be voted if I return a blank proxy or voting instruction form?

If you are a stockholder of record, and you sign and return a proxy card without giving specific voting instructions, your shares will be voted in accordance with the recommendations of the Board of Directors shown above and as the named proxies may determine in their discretion with respect to any other matters properly presented for a vote before the meeting.

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If you are a beneficial owner and do not provide your broker, bank or other trustee with voting instructions, your shares may constitute broker non-votes and may not be counted in connection with certain matters. See **What are broker non-votes?** below.

If your shares are held in one of our 401(k) retirement plans and the trustee of the plan does not receive voting instructions for shares in your plan account on a matter, your shares will not be voted by the trustee on that matter.

What other business may be properly brought before the meeting, and what discretionary authority is granted?

Under the Company's Bylaws, a stockholder may bring business before the meeting for publication in the Company's 2008 proxy statement only if the stockholder gave written notice to the Company on or before December 21, 2007. Aside from nominations for director, the only such business as to which the Company received proper advance notice from a stockholder are (i) the three stockholder proposals described in this proxy statement and included on the Company's proxy card, and (ii) a stockholder proposal that we were permitted to exclude from this proxy statement under applicable rules and regulations of the Securities and Exchange Commission (SEC). Under the Bylaws, stockholders may also act on any business not set forth in the notice of meeting but otherwise properly brought before the meeting by or at the direction of the Board of Directors.

The Company has not received notice that any business other than that described or referenced in this proxy statement will be brought before the meeting. As to any other matters that may properly come before the meeting and are not on the proxy card, the proxy grants to Messrs. Ayer and Loveless the authority to vote the shares for which they hold proxies in accordance with their best judgment. With respect to the stockholder proposal referenced above that has been excluded from this proxy statement under applicable rules of the SEC, Messrs. Ayer and Loveless intend to utilize the discretionary authority conferred by the proxies submitted to vote against such proposal if it is properly presented at the Annual Meeting.

What does it mean if I receive more than one proxy card, voting instruction form or email notification from the Company?

It means that you have more than one account for your AAG shares. Please complete and submit all proxies to ensure that all your shares are voted or vote by internet or telephone using each of the identification numbers.

What if I change my mind after I submit my proxy?

You may revoke your proxy and change your vote by delivering a later-dated proxy or, except for persons who beneficially own shares held in trust in one of the Company's 401(k) retirement plans, by voting at the meeting. The later-dated proxy may be delivered by telephone, internet or mail and need not be delivered by the same means used in delivering the to-be-revoked proxy. Except for persons beneficially holding stock in one of the Company's 401(k) retirement plans, you may do this at a later date or time by:

voting by telephone or on the internet (which may not be available to some beneficial holders) before 11:59 p.m. Eastern Time Monday, May 19, 2008 (your latest telephone or internet proxy is counted);

signing and delivering a proxy card with a later date; or

voting at the meeting. (If you hold your shares beneficially through a broker, you must bring a legal proxy from the broker in order to vote at the meeting. Please also note that attendance at the meeting, in and of itself, without voting in person at the meeting, will not cause your previously granted proxy to be revoked.)

Persons beneficially holding stock in one of the Company's 401(k) retirement plans cannot vote in person at the meeting and must vote in accordance with instructions from the trustees. Subject to these qualifications, such holders have the same rights as other record and beneficial holders to change their votes.

If you are a registered stockholder, you can obtain a new proxy card by contacting the

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Company's Corporate Secretary, Alaska Air Group, Inc., P.O. Box 68947, Seattle, WA 98168, telephone (206) 392-5131. If your shares are held by a broker, trustee or bank, you can obtain a new voting instruction form by contacting your broker, trustee or bank. If your shares are held by one of the Company's 401(k) retirement plans, you can obtain a new voting instruction form by contacting the trustee of such plan. You can obtain information about how to contact the trustee from the Company's Corporate Secretary. Please refer to the section below titled "How are shares voted that are held in a Company 401(k) plan?" for more information. If you sign and date the proxy card or voting instruction form and submit it in accordance with the accompanying instructions and in a timely manner, any earlier proxy card or voting instruction form will be revoked and your choices on the proxy card or voting instruction form will be voted as you instruct.

What are broker non-votes?

As indicated above, if you are a stockholder of record who submits a proxy but does not indicate how the proxies should vote on one or more matters, the named proxies will vote as recommended by the Board of Directors. However, if your shares are held by a broker and you do not provide instructions to the broker on how to vote (whether you use the internet or phone or return the enclosed voting instruction form), the absence of instructions may cause your shares to result in a broker non-vote on the matters for which you do not provide instructions on how to vote. Accordingly, if you want to vote your shares on a matter, it is important that you provide voting instructions on that matter.

The following sets forth the application of broker non-vote rules to the proposals.

Election of Directors.

The election of directors is the subject of Proposal 1. Mr. Stephen Nieman, a stockholder of the Company, has informed the Company of his intention to nominate up to six persons at the annual meeting for election to the Board of Directors. Although Mr. Nieman has filed his own proxy materials with the SEC, he has indicated that he does not intend to mail his proxy materials to all of the Company's stockholders. The current position of the New York Stock Exchange (NYSE) is that an election is not contested unless the challengers . . . do a mailing to all stockholders who hold their shares beneficially or in street name through banks, brokers or other intermediaries. Accordingly, we currently believe that the election of directors will not be contested for purposes of NYSE Rule 452 and a broker will have the discretion to vote your shares in the election of directors in the absence of specific instructions.

Board Proposals.

The approval of a new 2008 Performance Incentive Plan is the subject of Proposal 2. If you do not give the broker that holds your shares voting instructions regarding this proposal, your shares will be considered broker non-votes. As a result, your shares will not be voted on this proposal and will not be counted in determining the outcome of the vote on the proposal, although they will count for purposes of determining whether a quorum exists at the meeting.

Stockholder Proposals.

Brokers will not be allowed to vote on any of the Proposals 3 through 5 for which you do not provide instructions. For example, if you provide instructions for Proposals 3 through 4, but not for Proposal 5, the broker will not cast a vote on your behalf on Proposal 5; in other words, there will be a broker non-vote on Proposal 5. As a result, if you do not give the broker that holds your shares voting instructions regarding one or more of these proposals, your shares will not be voted on that proposal and will not be counted in determining the outcome of the vote on that proposal, although they will count for purposes of determining whether a quorum exists at the meeting.

How are shares voted that are held in a Company 401(k) plan?

On the record date, 1,589,009 shares were held in trust for Alaska Air Group 401(k) plan

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participants. The trustees, Vanguard and Fidelity, sent a proxy statement, an annual report and a voting instruction form to each participant who held shares through the Company's 401(k) plans on the record date. The trustee will vote only those shares for which instructions are received from participants. If a participant does not indicate a preference as to a matter, including the election of directors, then the trustee will not vote the participants' shares on such matters.

To allow sufficient time for voting by the trustee, please provide voting instructions no later than 11:59 p.m. on Thursday, May 15, 2008. Because the shares must be voted by the trustee, employees who hold stock through the 401(k) plans may not vote these shares at the meeting.

May I vote in person at the meeting?

We will pass out a ballot to any record holder of our stock who requests a ballot at the meeting. If you hold your shares through a broker, you must bring a legal proxy from your broker in order to vote by ballot at the meeting. You may request a legal proxy from your broker by indicating on your voting instruction form that you plan to attend and vote your shares at the meeting, or at the internet voting site to which your voting materials direct you. Please allow sufficient time to receive a legal proxy through the mail after your broker receives your request. Because shares held by employees in the 401(k) plans must be voted by the trustee, these shares may not be voted at the meeting.

Can I receive future materials via the internet?

If you vote on the internet, simply follow the prompts for enrolling in the electronic proxy delivery service. This will reduce the Company's printing and postage costs, as well as the number of paper documents you will receive.

Stockholders may enroll in that service at any time after the annual meeting and can read additional information about this option and request electronic delivery by going to Broadridge's website, <http://enroll.icsdelivery.com/alk>.

If you already receive your proxy materials via the internet, you will continue to receive them that way until you instruct otherwise through the website referenced above.

How many shares must be present to hold the meeting?

A majority of the Company's outstanding shares entitled to vote as of the record date, or 36,575,476 shares, must be present or represented at the meeting and entitled to vote in order to hold the meeting and conduct business (i.e., to constitute a quorum). Shares are counted as present or represented at the meeting if the stockholder of record attends the meeting; if the beneficial holder attends with a legal proxy from the record holder; or if the record holder has granted a proxy, whether by returning a proxy card or by telephone or internet, without regard to whether the proxy actually casts a vote or withholds or abstains from voting.

How many votes must the nominees have to be elected?

The Company has amended its Bylaws to require each director to be elected at each annual meeting by a majority of votes cast with respect to that director. This means that the number of votes for a director must exceed the number of votes against that director. In the event that a nominee for director receives more against votes for his or her election than for votes, the board must consider such director's resignation following a recommendation by the Board's Governance and Nominating Committee. The majority voting standard does not apply, however, in the event that the number of nominees for director exceeds the number of directors to be elected. In such circumstances, directors will instead be elected by a plurality of the votes cast, meaning that the persons receiving the highest number of for votes, up to the total number of directors to be elected at the annual meeting, will be elected.

The Company has been informed that an opposing solicitation for the election of up to six directors will be made by Mr. Nieman. (See Opposing Solicitation on page [].) If there are

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more nominees than the number of directors to be elected, directors will be elected by a plurality vote. Withheld votes will not be taken into account in determining the outcome of the election of directors. Based on the Company's understanding that the opponents do not intend to mail their proxy materials to all of the Company's stockholders, brokers will have discretionary authority to vote shares for which beneficial holders do not provide instructions.

The determination that Mr. Nieman's notice of nomination was timely received for purposes of determining the applicability of the majority voting bylaw is not an admission that Mr. Nieman complied with the Bylaws or that Mr. Nieman's nominees are eligible for nomination to the Company's Board of Directors. By accepting Mr. Nieman's notice of nomination for the 2008 Annual Meeting, the Company does not waive its rights to challenge any future notice of nomination submitted by Mr. Nieman or by any other stockholder or the eligibility of their director nominees.

What happens if a director candidate nominated by the Board of Directors is unable to stand for election?

The Board of Directors may reduce the number of seats on the Board or it may designate a substitute nominee. If the Board designates a substitute, shares represented by proxies held by the named proxies, Messrs. Ayer and Loveless, will be voted *for* the substitute nominee.

How many votes must the proposal to approve the 2008 Performance Incentive Plan and each of the stockholder proposals (Proposals 3 through 5) receive in order to pass?

A majority of the shares present in person or by proxy at the meeting and entitled to vote on the subject matter of the proposal must be voted *for* each proposal in order for it to pass. Abstain votes are deemed present and entitled to vote and are included for purposes of determining the number of shares constituting a majority of shares present and entitled to vote. Accordingly, an abstention, not being a vote *for*, will have the effect of a negative vote. A broker non-vote is not deemed present and entitled to vote for proposals for which it is applicable and are not included for purposes of determining the number of shares constituting a majority of shares present and entitled to vote. Accordingly, a broker non-vote is disregarded for purposes of determining the outcome of the vote on these proposals. See *What are broker non-votes?* Page [].

How are votes counted?

Voting results will be tabulated by Broadridge Financial Solutions, Inc. IVS and Associates, or its designee, will serve as the independent inspector of elections.

Is my vote confidential?

The Company has a confidential voting policy as a part of its governance guidelines, which are published on the Company's website.

Who pays the costs of proxy solicitation?

The Company pays for distributing and soliciting proxies and reimburses brokers, nominees, fiduciaries and other custodians their reasonable fees and expenses in forwarding proxy materials to beneficial owners. The Company has engaged Georgeson Inc. (Georgeson) to assist in the solicitation of proxies for the meeting. Georgeson may use up to 10 employees in connection with the solicitations. It is intended that proxies will be solicited by the following means: additional mailings, personal interview, mail, telephone and electronic means. Proxies may also be solicited by the persons identified as Participants under the heading *Participants in the Solicitation*, who will receive no additional compensation, except for reimbursement of expenses. Although no precise estimate can be made at this time, we anticipate that the aggregate amount we will spend in connection with the solicitation of proxies will be \$23,500 (exclusive of costs we would ordinarily expend in solicitation of proxies in the absence of an election contest). To date, \$16,000 has been incurred. This amount includes fees payable to Georgeson, but excludes salaries and expenses of our officers, directors and employees.

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Is a list of stockholders entitled to vote at the meeting available?

A list of stockholders of record entitled to vote at the annual meeting will be available at the annual meeting. It will also be available Monday through Friday from April 1 through May 19 between the hours of 9 a.m. and 4 p.m., local time, at the offices of the Corporate Secretary, 19300 International Blvd., Seattle WA 98188. A stockholder of record may examine the list for any legally valid purpose related to the annual meeting.

Where can I find the voting results of the meeting?

We will publish the final results in our quarterly report on Form 10-Q for the second quarter of 2008. You can read or print a copy of that report by going to the Company's website, and then choosing Company Info, Investor Information, and SEC Filings. You can find the same Form 10-Q by going directly to the SEC EDGAR files at <http://www.sec.gov>. You can also get a copy by calling us at (206) 392-5131, or by calling the SEC at (800) SEC-0330 for the location of a public reference room.

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PROPOSAL 1.

ELECTION OF DIRECTORS

The Company currently has ten directors. On May 20, 2008, Mr. Richard A. Wien, whose term expires this year, will retire from the Board. The Board of Directors wishes to thank Mr. Wien for his dedication and service to the Board over the past 26 years. The Company's Certificate of Incorporation provides that the Board of Directors shall be composed of no less than nine and no more than 15 directors. On March 13, 2008, the Board passed a resolution providing that the Company shall have nine directors effective as of the Annual Meeting on May 20, 2008. The Company's Bylaws provide that the class of directors up for election this year shall serve a one-year term. Directors are elected to hold office until their successors are elected and qualified, or until resignation or removal in the manner provided in our Bylaws. Six directors are nominees for election this year and each has consented to serve a one-year term ending in 2009. The remaining directors will continue to serve the terms set out below.

NOMINEES FOR ELECTION TO TERMS EXPIRING IN 2009

William S. Ayer

Director since 1999

Age 53

Mr. Ayer has served as Chairman, President and CEO of Alaska Air Group since May 2003. In 1997, he was named President of Alaska Airlines. He was also named CEO of Alaska Airlines in 2002, and in 2003 took leadership of Alaska Air Group and Alaska Airlines as Chairman, President and CEO and Chairman of Horizon Air. Prior to 2000, he worked in various marketing, planning and operational capacities at Alaska Airlines and Horizon Air. In December 2007, Mr. Ayer was appointed to the Seattle Branch of the Federal Reserve Board. Mr. Ayer also serves on the boards of Alaska Airlines and Horizon Air, Puget Energy, Angel Flight, the Alaska Airlines Foundation, the University of Washington Business School Advisory Board and the Museum of Flight.

Phyllis J. Campbell

Director since 2002

Age 56

Ms. Campbell serves as Chair of the Board's Compensation Committee. She is President and CEO of The Seattle Foundation. She was President of U.S. Bank of Washington from 1993 until 2001 and has served as Chair of the Bank's Community Board. In August 2007, Ms. Campbell was appointed to Toyota's Diversity Advisory Board. She also serves on the boards of Alaska Airlines, Nordstrom, and Puget Energy. Ms. Campbell is also a member of the Board of Trustees of Seattle University.

Mark R. Hamilton

Director since 2001

Age 63

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Mr. Hamilton serves on the Board's Audit and Safety Committees, as well as on the Horizon Air Board. He is President of the University of Alaska, a position he has held since 1998. That same year, he retired as a U.S. Army Major General following 31 years of active military duty, primarily in the fields of teaching, management and administration. Formerly, Mr. Hamilton was Chief of Staff of the Alaskan Command at Elmendorf Air Force Base and Commander of Division Artillery at Fort Richardson. Mr. Hamilton is a graduate of the U.S. Military Academy at West Point and is the recipient of the Army's highest peacetime award, the Distinguished Service Medal.

R. Marc Langland

Director since 1991

Age 66

Mr. Langland is Lead Director and Chair of the Board's Governance and Nominating Committee. He has been President of Northrim Bank (Anchorage, Alaska) since November 1990 and Chairman since January 1998. Mr. Langland has also been Chairman, President and CEO of its parent company, Northrim BanCorp, Inc. since December 2001. He was Chairman and Chief Executive Officer of Key Bank of Alaska from 1987 to 1988 and President from 1985 to 1987. He served on the Board of Trustees of the Alaska Permanent Fund Corporation from

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February 1987 to January 1991 and was Chairman from June 1990 to January 1991. He is also a director Horizon Air, Northrim BanCorp, Inc. and Usibelli Coal Mine, and is a member of the Anchorage Chamber of Commerce and a board member and past chairman of Commonwealth North.

Dennis F. Madsen

Director since 2003

Age 59

Mr. Madsen serves on the Compensation and Audit Committees. He is currently the Chairman of Seatab Software (Bellevue, Washington). From 2000 to 2005, Mr. Madsen was President and CEO of Recreational Equipment, Inc. (REI), a retailer and online merchant for outdoor gear and clothing. He served as REI's Executive Vice President and Chief Operating Officer from 1987 to 2000, and held numerous positions throughout the company. He also serves on the boards of Alaska Airlines, Horizon Air, Seatab Software, the Western Washington University Foundation, Western Washington University, Islandwood, Performance Bicycles and the Youth Outdoors Legacy Fund.

Byron I. Mallott

Director since 1982

Age 65

Mr. Mallott serves on the Board's Safety and Governance and Nominating Committees. Currently he is a Senior Fellow of the First Alaskans Institute, a nonprofit organization dedicated to the development of Alaska Native peoples and their communities. In January 2007, Mr. Mallott was appointed to the Board of Trustees of the Smithsonian Institution's National Museum of the American Indian. From 1995 to 1999, he served as Executive Director (chief executive officer) of the Alaska Permanent Fund Corporation, a trust managing proceeds from the state of Alaska's oil reserves. He was a director of Sealaska Corporation (Juneau, Alaska) from 1972 to 1988, Chairman from 1976 to 1983, and Chief Executive Officer from 1982 to 1992. He owns Mallott Enterprises (person investments) and is a director of Alaska Airlines, Sealaska Corporation, Yak-Tat Kwaan, Inc. and Native American Bank, NA.

CONTINUING DIRECTORS WHOSE TERMS EXPIRE IN 2010

Patricia M. Bedient

Director since 2004

Age 54

Ms. Bedient serves as Chair of the Board's Audit Committee and is a director of Alaska Airlines. She is Executive Vice President and Chief Financial Officer for the Weyerhaeuser Company, one of the world's largest integrated forest products companies. A certified public accountant, she served as the managing partner of Arthur Andersen LLP's Seattle office prior to joining Weyerhaeuser. Ms. Bedient also worked at the firm's Portland and Boise offices as a partner and as a CPA during her 27-year career with Andersen. She currently serves on the Weyerhaeuser Foundation Board and the advisory board of the University of Washington School of Business. She has also served on the boards of a variety of civic organizations including the Oregon State University Foundation Board of Trustees, the World Forestry Center, the City Club of Portland, St. Mary's Academy of Portland and the Chamber of Commerce in Boise, Idaho. She is a member of the American Institute of CPAs and the Washington Society of CPAs.

Jessie J. Knight, Jr.

Director since 2002

Age 57

Mr. Knight serves on the Board's Compensation and Governance and Nominating Committees. Since 2006, he has been Executive Vice President of External Affairs at Sempra Energy, a company that develops energy infrastructure, operates utilities, and provides related products and services to more than 29 million consumers in the United States, Europe, Canada, Mexico, South America and Asia. From 1999 to 2006, Mr. Knight served as the President and Chief Executive Officer of the San Diego Regional Chamber of Commerce and,

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from 1993 to 1998, he was a commissioner of the California Public Utilities Commission. Mr. Knight also serves on the boards of Alaska Airlines and the San Diego Padres Baseball club. He is a standing member of the Council on Foreign Relations.

J. Kenneth Thompson

Director since 1999

Age 56

Mr. Thompson serves on the Board's Governance and Nominating Committee and its Safety Committee. He has been appointed to succeed Mr. Wien as chair of the Board's Safety Committee on May 20, 2008. Mr. Thompson served as Executive Vice President of ARCO's Asia Pacific oil and gas operating companies in Alaska, California, Indonesia, China and Singapore from 1998 to 2000. Prior to that, he was President of ARCO Alaska, Inc., the parent company's oil and gas producing division based in Anchorage, Alaska. Mr. Thompson is currently President and CEO of Pacific Star Energy LLC, a private energy investment company in Alaska, with partial ownership in the oil exploration firm Alaska Venture Capital Group (AVCG LLC) where he serves as the Managing Director. In 2007, Mr. Thompson was appointed to the board of Tetra Tech. He also serves on the boards of Horizon Air, Coeur d'Alene Mines Corporation, and serves on a number of community service organizations.

Vote Required and Recommendation of the Board of Directors

As indicated above, the Company has received a notice from Mr. Nieman, a stockholder of the Company, for the nomination of six individuals, including himself, to the Board of Directors at the 2008 Annual Meeting. Mr. Nieman has filed proxy materials with the SEC in connection with his solicitation of proxies for those nominees. If Mr. Nieman properly brings his nominations before the meeting, the number of nominees will exceed the number of directors to be elected and, in accordance with the majority voting standard set forth in the Company's Bylaws, the directors will be elected by a plurality vote. This means that the six persons receiving the highest number of votes at the annual meeting will be elected. This voting standard for the election of directors is discussed further under the section entitled "Question and Answers - How many votes must the nominees have to be elected?" above.

THE BOARD OF DIRECTORS RECOMMENDS THAT YOU VOTE *FOR* THE ELECTION OF THE SIX NOMINEES NAMED ABOVE AS DIRECTORS. UNLESS OTHERWISE INDICATED ON YOUR PROXY, THE SHARES WILL BE VOTED *FOR* THE ELECTION OF THESE SIX NOMINEES AS DIRECTORS.

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PROPOSAL 2.

APPROVAL OF THE ALASKA AIR GROUP, INC.

2008 PERFORMANCE INCENTIVE PLAN

General

At the Annual Meeting, stockholders will be asked to approve the Alaska Air Group, Inc. 2008 Performance Incentive Plan (the 2008 Plan), which was adopted, subject to stockholder approval, by the Board of Directors on March 13, 2008.

The Company believes that incentives and stock-based awards focus employees on the objective of creating stockholder value and promoting the success of the Company, and that incentive compensation plans like the proposed 2008 Plan are an important attraction, retention and motivation tool for participants in the plan.

The Company currently maintains the Alaska Air Group, Inc. 2004 Long-Term Incentive Plan (the 2004 Plan). As of March 13, 2008, a total of 1,706,529 shares of the Company s common stock were then subject to outstanding awards granted under the 2004 Plan, and 145,615 shares of the Company s common stock were then available for new award grants under the 2004 Plan. For all of the Company s equity incentive plans (including the 2004 Plan), as of March 13, 2008, a total of 2,777,214 shares of the Company s common stock were subject to outstanding options (with a weighted-average exercise price of \$32.13 and a weighted-average remaining term of 4.99 years), and a total of 686,283 shares of the Company s common stock were subject to outstanding restricted stock unit and performance unit awards. (In each case, these numbers are calculated assuming that outstanding performance unit awards are ultimately paid out at target levels of performance. The Company s outstanding options generally may not be transferred to third parties for value and do not include dividend equivalent rights.

The Board of Directors approved the 2008 Plan based, in part, on a belief that the number of shares currently available under the 2004 Plan does not give the Company sufficient authority and flexibility to adequately provide for future incentives. If stockholders approve the 2008 Plan, no new awards will be granted under the 2004 Plan after the Annual Meeting. In that case, the number of shares of the Company s common stock that remain available for award grants under the 2004 Plan immediately prior to the Annual Meeting will become available for award grants under the 2008 Plan. An additional 2,100,000 shares of the Company s common stock will also be made available for award grants under the 2008 Plan, so that if stockholders approve the 2008 Plan, a maximum of 2,245,615 shares will initially be available for award grants under that plan. In addition, if stockholders approve the 2008 Plan, any shares of common stock subject to award grants under the 2004 Plan that expire, are cancelled, or otherwise terminate after the Annual Meeting will also be available for award grant purposes under the 2008 Plan.

If stockholders do not approve the 2008 Plan, the Company will continue to have the authority to grant awards under the 2004 Plan. If stockholders approve the 2008 Plan, the termination of our grant authority under the 2004 Plan will not affect awards then-outstanding under that plan.

Summary Description of the 2008 Performance Incentive Plan

The principal terms of the 2008 Plan are summarized below. The following summary is qualified in its entirety by the full text of the 2008 Plan, which appears as Exhibit A to this Proxy Statement.

Purpose

The purpose of the 2008 Plan is to promote the success of the Company and the interests of our stockholders by providing an additional means for us to attract, motivate, retain and reward officers, employees, nonemployee directors and other eligible persons through the grant of awards and incentives for high levels of individual performance and improved financial performance of the Company. Equity-based

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awards are also intended to further align the interests of award recipients and our stockholders.

Administration

Our Board of Directors or one or more committees appointed by our Board of Directors will administer the 2008 Plan. Our Board of Directors has delegated general administrative authority for the 2008 Plan to the Compensation Committee. A committee may delegate some or all of its authority with respect to the 2008 Plan to another committee of directors, and certain limited authority to grant awards to employees may be delegated to one or more officers of the Company. (The appropriate acting body, be it the Board of Directors, a committee within its delegated authority, or an officer within his or her delegated authority, is referred to in this proposal as the Administrator).

The Administrator has broad authority under the 2008 Plan with respect to award grants including, without limitation, the authority:

to select participants and determine the type(s) of award(s) that they are to receive;

to determine the number of shares that are to be subject to awards and the terms and conditions of awards, including the price (if any) to be paid for the shares or the award;

to cancel, modify, or waive the Company's rights with respect to, or modify, discontinue, suspend, or terminate any or all outstanding awards, subject to any required consents;

to accelerate or extend the vesting or exercisability or extend the term of any or all outstanding awards;

subject to the other provisions of the 2008 Plan, to make certain adjustments to an outstanding award and to authorize the conversion, succession or substitution of an award; and

to allow the purchase price of an award or shares of the Company's common stock to be paid in the form of cash, check, or electronic funds transfer, by the delivery of already-owned shares of the Company's common stock or by a reduction of the number of shares deliverable pursuant to the award, by services rendered by the recipient of the award, by notice and third party payment or cashless exercise on such terms as the Administrator may authorize, or any other form permitted by law.

No Repricing

In no case (except due to an adjustment to reflect a stock split or similar event or any repricing that may be approved by stockholders) will any adjustment be made to a stock option or stock appreciation right award under the 2008 Plan (by amendment, cancellation and regrant, exchange or other means) that would constitute a repricing of the per share exercise or base price of the award.

Eligibility

Persons eligible to receive awards under the 2008 Plan include officers or employees of the Company or any of its subsidiaries, directors of the Company, and certain consultants and advisors to the Company or any of its subsidiaries. Currently, approximately 14,000 officers and employees of the Company and its subsidiaries (including all of the Company's named executive officers with the exception of Mr. Kevin P. Finan who retired from the Company on January 1, 2008), and each of the Company's nine non-employee directors, are considered eligible under the 2008 Plan.

Authorized Shares; Limits on Awards

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The maximum number of shares of the Company's common stock that may be issued or transferred pursuant to awards under the 2008 Plan equals the sum of: (1) 2,100,000 shares, plus (2) the number of shares available for additional award grant purposes under the 2004 Plan as of the date of the Annual Meeting and determined immediately prior to the termination of the authority to grant new awards under that

plan as of the date of the Annual Meeting, plus (3) the number of any shares subject to stock options granted under the 2004 Plan and outstanding as of the date of the Annual Meeting

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which expire, or for any reason are cancelled or terminated, after the date of the Annual Meeting without being exercised (including any shares subject to outstanding stock options granted under the 1999 Long-Term Incentive Equity Plan (the "1999 LTIP") which expire, or for any reason are cancelled or terminated, after the date of the Annual Meeting without being exercised that would otherwise become available for award grant purposes under the 2004 Plan in accordance with the terms of that plan), plus (4) the number of any shares subject to restricted stock and restricted stock unit awards granted under the 2004 Plan that are outstanding and unvested as of the date of the Annual Meeting which are forfeited, terminated, cancelled, or otherwise reacquired after the date of the Annual Meeting without having become vested. As of March 13, 2008, 145,615 shares were available for additional award grant purposes under the 2004 Plan, approximately 1,706,529 shares were subject to awards then outstanding under the 2004 Plan and approximately 1,147,873 shares were subject to awards then outstanding under the 1999 LTIP. As noted above, no additional awards will be granted under the 2004 Plan if stockholders approve the 2008 Plan.

Shares issued in respect of any full-value award granted under the 2008 Plan will be counted against the share limit described in the preceding paragraph as 1.7 shares for every one share actually issued in connection with the award. For example, if the Company granted 100 shares of its common stock under the 2008 Plan, 170 shares would be charged against the share limit with respect to that award. For this purpose, a full-value award generally means any award granted under the plan other than a stock option or stock appreciation right.

The following other limits are also contained in the 2008 Plan:

The maximum number of shares that may be delivered pursuant to options qualified as incentive stock options granted under the plan is 2,100,000 shares.

The maximum number of shares subject to those options and stock appreciation rights that are granted during any calendar year to any individual under the plan is 300,000 shares.

Performance-Based Awards under Section 5.2 of the 2008 Plan payable only in cash and not related to shares and granted to a participant in any one calendar year will not provide for payment of more than \$1,000,000.

To the extent that an award is settled in cash or a form other than shares, the shares that would have been delivered had there been no such cash or other settlement will not be counted against the shares available for issuance under the 2008 Plan. In the event that shares are delivered in respect of a dividend equivalent right, only the actual number of shares delivered with respect to the award shall be counted against the share limits of the 2008 Plan. To the extent that shares are delivered pursuant to the exercise of a stock appreciation right or stock option, the number of underlying shares as to which the exercise related shall be counted against the applicable share limits, as opposed to only counting the shares actually issued. (For purposes of clarity, if a stock appreciation right relates to 100,000 shares and is exercised at a time when the payment due to the participant is 15,000 shares, 100,000 shares shall be charged against the applicable share limits with respect to such exercise.) Shares that are subject to or underlie awards which expire or for any reason are cancelled or terminated, are forfeited, fail to vest, or for any other reason are not paid or delivered under the 2008 Plan will again be available for subsequent awards under the 2008 Plan. Shares that are exchanged by a participant or withheld by the Company to pay the exercise price of an award granted under the 2008 Plan, as well as any shares exchanged or withheld to satisfy the tax withholding obligations related to any award, will not be available for subsequent awards under the 2008 Plan. In addition, the 2008 Plan generally provides that shares issued in connection with awards that are granted by or become obligations of the company through the assumption of awards (or in substitution for awards) in connection with an acquisition of another company will not count against the shares available for issuance under the 2008

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Plan. The Company may not increase the applicable share limits of the 2008 Plan by repurchasing shares of common stock on the market (by using cash received through the exercise of stock options or otherwise).

Types of Awards

The 2008 Plan authorizes stock options, stock appreciation rights, restricted stock, stock bonuses and other forms of awards granted or denominated in the Company's common stock or units of the Company's common stock, as well as cash bonus awards pursuant to Section 5.2 of the 2008 Plan. The 2008 Plan retains flexibility to offer competitive incentives and to tailor benefits to specific needs and circumstances. Any award may be paid or settled in cash.

A stock option is the right to purchase shares of the Company's common stock at a future date at a specified price per share (the exercise price). The per share exercise price of an option generally may not be less than the fair market value of a share of the Company's common stock on the date of grant. The maximum term of an option is ten years from the date of grant. An option may either be an incentive stock option or a nonqualified stock option. Incentive stock option benefits are taxed differently from nonqualified stock options, as described under Federal Income Tax Consequences of Awards Under the 2008 Plan below. Incentive stock options are also subject to more restrictive terms and are limited in amount by the U.S. Internal Revenue Code and the 2008 Plan. Incentive stock options may only be granted to employees of the Company or a subsidiary.

A stock appreciation right is the right to receive payment of an amount equal to the excess of the fair market value of share of the Company's common stock on the date of exercise of the stock appreciation right over the base price of the stock appreciation right. The base price will be established by the Administrator at the time of grant of the stock appreciation right and generally may not be less than the fair market value of a share of the Company's common stock on the date of grant. Stock appreciation rights may be granted in connection with other awards or independently. The maximum term of a stock appreciation right is ten years from the date of grant.

The per share exercise price of an option or the per share base price of a stock appreciation right may, however, be less than the fair market value of a share of the Company's common stock on the date of grant if the option or stock appreciation right will be treated as a full-value award under the share-counting rules for the 2008 Plan described above.

The other types of awards that may be granted under the 2008 Plan include, without limitation, stock bonuses, restricted stock, performance stock, stock units, dividend equivalents, or similar rights to purchase or acquire shares, and cash awards granted consistent with Section 5.2 of the 2008 Plan as described below.

Performance-Based Awards

The Administrator may grant awards that are intended to be performance-based within the meaning of Section 162(m) of the U.S. Internal Revenue Code (Performance-Based Awards). Performance-Based Awards are in addition to any of the other types of awards that may be granted under the 2008 Plan (including options and stock appreciation rights which may also qualify as performance-based awards for Section 162(m) purposes). Performance-Based Awards may be in the form of restricted stock, performance stock, stock units, other rights, or cash bonus opportunities.

The vesting or payment of Performance-Based Awards (other than options or stock appreciation rights) will depend on the absolute or relative performance of the Company on a consolidated, subsidiary, segment, division, or business unit basis. The Administrator will establish the criterion or criteria and target(s) on which performance will be measured. The Administrator must establish criteria and targets in advance of applicable deadlines under the U.S. Internal Revenue Code and while the attainment of the performance targets remains substantially uncertain. The criteria that the

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Administrator may use for this purpose will include one or more of the following: earnings per share, cash flow (which means cash and cash equivalents derived from either net cash flow from operations or net cash flow from operations, financing and investing activities), total stockholder return, gross revenue, revenue growth, operating income (before or after taxes), net earnings (before or after interest, taxes, depreciation and/or amortization), return on equity or on assets or on net investment, cost containment or reduction, profitability, economic value added, market share, productivity, safety, customer satisfaction, on-time performance, or any combination thereof. The performance measurement period with respect to an award may range from three months to ten years. Performance targets will be adjusted to mitigate the unbudgeted impact of material, unusual or nonrecurring gains and losses, accounting changes or other extraordinary events not foreseen at the time the targets were set unless the Administrator provides otherwise at the time of establishing the targets.

Performance-Based Awards may be paid in stock or in cash (in either case, subject to the limits described under the heading "Authorized Shares; Limits on Awards" above). Before any Performance-Based Award (other than an option or stock appreciation right) is paid, the Administrator must certify that the performance target or targets have been satisfied. The Administrator has discretion to determine the performance target or targets and any

other restrictions or other limitations of Performance-Based Awards and may reserve discretion to reduce payments below maximum award limits.

Deferrals

The Administrator may provide for the deferred payment of awards, and may determine the other terms applicable to deferrals. The Administrator may provide that deferred settlements include the payment or crediting of interest or other earnings on the deferred amounts, or the payment or crediting of dividend equivalents where the deferred amounts are denominated in shares.

Assumption and Termination of Awards

Generally, and subject to limited exceptions set forth in the 2008 Plan, if the Company dissolves or undergoes certain corporate transactions such as a merger, business combination, or other reorganization, or a sale of substantially all of its assets, all awards then-outstanding under the 2008 Plan will become fully vested or paid, as applicable, and will terminate or be terminated in such circumstances, unless the Administrator provides for the assumption, substitution or other continuation of the award. The Administrator also has the discretion to establish other change in control provisions with respect to awards granted under the 2008 Plan. For example, the Administrator could provide for the acceleration of vesting or payment of an award in connection with a corporate event that is not described above and provide that any such acceleration shall be automatic upon the occurrence of any such event.

Transfer Restrictions

Subject to certain exceptions contained in Section 5.7 of the 2008 Plan, awards under the 2008 Plan generally are not transferable by the recipient other than by will or the laws of descent and distribution and are generally exercisable, during the recipient's lifetime, only by the recipient. Any amounts payable or shares issuable pursuant to an award generally will be paid only to the recipient or the recipient's

beneficiary or representative. The Administrator has discretion, however, to establish written conditions and procedures for the transfer of awards to other persons or entities, provided that such transfers comply with applicable federal and state securities laws and, with limited exceptions set forth in the 2008 Plan, are not made for value.

Adjustments

As is customary in incentive plans of this nature, each share limit and the number and kind of shares available under the 2008 Plan and any outstanding awards, as well as the exercise or purchase prices of awards, and performance targets under certain types of performance-based awards, are subject to

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adjustment in the event of certain reorganizations, mergers, combinations, recapitalizations, stock splits, stock dividends, or other similar events that change the number or kind of shares outstanding, and extraordinary dividends or distributions of property to the stockholders.

No Limit on Other Authority

Except as expressly provided with respect to the termination of the authority to grant new awards under the 2004 Plan if stockholders approve the 2008 Plan, the 2008 Plan does not limit the authority of the Board of Directors or any committee to grant awards or authorize any other compensation, with or without reference to the Company's common stock, under any other plan or authority.

Termination Of or Changes to the 2008 Plan

The Board of Directors may amend or terminate the 2008 Plan at any time and in any manner. Stockholder approval for an amendment will be required only to the extent then required by applicable law or any applicable listing agency or required under Sections 162, 422 or 424 of the U.S. Internal Revenue Code to preserve the intended tax consequences of the plan. For example, stockholder approval will be required for any amendment that proposes to increase the maximum number of shares that may be delivered with respect to awards granted under the 2008 Plan. (Adjustments as a result of stock splits or similar events will not, however, be considered an amendment requiring stockholder approval.) Unless terminated earlier by the Board of Directors, the authority to grant new awards under the 2008 Plan will terminate on March 12, 2018. Outstanding awards, as well as the Administrator's authority with respect thereto, generally will continue following the expiration or termination of the plan. Generally speaking, outstanding awards may be amended by the Administrator (except for a repricing), but the consent of the award holder is required if the amendment (or any plan amendment) materially and adversely affects the holder.

Federal Income Tax Consequences of Awards under the 2008 Plan

The U.S. federal income tax consequences of the 2008 Plan under current federal law, which is subject to change, are summarized in the following discussion of the general tax principles applicable to the 2008 Plan. This summary is not intended to be exhaustive and, among other considerations, does not describe the deferred compensation provisions of Section 409A of the U.S. Internal Revenue Code to the extent an award is subject to and does not satisfy those rules, nor does it describe state, local, or international tax consequences.

With respect to nonqualified stock options, the company is generally entitled to deduct and the participant recognizes taxable income in an amount equal to the difference between the option exercise price and the fair market value of the shares at the time of exercise. With respect to incentive stock options, the company is generally not entitled to a deduction nor does the participant recognize income at the time of exercise, although the participant may be subject to the U.S. federal alternative minimum tax.

The current federal income tax consequences of other awards authorized under the 2008 Plan generally follow certain basic patterns: nontransferable restricted stock subject to a substantial risk of forfeiture results in income recognition equal to the excess of the fair market value over the price paid (if any) only at the time the restrictions lapse (unless the recipient elects to accelerate recognition as of the date of grant); bonuses, stock appreciation rights, cash and stock-based performance awards, dividend equivalents, stock units, and other types of awards are generally subject to tax at the time of payment; and compensation otherwise effectively deferred is taxed when paid. In each of the foregoing cases, the company will generally have a corresponding deduction at the time the participant recognizes income.

If an award is accelerated under the 2008 Plan in connection with a change in control (as this term is used under the U.S. Internal Revenue Code), the company may not be permitted to deduct the portion of the

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compensation attributable to the acceleration (parachute payments) if it exceeds certain threshold limits under the U.S. Internal Revenue Code (and certain related excise taxes may be triggered). Furthermore, the aggregate compensation in excess of \$1,000,000 attributable to awards that are not performance-based within the meaning of Section 162(m) of the U.S. Internal Revenue Code may not be permitted to be deducted by the company in certain circumstances.

Specific Benefits under the 2008 Performance Incentive Plan

As described under Director Compensation, the Board of Directors has approved a program under which a portion of the annual retainer for each of our non-employee directors is paid in the form of deferred stock units. As of 2008, the number of stock units paid to each director will be determined by dividing \$36,000 by the closing price of a share of our common stock on the date of our Annual Meeting each year. The stock units will be fully vested and will be paid out in shares of our common stock on a one-for-one basis upon the termination of the director's service under the 2008 Plan. The actual number of shares that will be paid to our non-employee directors under this program is not determinable as that number will be calculated each year based on our stock price on the applicable Annual Meeting date. For purposes of illustration, if the closing price on the date of the 2008 Annual Meeting were the same as the closing price on March 13, 2008 listed below, each of our nine non-employee directors would be credited 1,935 stock units on that date (calculated by dividing \$36,000 by \$18.60, the closing price of our common stock on March 13, 2008).

Except for the non-employee director program described above, the Company has not approved any other awards that are conditioned upon stockholder approval of the proposed 2008 Plan. The Company is not currently considering any other specific award grants under the 2008 Plan. If the 2008 Plan had been in existence in fiscal 2007, the Company expects that its award grants for fiscal 2007 would not have been substantially different from those actually made in that year under the 2004 Plan. For information regarding stock-based awards granted to the Company's named executive officers during fiscal 2007, see the material in this proxy statement under the heading Executive Compensation.

The closing market price for a share of the Company's common stock as of March 13, 2008 was \$18.60 per share.

Equity Compensation Plan Information

The Company currently maintains five equity compensation plans that have been approved by the Company's stockholders: the 2004 Plan, the 2002 Employee Stock Purchase Plan (the ESPP), 1999 LTIP, the 1996 Long-Term Incentive Equity Plan (the 1996 LTIP) and the 1988 Stock Option Plan (the 1988 Plan). In addition, the Company currently maintains the 1997 Non-Officer Long-Term Incentive Equity Plan (the 1997 Plan) which was not approved by the Company's stockholders. Stockholders are also being asked to approve a new equity compensation plan, the 2008 Plan, as described above.

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The following table sets forth, for each of the Company's equity compensation plans, the number of shares of common stock subject to outstanding options and other rights, the weighted-average exercise price of outstanding options, and the number of shares remaining available for future award grants as of December 31, 2007.

Plan category	Number of shares of Common Stock to be issued upon exercise of outstanding options and rights	Weighted-average exercise price of outstanding options	Number of shares of Common Stock remaining available for future issuance under equity compensation plans (excluding shares reflected in the first column)
Equity compensation plans approved by stockholders	2,497,584(1)	\$ 32.34(2)	1,054,110(3)
Equity compensation plans not approved by stockholders(4)	448,995	\$ 34.18	N/A
Total	2,946,579	\$ 32.67	1,054,110

- (1) Of these shares, 726,518 were subject to options then outstanding under the 2004 Plan, and 440,796 were subject to outstanding restricted and performance stock unit awards granted under the 2004 Plan. In addition, 1,151,248 shares were subject to options then outstanding under the 1999 LTIP, 169,022 shares were subject to options then outstanding under the 1996 LTIP, and 10,000 shares were subject to options then outstanding under the 1988 Plan. No new award of grants may be made under the 1999 LTIP, the 1996 LTIP or the 1988 Plan.
- (2) This number does not reflect the 440,796 shares that were subject to outstanding stock unit awards granted under the 2004 Plan.
- (3) This number is presented after giving effect to purchases under the ESPP for the purchase period that ended November 30, 2007. Of the aggregate number of shares that remained available for future issuance, 684,830 shares were available under the 2004 Plan, and 369,280 shares were available under the ESPP. No new awards will be granted under the 2004 Plan if stockholders approve the 2008 Plan. This table does not reflect the 2,100,000 additional shares that will be available under the 2008 Plan if stockholders approve the 2008 Plan proposal.
- (4) All of these shares were subject to options then outstanding under the 1997 Plan. No new award of grants may be made under the 1997 Plan.

1997 Non-Officer Long-Term Incentive Equity Plan

The 1997 Plan terminated on November 3, 2002 and no further awards may be granted under the plan. Awards granted before that date remain outstanding in accordance with their terms. Employees of the Company who were not officers or non-employee directors were eligible for award of grants under the 1997 Plan. The 1997 Plan is administered by the Compensation Committee. The Committee has broad discretion authority to construe and interpret the plan. No award or any interest in any award granted under the 1997 Plan may be transferred in any manner, other than by will or the laws of descent and distribution, except as otherwise provided by the Committee.

Vote Required and Recommendation of the Board of Directors

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The Board of Directors believes that the adoption of the 2008 Plan will promote the interests of the Company and its stockholders and will help the Company and its subsidiaries continue to be able to attract, retain and reward persons important to our success.

All members of our Board of Directors and all of our executive officers are eligible for awards under the 2008 Plan and thus have a personal interest in the approval of the 2008 Plan.

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Approval of Proposal 2 requires the affirmative vote of the holders of a majority of shares present in person or represented by proxy and entitled to vote on the proposal. Any broker non-votes will not be counted in determining the number of shares necessary for approval of the proposal, assuming a quorum is obtained. Abstentions will have the same effect as a vote against Proposal 2.

THE BOARD OF DIRECTORS RECOMMENDS THAT YOU VOTE *FOR* PROPOSAL 2 TO APPROVE THE 2008 PERFORMANCE INCENTIVE PLAN AS DESCRIBED ABOVE AND SET FORTH IN *EXHIBIT A* HERETO.

Table of Contents**CORPORATE GOVERNANCE****Structure of the Board of Directors**

In accordance with the Delaware General Corporation Law and the Company's Certificate of Incorporation and Bylaws, our business affairs are managed under the direction of our Board of Directors. Directors meet their responsibilities by, among other things, participating in meetings of the Board and Board committees on which they serve, discussing matters with our Chairman and Chief Executive Officer and other officers, reviewing materials provided to them, and visiting our facilities.

Pursuant to the Bylaws, the Board of Directors has established four standing committees, which are the Audit Committee, the Compensation Committee, the Governance and Nominating Committee, and the Safety Committee. Only independent directors serve on these committees. The Board has adopted a written charter for each committee. The charters of the Audit, Compensation, Governance and Nominating, and Safety Committees are posted on the Company's website and can be accessed free of charge at <http://www.alaskaair.com/> and are available in print to any stockholder who submits a written request to the Company's Corporate Secretary.

The table below shows the current membership of the standing Board committees. An asterisk (*) identifies the chair of each committee. Mr. Wien will retire from the Board of Directors and as the chair of the Safety Committee effective May 20, 2008. Mr. Thompson has been appointed to replace Mr. Wien as chair of that Committee.

Name	Audit	Compensation	Governance and Nominating	Safety
Patricia M. Bedient	X*			
Phyllis J. Campbell		X*		
Mark R. Hamilton	X			X
Jessie J. Knight, Jr.		X	X	
R. Marc Langland			X*	
Byron I. Mallott			X	X
Dennis F. Madsen	X	X		
J. Kenneth Thompson			X	X*
Richard A. Wien				X*

The principal functions of the standing Board committees are as follows:

Audit Committee

Pursuant to its charter, the Audit Committee's responsibilities include the following:

1. Matters pertaining to the independent auditors:

appoint them and oversee their work;

review at least annually their statement regarding their internal quality-control procedures and their relationship with the Company;

maintain a dialogue with respect to their independence;

pre-approve all auditing and non-auditing services they are to perform;

review annual and quarterly financial statements and filings made with the SEC; and

receive and review communications required from the independent auditors under applicable rules and standards.

2. Review the planned activities and results of the internal auditors and any changes in the internal audit charter.

3. Prepare the Audit Committee Report required for the annual proxy statement.

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4. Matters pertaining to controls:

review financial reporting risk and associated internal controls;

review procedures with respect to significant accounting policies and the adequacy of financial controls;

discuss with management policies with respect to risk assessment and risk management including the process by which the Company undertakes risk assessment and management;

discuss with management, as appropriate, earnings releases and any information provided to analysts and rating agencies;

develop and monitor a Corporate Compliance program, including a Code of Conduct and Ethics policy, decide on requested changes to or waivers of such program and code relating to officers and directors, and establish procedures for confidential treatment of complaints concerning accounting, internal controls or auditing matters; and

obtain and review at least quarterly a statement from the CEO, CFO and Disclosure Committee disclosing any significant deficiencies in internal controls and any fraud that involves management or other employees with significant roles in internal controls.

5. Annually review and reassess the adequacy of its charter and the Committee's performance and recommend for Board approval any proposed changes to the charter.

Compensation Committee

Pursuant to its charter, the Compensation Committee's responsibilities include the following:

1. Establish the process for approving corporate goals relevant to CEO compensation and evaluating CEO performance in light of those goals.

2. Set the salary of the CEO.

3. Approve salaries of other elected executive officers of Alaska Airlines and Horizon Air.

4. Set annual goals under the Performance-Based Pay plan and administer the plan.

5. Grant stock awards and stock options.

6. Administer the supplementary retirement plans for elected officers and the equity-based incentive plans.

7. Make recommendations to the Board regarding other executive compensation issues, including modification or adoption of plans.

8. Fulfill ERISA fiduciary and non-fiduciary functions for tax-qualified retirement plans by monitoring the Pension/Benefits Administrative Committee and the Pension/Benefits Funds Investment Committee, and approve the membership of those

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committees, trustees and trust agreements, and extension of plan participation to employees of subsidiaries.

9. Approve the terms of employment and severance agreements with elected officers and the form of change in control agreements.

10. Review executive-level development and succession plans.

11. Administer and make recommendations to the Board of Directors with respect to the Company's equity and other long-term incentive equity plans.

12. Produce the report on executive compensation required for the annual proxy statement.

13. Annually review and reassess the adequacy of the Committee's charter and its performance, and recommend any proposed changes in the charter to the Board of Directors for approval.

Pursuant to its charter, the Compensation Committee is authorized to retain such

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compensation consultants and other outside experts or advisors as it believes to be necessary or appropriate to carry out its duties. In 2007, the Compensation Committee retained the firm of Deloitte Consulting LLP (Deloitte Consulting) as independent compensation consultants to assist it in determining compensation matters for our senior executive officers.

During 2007, the Committee reviewed its charter and recommended that the Board of Directors modify the charter to update the fiduciary functions of the Alaska Air Group Defined Contribution Retirement Plan Administrative Committee.

Governance and Nominating Committee

Pursuant to its charter, the Governance and Nominating Committee s responsibilities include the following:

1. Develop and monitor the Corporate Governance Guidelines.
2. Evaluate the size and composition of the Board and annually review compensation paid to members of the Board.
3. Develop criteria for Board membership.
4. Evaluate the independence of existing and prospective members of the Board.
5. Seek qualified candidates for election to the Board.
6. Evaluate the nature, structure and composition of other Board committees.
7. Take steps it deems necessary or appropriate with respect to annual assessments of the performance of the Board, and each Board committee, including itself.
8. Annually review and reassess the adequacy of the Committee s charter and its performance, and recommend any proposed changes in the charter to the Board of Directors for approval.

Safety Committee

Pursuant to its charter, the Safety Committee s responsibilities include the following:

1. Monitor management s efforts to ensure the safety of passengers and employees.
2. Monitor and assist management in creating a uniform safety culture that achieves the highest possible industry performance measures.
3. Periodically review with management and outside experts all aspects of airline safety.
4. Evaluate the Company s health, safety and environmental policies and practices.

Board and Committee Meetings

In 2007, the Board of Directors held six regular meetings. The standing Board committees held the following number of meetings in 2007:

Audit Committee 10

Compensation Committee 6

Governance and Nominating Committee 5

Safety Committee 4

Each director attended at least 97% of all Board and applicable committee meetings during 2007. Each director is expected to attend the Company's Annual Meeting of Stockholders. Last year, all then-current directors attended the annual meeting.

Board and Committee Independence

The Board of Directors of the Company has determined that all of the directors except Mr. Ayer, which includes each member of the Audit Committee, Governance and Nominating Committee, and Compensation Committee, are independent under the NYSE listing standards and the Company's independent director standards that are set forth in the Company's Corporate Governance Guidelines. In making its determination, the Board of Directors considered the amount of charitable contributions made by

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the Company to certain charitable organizations on which Ms. Bedient and Messrs. Thompson and Mallott serve as directors or advisory board members and the amount of a charitable contribution made by the Company to the University of Alaska where Mr. Hamilton is currently employed as President. After consideration of these matters and in accordance with the Board's independent director criteria, the Board of Directors affirmatively determined that none of these matters is a material relationship with the Company because the amount of the contributions were immaterial with respect to the Company's and the charitable organizations' annual revenues.

Each member of the Company's Audit Committee meets the additional independence, financial literacy and experience requirements contained in the corporate governance listing standards of the NYSE relating to audit committees or required by the SEC. The Board has determined that Ms. Bedient is an audit committee financial expert as defined in SEC rules.

The Corporate Governance Guidelines are available on the Company's internet website at <http://www.alaskaair.com> and are available in print to any stockholder who submits a written request to the Company's Corporate Secretary. Specifically, the Board has determined that independent directors meet the following criteria:

An independent director must have no material relationship with the Company, based on all material facts and circumstances. At a minimum, an independent director must meet each of the categorical standards listed below.

1. The director has not, within the last three years, been employed by and no immediate family member has been an executive officer of the Company.
2. Neither the director nor any immediate family member has, in any 12-month period in the last three years, received more than \$100,000 in direct compensation from the Company, other than compensation for director or committee service and pension or other deferred compensation for prior service.
3. (i) Neither the director nor any immediate family member is a current partner of the Company's independent auditor; (ii) the director is not a current employee of the audit firm; (iii) no immediate family member is a current employee of the audit firm working in its audit, assurance or tax compliance practice; and (iv) neither the director nor any immediate family member was an employee or partner of the audit firm within the last three years and worked on the Company's audit within that time.
4. Neither the director nor any immediate family member has, within the last three years, been part of an interlocking directorate. This means that no executive officer of the Company serves on the compensation committee of a company that employs the director or immediate family member.
5. The director is not currently an employee, and no immediate family member is an executive officer, of another company (i) that represented at least 2% or \$1 million, whichever is greater, of the Company's gross revenues, or (ii) of which the Company represented at least 2% or \$1 million, whichever is greater, of such other company's gross revenues, in any of the last three fiscal years. Charitable contributions are excluded from this calculation.

The Board considers that the following situations do not create material relationships:

- a. the receipt by a director of retirement compensation earned under one or more tax-qualified or nonqualified plans during the director's employment with the Company;
- b. ordinary-course business between the Company and an organization of which the Board member is an officer or director, where the amount of such business is immaterial with respect to the Company's or the organization's annual revenues; or
- c. the receipt of cash or in-kind contributions from the Company by a tax-exempt charitable organization of which the Board member is an officer or director, the value of which is immaterial with respect to the Company's or the charitable organization's annual revenues.

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For the purposes of these standards, Company includes all Alaska Air Group subsidiaries and other affiliates. Immediate family member includes the director's spouse, domestic partner, parents, children, siblings, mothers- and fathers-in-law, sons- and daughters-in-law, and anyone sharing the director's home. The independence standards for the members of the Audit Committee provide that in addition to the foregoing standards they may not (a) receive any compensation other than director's fees for Board and Audit Committee service and permitted retirement pay, or (b) be an affiliate of the Company as defined by applicable SEC rules.

Director Nomination

Identification and Evaluation of Candidates

1. Internal Process for Identifying Candidates

The Governance and Nominating Committee (the Committee) has two primary methods for identifying candidates (other than those proposed by the Company's stockholders, as discussed below). First, on a periodic basis, the Committee solicits ideas for possible candidates from a number of sources including, but not limited to, members of the Board, senior-level Company executives, individuals personally known to the members of the Board, and research, including database and internet searches.

Additionally, the Committee may, from time to time, use its authority under its charter to retain at the Company's expense one or more search firms to identify candidates (and to approve any such firms' fees and other retention terms). If the Committee retains one or more search firms, those firms may be asked to identify possible candidates who meet the minimum and desired qualifications established by the Committee and to undertake such other duties as the Committee may direct.

2. Candidates Proposed by Stockholders

a. General Nomination Right of All Stockholders

Any stockholder of the Company may nominate one or more persons for election as a director of the Company at an annual meeting of stockholders if the stockholder complies with the notice, information and consent provisions contained in Article II, Section 8 of the Company's Bylaws. Specifically, these provisions require that written notice of a stockholder's intent to make a nomination for the election of directors be received by the Secretary of the Company at least 90 days in advance of the third Tuesday in May (with respect to elections held at a regular annual meeting of stockholders), and that such notice include:

The name and address of the stockholder who intends to make the nomination and of the person(s) to be nominated;

A representation that the stockholder of record is entitled to vote at the meeting;

A description of all arrangements or understandings between the stockholder and each nominee and any other person(s) (naming them) pursuant to which the nomination is to be made;

Other information regarding each nominee as would have been required to be included in a proxy statement filed pursuant to the proxy rules of the Securities and Exchange Commission had each nominee been nominated by the Board of Directors; and

The consent of each nominee to serve as a director if elected.

The Corporate Secretary and General Counsel will send a copy of the Company's Bylaws to any interested stockholder who requests them. The Company's Bylaws are also available on the Company's website at <http://www.alaskaair.com>.

b. Consideration of Director Candidates Recommended by Stockholders

The Committee will evaluate candidates recommended by a single stockholder, or group of stockholders, that has beneficially owned more than 5% of the Company's outstanding common stock for at least one year and that satisfies the notice, information and consent

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provisions set forth below (such individual or group is referred to as the Qualified Stockholder). The Committee s policy on the evaluation of candidates recommended by stockholders who are not Qualified Stockholders is to evaluate such recommendations, and establish procedures for such evaluations, on a case-by-case basis. This policy allows the Committee to devote an appropriate amount of its own and the Company s resources to each such recommendation, depending on the nature of the recommendation itself and any supporting materials provided. In addition, as discussed above, non-Qualified Stockholders have the ability to nominate one or more director candidates directly at the Annual Meeting. All candidates (whether identified internally or by a stockholder) who, after evaluation, are then recommended by the Committee and approved by the Board, will be included in the Company s recommended slate of director nominees in its proxy statement.

c. Initial Consideration of Candidates Recommended by Qualified Stockholders

The Committee will evaluate candidates recommended by Qualified Stockholders in accordance with the following procedures.

Qualified Stockholders may propose a candidate for evaluation by the Committee by delivering a written notice to the Committee satisfying each of the requirements described below (the Notice). The Notice must be received by the Committee not less than 120 calendar days before the anniversary of the date that the Company s proxy statement was released to stockholders in connection with the previous year s annual meeting. No such notice was received in connection with the 2008 Annual Meeting.

Any candidate recommended by a Qualified Stockholder must be independent of the Qualified Stockholder in all respects (i.e., free of any material personal, professional, financial or business relationships from the nominating stockholder), as determined by the Committee or by applicable law. Any candidate submitted by a Qualified Stockholder must also meet the definition of an independent director under applicable NYSE rules.

The Notice shall also contain or be accompanied by the following information or documentation:

Proof of the required stock ownership (including the required holding period) of the stockholder or group of stockholders. The Committee may determine whether the required stock ownership condition has been satisfied for any stockholder that is the stockholder of record. Any stockholder that is not the stockholder of record must submit such evidence as the Committee deems reasonable to evidence the required ownership percentage and holding period.

A written statement that the stockholder intends to continue to own the required percentage of shares through the date of the annual meeting with respect to which the candidate is nominated.

The name or names of each stockholder submitting the proposal, the name of the candidate, and the written consent of each such stockholder and the candidate to be publicly identified.

Regarding the candidate, such person s name, age, business and residence address, principal occupation or employment, number of shares of the Company s stock beneficially owned, if any, a written resume or curriculum vitae of personal and professional experiences, and all other information relating to the candidate that would be required to be disclosed in a proxy statement or other filings required in connection with the solicitation of proxies for election of directors pursuant to Section 14 of the Securities Exchange Act of 1934, as amended, and the regulations promulgated thereunder (the Exchange Act).

Regarding the candidate, information, documents or affidavits demonstrating to what extent the candidate meets the required minimum criteria, and the desirable qualities or skills, established

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by the Committee. The Notice must also include a written statement that the stockholder submitting the proposal and the candidate will make available to the Committee all information reasonably requested in furtherance of the Committee's evaluation of the candidate.

Regarding the stockholder submitting the proposal, the person's business address and contact information and any other information that would be required to be disclosed in a proxy statement or other filings required in connection with the solicitation of proxies for election of directors pursuant to Section 14 of the Exchange Act.

The signature of each candidate and of each stockholder submitting the proposal.

The Notice shall be delivered in writing by registered or certified first-class mail, postage prepaid, to the following address:

Board of Directors

Alaska Air Group, Inc.

PO Box 68947

Seattle, WA 98168

The Corporate Secretary and General Counsel will promptly forward the Notice to the Chair of the Governance and Nominating Committee.

d. Initial Consideration of Candidates Recommended by Other Stockholders

If, based on the Committee's initial screening of a candidate recommended by a Qualified Stockholder, a candidate continues to be of interest to the Committee, the Chair of the Committee will request that the CEO interview the candidate and the candidate will be interviewed by one or more of the other Committee members. If the results of these interviews are favorable, the candidate recommended by a Qualified Stockholder will be evaluated as set forth below. Except as may be required by applicable law, rule or regulation, the Committee will have no obligation to discuss the outcome of the evaluation process or the reasons for the Committee's recommendations with any Qualified Stockholder who made a proposal.

3. Evaluation of Candidates

As to each recommended candidate that the Committee believes merits consideration, the Committee will cause to be assembled information concerning the background, qualifications and appropriate references of the candidate, including information concerning the candidate required to be disclosed in the Company's proxy statement under the rules of the SEC and any relationship between the candidate and the person or persons recommending the candidate. The Committee will then (i) determine if the candidate satisfies the qualifications set forth below under the caption *Policy on Minimum Qualifications for All Directors*; (ii) conduct interviews with the candidate as it deems necessary and appropriate; and (iii) consider the contribution that the candidate can be expected to make to the overall functioning of the Board. The Committee will then meet to consider and finalize its list of recommended candidates for the Board's consideration.

The Governance and Nominating Committee will consider incumbent candidates based on the same criteria used for candidates recommended by Qualified Stockholders, provided that incumbents will also be considered on the basis of the Committee's annual evaluations of the effectiveness of the Board, its committees and their members.

Policy on Minimum Qualifications for All Directors

While there is no formal list of qualifications, the Governance and Nominating Committee considers, among other things, the prospective nominees' relevant experience, intelligence, independence, commitment, ability to work with the Chief Executive Officer and within the Board culture, prominence, diversity, age, understanding of the Company's business, and other factors deemed relevant. For

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candidates to serve as independent directors, an independent and questioning mindset is critical. The Committee also considers whether the prospective candidates' workloads would allow them to attend the vast majority of Board meetings, be willing and available to serve on Board committees, and devote the additional time and effort necessary to keep up with Board matters and the rapidly changing environment in which the Company operates. Different substantive areas may assume greater or lesser significance at particular times, in light of the Board's present composition and the Committee's (or the Board's) perceptions about future issues and needs. Relevant experiences might include, among other things, company CEO experience, senior-level international experience, senior-level regulatory or legal experience, and relevant senior-level expertise in one or more of the following areas: finance, accounting, sales and marketing, organizational development, information technology and public relations.

Stockholder Communication Policy

Any stockholder or interested party who wishes to communicate with our Board of Directors or any specific directors, including our Lead Director (who presides over executive sessions of the non-employee directors) or with the non-employee directors as a group, may write to:

Board of Directors

Alaska Air Group, Inc.

PO Box 68947

Seattle, WA 98168

Depending on the subject matter, management will:

forward the communication to the director or directors to whom it is addressed (for example, if the communication received deals with questions, concerns or complaints regarding accounting, internal accounting controls and auditing matters, it will be forwarded by management to the Chairman of the Audit Committee for review);

attempt to handle the inquiry directly (for example, where it is a request for information about us or our operations or it is a stock-related matter that does not appear to require direct attention by our Board of Directors or an individual director); or

not forward the communication if it is primarily commercial in nature or if it relates to an improper or irrelevant topic. At each meeting of the Governance and Nominating Committee, the Corporate Secretary and General Counsel will present a summary of all communications received since the last meeting of the Governance and Nominating Committee that were not forwarded and will make those communications available to any director on request.

Executive Sessions and Lead Director

The Board holds regular executive sessions of non-management directors quarterly. As provided in the Governance and Nominating Committee Charter, the Lead Director who presides over these executive sessions is the chair of the Governance and Nominating Committee.

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The following table presents information regarding the compensation paid for 2007 to members of our Board of Directors who are not also our employees (referred to herein as Non-Employee Directors). The compensation paid to Mr. Ayer, who is also one of our employees, is presented in the Summary Compensation Table and the related explanatory tables. Mr. Ayer does not receive additional compensation for his service as a director.

Name	Fees Earned or Paid in Cash	Stock Awards	Option Awards	Non-Equity Incentive Plan Compensation	Change in Pension Value and Nonqualified Deferred Compensation Earnings	All Other Compensation	Total
(a)	(\$)(1) (b)	(\$)(2) (c)	(\$)(2) (d)	(\$)(2) (e)	(\$)(2) (f)	(\$)(3) (g)	(\$) (h)
Patricia M. Bedient	62,200	0	0	0	0	901	63,101
Phyllis J. Campbell	60,200	0	0	0	0	1,867	62,067
Mark R. Hamilton	51,300	0	0	0	0	6,757	58,057
Bruce R. Kennedy(4)	35,300	0	0	0	0	131,715	167,015
Jessie J. Knight, Jr.	50,550	0	0	0	0	2,711	53,261
R. Marc Langland	58,250	0	0	0	0	3,839	62,089
Dennis F. Madsen	54,900	0	0	0	0	3,298	58,198
Byron I. Mallott	49,500	0	0	0	0	11,233	60,733
John V. Rindlaub(6)	14,800	0	0	0	0	2,240	17,040
J. Kenneth Thompson	51,500	0	0	0	0	10,237	61,737
Richard A. Wien	49,300	0	0	0	0	3,790	53,090

- (1) Each of our non-employee directors received at least 50% of their \$30,000 annual retainer for 2007 in the form of shares of the Company's common stock issued under the Company's 2004 Plan. The Board of Directors (or a committee appointed by the Board of one or more individuals who are not eligible to participate in the plan) administers the plan as to non-employee director stock payments and has the ability to interpret and make all required determinations under the plan, subject to plan limits. In connection with the payment of a portion of a non-employee director's annual retainer in the form of common stock, the Board of Directors has established stock ownership guidelines that strongly encourage non-employee directors to accumulate shares of Company stock equal in value to one year's retainer within five years of becoming a director. For 2007, Ms. Bedient and Messrs. Knight, Madsen and Thompson elected to receive the entire amount of their annual retainer in stock, and Mr. Langland elected to receive an additional 25% of his annual retainer in stock, per the terms of the 2004 Plan. The number of shares awarded was determined pursuant to the terms of the 2004 Plan by dividing the dollar value of the retainer to be paid in stock by \$26.51, the closing price of our stock the day immediately following our 2007 annual meeting. Fractional shares are settled in cash. Accordingly, each of our Non-Employee Directors received 565 shares on June 13, 2007, except the four directors identified above who each received 1,131 shares and Mr. Langland who received 848 shares on that date. These shares were fully vested on issue. No other equity-based awards were granted to our non-employee directors for 2007.

In 2007, in addition to the \$30,000 annual retainer referenced above, the compensation for our non-employee directors included the following:

attendance fees of \$2,000 for each Audit Committee meeting and \$1,200 per day for each Board or other committee meeting in which a non-employee director participated in person, or \$750 if participation was via telephone;

\$500 for participation in telephone updates that occur between meetings;

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an annual retainer of \$8,000 to the Audit Committee chair and \$5,000 to other committee chairs;

an annual retainer of \$1,000 to non-employee directors who also served on the Board of Directors of Alaska Airlines or Horizon Air;

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attendance fees of \$1,500 to members of the Company's Finance Group; and

reimbursement of expenses in connection with attending Board and committee meetings as well as expenses in connection with director education.

In 2008, the Board of Directors increased from \$5,000 to \$10,000 the annual retainer for the Chair of the Governance and Nominating Committee, who is also the Lead Director, in light of the responsibilities of the Lead Director role. This change is effective May 20, 2008.

- (2) None of our non-employee directors held any unvested equity-based awards as of December 31, 2007. We do not grant stock options to our non-employee directors. Our directors do not participate in any non-equity incentive compensation plans, nor do they participate in a nonqualified deferred compensation plan. Directors do not receive pension benefits for their service.

In November 2007, the Board of Directors approved certain changes to the compensation for our non-employee directors. Beginning in 2008, the annual retainer for each non-employee director will be paid \$15,000 in cash and \$36,000 in the form of deferred stock units, with the number of units to be determined by dividing the retainer amount by the closing price of our common stock on the date of the annual meeting. The stock units will be paid in shares of our common stock on a one-for-one basis following the termination of the director's service as a member of the Board. In all other respects, the fee schedule for non-employee directors described above remains in effect.

- (3) As part of a director's compensation, each Non-Employee Director, the Non-Employee Director's spouse and the Non-Employee Director's dependent children are provided transportation on Alaska Airlines and Horizon Air. Included in the All Other Compensation column for each non-employee director is the incremental cost to the Company of providing these benefits, as well the value of each director's membership in our airport Boardroom program.

In addition, the All Other Compensation column includes the value of reimbursements for taxes on the transportation benefits provided to each director as quantified below:

Director	Value of Taxes Paid (\$)
Patricia M. Bedient	563
Phyllis J. Campbell	1,403
Mark R. Hamilton	5,747
Bruce R. Kennedy	848
Jessie J. Knight, Jr.	2,268
R. Marc Langland	3,218
Dennis F. Madsen	2,634
Byron I. Mallott	9,572
John V. Rindlaub	1,734
J. Kenneth Thompson	9,206
Richard A. Wien	3,284

- (4) Mr. Kennedy passed away on June 28, 2007. During the years that Mr. Kennedy was employed by the Company, he accrued annual retirement benefits under the Company's Retirement Plan for Salaried Employees and its 1976 Elected Officers Supplementary Retirement Plan. Mr. Kennedy's benefits paid under these plans in 2007 were \$39,340 and \$90,601, respectively. Mr. Kennedy did not receive any retirement or death benefits in connection with his service as a director.

(5) Amount reported for Mr. Knight includes California state tax reimbursement provided in connection with his transportation benefit.

(6) Mr. Rindlaub retired from the board effective June 12, 2007.

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CEO AND CFO CERTIFICATIONS

In accordance with NYSE listing standards, the Company's 2007 CEO certification required by Section 303a.12(a) of the NYSE Listed Company Manual has been filed with the NYSE. In addition, the Company's CEO and CFO certifications required under Section 302 of the Sarbanes-Oxley Act are filed as exhibits to the Company's Annual Report on Form 10-K.

CODE OF CONDUCT AND ETHICS

The Company has adopted a Code of Conduct and Ethics that applies to all employees of the Company, including our Chief Executive Officer, Chief Financial Officer, principal accounting officer and persons performing similar functions. The Code of Conduct and Ethics is located on the Company's internet website at <http://www.alaskaair.com> and is available in print to any stockholder who requests it. Information on the Company's website, however, does not form a part of this proxy statement. The Company intends to disclose any amendments (other than technical, administrative or non-substantive amendments) to, and any waivers from, a provision of the Code of Conduct and Ethics for directors or executive officers on the Company's internet website.

CERTAIN RELATIONSHIPS AND RELATED TRANSACTIONS

Policies and Procedures for Approval of Related Person Transactions

Our Board of Directors has adopted a written policy for review, approval or ratification of any transaction, arrangement or relationship in which we were, are or will be a participant, the aggregate amount involved exceeds \$120,000 in any calendar year, and a related person has or will have a direct or indirect material interest (other than solely as a result of being a director or the beneficial owner of less than 10% of another entity). For purposes of the policy, a related person is (i) any person who is, or at any time since the beginning of our last fiscal year was, one of our directors or executive officers or a nominee to become a director, (ii) any beneficial owner of more than 5% of our common stock; or (iii) any immediate family member of any of these persons.

Under the policy, once a related person transaction has been identified, the Audit Committee (or the Chair of the Audit Committee for transactions that involve an aggregate amount of less than \$1 million) must review the transaction for approval or ratification. Members of the Audit Committee or the Chair of the Audit Committee, as applicable, will review all relevant facts regarding the transaction in determining whether to approve or ratify it, including the extent of the related person's interest in the transaction, whether the terms are comparable to those generally available in arms-length transactions, and whether the transaction is consistent with the best interests of the Company. The related person involved in the transaction will participate in the approval or ratification process only to provide additional information as requested for the review. Once initially approved or ratified, all transactions with related persons will be reviewed at least annually.

The policy does not require review or approval of the following transactions: (i) employment by the Company of an executive officer unless he or she is an immediate family member of another related person; (ii) any compensation paid by the Company to a director; and (iii) transaction in which a related person's interest arises solely from the ownership of equity securities and all holders of the securities receive the same benefit on a pro rata basis.

Certain Transactions with Related Persons

The Company and its subsidiaries have transactions in the ordinary course of business with other corporations of which the Company's executive officers or directors or members of their immediate families are directors, executive

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officers, or stockholders. The amounts involved are below disclosure thresholds set by the SEC, or the executive officer or director or his or her family member does not have a direct or indirect material interest, as that term is used in SEC rules, in the transaction.

SECTION 16(a) BENEFICIAL OWNERSHIP REPORTING COMPLIANCE

Section 16(a) of the Securities Exchange Act of 1934 requires the Company's directors and certain of its officers to send reports of their ownership of Company common stock and changes in such ownership to the SEC and the NYSE. The Company assists its directors and officers by preparing forms for filing. SEC regulations also require the Company to identify in this proxy statement any person subject to this requirement who failed to file a report on a timely basis. Based on a review of copies of reports furnished to the Company and written representations that no other reports were required, the Company believes that everyone subject to Section 16(a) filed the required reports on a timely basis during 2007.

INDEPENDENT AUDITORS**Selection of Independent Auditors for the Current Fiscal Year**

The Audit Committee of the Board of Directors has selected KPMG LLP (KPMG) as the Company's independent auditors for the current fiscal year. Representatives of KPMG are expected to attend the meeting to respond to questions from stockholders and will have the opportunity to make a statement, if they wish to do so.

Fees Paid to Independent Auditors

During fiscal years 2007 and 2006, the Company retained KPMG as its principal auditors. The independent auditors provided services in the following categories and amounts:

2007	KPMG LLP
Audit Fees for the Company's Annual Financial Statements and Quarterly Reviews(1)	\$ 1,212,523
Audit-Related Fees(2)	155,000
Tax Fees(3)	24,159
All Other Fees(4)	33,000
Total Fees for 2007	\$ 1,424,682
2006	KPMG LLP
Audit Fees for the Company's Annual Financial Statements and Quarterly Reviews(1)	\$ 1,219,139
2006	KPMG LLP
Audit-Related Fees(2)	175,718
Tax Fees(3)	25,446
All Other Fees(4)	34,417
Total Fees for 2006	\$ 1,454,720

(1) Audit fees represent the arranged fees for the years presented, including the annual audit of internal controls as mandated under Sarbanes-Oxley Section 404.

- (2) Consists of fees paid in connection with the audit of Air Group's employee benefit plans in both years.
 - (3) Consists of fees paid for professional services in connection with tax consulting related to specific aircraft leasing and acquisition matters. These services were pre-approved by the audit committee.
 - (4) Consists of fees paid for professional services in connection with (i) the audit of passenger facility charges and examination of related controls, (ii) the examination of agreed-upon procedures for the U.S. Citizenship and Immigration Services, and (iii) agreed-upon procedures regarding Air Group's employee incentive pay plans.
- The Audit Committee has considered whether the provision of the non-audit services referenced above is compatible with maintaining the independence of the Company's independent auditors, and has determined that it does not impact the independence of the auditors.

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Independent Auditor Engagement Policy

The Audit Committee has established an Independent Auditor Engagement Policy that is designed to ensure that the Company's auditor performs its services independently and with the highest integrity and professionalism. The Audit Committee reviews the policy annually.

The policy provides that any engagement of the Company's outside auditor must be consistent with principles determined by the SEC, namely, whether the independent auditor is capable of exercising impartial judgment on all issues encompassed within the auditor's engagement.

Permitted services under the policy include audit services, audit-related services, certain tax services and certain other services not prohibited by SEC rules or other federal regulations. Before retaining its independent auditor for non-audit services, the Audit Committee will consider factors such as whether the services might compromise the auditor's independence, whether the auditor is the best provider for the services, and the appropriate proportion of audit to non-audit services.

All services must be pre-approved by the Audit Committee except for certain services other than audit, review or attest services that meet the de minimis exception under 17 CFR Section 210.2-01, namely:

the aggregate amount of fees paid for all such services is not more than five percent (5%) of the total fees paid by the Company to its auditor during the fiscal year in which the services are provided;

such services were not recognized by the Company at the time of the engagement to be non-audit services; and

such services are promptly brought to the attention of the Audit Committee and approved prior to the completion of the audit.

During fiscal years 2007 and 2006, there were no such services that were performed pursuant to the de minimis exception.

AUDIT COMMITTEE REPORT

The following report of the Audit Committee shall not be deemed to be soliciting material or to be filed with the SEC under the Securities Act of 1933, as amended, or the Securities Exchange Act of 1934, as amended, or incorporated by reference in any document so filed.

Review of Our Company's Audited Financial Statements

The Audit Committee has reviewed and discussed with management and KPMG, the Company's independent auditors, the Company's audited financial statements included in the Company's Annual Report on Form 10-K for the fiscal year ended December 31, 2007. We believe that management maintains an effective system of internal controls that results in fairly presented financial statements.

The discussions with KPMG also included the material and judgmental matters required by Statement on Auditing Standards No. 114, *The Auditor's Communication with Those Charged with Governance*, as amended, by the Auditing Standards Board of the American Institute of Certified Public Accountants.

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We have also received and reviewed the written disclosures and the KPMG letter required by Independence Standard No. 1, *Independence Discussions with Audit Committees* by the Independence Standards Board, and we have discussed with KPMG their independence.

Based on the review and discussions described above, the Audit Committee recommended to the Board of Directors that the audited financial statements be included in Alaska Air Group's Annual Report on Form 10-K for the fiscal year ended December 31, 2007.

Audit Committee of the Board of Directors

Patricia M. Bedient, Chairperson

Mark R. Hamilton, Member

Dennis F. Madsen, Member

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SECURITY OWNERSHIP OF CERTAIN BENEFICIAL OWNERS AND MANAGEMENT

This table shows how much Company common stock is owned as of March 14, 2008, by (a) each director and nominee, (b) each of the Company's executive officers named in the Summary Compensation Table, and (c) all executive officers as a group. Except as otherwise indicated and subject to applicable community property laws, the persons named in the table below have sole voting and investment power with respect to all shares of common stock beneficially owned.

Name	Number of Shares of Common Stock Owned(1)	Options Exercisable within 60 Days	Total Shares Beneficially Owned(2)	Percent of Outstanding Shares(3)
Patricia M. Bedient	3,082	0	3,082	*
Phyllis J. Campbell	3,224	0	3,224	*
Mark R. Hamilton	2,345	0	2,345	*
Jessie J. Knight, Jr.	4,252	0	4,252	*
R. Marc Langland	5,848	0	5,848	*
Dennis F. Madsen	3,938	0	3,938	*
Byron I. Mallott	3,957	0	3,957	*
J. Kenneth Thompson	8,082	0	8,082	*
Richard A. Wien	8,965	0	8,965	*
William S. Ayer	49,485	467,225	516,710	1.4%
Kevin P. Finan	7,396	74,607	82,003	*
Bradley D. Tilden	11,115	123,012	134,127	*
Gregg A. Saretsky	8,508	104,104	112,612	*
Jeffrey D. Pinneo	6,454	83,545	89,999	*
All directors and all executive officers as a group (17 persons)	131,626	936,602	1,068,228	2.9%

* Less than 1%

(1) Consists of the aggregate total of shares of common stock held by the reporting person either directly or indirectly, including 401(k) plan holdings.

(2) Total beneficial ownership is determined in accordance with the rules of the Securities and Exchange Commission and represents the sum of the columns "Number of Shares of Common Stock Owned" and "Options Exercisable with 60 Days." Beneficial ownership does not include shares of common stock payable upon the vesting of restricted stock units, none of which will vest within 60 days, as follows: Mr. Ayer, 30,825; Mr. Finan, 15,300; Mr. Tilden, 20,150; Mr. Saretsky, 18,670 and Mr. Pinneo, 16,060.

(3) We determine applicable percentage ownership based on 36,575,476 shares of our common stock outstanding as of March 14, 2008. We deem shares subject to options that are currently exercisable or exercisable on or before May 13, 2008 as outstanding for purposes of computing the percentage ownership of the person holding such stock options, but we do not deem them outstanding for purposes of computing the percentage ownership of any other person.

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The table below identifies those persons known by us to have beneficial ownership of more than 5% of the Company's outstanding common stock, as of March 14, 2008.

Name and Address of Beneficial Owner	Number of Shares Owned	Percent of Outstanding Shares(1)
Donald Smith & Co., Inc.(2) 152 West 57th Street New York, NY 10019	4,041,511	11.0
Dimensional Fund Advisors LP.(3) 1299 Ocean Avenue, 11th Floor Santa Monica, CA 90401	2,911,767	8.0
PRIMECAP Management Company(4) 225 South Lake Avenue, #400 Pasadena, CA 91101	2,701,050	7.4
Wells Fargo & Company(5) 420 Montgomery Street San Francisco, CA 94163	2,628,942	7.2
Vanguard Chester Funds Vanguard PRIMECAP Fund(6) 100 Vanguard Boulevard Malvern, PA 19355	2,540,000	6.9
Barclays Global Investors. NA(7) 45 Fremont Street San Francisco, CA 94105	1,901,351	5.2

- (1) We determine applicable percentage ownership based on 36,575,476 shares of our common stock outstanding as of March 14, 2008.
- (2) Beneficial ownership information is based on a Schedule 13G filed by Donald Smith & Co., Inc. (Donald Smith) on February 8, 2008. Donald Smith stated in the Schedule 13G that the reported securities are owned by its advisory clients, no one of which, to Donald Smith's knowledge, owns more than 5% of the class. Donald Smith further reported that it had sole voting power over 3,263,511 of the shares and dispositive voting power over all 4,041,511 shares.
- (3) Beneficial ownership information is based on a Schedule 13G/A filed by Dimensional Fund Advisors LP. (Dimensional) on February 6, 2008. Dimensional reported in the Schedule 13G/A that, as an investment advisor registered under Section 203 of the Investment Advisors Act of 1940, it furnishes investment advice to four investment companies and serves as investment manager to other accounts (collectively, the Funds), which hold the shares shown in the table above. To Dimensional's knowledge, the interest of any one Fund does not exceed 5% of the class of securities. Dimensional further reported that while it possesses voting and investment power over all 2,911,767 shares, such shares are owned by the Funds, and Dimensional disclaims beneficial ownership of such shares.
- (4) Beneficial ownership information is based on a Schedule 13G/A filed by PRIMECAP Management Company (PRIMECAP) on February 14, 2008. PRIMECAP reported in the Schedule 13G/A that it had sole voting power over 138,000 shares and sole dispositive power over all 2,701,050 shares.

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- (5) Beneficial ownership information is based on a Schedule 13G filed by Wells Fargo & Company on February 1, 2008. Wells Fargo & Company reported that it had sole voting power over 865,220 of the shares, sole dispositive power over 837,049 and shared dispositive power over 1,763,722. The Schedule 13G was filed by Wells Fargo & Company on its own behalf and on behalf of four subsidiaries: Wells Capital Management Incorporated; Wells Fargo Funds Management, LLC; Wells Fargo Bank, National Association; and Wells Fargo Investments, LLC.
- (6) Beneficial ownership information is based on a Schedule 13G/A filed by Vanguard Chester Funds-Vanguard Primecap Fund (Vanguard) on February 27, 2008. Vanguard reported in the Schedule 13G/A that it had sole voting power over all 2,540,000 shares.
- (7) Beneficial ownership information is based on a Schedule 13G filed by Barclay Global Investors, NA (Barclay) on January 22, 2008. Barclay reported that it had sole voting power over 744,865 shares and sole dispositive power over 910,819, and that Barclay Global Fund Advisors had sole voting and dispositive power over 990,532 shares.

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COMPENSATION DISCUSSION AND ANALYSIS

Executive Summary

This section contains a discussion of the material elements of compensation earned during 2007 by our Named Executive Officers listed in the Summary Compensation Table below: Chief Executive Officer (CEO) of Alaska Air Group, Inc. Bill Ayer; Chief Financial Officer of Alaska Air Group, Inc. Brad Tilden; Jeff Pinneo, the CEO of operating subsidiary Horizon Air Industries, Inc.; and Gregg Saretsky and Kevin Finan, two elected officers of subsidiary Alaska Airlines who have or had policy-making roles at the Alaska Air Group level. Mr. Finan retired on January 1, 2008.

The structure of our executive compensation program is designed to compensate executives appropriately and fairly and to drive superior performance. For our Named Executive Officers, a high proportion of total direct compensation is at risk and tied to the success of the Company because they are the leaders primarily responsible for the overall execution of the Company's strategy. The strategic goals of the Company are reflected in our incentive-based executive compensation programs so that executives' interests are aligned with shareholder interests. Executive compensation is designed to be internally equitable, reflective of the business challenges facing the Company, and scaled to the industry.

Objectives of our Executive Compensation Program

The objectives of the Company's executive compensation programs are as follows:

to attract and retain highly qualified executives who share our Company values and commitment to the Company's 2010 strategic plan by designing the total compensation package to be entrepreneurial, fair, and competitive with appropriate reference points as described below;

to motivate executives to provide excellent leadership and achieve Company goals by linking short-term and long-term incentives to the achievement of specific goals as reflected in executives' personal commitment plans, the Performance-Based Pay plan, and the Company's 2010 strategic plan;

to align the interests of executives, employees, and stockholders by tying a large portion of our executives' total direct compensation (base salary, short-term incentive pay, and equity awards) to the achievement of objective goals related to the Company's safety record, cost structure, employee engagement and profitability; and

to provide executives with reasonable security, through a combination of performance-based incentives, retirement plans and change in control agreements that motivate them to continue employment with the Company and achieve goals that will help the Company remain competitive and thrive in the long term.

How Executive Compensation is Determined

The Role of the Compensation Committee, Management and Consultants

Our Compensation Committee determines and approves Mr. Ayer's compensation. Mr. Ayer recommends compensation for the other Named Executive Officers and the Compensation Committee approves it. None of the other Named Executive Officers have a role in determining executive compensation.

The Committee retained Deloitte Consulting to provide advice with respect to trends in executive compensation, determination of pay programs, assessment of competitive pay levels and mix (e.g., proportion of fixed pay to incentive pay, proportion of annual cash pay to long-term incentive pay), and setting compensation levels. In 2007, Deloitte Consulting reviewed our peer group companies (identified below) and assisted the Committee with the collection and analysis of current executive compensation data

for these peer group companies. The Compensation Committee utilizes consulting advice in its deliberative process in addition to the other factors discussed below.

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How the Elements of our Executive Compensation Program were Selected

The Compensation Committee conducts an annual review of the Company's executive compensation to ensure that it is structured to satisfy our objectives. The Committee considers how each component of compensation motivates executives to help the Company achieve its performance goals and how it promotes retention of executives who share the Company's values. Our compensation structure is designed to promote initiative, resourcefulness and teamwork by key employees whose performance and responsibilities directly affect our results of operations.

The Committee utilizes both fixed compensation and variable performance-based compensation to achieve a balanced program that is competitive and fair. Base salaries, benefits, perquisites, retirement benefits, and change in control benefits are primarily intended to attract and retain highly qualified executives. Base salaries, benefits and perquisites are service-based and are paid out on a short-term or current basis. These are the elements of the Company's executive compensation program where the value of the benefit in any given year is not dependent on performance (although base salary and benefits determined by reference to base salary may increase from year to year depending on performance, among other things).

Annual incentives and long-term equity-based incentives are intended to motivate executives to achieve specific performance objectives. Annual incentives, based on the achievement of objective performance goals and long-term equity-based incentives are paid out on a longer-term basis. We believe that this mix of short-term and longer-term compensation allows us to achieve our dual goals of attracting and retaining highly qualified executives with an entrepreneurial spirit and providing meaningful performance incentives for those executives.

Executive Pay Mix and the Emphasis on At Risk Pay

The Compensation Committee believes that emphasis on at risk compensation at the senior executive levels of the Company is a key element in achieving a pay-for-performance culture, since it aligns management's interests with those of the Company's stockholders.

Total direct compensation for a Named Executive Officer is tailored to place a substantial emphasis on at risk pay that is tied to performance objectives. For 2007, the Committee approved target-level compensation for Mr. Ayer that is 80% at risk and tied to stockholder value creation. With respect to the other Named Executive Officers, the Committee approved target compensation that is on average 67% at risk and tied also to stockholder value creation.

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Methodology for Determining Pay

The Use of Benchmarking

In 2007, the Compensation Committee reviewed and analyzed total direct compensation at the executive level. The analysis included the use of benchmarking, a review of total direct compensation as compared to market data. For this purpose, the Committee considered air carrier peer group data as well as general industry data. The data was weighted 2/3 airline and 1/3 general industry to identify a market consensus compensation level for each executive position. For the analysis of market consensus, the Committee applied a greater focus on peer group air carriers because these are the primary companies that compete with the Company for key talent, customers, and stockholder investment. Peer group air carrier companies also receive greater emphasis because in our industry the vast majority of our employees are unionized and have pay that is often compared to their industry peers. For 2007, the peer group consisted of Air Tran Holdings, AMR Corporation, Continental Airlines Inc., Delta Air Lines Inc., Frontier Airline Holdings, Jet Blue Airways Corporation, Northwest Airlines Corporation, Southwest Airlines Corporation, UAL Corporation and US Airways Group Inc. The Committee also considered general industry data of companies with similar revenues because it recognizes that our executives have opportunities outside the industry.

The Application of Internal Equity Considerations

The Committee believes that the appropriate way to compensate executive officers is to consider many principles of compensation, including internal equity and fundamental fairness. The Committee recognizes that Chief Executive Officer compensation at many publicly traded companies in the United States has dramatically increased over a short period of time. The Committee recognizes that compensation data is susceptible to ratcheting, or one-upmanship. This leads the Committee, with the Chief Executive Officer's full support, to not blindly accept benchmarking data to set compensation levels. Thus, while the Committee has considered peer group data as described above, it has also applied other compensation principles such as internal equity when determining Chief Executive Officer compensation. As a result, the Committee's determination of total direct compensation for the Chief Executive Officer position reflects a substantial discount from market consensus. At current levels, the Chief Executive Officer's total direct compensation represents approximately two times that of the Executive Vice President level, and approximately four times that of the Vice President level. By considering internal equity, the Committee believes that the resulting data points are more reliable and more insulated from external ratcheting effects.

The Use of Tally Sheets and Wealth Accumulation Analysis

Annually, the Committee reviews tally sheets that show each element of compensation for an individual. For each Named Executive Officer, base salaries, benefit values, incentive plan payments, equity awards, equity exercises, perquisites and retirement benefits are included on tally sheets. The Company's corporate affairs and human resource departments prepare the tally sheets. To date, the Committee's use of tally sheets has provided verification that executive compensation is internally equitable and proportioned according to the Committee's expectations with regard to at risk compensation.

The Use of Performance Measures

We use objective performance goals in our annual incentive program, our Performance-Based Pay plan, and in our long-term equity incentive program. Annual incentives and long-term incentives are intended to motivate executives to achieve superior performance levels by setting goals that are tied to the Alaska 2010 plan and by linking executives' compensation to long-term stockholder gain.

Current Executive Compensation Elements

Base Pay

In general, for Named Executive Officers, the Committee targeted base salary levels in the 25th percentile based on market consensus data

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identified in the review described above. The Committee assessed each executive's duties and scope of responsibilities, past performance and expected future contributions to the Company, the market demand for the individual's skills, the individual's influence on long-term Company strategies and success, and the individual's leadership performance, and internal equity.

In setting Chief Executive Officer compensation for 2007, the Committee received candid and direct input from Mr. Ayer. At the initiation of Mr. Ayer, his base salary for 2007 remained at the same level it has for the past two years, and lower than it had been in the three years prior to that. The Committee believes that Mr. Ayer's leadership in this matter has been invaluable in re-affirming the Company's values and commitment to the 2010 strategic plan. In 2007, Mr. Ayer's base salary was in the 25th percentile compared to our peer group. The chart below depicts Chief Executive Officer base salaries at airline peer group companies.

CEO Base Pay Comparisons (Airlines)**2005, 2006 and 2007 Base Salary**

Alaska Air Group, Inc.	\$	360,000
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2007 Base Salary (Air Group peers)

Air Tran Holdings	\$	450,000
AMR Corporation	\$	581,534
Continental Airlines, Inc.	\$	712,500
Delta Air Lines, Inc.	\$	337,500
Frontier Airline Holdings	\$	311,250
Jet Blue Airways Corporation	\$	200,000
Northwest Airlines Corporation	\$	516,384
Southwest Airlines Corporation	\$	424,065
UAL Corporation	\$	850,000
US Airways Group, Inc.	\$	550,000
Average Base Salary (Air Group peers)	\$	493,323

Based on its review of executive compensation, the Committee did not increase base salary levels of the other Named Executive Officers in 2007. The Committee believes that 25th percentile base salary levels for the other Named Executive Officers, with the opportunity to earn market-level compensation through short- and long-term incentive plans that pay when performance objectives are met, are appropriate. The base salary levels of the other Named Executive Officers averaged in the 25th percentile for 2007.

Performance-Based Annual Incentives

Our Named Executive Officers are eligible to earn annual incentive pay under our Performance-Based Pay plan, which is intended to motivate the executives to achieve specific Company goals. The Committee aligns executive compensation with the Company's strategic plan by choosing a target level performance for the Performance-Based Pay plan that is consistent with the Company's strategic plan goals.

Each participant in the Performance-Based Pay plan is assigned a target participation level, expressed as a percentage of the participant's base salary. For the Named Executive Officers, the 2007 target participation levels are as follows:

Name	Target Participation as % of Base Salary
Bill Ayer	100%
Brad Tilden	75%
Gregg Saretsky	75%

Kevin Finan

75%

Jeff Pinneo

75%

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Incentive award payments may range from zero to 200% of the Named Executive Officers' target based on the achievement of the objective performance standards set by the Compensation Committee at the beginning of each year. For 2007, the Performance-Based Pay Plan metrics were set as follows:

Goal	Weight	Threshold		Target		Maximum	
		Alaska	Horizon	Alaska	Horizon	Alaska	Horizon
Operational Performance							
Safety on-the-job injuries per 100 full time employees	10%	9.06	9.8	8.61	9.31	8.15	8.82
		or fewer	or fewer	or fewer	or fewer	or fewer	or fewer
Employee Engagement increase in favorable rating (& no increase in unfavorable)	10%	5%	3%	10%	5%	15%	8%
CASM ex fuel (cost per available seat mile)	10%	7.55¢	13.88¢	7.45¢	13.68¢	7.25	13.38¢
AAG Profitability							
Adjusted Pretax Profit	70%	\$200 m		\$325 m		\$450 m	

Target performance is set according to measures that will keep the Company on course for achieving its 2010 strategic plan. Maximum targets are approximately one and one half times target, and intended as "stretch" goals. Threshold goals are set to improve year-over-year performance. The 2007 Alaska Air Group Profitability target was established by identifying the level of profitability achieved with an 8% adjusted pre-tax profit margin. The Safety and Employee Engagement metrics were set to drive continuous improvement on those measures. The Cost Per Available Seat Mile metric was similarly chosen to promote the Company's progress on its 2010 strategic plan.

Historically, the Performance-Based Pay plan has paid out as follows:

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In addition, all of our employees, including our executive officers, participate in a separate incentive plan called Operational Performance Rewards, which pays a monthly incentive payment to all employees when particular operational performance targets are met. Awards are based on operational performance and customer satisfaction, and the maximum annual payout for each employee is \$1,200.

Long-Term Equity-Based Incentive Awards

An important element of our executive compensation program is our long-term equity-based incentive awards, which link executive pay to stockholder value. Our long-term equity incentives are primarily intended to align Named Executive Officers' long-term interests with stockholders' long-term interests, although we believe that by promoting stock ownership by our executives, they also play a role in helping us to attract and retain top-performing executives who fit a team-oriented and performance-driven culture.

The Committee issues annual equity grants to provide incentives to our executives to increase stockholder value. The Committee reviews equity grant guidelines that are modeled according to the total direct compensation levels and pay mix described above. Target equity grants achieve total direct compensation at the 50% percentile of market consensus for Named Executive Officers. Named Executive Officers' equity grants may be adjusted above or below target based on:

the individual's contribution to the success of the Company's financial performance;

internal equity;

the individual's performance of his or her job responsibilities; and

the accounting impact to the Company and potential dilution effects of the grant.

For our Named Executive Officers, equity incentive awards are proportioned according to a formula that considers the risk inherent in the various equity vehicles. For 2007, the Named Executive Officers were awarded equity as follows:

Name	Equity Target as % of Base Pay	Stock Options	Equity Mix	
			Restricted Stock Units	Performance Shares
Bill Ayer	200%	40%	20%	40%
Brad Tilden	100%	40%	20%	40%
Gregg Saretsky	100%	40%	20%	40%
Kevin Finan	100%	40%	20%	40%
Jeff Pinneo	100%	40%	20%	40%

Stock Options

The Company makes a portion of its long-term incentive grants to Named Executive Officers in the form of stock options with an exercise price that is equal to the fair market value of our common stock on the grant date. Thus, the Named Executive Officers will only realize value on their stock options if our stockholders realize value on their shares. The stock options also function as a retention incentive for our executives as they vest ratably over the four-year period after the date of grant.

Restricted Stock Units

The Company also grants long-term incentive awards to Named Executive Officers in the form of restricted stock units. Subject to the executive's continued employment with the Company, the restricted stock units vest only on the third anniversary of the date they are granted and, upon vesting, are paid in shares of our common stock. Thus, the units are designed both to link executives' interests with those of our stockholders as the units' value is based on the value of our common stock and to provide a long-term retention incentive for the vesting period.

Performance Shares

For 2007, the Company's granted the Named Executive Officers performance shares as part of our long-term equity-based incentive program. The shares will vest only if the Company achieves a pre-determined average pre-tax profit margin over the course of three years. For 2007, the Compensation Committee set target performance at 8% adjusted pre-tax profit margin (referred to as APM in the table

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below), which was consistent with the goal of the Company and identical to the target set for the Performance-Based Pay plan. By designating a proportion of an executive's compensation in performance shares, the Compensation Committee aims to further align total direct compensation for executives with the Company's strategic plan goals.

The 2007 grant of performance shares was set according to the following metrics:

Performance Share Metrics		Percentage of Stock
APM (three-year	average)	Units that Vest
Less than 4%		0.00%
4%		25.00%
5%		43.75%
6%		62.50%
7%		81.25%
8%		100.00%
9%		125.00%
10%		150.00%
11%		175.00%
12% and above		200.00%

Perquisites and Personal Benefits

In addition to cash and equity compensation, the Company provides the Named Executive Officers with certain perquisites and personal benefits, including automobile expenses and travel benefits. We believe that any perquisites offered to executives should be modest and should not make up a large proportion of the executive's compensation. In 2008, the Committee determined that an annual amount would be paid to each Named Executive Officer in lieu of all perquisites but travel, life insurance, health exams, AD&D insurance, and Alaska Airlines Boardroom membership. In terms of total direct compensation, the CEO's annual sum will be 2 % of total direct compensation.

Retirement Benefits/Deferred Compensation Opportunities

The Company provides retirement benefits to the Named Executive Officers under the terms of qualified and non-qualified defined-benefit and defined-contribution retirement plans. The Retirement Plan for Salaried Employees (the Salaried Retirement Plan) and our 401(k) plan are both tax-qualified retirement plans that the Named Executive Officers participate in on substantially the same terms as our other participating employees. However, due to maximum limitations imposed by the Employee Retirement Income Security Act of 1974 and the Internal Revenue Code on the annual amount of a pension which may be paid under a qualified defined benefit plan, the benefits that would otherwise be payable to the Named Executive Officers under the Salaried Retirement Plan are required to be limited. Because we wish to provide supplemental retirement benefits, we established the 1995 Elected Officers Supplementary Retirement Plan (the Supplementary Retirement Plan), an unfunded defined benefit plan designed to permit participants to receive the full amount of benefits that would be paid under the Salaried Retirement Plan but for the limitations and to provide supplemental retirement benefits.

Under our Nonqualified Deferred Compensation Plan, our Named Executive Officers are also permitted to elect to defer up to 100% of their annual Performance-Based Pay payments. The Company believes that providing the Named Executive Officers with deferred compensation opportunities is a cost-effective way to permit executives to receive the tax benefits associated with delaying the income tax event on the compensation deferred.

Please see the 2007 Pension Benefits and 2007 Nonqualified Deferred Compensation tables and information following them for a description of these plans.

Analysis of Our Agreements Regarding Change in Control and Termination

We do not have an employment agreement in place with Mr. Ayer nor with Messrs. Tilden, Saretsky, and Pinneo. Upon a leadership restructuring in April 2007, we entered into a Retirement and Non-Compete Agreement and a Consulting Agreement

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with Mr. Finan, who served as our Executive Vice President/Operations until April 25, 2007. Under the terms of the Retirement and Non-Compete Agreement, Mr. Finan served the remainder of 2007 as

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Executive Vice President/Strategic Projects and retired as of January 1, 2008. The full description of Mr. Finan's termination arrangements are set forth in the section "Potential Payments Upon Change In Control And Termination" on page 74.

We have change in control agreements with our other Named Executive Officers. In 2007, the Committee analyzed the Company's entire change in control program by reviewing a market analysis of change in control programs generally, and different potential scenarios for the Company specifically. The Committee concluded that the Company's program was competitive at the senior-most levels of the Company, but that it was overly broad with regard to participation. The Committee assessed the market data and the publicized institutional investor opinions regarding particular terms of change in control agreements, including excise tax reimbursement provisions. The Committee also reviewed changes necessary for compliance with Internal Revenue Service Section 409A regulations.

As a result of the review, the Committee narrowed program participation to a smaller group of executives. For some positions, the Committee reduced the severance multiple with respect to future hires, and the Committee re-defined the definition of "change in control" and modified the excise tax reimbursement provisions for current and future executives.

For the Named Executive Officers (with the exception of Mr. Finan, who is retired and no longer subject to a change in control agreement), the terms of their existing change in control agreements changed as of February 29, 2008, the date by which all four executed agreements with the new provisions. For the Named Executive Officers, the agreements contain a definition of "change in control" that requires consummation of a transaction and a modified excise tax reimbursement provision that requires excise taxes to exceed a 10 percent threshold before excise taxes will be reimbursed by the Company.

We have entered into change in control agreements because we believe that the occurrence, or potential occurrence, of a change in control transaction will create uncertainty and disruption during a critical transaction time for the Company. The payment of cash severance benefits is only triggered by an actual or constructive termination of employment following a change in control transaction because we believe that Named Executive Officers should be entitled to receive cash severance benefits only if both conditions are met. Once the change in control event commences, the Named Executive Officer's severance and benefits payable under the contract begins to diminish with time, until ultimate expiration of the agreement thirty-six months later.

In 2007, the Compensation Committee also revised the Company's equity award agreements such that equity will vest on an accelerated basis only in the event of a change in control plus actual or constructive discharge of the executive.

Policy with Respect to Section 162(m)

Section 162(m) of the Internal Revenue Code generally prohibits the Company from deducting certain compensation over \$1 million paid its chief executive officer and certain other executive officers unless such compensation is based on performance objectives meeting certain criteria or is otherwise excluded from the limitation. The Company strives whenever possible to structure its compensation plans such that they are tax deductible and believes that a substantial portion of compensation paid under its current program (including the annual incentives and stock option grants described above) satisfies the requirements under Section 162(m). However, the Company reserves the right to design programs that recognize a full range of performance criteria important to its success, even where the compensation paid under such programs may not be deductible. For 2007, the Company believes that no portion of its tax deduction for compensation paid to its Named Executive Officers will be disallowed under Section 162(m).

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COMPENSATION COMMITTEE REPORT(1)

The Compensation Committee has certain duties and powers as described in its charter. The Compensation Committee is currently composed of the three non-employee directors named at the end of this report, each of whom is independent as defined by the New York Stock Exchange listing standards.

The Compensation Committee has reviewed and discussed with management the disclosures contained in the Compensation Discussion and Analysis section of this proxy statement. Based upon this review and discussion, the Compensation Committee recommended to our Board of Directors that the Compensation Discussion and Analysis section be included in the Company's 2007 Annual Report on Form 10-K on file with the SEC.

Compensation Committee of the Board of Directors

Phyllis J. Campbell, Chairperson

Jessie J. Knight, Jr.

Dennis F. Madsen

COMPENSATION COMMITTEE INTERLOCKS AND INSIDER PARTICIPATION

The Compensation Committee members whose names appear on the Compensation Committee Report above were committee members during all of 2007. During 2007, Mr. Rindlaub also served as a member of the Compensation Committee until his retirement on June 12, 2007. No member of the Compensation Committee during 2007 is or has been a former or current executive officer or employee of the Company or has had any relationships requiring disclosure by the Company under the SEC's rules requiring disclosure of certain relationships and related-party transactions. None of the Company's executive officers served as a director or a member of a compensation committee (or other committee serving an equivalent function) of any other entity, the executive officers of which served as a director or member of the Compensation Committee during the fiscal year ended December 31, 2007.

- (1) SEC filings sometimes incorporate information by reference. This means the Company is referring you to information that has previously been filed with the SEC, and that this information should be considered as part of the filing you are reading. Unless the Company specifically states otherwise, this report shall not be deemed to be incorporated by reference and shall not constitute soliciting material or otherwise be considered filed under the Securities Act or the Securities Exchange Act.

Table of Contents**2007 SUMMARY COMPENSATION TABLE**

The following table presents information regarding compensation of our CEO, our chief financial officer and our three other most highly compensated executive officers for services rendered during 2007. These individuals are referred to as Named Executive Officers in this Proxy Statement.

Name and Principal Position (a)	Year (b)	Salary (\$) (c)	Bonus (\$) (d)	Stock Awards (\$)(1) (e)	Option Awards (\$)(1) (f)	Non-Equity Incentive Plan Compensation (\$)(2) (g)	Change in Pension Value and Nonqualified Deferred Compensation Earnings (\$)(3) (h)	All Other Compensation (\$)(4) (i)	Total (\$) (j)
William S. Ayer	2007	360,000	0	349,667	595,511	76,320	15,924	47,508	1,444,930
Chairman, President and CEO	2006	360,000	0	302,484	606,675	538,965	57,541	55,402	1,921,067
Bradley D. Tilden	2007	260,000	0	212,010	214,018	41,340	171,291	43,754	942,413
Executive Vice President/Finance and Planning and Chief Financial Officer	2006	260,000	0	130,554	151,486	233,531	49,450	69,389	894,410
Gregg A. Saretsky	2007	280,000	0	209,721	218,204	44,520	32,280	46,621	831,346
Executive Vice President/Marketing and Flight	2006	280,000	0	135,095	157,286	243,204	104,362	81,705	1,001,652
Kevin P. Finan(5)	2007	260,000	0	211,746	167,425	41,340	143,518	283,023	1,107,052
Former Executive Vice President/ Strategic Projects	2006	260,000	0	139,967	110,504	225,846	195,773	64,973	997,063
Jeffrey D. Pinneo(6)	2007	237,000	0	180,694	167,630	35,550	803,127	52,094	1,476,095
President and CEO (Horizon Air Industries)	2006	237,000	0	117,593	142,786	209,995	30,202	60,917	798,493

- (1) The amounts reported in Columns (e) and (f) of the Summary Compensation Table above reflect the aggregate dollar amounts recognized for stock awards and option awards, respectively, for financial statement reporting purposes with respect to 2007 and 2006 (disregarding any estimate of forfeitures related to service-based vesting conditions). Mr. Finan forfeited 2,875 options upon retirement on January 1, 2008. Otherwise, no stock awards or option awards granted to Named Executive Officers were forfeited in 2006 or 2007. For a discussion of the assumptions and methodologies used to value the awards reported in Column (e) and Column (f), please see the discussion of stock awards and option awards contained in Note 12 (Stock-Based Compensation Plans) to the Company's Consolidated Financial Statements, included as part of the Company's 2007 Annual Report filed on Form 10-K with the SEC and incorporated herein by reference. For information about the stock awards and option awards granted to our Named Executive Officers for 2007, please see the discussion under Grants of Plan-Based Awards below.

(2) The material terms of these bonus awards are described in the Compensation Discussion and Analysis section above.

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- (3) The amount reported in Column (h) of the Summary Compensation Table above reflects the year-over-year change in present value of accumulated benefits determined as of December 31 of each year for the Retirement Plan for Salaried Employees and the Officers Supplementary Retirement Plan as well as earnings on each Named Executive Officer's account under the Nonqualified Deferred Compensation Plan.
- (4) The following table presents detailed information on the types and amounts of compensation reported for the Named Executive Officers in Column (i) of the Summary Compensation Table. For Column (i), each perquisite and other personal benefit is included in the total and identified and, if it exceeds the greater of \$25,000 or 10% of the total amount of perquisites and other benefits for that officer, is quantified in the table below. All reimbursements of taxes with respect to perquisites and other benefits are identified and quantified. Also included in the total for Column (i) are: the Company's incremental cost of providing flight benefits, Alaska Airlines Board Room membership; gas allowance; annual physical; hotel allowance; financial, tax and estate planning; and accidental death and dismemberment insurance premiums.

Name	Company Contribution to 401(k) Account	Term Life Insurance Premiums (and Taxes Paid)	Medical Insurance Premiums (and Taxes Paid)	Automobile Expense	Travel Taxes Paid
William S. Ayer	\$ 6,750	\$1,164 (\$667)	\$9,899 (\$0)	\$20,800	\$ 8,269
Bradley D. Tilden	\$ 6,750	\$603 (\$346)	\$9,899 (\$0)	\$17,800	\$ 15,906
Gregg A. Saretsky	\$ 6,750	\$650 (\$372)	\$9,899 (\$0)	\$18,400	\$ 16,451
Kevin P. Finan	\$ 6,750	\$1,854 (\$1,063)	\$9,899 (\$0)	\$17,800	\$ 26,584
Jeffrey D. Pinneo	\$ 15,500	\$690 (\$395)	\$5,729 (\$3,981)	\$17,110	\$ 13,127

- (5) Mr. Finan retired on January 1, 2008. The amount reported in Column (i) for Mr. Finan also includes payments made pursuant to his Employment, Retirement and Non-Compete Agreement with the Company dated April 25, 2007. Mr. Finan received a retirement bonus payment of \$200,000 plus \$30,000 in payment of all accrued and unused vacation pursuant to the agreement.
- (6) In 2007, Mr. Pinneo became partially vested under the Supplementary Retirement Plan, and earned sufficient service under the Plan to accrue a benefit payable at his Normal Retirement Age. As a result of these changes, \$802,627 is included in the Summary Compensation Table in Column (h) as the Change in Pension Value and is attributable to Mr. Pinneo's vesting and service accruals under the Supplementary Retirement Plan during 2007. This accrual also includes Mr. Pinneo's nonqualified benefits described in the paragraph below. The Supplementary Retirement Plan and the nonqualified benefits are payable over the long-term after Mr. Pinneo retires from the Company.

Regarding Mr. Pinneo's nonqualified benefits, when Mr. Pinneo was elected President and CEO of Horizon Air in 2002, he was 100% vested under the Salaried Retirement Plan on account of prior service at Alaska. At that time, Horizon Air, which does not have a plan similar to the Salaried Retirement Plan, agreed to supplement his benefits to ensure that his retirement benefit will be equivalent to what he would have received had he been participating in the Salaried Retirement Plan during his tenure as President and CEO of Horizon Air.

Table of Contents**2007 GRANTS OF PLAN-BASED AWARDS**

The following table presents information regarding the incentive awards granted to the Named Executive Officers for 2007. Each of the equity-based awards reported in the table below was granted under our 2004 Plan.

Name	Grant Date	Thres-hold			Thres-hold			All Other Stock Awards: Number of Shares Underlying		All Other Option Awards: Number of Securities Underlying		Exercise or Base Price of Option Awards	Grant Date Fair Value of Stock and Option Awards
		(\$)	(\$)	(\$)	(\$)	(\$)	(\$)	(#)	(#)	(#)	(#)	(\$/Sh)	(\$)(2)
(a)	(b)	(c)	(d)	(e)	(f)	(g)	(h)	(i)	(j)	(k)	(l)	(m)	(n)
William S. Ayer	1/31/07	0	0	0	2,500	10,000	20,000	5,200	23,800	42.85	1,172,871		
	N/A	0	360,000	720,000	0	0	0	0	0	0	0		0
Kevin P. Finan	1/31/07	0	0	0	1,250	5,000	10,000	2,500	11,500(3)	42.85	563,033		
	N/A	0	195,000	390,000	0	0	0	0	0	0	0		0
Gregg A. Saretsky	1/31/07	0	0	0	1,350	5,400	10,800	2,700	12,300	42.85	605,554		
	6/14/07	0	0	0	0	0	0	0	7,700	27.40	105,412		
	N/A	0	210,000	420,000	0	0	0	0	0	0	0		0
Bradley D. Tilden	1/31/07	0	0	0	1,350	5,400	10,800	3,200	12,300	42.85	626,979		
	6/14/07	0	0	0	0	0	0	0	7,700	27.40	105,412		
	N/A	0	195,000	390,000	0	0	0	0	0	0	0		0
Jeffrey D. Pinneo	1/31/07	0	0	0	1,150	4,600	9,200	2,300	10,400	42.85	514,207		
	N/A	0	177,750	355,500	0	0	0	0	0	0	0		0

(1) Threshold, target and maximum are based on 25%, 100% and 200% estimated future payouts, respectively.

(2) The amounts reported in Column (l) reflect the fair value of these awards on the grant date as determined under the principles used to calculate the value of equity awards for purposes of the Company's financial statements and may or may not be representative of the value eventually realized by the executive. For a discussion of the assumptions and methodologies used to value the awards reported in Column (l), please see the discussion of stock awards and option awards contained in Note 10 (Stock-Based Compensation Plans) to the Company's Consolidated Financial Statements, included as part of the Company's 2007 Annual Report filed on Form 10-K with the SEC and incorporated herein by reference.

(3) This award preceded Mr. Finan's retirement on January 1, 2008. Upon retirement, 2,875 shares of the 11,500 options granted to him were forfeited pursuant to the terms of the equity agreement.

Description of Equity-Based Awards

Each of the equity-based awards reported in the Grants of Plan-Based Awards Table was granted under, and is subject to, the terms of the 2004 Plan. The 2004 Plan is administered by the Compensation Committee. The Committee has authority to interpret the plan provisions and make all required determinations under the plans. This authority includes making required proportionate adjustments to outstanding awards upon the occurrence of certain corporate events such as reorganizations, mergers and stock splits, and making provisions to ensure that any tax withholding obligations incurred in respect of awards are satisfied. Unless otherwise provided by the Committee, awards granted under the 2004 Plan are generally only transferable to a beneficiary of a Named Executive Officer upon his death.

Options

Each option reported in Column (j) of the table above was granted with a per-share exercise price equal to the fair market value of a share of our common stock on the grant date. For these purposes, and in accordance with the terms of the 2004 Plan and our option grant practices, the fair market value is equal to the closing price of a share of our common stock on the applicable grant date.

Each option granted to our Named Executive Officers in 2007 is subject to a four-year vesting schedule, with 25% of the option vesting on each of the first four anniversaries of the grant date. Once vested, each option will generally remain exercisable until its normal expiration date. Each of the options granted to our Named Executive Officers in 2007 has a term of ten years. If a

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Named Executive Officer's employment terminates for any reason other than due to his death, disability or retirement, the unvested portion of the option will immediately terminate. If the Named Executive Officer's employment is terminated as a result of the officer's death or disability, the option will immediately vest and become exercisable. If the Named Executive Officer's employment is terminated as a result of the officer's retirement, the option will continue to vest and become exercisable over the three-year period following the retirement date (subject to earlier termination at the end of the option's stated term). For these purposes, retirement generally means a termination of employment on or after attaining age 60, attaining age 55 with at least five years of service with the Company, or becoming entitled to commence benefits under a Company-sponsored defined benefit plan in which the officer participates (with at least 10 years service). Unless otherwise provided by the Board of Directors, if there is a change in control of the Company, the options will generally become fully vested and exercisable.

The options granted to Named Executive Officers during 2007 do not include any dividend rights.

Restricted Stock Units

Column (i) of the table above reports awards of restricted stock units granted to our Named Executive Officers for 2007. Each restricted stock unit represents a contractual right upon vesting to receive one share of our common stock. Restricted stock units granted to our Named Executive Officers for 2007 will generally vest in one installment on the third anniversary of the grant date, provided that the officer continues to be employed with the Company through that date. However, the restricted stock units will become fully vested if the Named Executive Officer's employment terminates due to the officer's death or disability. If the Named Executive Officer's employment terminates due to the officer's retirement, the restricted stock units will continue to vest for the three-year period following the retirement date. (See the description of Options above for the definition of retirement.) Unless otherwise provided by the Board of Directors, the restricted stock units will also generally become fully vested upon a change in control of the Company.

The restricted stock units granted to Named Executive Officers during 2007 do not include any dividend rights.

Performance Shares

Columns (f) and (h) of the table above report awards of performance shares granted to our Named Executive Officers for 2007. Like restricted stock units, each performance share represents a contractual right upon vesting to receive one share of our common stock. Performance shares granted to our Named Executive Officers for 2007 will generally vest based on the Company's achievement of pre-established performance goals for adjusted pre-tax profit margin over a three-year period as described in the Compensation Discussion and Analysis section above. If the Named Executive Officer's employment terminates due to the officer's death, disability or retirement, the performance shares will be eligible to vest on a prorated basis based on the Company's performance over the three-year performance period. Unless otherwise provided by the Board of Directors, the performance shares will also generally become fully vested upon a change in control of the Company.

The performance shares granted to the Named Executive Officers during 2007 do not include any dividend rights.

Table of Contents**OUTSTANDING EQUITY AWARDS AT FISCAL YEAR-END**

The following table presents information regarding the outstanding equity awards held by each of our Named Executive Officers as of December 31, 2007, including the vesting dates for the portions of these awards that had not vested as of that date.

Name	Option Awards					Stock Awards			
	Option Grant/ Award	Number of Securities Underlying Unexercised Options Exercisable	Number of Securities Underlying Unexercised Options Unexercisable	Option Exercise Price	Option Expiration	Number of Shares or Units of Stock That Have Not Vested	Market Value of Shares or Units of Stock That Have Not Vested	Equity Incentive Plan Awards: Number of Unearned Shares, Units, or Other Rights That Have Not Vested	Equity Incentive Plan Awards: Market or Payout Value of Unearned Shares, Units or Other Rights That Have Not Vested
	Date	(#)	(#)	(\$)	Date	(#)	(\$)(1)	(#)	(\$)
(a)	(b)	(c)	(d)	(e)	(f)	(g)	(h)	(i)	(j)
William S. Ayer	5/7/98	24,100	0	47.125	5/7/08				
	5/25/99	33,100	0	39.6875	5/25/09				
	1/25/00	40,100	0	30.50	1/25/10				
	1/30/01	41,900	0	31.80	1/30/11				
	11/12/01	39,000	0	25.20	11/12/11				
	1/30/02	75,000	0	30.89	1/30/12				
	5/31/02	75,000	0	27.85	5/31/12				
	2/11/03	55,000	0	18.76	2/11/13				
	3/1/04	23,025	7,675(2)	26.10	3/1/14				
	11/17/04	15,000	5,000(3)	28.85	11/17/14				
	8/30/05	23,050	23,050(4)	32.96	8/30/15	14,000(4)	350,140		
	9/13/06	9,325	27,975(6)	37.96	9/13/16				
	1/31/07	0	23,800(7)	42.85	1/31/17	5,200(7)	130,052	10,500(8)	262,605
Totals:		453,600	87,500			29,700	480,192	10,500	262,605
Bradley D. Tilden	5/7/98	3,675	0	47.125	5/7/08				
	5/25/99	8,400	0	39.6875	5/25/09				
	1/25/00	11,600	0	30.50	1/25/10				
	1/30/01	13,000	0	31.80	1/30/11				
	11/12/01	15,600	0	25.20	11/12/11				
	5/31/02	30,000	0	27.85	5/31/12				
	2/11/03	15,000	0	18.76	2/11/13				
	3/1/04	9,675	3,225(2)	26.10	3/1/14				
	8/30/05	6,450	6,450(4)	32.96	8/30/15	5,350(4)	133,804		
	9/13/06	2,887	8,663(6)	37.96	9/13/16	5,300(6)	132,553		
	1/31/07	0	12,300(7)	42.85	1/31/17	3,200(7)	80,032	5,400(8)	135,054
	6/14/07	0	7,700(9)	27.40	6/14/17				
Totals:		116,287	38,338			19,250	346,389	5,400	135,054
Gregg A. Saretsky	3/15/98	10,000	0	57.3125	3/15/08				
	5/7/98	8,000	0	47.125	5/7/08				
	5/25/99	11,200	0	39.6875	5/25/09				
	1/25/00	13,600	0	30.50	1/25/10				
	1/30/01	15,500	0	31.80	1/30/11				
	11/12/01	10,800	0	25.20	11/12/11				

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5/31/02	3,590	0	27.85	5/31/12					
2/11/03	5,202	0	18.76	2/11/13					
3/1/04	10,125	3,375(2)	26.10	3/1/14					
8/30/05	6,750	6,750(4)	32.96	8/30/15	5,570(4)	139,306			
9/13/06	2,887	8,663(6)	37.96	9/13/16	5,300(6)	132,553			
1/31/07	0	12,300(7)	42.85	1/31/17	2,700(7)	67,527	5,400(8)	135,054	
6/14/07	0	7,700(9)	27.40	6/14/17					
Totals:	97,654	38,788			18,970	339,386	5,400	135,054	

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Option Awards							Stock Awards			
							Equity Incentive Plan Awards: Market Value of Unearned Shares, Units, or Other Rights That Have Not		Equity Incentive Plan Awards: Market Value of Unearned Shares, Units, or Other Rights That Have Not	
Name	Option Grant/Award	Number of Securities Underlying Unexercised Options Exercisable	Number of Securities Underlying Unexercised Options Unexercisable	Option Exercise Price	Option Expiration	Allocable Financial Charge Recognized for 2006	Number of Shares or Units of Stock That Have Not Vested	Market Value of Shares or Units of Stock That Have Not Vested	Unearned Shares, Units, or Other Rights That Have Not Vested	Equity Incentive Plan Awards: Market Value of Unearned Shares, Units, or Other Rights That Have Not Vested
(a)	(b)	(c)	(d)	(e)	(f)	(g)	(g)	(\$)(1)(h)	(#)(i)	(\$)(j)
Kevin P. Finan	7/26/00	14,500	0	28.5625	7/26/10	0				
	1/30/01	14,800	0	31.80	1/30/11	0				
	11/12/01	17,700	0	25.20	11/12/11	0				
	2/11/03	8,850	0	18.76	2/11/13	4,377				
	3/1/04	6,600	2,200(2)	26.10	3/1/14	25,550				
	8/30/05	4,400	4,400(4)	32.96	8/30/15	31,629	6,880(4)	172,069		
	1/26/06						1,000(5)	25,010		
	9/13/06	2,682	8,048(6)	37.96	9/13/16	50,582	4,920(6)	123,049		
	1/31/07	0	8,625(7)	42.85	1/31/17	55,287	2,500(7)	62,525	5,000(8)	125,050
Totals:		69,532	23,273			167,425	20,300	382,653	5,000	125,050
Jeffrey D. Pinneo	5/7/98	3,000	0	47.125	5/7/08	0				
	5/25/99	3,900	0	39.6875	5/25/09	0				
	1/25/00	4,700	0	30.50	1/25/10	0				
	1/30/01	6,000	0	31.80	1/30/11	0				
	11/12/01	2,700	0	25.20	11/12/11	0				
	5/31/02	30,000	0	27.85	5/31/12	0				
	2/11/03	12,000	0	18.76	2/11/13	1,651				
	3/1/04	8,100	2,700(2)	26.10	3/1/14	31,055				
	8/30/05	5,400	5,400(4)	32.96	8/30/15	38,810	4,870(4)	121,799		
	9/13/06	2,445	7,335(6)	37.96	9/13/16	46,100	4,490(6)	112,295		
	1/31/07	0	10,400(7)	42.85	1/31/17	50,013	2,300(7)	57,523	4,600(8)	4,625
Totals:		78,245	25,835			167,629	16,260	291,617	4,600	4,625

- (1) The dollar amounts shown in Column (h) and Column (j) are determined by multiplying the number of shares or units reported in Column (g) and Column (i), respectively, by \$25.01 (the closing price of our common stock on the last trading day of fiscal 2007).
- (2) The unvested options under the 3/1/04 grant will become vested as follows: Mr. Ayer 7,675 on 3/1/08; Mr. Tilden 3,225 on 3/1/08; Mr. Saretsky 3,375 on 3/1/08; Mr. Finan 2,200 on 3/1/08; and Mr. Pinneo 2,700 3/1/08.
- (3) The unvested options under the 11/17/04 grant will become fully vested on 11/17/08.
- (4) The RSUs awarded on 8/30/05 will become fully vested on 8/30/08. The unvested options under the 8/30/05 grant will become vested as follows: Mr. Ayer 11,525 on 8/30/08 and 11,525 on 8/30/09; Mr. Tilden 3,225 on 8/30/08 and 3,225 on 8/30/09; Mr. Saretsky 3,375 on 8/30/08, and 3,375 on 8/30/09; Mr. Finan 2,200 on 8/30/08 and 2,200 on 8/30/09; and Mr. Pinneo 2,700 on 8/30/08 and 2,700 on 8/30/09.
- (5) The RSUs awarded to Mr. Finan on 1/26/06 will become fully vested on 1/25/09.
- (6) The RSUs awarded on 9/13/06 will become fully vested on 9/13/09. The unvested options under the 9/13/06 grant will become vested as follows: Mr. Ayer 9,325 on 9/13/08, 9,325 on 9/13/09 and 9,325 on 9/13/10; Mr. Tilden 2,888 on 9/13/08, 2,887 on 9/13/09 and 2,888 on 9/13/10; Mr. Saretsky 2,888 on 9/13/08, 2,887 on 9/13/09 and 2,888 on 9/13/10; Mr. Finan 2,683 on 9/13/08, 2,682 on 9/13/09 and 2,683 on 9/13/10; and Mr. Pinneo 2,445 on 9/13/08, 2,445 on 9/13/09 and 2,445 on 9/13/10.
- (7) The RSUs awarded on 1/31/07 will become fully vested on 1/31/2010. The unvested options under the 1/31/07 grant will become vested as follows: Mr. Ayer 5,950 on 1/31/08, 5,950 on 1/31/09, 5,950 on 1/31/10 and 5,950 on 1/31/11; Mr. Tilden and Mr. Saretsky 3,075 on 1/31/08, 3,075 on 1/31/09, 3,075 on 1/31/10 and 3,075 on 1/31/11; Mr. Finan 2,875 on 1/31/08,

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2,875 on 1/31/09 and 2,875 on 1/31/10 (2,875 options due to vest on 1/31/11 were forfeited upon Mr. Finan's retirement); Mr. Pinneo 2,600 on 1/31/08, 2,600 on 1/31/09, 2,600 on 1/31/10 and 2,600 on 1/31/11.

- (8) The awards reported in Column (i) are eligible to vest based on the Company's performance over a three-year period as described in the Compensation Discussion and Analysis section above.
- (9) The options granted to Mr. Saretsky and Mr. Tilden on 6/14/07 will become vested as follows: 1,925 on 6/14/08, 1,925 on 6/14/09, 1,925 on 6/14/10 and 1,925 on 6/14/11.

Table of Contents**2007 OPTION EXERCISES AND STOCK VESTED**

The following table presents information regarding the exercise of stock options by Named Executive Officers during 2007, and on the vesting during 2007 of other stock awards previously granted to the Named Executive Officers.

Name	Option Awards		Stock Awards	
	Number of Shares	Value Realized on	Number of Shares	Value Realized
	Acquired on	Exercise	Acquired on Vesting	on Vesting
	(#) (b)	(\$)(1) (c)	(#) (d)	(\$) (e)
(a)				
William S. Ayer	0	0	15,400	335,720
Bradley D. Tilden	0	0	5,350	116,630
Gregg A. Saretsky	26,410	418,841	5,570	121,426
Kevin P. Finan	0	0	3,880	84,584
Jeffrey D. Pinneo	0	0	4,870	106,166

- (1) The dollar amounts shown in Column (c) above for option awards are determined by multiplying (i) the number of shares of our common stock to which the exercise of the option related, by (ii) the difference between the per-share closing price of our common stock on the date of exercise and the exercise price of the options. The dollar amounts shown in Column (e) above for stock awards are determined by multiplying the number of shares or units, as applicable, that vested by the per-share closing price of our common stock on the vesting date.

2007 PENSION BENEFITS

The following table presents information regarding the present value of accumulated benefits that may become payable to the Named Executive Officers under our qualified and nonqualified defined-benefit pension plans.

Name	Plan Name	Number of Years	Present Value of	Payments During
		Credit Service	Accumulated	Last Fiscal Year
		(#)(1)	Benefit	
		(c)	(\$)(1) (d)	(\$) (e)
(a)	(b)			
William S. Ayer	Salaried Retirement Plan	12.308	367,576	0
	Supplemental Retirement Plan	12.398	1,545,646	0
Bradley D. Tilden	Salaried Retirement Plan	16.844	354,626	0
	Supplemental Retirement Plan	8.919	577,810	0
Gregg A. Saretsky	Salaried Retirement Plan	9.771	218,057	0
	Supplemental Retirement Plan	9.771	486,807	0
Kevin P. Finan	Salaried Retirement Plan	7.458	863,690	0
	Supplemental Retirement Plan	7.430	933,185	0
Jeffrey D. Pinneo(2)	Salaried Retirement Plan	3.816	19,815	0
	Supplementary Retirement Plan	5.920	935,670	0

- (1) The years of credited service and present value of accumulated benefits shown in the table above are presented as of December 31, 2007 assuming that each Named Executive Officer retires at normal retirement age and that benefits are paid out in accordance with the terms of each plan described below. For a description of the material assumptions used to calculate the present value of accumulated benefits shown above, please see Note 8 (Employee Benefits Plans) to the Company's Consolidated Financial Statements, included as part of the Company's 2007 Annual Report filed on Form 10-K with the SEC and incorporated herein by reference.

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- (2) In 2007, Mr. Pinneo became partially vested under the Supplementary Retirement Plan and earned sufficient service under the Plan to accrue a benefit payable at his Normal Retirement Age. As a result of these changes, \$802,627 is included in the Pension Benefits table in Column (d) as the Present Value of Accumulated Benefit and is attributable to Mr. Pinneo's vesting and service accruals under the Supplementary Retirement Plan during 2007. This accrual also includes Mr. Pinneo's nonqualified benefits described in the paragraph below. The Supplementary Retirement Plan benefits and the nonqualified benefits are payable over the long term after Mr. Pinneo retires from the Company.

Regarding Mr. Pinneo's nonqualified benefits, when Mr. Pinneo was elected President and CEO of Horizon Air in 2002, he was 100% vested under the Salaried Retirement Plan (as defined below) on account of prior service at Alaska. At that time, Horizon Air, which does not have a plan similar to the Salaried Retirement Plan, agreed to supplement his benefits to ensure that his retirement benefit will be equivalent to what he would have received had he been participating in the Salaried Retirement Plan during his tenure as President and CEO of Horizon Air.

Pension and Other Retirement Plans

The Company maintains two primary defined benefit pension plans covering the Named Executive Officers. The Alaska Air Group, Inc. Retirement Plan for Salaried Employees (the Salaried Retirement Plan) is our qualified defined benefit employee retirement plan, and the Named Executive Officers participate in this plan on the same general terms as our other eligible employees. The Named Executive Officers also participate in the Alaska Air Group, Inc. 1995 Elected Officers Supplementary Retirement Plan (the Supplementary Retirement Plan).

Salaried Retirement Plan

The Salaried Retirement Plan is a tax-qualified, defined-benefit retirement plan for salaried Alaska Airlines employees hired prior to April 1, 2003, in which all of the Named Executive Officers participate. Each of our Named Executive Officers is fully vested in his accrued benefits under the Salaried Retirement Plan. Benefits payable under the Salaried Retirement Plan are generally based on years of credited service with the Company and its affiliates and final average base salary for the five highest complete and consecutive calendar years of an employee's last ten complete calendar years of service. The annual retirement benefit at age 62 (normal retirement age under the Salaried Retirement Plan) is equal to 2% of the employee's final average base salary times years of credited service (limited to 40 years). Annual benefits are computed on a straight life annuity basis beginning at normal retirement age. Benefits under the Salaried Retirement Plan are not subject to offset for Social Security benefits.

The tax law limits the compensation on which annual retirement benefits are based. For 2007, this limit was \$225,000. The tax law also limits the annual benefits that may be paid from a tax-qualified retirement plan. For 2007, this limit on annual benefits was \$180,000. To the extent the retirement benefits of our Named Executive Officers and certain other employees under the Salaried Retirement Plan exceed these limits, the excess benefits may be paid under the Supplementary Retirement Plan as described below.

Supplementary Retirement Plan

In addition to the benefits described above, the Named Executive Officers are eligible to receive retirement benefits under the Supplementary Retirement Plan. The Supplementary Retirement Plan is a nonqualified, unfunded, noncontributory defined-benefit plan. Normal retirement benefits are payable once the officer reaches age 60. Benefits are calculated as a monthly amount on a straight life annuity basis. In general, the monthly benefit is determined as a percentage (between 50% to 75% of a participant's final average monthly base salary) with the percentage determined based on both the officer's length of service with the Company and length of service as an elected officer. This benefit amount is subject to offset by the amount of the officer's Social Security benefits and the amount of benefits paid under the Salaried Retirement Plan to the extent such benefits were accrued after the officer became a

participant in the Supplementary Retirement Plan. (There is no offset for any Salaried Retirement Plan benefits accrued for service

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before the officer became a participant in the Supplementary Retirement Plan.)

Participants in the Supplementary Retirement Plan become fully vested in their benefits under the plan upon attaining age 50 and completing 10 years of service as an elected officer. Plan benefits will also become fully vested upon a change of control of the Company or upon termination of the participant's employment due to death or disability.

2007 NONQUALIFIED DEFERRED COMPENSATION

Under the Deferred Compensation Plan, the Named Executive Officers and other key employees may elect to receive a portion of some or all of their Performance-Based Pay awards on a deferred basis. For 2007, Messrs. Ayer and Finan elected to defer their Performance-Based Pay payouts. We do not make any matching or other contributions to any employee's account under this plan. For 2007, amounts deferred under the Deferred Compensation Plan were credited with interest at a rate of 6.25%. This rate (as in prior years) is based on the mean between the high and the low rates during the first 11 months of the preceding year of yields of Ba2-rated industrial bonds as determined by the plan administrator (rounded to the nearest one-quarter of one percent). Beginning in 2007, participants under the plan had the opportunity to elect among the investment funds offered under our 401(k) plan for purposes of determining the return on their plan accounts. Alternatively, participants may allocate some or all of their plan account to an interest-bearing option with a rate equal to the yield on a Moody's index of Ba2-rated industrial bonds as of November of the preceding year, rounded to the nearest one-quarter of one percent. Subject to applicable tax laws, amounts deferred under the plan are generally distributed on termination of the participant's employment, although participants may elect an earlier distribution date and/or may elect payment in a lump sum or installments.

The following table presents information regarding the contributions to and earnings on the Named Executive Officers' balances under the Company's nonqualified defined contribution plans during 2007, and also shows the total deferred amounts for the Named Executive Officers as of December 31, 2007.

Name	Executive Contributions in Last FY	Registrant Contributions in Last FY	Aggregate Earnings in Last FY	Aggregate Withdrawals/ Distributions	Aggregate Balance at Last FYE
(a)	(\$) (b)	(\$) (c)	\$(1) (d)	(\$) (e)	\$(1) (f)
William S. Ayer	76,320	0	13,719	24,723	220,337
Bradley D. Tilden	0	0	0	0	0
Gregg A. Saretsky	0	0	3,010	5,759	48,247
Kevin P. Finan	41,340	0	2,409	4,113	28,761
Jeffrey D. Pinneo	0	0	505	966	8,094

- (1) Only the portion of earnings on deferred compensation that is considered to be at above-market rates under SEC rules is included as compensation for each Named Executive Officer in Column (h) of the Summary Compensation Table. Total earnings for each Named Executive Officer listed in Column (d) above were also included as earnings in the Summary Compensation Table.

Potential Payments Upon Change in Control and Termination

Under the change in control agreements in place with Messrs. Ayer, Tilden, Saretsky and Pinneo, if a change of control occurs, a three-year employment period would go into effect. During the employment period, the executive would be entitled to:

receive the highest monthly salary the executive received at any time during the 12-month period preceding the change in control;

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receive an annual incentive payment equal to the higher of the executive's target Performance-Based Pay plan incentive or the average of his annual incentive payments for the three years preceding the year in which the change in control occurs;

continue to accrue age and service credit under our qualified and non-qualified defined benefit retirement plan; and

participate in fringe benefit programs that are at least as favorable as those in which the executive was participating prior to the change in control.

If the executive's employment is terminated by the Company without cause or by the executive for good reason during the employment period (or, in certain circumstances, if such a termination occurs prior to and in connection with a change in control), the executive would be entitled to receive a lump sum payment equal to the value of the payments and benefits identified above that the executive would have received had he continued to be employed for the entire employment period. (The terms "cause," "good reason" and "change of control" are each defined in the change in control agreements.) In the event that the executive's benefits under the agreement are subject to the excise tax imposed under Section 280G of the Internal Revenue Code, the Company will make a tax payment to the executive so that the net amount of such payment (after taxes) he receives is sufficient to pay the excise tax due.

In addition, as noted above, the executive's unvested benefits under our Supplementary Retirement Plan and, unless two-thirds of our Board determines otherwise, outstanding and unvested stock options and restricted stock units and the target number of performance stock units generally become vested upon a change in control irrespective of a termination of employment.

In the table below, we have estimated the potential cost to us of the payments and benefits each Named Executive Officer would have received if his employment had terminated under the circumstances described above on December 31, 2007. As described above, except for the equity acceleration value, the amount an executive would be entitled to receive would be reduced pro-rata for any period the executive actually worked during the employment period.

	Cash Severance(1)	Enhanced Retirement Benefit(2)	Benefit Continuation(3)	Equity Acceleration(4)	Excise Tax Reimbursement(5)	Total
William S. Ayer	\$ 2,160,000	\$ 167,646	\$ 184,985	\$ 730,292	\$ 1,357,663	\$ 4,600,586
Bradley D. Tilden	\$ 1,365,000	\$ 764,145	\$ 240,328	\$ 406,663	\$ 907,756	\$ 3,683,892
Gregg A. Saretsky	\$ 1,470,000	\$ 771,914	\$ 253,223	\$ 474,440	\$ 931,530	\$ 3,901,107
Jeffrey D. Pinneo	\$ 1,244,250	\$ 711,448	\$ 162,700	\$ 481,443	\$ 800,179	\$ 3,400,020

(1) Represents the amount obtained by multiplying three by the sum of the executive's highest rate of base salary during the preceding 12 months and the higher of the executive's target incentive or his average incentive for the three preceding years.

(2) Represents the sum of (a) the actuarial equivalent of an additional three years of age and service credit under our qualified and non-qualified retirement plan using the executive's highest rate of salary during the preceding 12-months prior to a change in control, (b) the present value of the accrued but unvested portion of the non-qualified retirement benefits that would vest upon a change of control, and (c) the matching contribution the executive would have received under our qualified defined contribution plan had the executive continued to contribute the maximum allowable amount during the employment period.

(3) Represents the estimated cost of (a) three years of premiums under our medical, dental, life, disability, and accidental death insurance programs and (b) three years of continued participation in fringe benefit programs.

(4)

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Represents the in-the-money value of unvested stock options and the face value of unvested restricted stock and performance stock unit awards that would vest upon a change of control based on a stock price of \$25.01 (the closing price of our stock on the last trading day of fiscal 2007).

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- (5) For purposes of this calculation, we have assumed that the executive's outstanding stock options would be assumed by the acquiring company pursuant to a change of control.

This calculation is an estimate for proxy disclosure purposes only. Payments on an actual change in control may differ based on factors such as transaction price, timing of employment termination and payments, methodology for valuing stock options, changes in compensation, and reasonable compensation analyses.

Mr. Finan retired as an executive officer and employee of the Company on January 1, 2008. In accordance with his Employment, Retirement and Non-Compete Agreement he received a bonus of \$200,000 upon his retirement. In accordance with his Consulting Agreement, he will receive a retainer of \$276,000 for consulting services during the period from January 2, 2008 through January 1, 2009.

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PROPOSAL NO. 3

STOCKHOLDER PROPOSAL

John Chevedden has given notice of his intention to present a proposal at the 2008 Annual Meeting. Mr. Chevedden's address is 2215 Nelson Avenue, No. 205, Redondo Beach, CA 90278, and Mr. Chevedden represents that he owns 1,847 shares of the Company's common stock. Mr. Chevedden's proposal and supporting statement, as submitted to the Company, appear below in italics.

The Board of Directors opposes adoption of Mr. Chevedden's proposal and asks stockholders to review the Board's response, which follows Mr. Chevedden's proposal and supporting statement below.

The affirmative vote of the holders of a majority of the shares of common stock present, in person or represented by proxy at the meeting, and entitled to vote on the proposal is required to approve this proposal.

Stockholder Proposal

POISON PILL VOTE

RESOLVED, Shareholders request that our Board adopt a bylaw or charter amendment that any 2007 or subsequent company poison pill shall trigger a mandatory shareholder vote as a separate ballot item.

Such a mandatory vote, in compliance with applicable law, would be at the earliest next shareholder meeting or special meeting. When our directors know that a poison pill will be subject to a mandatory vote, this certainty of a vote will give our directors a far greater incentive to use their utmost discretion before using such a drastic measure as a poison pill. A poison pill expiration date shall have no power to exclude this mandatory vote.

Poison pills prevent shareholders, and the overall market, from exercising their right to discipline management by turning it out. They entrench the current management, even when it's doing a poor job. They water down shareholders' votes and deprive them of a meaningful voice in corporate affairs. Take on the Street by Arthur Levitt, SEC Chairman, 1993-2001.

That's the key negative of poison pills: instead of protecting investors, they can also preserve the interests of management deadwood as well. Morningstar.com, August 15, 2003.

John Chevedden, Redondo Beach, California said the merits of this proposal should also be considered in the context of our company's overall corporate governance structure and individual director performance. For instance in 2007 the following structure and performance issues were identified:

We had no shareholder right to:

- 1. Cumulative voting*
- 2. Call a special meeting*

3. *Act by written consent*
4. *A majority vote standard in electing our directors*

Thus future shareholder proposals on the above topics could obtain significant support.

The voting figures at our 2007 annual meeting were withheld from shareholders for two months except for certain privileged shareholders.

We did not have an Independent Chairman or even a Lead Director Independence concern.

Our Company will take three-years to transition to annual election of each director when the transition could be completed in one-year.

Thus we cannot vote on some directors until 2009.
Additionally:

Our full board met only five times in a year.

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Poison pill: Our directors have the power to adopt a poison pill that is never subject to a shareholder vote.

Three directors had 16 to 25 years tenure Independence concern and director retirement concern.

Mr. Langland, with 16 years director tenure, chaired our nomination committee Independence concern and recruitment concern.

Ms. Bedient chaired our Audit Committee and yet was not even an Audit Financial Expert.

Plus Ms. Bedient received our most withheld votes in 2007.

The above concerns show there is need for improvement and reinforces the reason to encourage our board to respond positively to this proposal:

Poison Pill Vote

Yes on 3

BOARD OF DIRECTORS RESPONSE TO STOCKHOLDER PROPOSAL 3

THE BOARD OF DIRECTORS RECOMMENDS A VOTE AGAINST PROPOSAL 3

FOR THE FOLLOWING REASONS:

The Board opposes the proposal as unnecessary and duplicative because the Company currently does not have a stockholder rights plan (sometimes referred to as a poison pill&line; FONT-FAMILY: times new roman; FONT-SIZE: 10pt">

Commitments and contingencies

Shareholders' equity

Preferred stock - \$.001 par value stock, 5,000,000 shares authorized:

Series A – 260,000 shares authorized, none outstanding.

Series B – 200,000 shares authorized, none outstanding, non-voting, convertible, redeemable.

Series C – 100,000 shares authorized, 23,700 and 32,700 shares issued and outstanding, redeemable, convertible, and a liquidation preference of \$5 per share

24 33

Common stock - \$.001 par value stock, 75,000,000 shares authorized, 9,035,012 and 8,922,512 shares issued and outstanding

9,035 8,922

Additional paid-in capital
22,995,384 22,911,827
Accumulated deficit
(15,647,660) (18,491,284)

Total shareholders' equity
7,356,783 4,429,498

Total liabilities and shareholders' equity
\$10,580,627 \$8,291,626

See notes to consolidated financial statements.

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SURGE COMPONENTS, INC. AND SUBSIDIARIES

Consolidated Statements of Income

	Year Ended November 30,	
	2011	2010
Net sales	\$23,208,269	\$21,613,911
Cost of goods sold	16,600,206	15,061,118
Gross profit	6,608,063	6,552,793
Operating expenses:		
Selling and shipping	1,826,729	1,813,471
General and administrative	3,209,914	2,910,775
Depreciation expense	88,188	136,154
Total operating expenses	5,124,831	4,860,400
Income before other income (expense) and income taxes	1,483,232	1,692,393
Other income (expense):		
Investment income	1,951	4,340
Interest expense	(61,253)	(117,973)
Other income (expenses)	(59,302)	(113,633)
Income before income taxes	1,423,930	1,578,760
Income (benefit)taxes	(1,433,794)	82,672
Net income	\$2,857,724	\$1,496,088
Dividends on preferred stock	14,100	16,350
Net income available to common shareholders	\$2,843,624	\$1,479,738
Net income per share available to common shareholders:		
Basic	\$.32	\$.17
Diluted	\$.30	\$.16
Weighted Shares Outstanding:		
Basic	9,002,957	8,901,865

Diluted	9,652,096	9,304,813
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See notes to consolidated financial statements.

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SURGE COMPONENTS, INC. AND SUBSIDIARIES

Consolidated Statements of Changes in Shareholders' Equity

Years ended November 30, 2011 and 2010

	Series C Preferred Shares	Amount	Common Shares	Amount	Additional Paid-In Capital	Accumulated Deficit	Total
Balance – November 30, 2009	32,700	33	8,874,512	8,874	22,888,135	(19,971,022)	2,926,020
Preferred stock dividends	--	--	--	--	--	(16,350)	(16,350)
Stock issued as compensation	--	--	48,000	48	8,592	--	8,640
Issuance of options	--	--	--	--	15,100	--	15,100
Net Income	--	--	--	--	--	1,496,088	1,496,088
Balance – November 30, 2010	32,700	33	8,922,512	8,922	22,911,827	(18,491,284)	4,429,498
Preferred stock dividends	--	--	--	--	--	(14,100)	(14,100)
Issuance of options	--	--	--	--	83,661	--	83,661
Repurchased and issued shares	(9,000)	(9)	112,500	113	(104)	--	--
Net income	--	--	--	--	--	2,857,724	2,857,724
Balance – November 30, 2011	23,700	\$24	9,035,012	9,035	\$22,995,384	\$(15,647,660)	\$7,356,783

See notes to consolidated financial statements.

SURGE COMPONENTS, INC. AND SUBSIDIARIES

Consolidated Statements of Cash Flows

	Year Ended November 30,	
	2011	2010
CASH FLOWS FROM OPERATING ACTIVITIES:		
Net income	\$2,857,724	\$1,496,088
Adjustments to reconcile net income to net cash provided by operating activities:		
Depreciation and amortization	88,188	136,154
Stock compensation expense	83,661	23,740
Changes in allowance for doubtful accounts	10,163	--
Deferred income taxes	(1,468,916)	--
CHANGES IN OPERATING ASSETS AND LIABILITIES:		
Accounts receivable	(42,182)	(1,569,836)
Inventory	(11,001)	(1,172,063)
Prepaid expenses and taxes	(65,595)	(2,631)
Other assets	241,150	1,953
Accounts payable	(613,016)	962,113
Deferred rent	14,277	(20,550)
Accrued expenses	(53,645)	675,656
NET CASH FLOWS FROM OPERATING ACTIVITIES	1,040,808	530,624
CASH FLOWS FROM INVESTING ACTIVITIES:		
Acquisition of fixed assets	(18,684)	(19,860)
NET CASH FLOWS USED IN INVESTING ACTIVITIES	(18,684)	(19,860)

See notes to consolidated financial statements.

SURGE COMPONENTS, INC. AND SUBSIDIARIES

Consolidated Statements Of Cash Flows
(CONTINUED)

	Year Ended November 30,	
	2011	2010
CASH FLOWS FROM FINANCING ACTIVITIES:		
Net borrowings from line of credit	-	(766,467)
Net borrowings from note payable	-	(1,304)
NET CASH FLOWS USED IN FINANCING ACTIVITIES	-	(767,771)
NET CHANGE IN CASH	1,022,124	(257,007)
CASH AT BEGINNING OF YEAR	883,331	1,140,338
CASH AT END OF YEAR	\$1,905,455	\$883,331
SUPPLEMENTAL DISCLOSURE OF CASH FLOW INFORMATION:		
Income taxes paid	\$87,577	\$9,527
Interest paid	\$61,253	\$117,973
NONCASH INVESTING AND FINANCING ACTIVITIES:		
Accrued dividends on preferred stock	\$14,100	\$16,350

See notes to consolidated financial statements.

SURGE COMPONENTS, INC. AND SUBSIDIARIES

Notes to Consolidated Financial Statements

NOTE A – ORGANIZATION, DESCRIPTION OF COMPANY'S BUSINESS AND BASIS OF PRESENTATION

Surge Components, Inc. (“Surge”) was incorporated in the State of New York and commenced operations on November 24, 1981 as an importer of electronic products, primarily capacitors and discrete semi-conductors selling to customers located principally throughout North America. On June 24, 1988, Surge formed Challenge/Surge Inc., (“Challenge”) a wholly-owned subsidiary to engage in the sale of electronic component products and sounding devices from established brand manufacturers to customers located principally throughout North America.

In May 2002, Surge and an officer of Surge founded and became sole owners of Surge Components, Limited (“Surge Limited”), a Hong Kong corporation. Under current Hong Kong law, Surge Limited is required to have at least two shareholders. Surge owns 999 shares of the outstanding common stock and the officer of Surge owns 1 share of the outstanding common stock. The officer of Surge has assigned his rights regarding his 1 share to Surge. Surge Limited started doing business in July 2002. Surge Limited operations have been consolidated with the Company. Surge Limited is responsible for the sale of Surge’s products to the customers located in Asia.

On August 31, 2010, the Company changed its corporate domicile by merging into a newly-formed corporation, Surge Components, Inc. (Nevada), which was formed in the State of Nevada for that purpose. Surge Components Inc. is the surviving entity. The number of common stock shares authorized for issuance was increased to 75,000,000 shares.

NOTE B – SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

[1] Principles of Consolidation:

The consolidated financial statements include the accounts of Surge, Challenge, and Surge Limited (collectively the “Company”). All material intercompany balances and transactions have been eliminated in consolidation.

(2) Accounts Receivable:

Trade accounts receivable are recorded at the net invoice value and are not interest bearing. The Company considers receivables past due based on the payment terms. The Company reviews its exposure to amounts receivable and reserves specific amounts if collectability is no longer reasonably assured. The Company also reserves a percentage of its trade receivable balance based on collection history and current economic trends that might impact the level of future credit losses. The Company re-evaluates such reserves on a regular basis and adjusts its reserves as needed. Based on the Company’s operating history and customer base, bad debts to date have not been material.

(3) Revenue Recognition:

Revenue is recognized for products sold by the Company when persuasive evidence of an arrangement exists, delivery has occurred, the price is fixed and determinable, collectability is reasonably assured and title and risk of loss have been transferred to the customer. This occurs when product is shipped from the Company's warehouse.

For direct shipments, revenue is recognized when product is shipped from the Company’s supplier. The Company has no written arrangements with its suppliers. The Company purchases the merchandise from the supplier and has the supplier directly ship to the customer through a freight forwarder. Title passes to customer upon the merchandise

being received by a freight forwarder. Direct shipments were approximately \$3,826,000 and \$2,889,000 for the years ended November 30, 2011 and 2010 respectively.

The Company also acts as a sales agent to certain customers in North America for one of its suppliers. The Company reports these commissions as revenues in the period earned. Commission revenue totaled \$348,768 and \$212,502 for the years ended November 30, 2011 and 2010, respectively.

The Company performs ongoing credit evaluations of its customers and maintains reserves for potential credit losses.

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SURGE COMPONENTS, INC. AND SUBSIDIARIES

Notes to Consolidated Financial Statements

NOTE B – SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (Continued)

The Company and its subsidiaries currently have agreements with several distributors. Some of these agreements allow for the return of up to 10% of certain product sales for the previous 6 month period. The Company does not recognize this portion of the revenues, or the related costs of the sale, until the right of return has expired. There are no provisions for the granting of price concessions in any of the agreements. Revenues under these distribution agreements were approximately \$4,648,000 and \$4,105,000 for the years November 30, 2011 and 2010, respectively.

(4) Inventories:

Inventories, which consist solely of products held for resale, are stated at the lower of cost (first-in, first-out method) or market. Products are included in inventory when the Company obtains title and risk of loss on the products, primarily when shipped from the supplier. Inventory in transit principally from foreign suppliers at November 30, 2011 approximated \$703,000. The Company, at November 30, 2011, has a reserve against slow moving and obsolete inventory of \$927,364. From time to time the Company's products are subject to legislation from various authorities on environmental matters. Legislation was enacted, effective July 2006, eliminating lead in certain of the Company's products. The Company has provided a reserve for these products which is reflected as slow moving. The Company is able to currently obtain products which comply with this law.

(5) Depreciation and Amortization:

Fixed assets are recorded at cost. Depreciation is generally on a straight line method and amortization of leasehold improvements is provided for on the straight-line method over the estimated useful lives of the various assets as follows:

Furniture, fixtures and equipment	5 - 7 years
Computer equipment	5 years
Leasehold Improvements	Estimated useful life or lease term, whichever is shorter

Maintenance and repairs are expensed as incurred while renewals and betterments are capitalized.

SURGE COMPONENTS, INC. AND SUBSIDIARIES

Notes to Consolidated Financial Statements

NOTE B – SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (Continued)

(6) Concentration of Credit Risk:

Financial instruments that potentially subject the Company to concentrations of credit risk consist principally of accounts receivable. The Company maintains substantially all of its cash balances in two financial institutions. The balances are each insured by the Federal Deposit Insurance Corporation up to \$250,000 through December 31, 2013. At November 30, 2011 and November 30, 2010, the Company's uninsured cash balances totaled approximately \$1,121,000 and \$690,000, respectively.

(7) Income Taxes:

The Company's deferred income taxes arise primarily from the differences in the recording of net operating losses, allowances for bad debts, inventory reserves and depreciation expense for financial reporting and income tax purposes. A valuation allowance is provided when it has been determined to be more likely than not that the likelihood of the realization of deferred tax assets will not be realized.

The Company follows the provisions of the Accounting Standards Codification topic, ASC 740, "Income Taxes" (ASC 740). There have been no unrecognized tax benefits and, accordingly, there has been no effect on the Company's financial condition or results of operations as a result of ASC 740.

The Company files income tax returns in the U.S. federal jurisdiction and various state and foreign jurisdictions. The Company is no longer subject to U.S. federal tax examinations for years before fiscal years ending November 30, 2008, and state tax examinations for years before fiscal years ending November 30, 2007. Management does not believe there will be any material changes in our unrecognized tax positions over the next twelve months.

The Company's policy is to recognize interest and penalties accrued on any unrecognized tax benefits as a component of income tax expense. As of the date of adoption of ASC 740, there was no accrued interest or penalties associated with any unrecognized tax benefits, nor was any interest expense recognized during the year ended November 30, 2011 and 2010.

SURGE COMPONENTS, INC. AND SUBSIDIARIES

Notes to Consolidated Financial Statements

NOTE B – SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (Continued)

(8) Cash Equivalents:

The Company considers all highly liquid investments with an original maturity of three months or less to be cash equivalents.

(9) Use of Estimates:

The preparation of financial statements in conformity with accounting principles generally accepted in the United States of America requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenue and expenses during the reporting period. Actual results could differ from those estimates.

(10) Marketing and promotional costs:

Marketing and promotional costs are expensed as incurred and have not been material to date. The Company has contractual arrangements with several of its distributors which provide for cooperative advertising rights to the distributor as a percentage of sales. Cooperative advertising is reflected as a reduction in revenues and has not been material to date.

(11) Fair Value of Financial Instruments:

Cash balances and the carrying amount of the accrued expenses approximate their fair value based on the nature of those items. Estimated fair values of financial instruments are determined using available market information and appropriate valuation methodologies. Considerable judgment is required to interpret the market data used to develop the estimates of fair value, and accordingly, the estimates are not necessarily indicative of the amounts that could be realized in a current market exchange.

SURGE COMPONENTS, INC. AND SUBSIDIARIES

Notes to Consolidated Financial Statements

NOTE B – SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (Continued)

(12) Shipping Costs

The Company classifies shipping costs as a component of selling expenses. Shipping costs totaled \$11,955 and \$13,808 for the year ended November 30, 2011 and 2010, respectively.

(13) Earnings Per Share

Basic earnings per share includes no dilution and is computed by dividing net income available to common stockholders by the weighted average number of common shares outstanding for the period. The difference between reported basic and diluted weighted-average common shares results from the assumption that all dilutive stock options and convertible preferred stock exercised into common stock. Total potentially dilutive shares excluded from diluted weighted shares outstanding at November 30, 2011 and 2010 totaled 272,861 and 524,053, respectively.

(14) Stock Based Compensation to Employees

The Company accounts for its stock-based compensation for employees in accordance with Accounting Standards Codification (“ASC”) 718. The Company recognizes in the statement of operations the grant-date fair value of stock options and other equity-based compensation issued to employees and non-employees over the related vesting period.

Stock Based Compensation to Other than Employees

The Company accounts for equity instruments issued in exchange for the receipt of goods or services from other than employees in accordance with ASC 718. Costs are measured at the estimated fair market value of the consideration received or the estimated fair value of the equity instruments issued, whichever is more reliably determinable. The value of equity instruments issued for consideration other than employee services is determined on the earlier of a performance commitment or completion of performance by the provider of goods or services. In the case of equity instruments issued to consultants, the fair value of the equity instrument is recognized over the term of the consulting agreement.

(15) Recent Accounting Standards:

Comprehensive Income — In June 2011, the Financial Accounting Standards Board (“FASB”) issued new guidance on the presentation of comprehensive income. Specifically, the new guidance allows an entity to present components of net income and other comprehensive income in one continuous statement, referred to as the statement of comprehensive income, or in two separate, but consecutive statements. The new guidance eliminates the current option to report other comprehensive income and its components in the statement of changes in equity. While the new guidance changes the presentation of comprehensive income, there are no changes to the components that are recognized in net income or other comprehensive income under current accounting guidance. This new guidance is effective for fiscal years and interim periods beginning after December 15, 2011. We do not believe our adoption of the new guidance in the first quarter of fiscal 2013 will have an impact on our consolidated financial position, results of operations or cash flows.

Fair Value Measurement — In April 2011, the FASB issued new guidance to achieve common fair value measurement and disclosure requirements between GAAP and International Financial Reporting Standards. This new guidance

amends current fair value measurement and disclosure guidance to include increased transparency around valuation inputs and investment categorization. This new guidance is effective for fiscal years and interim periods beginning after December 15, 2011. We do not believe our adoption of the new guidance in the first quarter of fiscal 2013 will have an impact on our consolidated financial position, results of operations or cash flows.

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SURGE COMPONENTS, INC. AND SUBSIDIARIES

Notes to Consolidated Financial Statements

NOTE C - FIXED ASSETS

Fixed assets consist of the following:

	November 30, 2011	November 30, 2010
Furniture and Fixtures	\$350,563	\$349,930
Leasehold Improvements	906,449	898,942
Computer Equipment	930,575	1,102,497
Less-Accumulated Depreciation	(2,069,538)	(2,163,816)
Net Fixed Assets	\$118,049	\$187,553

Depreciation and amortization expense for the year ended November 30, 2011 and 2010 was \$88,188 and \$136,154, respectively.

NOTE D - ACCRUED EXPENSES

Accrued expenses consist of the following:

	November 30, 2011	November 30, 2010
Commissions	\$211,789	\$259,714
Preferred Stock Dividends	165,007	150,907
Interest	102,399	102,399
Other accrued expenses	190,754	204,933
	\$669,949	\$717,953

In March 2000, the Company completed a \$7,000,000 private placement. The entire note balance was converted into common stock in July 2001 pursuant to the automatic conversion provisions of the notes. The interest accrued on the notes required approval by the holder in order to convert to common stock. The accrued interest in the Company's disclosures relate to the portion of the interest which was not converted. No additional interest accrues on these amounts and none of this interest was repaid during any of the periods presented.

NOTE E – RETIREMENT PLAN

In June 1997, the Company adopted a qualified 401(k) plan for all full-time employees who are twenty-one years of age and have completed twelve months of service. The Plan allows total employee contributions of up to fifteen percent (15%) of the eligible employee's salary through salary reduction. The Company makes a matching contribution of twenty percent (20%) of each employee's contribution for each dollar of employee deferral up to five percent (5%) of the employee's salary. Net assets for the plan, as estimated by Union Central, Inc., which maintains the plan's records, were approximately \$770,000 at November 30, 2011. Pension expense for the year ended November 30, 2011

and 2010 was \$10,115 and \$5,229, respectively.

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SURGE COMPONENTS, INC. AND SUBSIDIARIES

Notes to Consolidated Financial Statements

NOTE F – SHAREHOLDERS’ EQUITY

[1] Preferred Stock:

In February 1996, the Company amended its Certificate of Incorporation to authorize the issuance of 1,000,000 shares of preferred stock in one or more series. In August 2010, the number of preferred shares authorized for issuance was increased to 5,000,000 shares.

In January 2000, the Company authorized 260,000 shares of preferred stock as Non-Voting Redeemable Convertible Series A Preferred Stock (“Series A Preferred”). None of the Series A preferred stock is outstanding as of November 30, 2011.

In November 2000, the Company authorized 200,000 shares of preferred stock as Voting Redeemable Convertible Series B Preferred Stock (“Series B Preferred”). None of the Series B Preferred Stock is outstanding as of November 30, 2011.

In November 2000, the Company authorized 100,000 shares of preferred stock as Non-Voting Redeemable Convertible Series C Preferred Stock (“Series C Preferred”). Each share of Series C Preferred is automatically convertible into 10 shares of the Company’s Common Stock upon shareholder approval. If the Series C Preferred were converted into common stock on or before April 15, 2001, these shares were entitled to cumulative dividends at the rate of \$.50 per share per annum commencing April 15, 2001 payable on June 30 and December 31 of each year. In November 2000, 70,000 shares of the Series C Preferred were issued in payment of financial consulting services to its investment banker and a shareholder of the Company. In April 2001, 8,000 shares of the Series C Preferred were repurchased and cancelled. Dividends aggregating \$165,007 have not been declared or paid for the semiannual periods ended December 31, 2001 through the semiannual payment due June 30, 2011. The Company has accrued these dividends. The December 31, 2011 dividend of \$5,925 has not been declared or paid.

In April 2002, in connection with a Mutual Release, Settlement, Standstill and Non-Disparagement Agreement and among other provisions, certain investors transferred back to the Company 252,000 shares of common stock, 19,300 shares of Series C preferred stock, and certain warrants, in exchange for \$225,000. These repurchased shares were cancelled.

In February 2006, the Company settled with a shareholder to repurchase 10,000 shares of Series C preferred stock plus accrued dividends for \$50,000.

Pursuant to exchange agreements dated as of March 14, 2011, 9,000 shares of Series C Preferred Stock were returned to the Company for cancellation in exchange for 112,500 shares of common stock.

At November 30, 2011 there are 23,700 shares of Series C Preferred stock issued and outstanding.

[2] 1995 Employee Stock Option Plan:

In January 1996, the Company adopted, and in February 1996 the shareholders ratified, the 1995 Employee Stock Option Plan ("Option Plan"). The plan provides for the grant of options to qualified employees of the Company, independent contractors, consultants and other individuals to purchase an aggregate of 350,000 common shares. In March 1998, the Option Plan was amended to increase the number of aggregate Common Shares available under the plan to 850,000.

The Option Plan has expired. The remaining 53,000 options outstanding expired in July 2010.

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SURGE COMPONENTS, INC. AND SUBSIDIARIES

Notes to Consolidated Financial Statements

NOTE F – SHAREHOLDERS' EQUITY (Continued)

[3] 2010 Incentive Stock Plan

In March 2010, the Company adopted, and in April 2010 the shareholders ratified, the 2010 Incentive Stock Plan ("Stock Plan"). The plan provides for the grant of options to officers, employees or consultants to the Company to purchase an aggregate of 1,500,000 common shares.

Stock option incentive plan activity is summarized as follows:

	Shares	Weighted Average Exercise Price
Options issued in May 2010	600,000	\$ 0.25
Options issued in February 2011	85,000	\$ 1.15
Options outstanding November 30, 2011	685,000	\$ 0.36
Options exercisable November 30, 2011	600,000	\$ 0.25

Stock Compensation

The fair values of stock options are estimated at the date of grant using the Black-Scholes option-pricing model with the following weighted-average assumptions during 2010: expected volatility of 60% (based on stock volatility of public company industry peers); average risk-free interest rate of 2.31% (the five year treasury note rate on the date of the grant); initial expected life of 5 years (based on the term of the options); no expected dividend yield; and amortized over the vesting period for a year.

The intrinsic value of the exercisable options at November 30, 2011 totaled \$294,000. At November 30, 2011 the weighted average remaining life of the stock options is 4.21 years. At November 30, 2011, there was \$52,294 of total unrecognized compensation cost related to the stock options granted under the plan. This cost is expected to be recognized over a weighted average period of 1.25 years.

On February 25, 2011, the Company granted stock options to employees to purchase 85,000 shares of the Company's common stock at an exercise price of \$1.15, the value of the common stock on the date of the grant. These options vest over a three year period and expire in ten years. The fair values of these stock options are estimated at the date of grant using the Black-Scholes option pricing model with the following weighted-average assumptions: expected volatility of 60% (based on stock volatility of public company industry peers); average risk-free interest rate of 3.42 (the ten year treasury note rate on the date of the grant); initial expected life of 10 years (based on the term of the options); no expected dividend yield; and amortized over the vesting period. During the year ended November 30, 2011, the Company recorded stock based compensation totaling \$17,433 as a result of these stock option grants.

The weighted average grant date fair value of the stock options granted during the year ended November 30, 2011 was \$0.82. During the year ended November 30, 2011, the Company recorded stock based compensation totaling \$66,228 as a result of these stock option grants.

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SURGE COMPONENTS, INC. AND SUBSIDIARIES

Notes to Consolidated Financial Statements

NOTE F – SHAREHOLDERS’ EQUITY (Continued)

[4] Authorized Repurchase:

In November 2002, the Board of Directors authorized the repurchase of up to 1,000,000 Common Shares at a price between \$.04 and \$.045. The Company has not repurchased any shares to date pursuant to such authority.

[5] Compensation of Directors

In May 2010, the Company issued 12,000 shares of its common stock to each non-officer director as compensation for services on the Board of Directors. These shares were valued at \$0.18 per share, the closing price of the common stock on the over-the-counter market. In addition, the directors receive \$200 each month for their services on the Board of Directors. In May 2010, options were granted to each non-officer director to purchase 25,000 shares of common stock at an exercise price of \$0.25. (See Note F[3] for disclosure on the valuation and terms of these options).

NOTE G – INCOME TAXES

Deferred income taxes reflect the net tax effects of temporary differences between the carrying amount of assets and liabilities for financial reporting purposes and the amounts used for income tax purposes using the enacted tax rates in effect in the years in which the differences are expected to reverse.

The Company’s deferred income taxes are comprised of the following:

	November 30, 2011	November 30, 2010
Deferred Tax Assets		
Net Operating income	\$5,345,554	\$6,150,931
Allowance for Bad debts	7,793	7,793
Inventory	498,220	498,220
Deferred Rent	985	985
Depreciation	183,646	183,646
Total deferred tax assets	6,036,198	6,841,575
Valuation allowance	(4,567,282)	(6,841,575)
Deferred Tax Assets	\$1,468,916	\$-

The valuation allowance for the deferred tax assets relates principally to the uncertainty of the utilization of deferred tax assets and was calculated in accordance with the provisions of ASC 740, which requires that a valuation allowance be established or maintained when it is “more likely than not” that all or a portion of deferred tax assets will not be realized. This valuation is based on management estimates of future taxable income. Although the degree of variability inherent in the estimates of future taxable income is significant and subject to change in the near term, management believes, that the estimate is adequate. The estimated valuation allowance is continually reviewed and as adjustments to the allowance become necessary, such adjustments are reflected in the current operations.

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SURGE COMPONENTS, INC. AND SUBSIDIARIES

Notes to Consolidated Financial Statements

NOTE G – INCOME TAXES(CONTINUED)

The valuation allowance decreased by approximately \$2,274,000 and \$682,000 during the years ended November 30, 2011 and the year ended November 30, 2010, respectively.

The Company's income tax expense consists of the following:

	Years Ended November 30,	
	2011	2010
Current:		
Federal	\$ 24,717	\$ 53,710
States	10,405	28,962
	35,122	82,672
Deferred:		
Federal	(1,161,913)	--
States	(307,003)	--
	(1,468,916)	--
Provision for income taxes	\$ (1,433,794)	\$ 82,672

The Company files a consolidated income tax return with its wholly-owned subsidiaries and has net operating loss carryforwards of approximately \$13,384,000 for federal and state purposes, which expire through 2020. The utilization of this operating loss carryforward may be limited based upon changes in ownership as defined in the Internal Revenue Code.

A reconciliation of the difference between the expected income tax rate using the statutory federal tax rate and the Company's effective rate is as follows:

	Years Ended November 30,	
	2011	2010
U.S. Federal income		
tax statutory rate	34%	34%
Valuation allowance	(143)%	(34)%
State income taxes	5%	5%
Other	4%	-
Effective tax rate	100%	5%

SURGE COMPONENTS, INC. AND SUBSIDIARIES

Notes to Consolidated Financial Statements

NOTE H- RENTAL COMMITMENTS

The Company leases its office and warehouse space through 2020 from a corporation that is controlled by officers/shareholders of the Company ("Related Company"). Annual minimum rental payments to the Related Company approximated \$215,000 for the Fiscal 2011, and increase at the rate of three per cent per annum throughout the lease term.

Pursuant to the lease, rent expense charged to operations differs from rent paid because of scheduled rent increases. Accordingly, the Company has recorded deferred rent. Rent expense is calculated by allocating to rental payments, including those attributable to scheduled rent increases, on a straight line basis, over the lease term.

In June 2010, the Company entered into a lease to rent office space in Hong Kong for two years. Annual minimum rental payments are approximately \$20,000.

The future minimum rental commitments at November 30, 2011:

Year Ending November 30,	
2012	171,103
2013	162,625
2014	165,878
2015	169,195
2016	172,579
2017 & thereafter	693,878
	\$1,535,258

Net rental expense for the year ended November 30, 2011 and 2010 were \$247,877 and \$209,465 respectively, of which \$215,000 was paid to the Related Company.

SURGE COMPONENTS, INC. AND SUBSIDIARIES

Notes to Consolidated Financial Statements

NOTE I – EMPLOYMENT AND OTHER AGREEMENTS

The Company has employment agreements, with terms through July 30, 2012 (renewable on each July 30th for an additional one year period) with two officers/stockholders of the Company, which provides each with a base salary of \$225,000, subject to certain increases as defined, per annum, plus fringe benefits and bonuses. The Compensation Committee of the Company's Board of Directors determines the bonuses. Bonuses have been accrued to the two officers for the year ended November 30, 2011 totaling \$400,000. The agreement also contains provisions prohibiting the officers from engaging in activities, which are competitive with those of the Company during employment and for one year following termination. The agreements further provide that in the event of a change of control, as defined, or a change in ownership of at least 25% of the issued and outstanding stock of the Company, and such issuance was not approved by either officer, or if they are not elected to the Board of Directors of the Company and/or are not elected as an officer of the Company, then the non-approving officer may elect to terminate his employment agreement. If he elects to terminate the agreement, he will receive 2.99 times his annual compensation (or such other amount then permitted under the Internal Revenue Code without an excess penalty), in addition to the remainder of his compensation under his existing employment contract. In addition, if the Company makes or receives a "firm commitment" for a public offering of Common Shares, each officer will receive a warrant to purchase, at a nominal value, up to 9.5% of the Company's common stock, provided they do not voluntarily terminate employment.

NOTE J– MAJOR CUSTOMERS

The Company had two customers who each accounted for 11% of net sales for the year ended November 30, 2011 and two customers who accounted for 13% and 11% of net sales for the year ended November 30, 2010. The Company had one customer who accounted for 24% and 22% of accounts receivable at November 30, 2011 and November 30, 2010, respectively.

NOTE K- MAJOR SUPPLIERS

During the year ended November 30, 2011 and 2010 there was one foreign supplier accounting for 46% and 52% of total inventory purchased.

The Company purchases a significant portion of its products overseas. For the year ended November 30, 2011, the Company purchased 49% from Taiwan, 19% from Hong Kong, 24% from elsewhere in Asia and less than 1% overseas outside of Asia.

NOTE L - EXPORT SALES

The Company's export sales approximated:

	Year Ended November 30,	
	2011	2010
Canada	2,927,760	1,671,816
China	4,324,694	5,336,289
Other Asian Countries	1,924,174	1,186,070

Europe	131,840	168,567
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Revenues are attributed to countries based on location of customer.

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SURGE COMPONENTS, INC. AND SUBSIDIARIES

Notes to Consolidated Financial Statements

NOTE M – LINE OF CREDIT

In July 2002, the Company obtained a financing commitment with an asset-based lender totaling \$1,000,000 (the “Credit Line”). Borrowings under the Credit Line accrue interest at the greater of the prime rate plus two percent (2.0%) or 6.75%. The Company was required to make monthly interest only payments. The Company could repay all or a portion of the line of credit at any time. In addition, the Company was obligated to pay one-quarter of one percent (1/4 of 1%) annually as an unused line fee for the difference between \$1,000,000 and the average daily balance of the Credit Line. The Credit Line was collateralized by substantially all the Company’s assets and contains various financial covenants pertaining to the maintenance of working capital and tangible net worth.

In December 2003, the Company entered into a Security Agreement with the lender establishing a restricted cash collateral account totaling \$200,000. The balance on the account including interest accrued is \$0 and \$245,883 at November 30, 2011 and November 30, 2010, respectively.

In June 2011, the Company replaced its existing credit line with a line of credit with a new bank totaling \$1,000,000. Borrowings under the line accrue interest at 2.56% over the LIBOR rate and is due in June 2012. The line is collateralized by all the Company’s assets and includes working capital and tangible net worth covenants. At November 30, 2011, the Company was in compliance with the financial covenants. As of November 30, 2011, the outstanding balance on the line of credit was zero.