

ALASKA AIR GROUP INC  
Form 10-Q  
November 05, 2010

UNITED STATES  
SECURITIES AND EXCHANGE COMMISSION  
WASHINGTON, DC 20549

FORM 10-Q  
(Mark One)

QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT  
OF 1934

For the quarterly period ended September 30, 2010.

OR

TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE  
ACT OF 1934

For the transition period from \_\_\_\_\_ to \_\_\_\_\_

Commission file number 1-8957  
ALASKA AIR GROUP, INC.  
(Exact name of registrant as specified in its charter)

Delaware  
(State or other jurisdiction of  
incorporation or organization)

91-1292054  
(I.R.S. Employer  
Identification No.)

19300 International Boulevard, Seattle, Washington 98188  
(Address of principal executive offices)

Registrant's telephone number, including area code: (206) 392-5040

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days. Yes  No

Indicate by check mark whether the registrant has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T (§232.405 of this chapter) during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files). Yes  No

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, a non-accelerated filer, or a smaller reporting company. See the definitions of "large accelerated filer," "accelerated filer," and "smaller reporting company" in Rule 12b-2 of the Exchange Act. (Check one):

Large accelerated filer   
Non-accelerated filer

Accelerated filer   
Smaller reporting company

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act.):  
Yes  No

Edgar Filing: ALASKA AIR GROUP INC - Form 10-Q

The registrant has 36,821,631 common shares, par value \$1.00, outstanding at October 31, 2010.

---

Table of Contents

ALASKA AIR GROUP, INC.  
Quarterly Report on Form 10-Q for the three months ended September 30, 2010

TABLE OF CONTENTS

|                                      |  |           |
|--------------------------------------|--|-----------|
| <u>PART I. FINANCIAL INFORMATION</u> |  | <u>4</u>  |
| <u>ITEM 1.</u>                       | <u>CONDENSED CONSOLIDATED FINANCIAL STATEMENTS</u>   | <u>4</u>  |
| <u>ITEM 2.</u>                       | <u>MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS</u> | <u>21</u> |
| <u>ITEM 3.</u>                       | <u>QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK</u>                            | <u>46</u> |
| <u>ITEM 4.</u>                       | <u>CONTROLS AND PROCEDURES</u>   | <u>47</u> |
| <u>PART II. OTHER INFORMATION</u>    |  | <u>47</u> |
| <u>ITEM 1.</u>                       | <u>LEGAL PROCEEDINGS</u>   | <u>47</u> |
| <u>ITEM 1A.</u>                      | <u>RISK FACTORS</u>  | <u>47</u> |
| <u>ITEM 2.</u>                       | <u>UNREGISTERED SALES OF EQUITY SECURITIES AND USE OF PROCEEDS</u>                           | <u>48</u> |
| <u>ITEM 3.</u>                       | <u>DEFAULTS UPON SENIOR SECURITIES</u>   | <u>48</u> |
| <u>ITEM 5.</u>                       | <u>OTHER INFORMATION</u>   | <u>48</u> |
| <u>ITEM 6.</u>                       | <u>EXHIBITS</u>  | <u>48</u> |
| <u>SIGNATURES</u>                    |  | <u>49</u> |
| <u>EXHIBIT INDEX</u>                 |  | <u>50</u> |

Table of Contents

As used in this Form 10-Q, the terms “Air Group,” “our,” “we” and the “Company” refer to Alaska Air Group, Inc. and its subsidiaries, unless the context indicates otherwise. Alaska Airlines, Inc. and Horizon Air Industries, Inc. are referred to as “Alaska” and “Horizon,” respectively, and together as our “airlines.”

Cautionary Note Regarding Forward-Looking Statements

In addition to historical information, this Form 10-Q contains forward-looking statements within the meaning of Section 27A of the Securities Act of 1933, as amended, Section 21E of the Securities Exchange Act of 1934, as amended, and the Private Securities Litigation Reform Act of 1995. Forward-looking statements are those that predict or describe future events or trends and that do not relate solely to historical matters. You can generally identify forward-looking statements as statements containing the words "believe," "expect," "will," "anticipate," "intend," "estimate," "project," "assume" or other similar expressions, although not all forward-looking statements contain these identifying words. Forward-looking statements involve risks and uncertainties that could cause actual results to differ materially from historical experience or the Company’s present expectations. Some of the things that could cause our actual results to differ from our expectations are:

- general economic conditions, including the impact of the economic recession on customer travel behavior;
- changes in our operating costs, including fuel, which can be volatile;
  - our significant indebtedness;
- the competitive environment in our industry;
  - our ability to meet our cost reduction goals;
  - an aircraft accident or incident;
  - labor disputes and our ability to attract and retain qualified personnel;
  - operational disruptions;
  - the concentration of our revenue from a few key markets;
- actual or threatened terrorist attacks, global instability and potential U.S. military actions or activities;
- our reliance on automated systems and the risks associated with changes made to those systems;
  - our reliance on third-party vendors and partners; and
  - changes in laws and regulations.

You should not place undue reliance on our forward-looking statements because the matters they describe are subject to known and unknown risks, uncertainties and other unpredictable factors, many of which are beyond our control. Our forward-looking statements are based on the information currently available to us and speak only as of the date on which this report was filed with the SEC. We expressly disclaim any obligation to issue any updates or revisions to our forward-looking statements, even if subsequent events cause our expectations to change regarding the matters discussed in those statements. Over time, our actual results, performance or achievements will likely differ from the anticipated results, performance or achievements that are expressed or implied by our forward-looking statements, and such differences might be significant and materially adverse to our shareholders. For a discussion of these and other risk factors, see "Item 1A: Risk Factors" of the Company’s annual report on Form 10-K for the year ended December 31, 2009. Please consider our forward-looking statements in light of those risks as you read this report.

Table of ContentsPART I. FINANCIAL INFORMATION  
ITEM 1. CONDENSED CONSOLIDATED FINANCIAL  
STATEMENTS

## CONDENSED CONSOLIDATED BALANCE SHEETS

(unaudited)

Alaska Air Group, Inc.

## ASSETS

(in millions)

|  | September 30, 2010 | December 31, 2009 |
|--|--------------------|-------------------|
| Current Assets                                 |                    |                   |
| Cash and cash equivalents                      | \$ 129.2           | \$ 164.2          |
| Marketable securities                          | 1,188.5            | 1,027.9           |
| Total cash and marketable securities           | 1,317.7            | 1,192.1           |
| Receivables - net                              | 139.6              | 111.8             |
| Inventories and supplies - net                 | 41.6               | 45.8              |
| Deferred income taxes                          | 129.8              | 120.3             |
| Fuel hedge contracts                           | 39.9               | 66.2              |
| Prepaid expenses and other current assets      | 99.7               | 98.1              |
| Total Current Assets                           | 1,768.3            | 1,634.3           |
| Property and Equipment                         |                    |                   |
| Aircraft and other flight equipment            | 3,804.6            | 3,660.1           |
| Other property and equipment                   | 624.1              | 631.3             |
| Deposits for future flight equipment           | 174.4              | 215.5             |
|  | 4,603.1            | 4,506.9           |
| Less accumulated depreciation and amortization | 1,456.1            | 1,339.0           |
| Total Property and Equipment - Net             | 3,147.0            | 3,167.9           |
| Fuel Hedge Contracts                           | 57.1               | 50.8              |
| Other Assets                                   | 147.7              | 143.2             |
| Total Assets                                   | \$ 5,120.1         | \$ 4,996.2        |

See accompanying notes to condensed consolidated financial statements.

Table of Contents

## CONDENSED CONSOLIDATED BALANCE SHEETS

(unaudited)

Alaska Air Group, Inc.

## LIABILITIES AND SHAREHOLDERS' EQUITY

| (in millions except share amounts)                         | September 30, 2010 | December 31, 2009 |
|--|--------------------|-------------------|
| Current Liabilities  |                    |                   |
| Accounts payable   | \$ 50.8            | \$ 63.3           |
| Accrued aircraft rent                                      | 34.6               | 54.0              |
| Accrued wages, vacation and payroll taxes                  | 152.2              | 155.4             |
| Other accrued liabilities                                  | 538.6              | 474.5             |
| Air traffic liability                                      | 462.0              | 366.3             |
| Current portion of long-term debt                          | 233.8              | 156.0             |
| Total Current Liabilities                                  | 1,472.0            | 1,269.5           |
| Long-Term Debt, Net of Current Portion                     | 1,390.1            | 1,699.2           |
| Other Liabilities and Credits                              |                    |                   |
| Deferred income taxes                                      | 251.7              | 151.1             |
| Deferred revenue   | 396.8              | 435.1             |
| Obligation for pension and postretirement medical benefits | 403.4              | 421.0             |
| Other liabilities  | 132.6              | 148.2             |
|  | 1,184.5            | 1,155.4           |
| Commitments and Contingencies                              |                    |                   |
| Shareholders' Equity                                       |                    |                   |
| Preferred stock, \$1 par value                             |                    |                   |
| Authorized: 5,000,000 shares, none issued or outstanding   | -                  | -                 |
| Common stock, \$1 par value                                |                    |                   |
| Authorized: 100,000,000 shares                             |                    |                   |
| Issued: 2010 - 36,790,005 shares                           |                    |                   |
| 2009 - 35,843,092 shares                                   | 36.8               | 35.8              |
| Capital in excess of par value                             | 805.7              | 767.0             |
| Treasury stock (common), at cost: 2010 - 840,922 shares    |                    |                   |
| 2009 - 252,084 shares                                      | (32.4 )            | (5.7 )            |
| Accumulated other comprehensive loss                       | (237.9 )           | (240.0 )          |
| Retained earnings  | 501.3              | 315.0             |
|  | 1,073.5            | 872.1             |
| Total Liabilities and Shareholders' Equity                 | \$ 5,120.1         | \$ 4,996.2        |

See accompanying notes to condensed consolidated financial statements.

Table of Contents

## CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS (unaudited)

Alaska Air Group, Inc.

| (in millions except per-share amounts)                   | Three Months Ended   |               | Nine Months Ended    |                |
|--|----------------------|---------------|----------------------|----------------|
|  | September 30<br>2010 | 2009          | September 30<br>2010 | 2009           |
| <b>Operating Revenues</b>                                |                      |               |                      |                |
| Passenger  | \$973.5              | \$884.8       | \$2,603.4            | \$2,326.1      |
| Freight and mail   | 29.4                 | 27.7          | 80.5                 | 72.3           |
| Other - net  | 64.6                 | 54.9          | 189.9                | 155.3          |
| <b>Total Operating Revenues</b>                          | <b>1,067.5</b>       | <b>967.4</b>  | <b>2,873.8</b>       | <b>2,553.7</b> |
| <b>Operating Expenses</b>                                |                      |               |                      |                |
| Wages and benefits                                       | 240.2                | 246.2         | 719.1                | 739.3          |
| Variable incentive pay                                   | 23.0                 | 24.0          | 62.5                 | 52.2           |
| Aircraft fuel, including hedging gains and losses        | 220.9                | 199.5         | 683.2                | 485.6          |
| Aircraft maintenance                                     | 55.3                 | 49.7          | 166.1                | 169.0          |
| Aircraft rent  | 33.9                 | 38.3          | 106.3                | 115.4          |
| Landing fees and other rentals                           | 59.8                 | 57.3          | 173.6                | 165.9          |
| Contracted services                                      | 40.7                 | 38.8          | 121.4                | 116.7          |
| Selling expenses   | 44.3                 | 37.0          | 116.1                | 97.3           |
| Depreciation and amortization                            | 57.8                 | 55.6          | 172.0                | 162.3          |
| Food and beverage service                                | 15.6                 | 12.7          | 42.2                 | 36.7           |
| Other  | 49.8                 | 49.7          | 145.8                | 154.1          |
| New pilot contract transition costs                      | -                    | -             | -                    | 35.8           |
| Horizon restructuring and CRJ-700 fleet transition costs | 9.8                  | -             | 13.2                 | -              |
| Fleet transition costs - Q200                            | -                    | (1.2 )        | -                    | 8.8            |
| <b>Total Operating Expenses</b>                          | <b>851.1</b>         | <b>807.6</b>  | <b>2,521.5</b>       | <b>2,339.1</b> |
| <b>Operating Income</b>                                  | <b>216.4</b>         | <b>159.8</b>  | <b>352.3</b>         | <b>214.6</b>   |
| <b>Nonoperating Income (Expense)</b>                     |                      |               |                      |                |
| Interest income  | 7.6                  | 8.3           | 22.7                 | 24.4           |
| Interest expense   | (29.5 )              | (25.9 )       | (81.4 )              | (77.8 )        |
| Interest capitalized                                     | 1.4                  | 1.4           | 4.7                  | 6.0            |
| Other - net  | 2.3                  | (0.8 )        | 4.1                  | (6.3 )         |
|  | (18.2 )              | (17.0 )       | (49.9 )              | (53.7 )        |
| <b>Income before income tax</b>                          | <b>198.2</b>         | <b>142.8</b>  | <b>302.4</b>         | <b>160.9</b>   |
| <b>Income tax expense</b>                                | <b>75.8</b>          | <b>55.2</b>   | <b>116.1</b>         | <b>63.4</b>    |
| <b>Net Income</b>  | <b>\$122.4</b>       | <b>\$87.6</b> | <b>\$186.3</b>       | <b>\$97.5</b>  |
| <b>Basic Earnings Per Share:</b>                         | <b>\$3.41</b>        | <b>\$2.48</b> | <b>\$5.21</b>        | <b>\$2.71</b>  |
| <b>Diluted Earnings Per Share:</b>                       | <b>\$3.32</b>        | <b>\$2.46</b> | <b>\$5.08</b>        | <b>\$2.69</b>  |
| <b>Shares used for computation:</b>                      |                      |               |                      |                |
| Basic  | 35.898               | 35.275        | 35.755               | 35.981         |
| Diluted  | 36.830               | 35.681        | 36.706               | 36.292         |

See accompanying notes to condensed consolidated financial statements.



Table of Contents

## CONDENSED CONSOLIDATED STATEMENTS OF SHAREHOLDERS' EQUITY

(unaudited)

Alaska Air Group,  
Inc.

| (in millions)   | Common                |                 | Capital<br>in<br>Excess<br>of<br>Par<br>Value | Accumulated                  |                                | Total    |                      |
|---|-----------------------|-----------------|---|------------------------------|--------------------------------|----------|----------------------|
|   | Shares<br>Outstanding | Common<br>Stock |   | Treasury<br>Stock<br>at Cost | Other<br>Comprehensive<br>Loss |          | Retained<br>Earnings |
| Balances at December 31, 2009                           | 35.591                | \$ 35.8         | \$ 767.0                                      | \$ (5.7 )                    | \$ (240.0 )                    | \$ 315.0 | \$ 872.1             |
| Net income for the nine months ended September 30, 2010 |                       |                 |   |                              |                                | 186.3    | 186.3                |
| Other comprehensive income (loss):                      |                       |                 |   |                              |                                |          |                      |
| Related to marketable securities:                       |                       |                 |   |                              |                                |          |                      |
| Change in fair value                                    |                       |                 |   |                              | 16.0                           |          |                      |
| Reclassification to earnings                            |                       |                 |   |                              | (5.6 )                         |          |                      |
| Income tax effect                                       |                       |                 |   |                              | (3.9 )                         |          |                      |
|   |                       |                 |   |                              | 6.5                            |          | 6.5                  |
| Related to employee benefit plans:                      |                       |                 |   |                              |                                |          |                      |
| Income tax effect                                       |                       |                 |   |                              | 16.3                           |          |                      |
|   |                       |                 |   |                              | (5.8 )                         |          |                      |
|   |                       |                 |   |                              | 10.5                           |          | 10.5                 |
| Related to interest rate derivative instruments:        |                       |                 |   |                              |                                |          |                      |
| Change in fair value                                    |                       |                 |   |                              | (23.8 )                        |          |                      |
| Income tax effect                                       |                       |                 |   |                              | 8.9                            |          |                      |
|   |                       |                 |   |                              | (14.9 )                        |          | (14.9 )              |
| Total comprehensive income                              |                       |                 |   |                              |                                |          | 188.4                |
| Purchase of treasury stock                              | (0.748 )              |                 |   | (31.2 )                      |                                |          | (31.2 )              |
| Stock-based compensation                                |                       |                 | 10.6  |                              |                                |          | 10.6                 |
| Treasury stock issued under stock plans                 | 0.159                 |                 |   | 4.5                          |                                |          | 4.5                  |
| Stock issued for employee stock purchase plan           | 0.016                 | 0.1             | -   |                              |                                |          | 0.1                  |

Edgar Filing: ALASKA AIR GROUP INC - Form 10-Q

|                                   |        |         |          |            |             |          |            |
|-----------------------------------|--------|---------|----------|------------|-------------|----------|------------|
| Stock issued under<br>stock plans | 0.931  | 0.9     | 28.1     |            |             |          | 29.0       |
| Balances at September<br>30, 2010 | 35.949 | \$ 36.8 | \$ 805.7 | \$ (32.4 ) | \$ (237.9 ) | \$ 501.3 | \$ 1,073.5 |

See accompanying notes to condensed consolidated financial statements.

7

---

Table of Contents

## CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS (unaudited)

Alaska Air Group, Inc.

| (in millions)  | Nine Months Ended September 30 |          |
|--|--------------------------------|----------|
|  | 2010                           | 2009     |
| Cash flows from operating activities:  |                                |          |
| Net income   | \$ 186.3                       | \$ 97.5  |
| Adjustments to reconcile net income (loss) to net cash provided by operating activities: |                                |          |
| Non-cash impact of pilot contract transition costs                                       | -                              | 15.5     |
| Restructuring and fleet transition costs   | 13.2                           | 8.8      |
| Depreciation and amortization  | 172.0                          | 162.3    |
| Stock-based compensation   | 10.6                           | 10.2     |
| Increase in air traffic liability  | 95.7                           | 24.4     |
| Changes in other assets and liabilities - net  | 28.6                           | (13.3)   |
| Net cash provided by operating activities  | 506.4                          | 305.4    |
| Cash flows from investing activities:  |                                |          |
| Property and equipment additions:  |                                |          |
| Aircraft and aircraft purchase deposits  | (109.3)                        | (295.0)  |
| Other flight equipment   | (20.6)                         | (25.1)   |
| Other property and equipment   | (24.0)                         | (27.2)   |
| Total property and equipment additions   | (153.9)                        | (347.3)  |
| Proceeds from disposition of assets  | 4.7                            | 5.1      |
| Purchases of marketable securities   | (796.7)                        | (767.8)  |
| Sales and maturities of marketable securities  | 646.6                          | 521.8    |
| Restricted deposits and other  | 0.3                            | (5.1)    |
| Net cash used in investing activities  | (299.0)                        | (593.3)  |
| Cash flows from financing activities:  |                                |          |
| Proceeds from issuance of long-term debt   | -                              | 191.6    |
| Proceeds from sale-leaseback transactions, net   | -                              | 230.0    |
| Long-term debt payments  | (231.3)                        | (226.8)  |
| Purchase of treasury stock   | (31.2)                         | (23.8)   |
| Proceeds and tax benefit from issuance of common stock                                   | 29.1                           | 3.6      |
| Other financing activities   | (9.0)                          | 0.2      |
| Net cash (used in) provided by financing activities                                      | (242.4)                        | 174.8    |
| Net change in cash and cash equivalents  | (35.0)                         | (113.1)  |
| Cash and cash equivalents at beginning of year   | 164.2                          | 283.1    |
| Cash and cash equivalents at end of period   | \$ 129.2                       | \$ 170.0 |

Supplemental disclosure of cash paid (received)  
during the period for:

|                                      |    |      |    |      |   |
|--------------------------------------|----|------|----|------|---|
| Interest (net of amount capitalized) | \$ | 83.6 | \$ | 77.6 |   |
| Income taxes                         |    | (4.9 | )  | (8.9 | ) |

See accompanying notes to condensed consolidated financial statements.

Table of Contents

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (unaudited)

Alaska Air Group, Inc.

NOTE 1. BASIS OF PRESENTATION AND SIGNIFICANT ACCOUNTING POLICIES

Organization and Basis of Presentation

The accompanying unaudited condensed consolidated financial statements of Alaska Air Group, Inc. (Air Group or the Company) include the accounts of the parent company, Alaska Air Group, Inc., and its principal subsidiaries, Alaska Airlines, Inc. (Alaska) and Horizon Air Industries, Inc. (Horizon), through which the Company conducts substantially all of its operations. These interim condensed consolidated financial statements are unaudited and should be read in conjunction with the consolidated financial statements in the Company's Annual Report on Form 10-K for the year ended December 31, 2009. In the opinion of management, all adjustments have been made that are necessary to present fairly the Company's financial position as of September 30, 2010, as well as the results of operations for the three and nine months ended September 30, 2010 and 2009. The adjustments made were of a normal recurring nature.

The Company's interim condensed consolidated financial statements have been prepared in conformity with accounting principles generally accepted in the United States of America (GAAP). In preparing these statements, the Company is required to make estimates and assumptions that affect the reported amounts of assets and liabilities and the disclosure of contingent liabilities, as well as the reported amounts of revenues and expenses. Significant estimates made include assumptions used to record expenses and revenues associated with the Company's Mileage Plan; assumptions used in the calculations of pension expense in the Company's defined-benefit plans; and the amounts of certain accrued liabilities. Actual results may differ from the Company's estimates.

Reclassifications

Certain reclassifications have been made to conform the prior year's data to the current format.

Prospective Accounting Pronouncements

New accounting standards on Revenue Arrangements with Multiple Deliverables were issued in September 2009 and update the current guidance pertaining to multiple-element revenue arrangements. This new guidance will be effective for contracts with effective dates beginning January 1, 2011. Management does not believe that there will be an immediate significant impact of this new standard on the Company's financial position, results of operations, cash flows, or disclosures.

Recently, the Financial Accounting Standards Board (FASB) has issued a number of proposed Accounting Standards Updates (ASUs). Those proposed ASUs are as follows:

- Proposed ASU – Comprehensive Income – was issued in May 2010 and will change the way comprehensive income is reported in the financial statements. The proposed standard, if adopted, will require a continuous statement of comprehensive income be reported combining the Company's current statement of operations with comprehensive income. Comprehensive income or loss will be removed from the statement of shareholders' equity.
- Proposed ASU – Accounting for Financial Instruments and Revisions to the Accounting for Derivative Instruments and Hedging Activities – was issued in May 2010. This proposed standard, if adopted, will make significant changes to accounting for financial instruments. It is expected that more financial instruments will be measured at fair value with subsequent changes recognized in net income. The proposed standard also simplifies the requirements for assessing hedge effectiveness for cash flow



Table of Contents

hedges and modifies the threshold to initially qualify as an effective hedge. Management believes this standard may have an impact on the Company's results of operations and disclosures specifically as it relates to unrealized gains and losses on our cash and marketable securities balance.

- Proposed ASU – Revenue Recognition – was issued in June 2010. This proposed standard, if adopted, will completely replace all existing revenue recognition accounting literature. Generally, the proposed standard would require an entity to identify separate performance obligations under a contract, determine the transaction price, allocate that price to the separate components based on relative fair value, and recognize revenue when each performance obligation is satisfied. This proposed standard could significantly impact the Company's financial position, results of operations, and disclosures specifically in the accounting for the Company's Mileage Plan revenue components.
- Proposed ASU – Fair Value Measurements and Disclosures – was issued in June 2010. This proposed standard, if adopted, will change how fair value is determined for certain assets and liabilities and will require additional disclosures about fair value instruments. Management is currently evaluating the impact of this new standard on the Company's financial position, results of operations, cash flows, and disclosures.
- Proposed ASU – Disclosure of Certain Loss Contingencies – was issued in July 2010. This proposed standard, if adopted, enhances financial statement disclosure surrounding certain loss contingencies such as legal disputes, environmental remediation liabilities, and self-insurance liabilities, among others. The proposed standard primarily focuses on asserted claims and assessments and will require more robust disclosure of amounts, court or agency where legal proceedings are pending, principal parties, and other details not historically required. As the proposed standard impacts disclosure only, management does not expect it to impact the Company's financial position or results of operations.
- Proposed ASU – Leases – was issued in August 2010. This proposed standard overhauls accounting for leases and will apply a "right-of-use" model in accounting for nearly all leases. For lessees, this will result in recognizing an asset representing the lessee's right to use the leased asset for the lease term and a liability to make lease payments. This proposed standard eliminates the operating lease concept from an accounting perspective, thereby eliminating rent expense from the income statement. This proposed standard, if adopted, will impact the Company's statement of operations, financial position, and disclosures.

These proposed ASUs are currently in comment period and are subject to change. There are no effective dates assigned to these proposals.

In July 2010, the FASB also issued an initial draft of new financial statement presentation requirements. These new requirements, as currently drafted, would substantially change the way financial statements are presented by disaggregating information in financial statements to explain the components of its financial position and financial performance. These changes will impact the presentation of the financial statements only and are not expected to impact the Company's overall financial position, results of operations, or cash flows.

NOTE 2. FAIR VALUE OF FINANCIAL INSTRUMENTS

Fair Value Measurements

Accounting standards define fair value as the exchange price that would be received for an asset or paid to transfer a liability (an exit price) in the principal or most advantageous market for the asset or liability in an orderly transaction between market participants on the measurement date. The standards also establish a fair





Table of Contents

value hierarchy, which requires an entity to maximize the use of observable inputs and minimize the use of unobservable inputs when measuring fair value. There are three levels of inputs that may be used to measure fair value:

Level 1 - Quoted prices in active markets for identical assets or liabilities.

Level 2 - Observable inputs other than Level 1 prices such as quoted prices for similar assets or liabilities; quoted prices in markets that are not active; or other inputs that are observable or can be corroborated by observable market data for substantially the full term of the assets or liabilities.

Level 3 - Unobservable inputs that are supported by little or no market activity and that are significant to the fair value of the assets or liabilities.

#### Cash, Cash Equivalents and Marketable Securities

The Company uses the “market approach” as defined in the accounting standards in determining the fair value of its cash, cash equivalents and marketable securities. The securities held by the Company are valued based on observable prices in active markets and considered to be liquid and easily tradable.

Amounts measured at fair value as of September 30, 2010 are as follows (in millions):

|                           | Level 1  | Level 2    | Level 3 | Total      |
|---------------------------|----------|------------|---------|------------|
| Cash and cash equivalents | \$ 61.2  | \$ 68.0    | \$ —    | \$ 129.2   |
| Marketable securities     | 221.7    | 966.8      | —       | 1,188.5    |
| Total                     | \$ 282.9 | \$ 1,034.8 | \$ —    | \$ 1,317.7 |

All of the Company’s marketable securities are classified as “available for sale” as defined in the accounting standards. The securities are carried at fair value, with the unrealized gains and losses, excluding credit losses, reported in shareholders’ equity under the caption “accumulated other comprehensive loss” (AOCL). Realized gains and losses are included in other nonoperating income (expense) in the condensed consolidated statements of operations.

The cost of securities sold is based on the specific identification method. Interest and dividends on marketable securities are included in interest income in the condensed consolidated statements of operations.

Marketable securities consisted of the following (in millions):

|                                | September 30,<br>2010 | December 31,<br>2009 |
|--------------------------------|-----------------------|----------------------|
| Amortized cost:                |                       |                      |
| Government securities/agencies | \$ 506.3              | \$ 376.7             |
| Asset-backed obligations       | 205.5                 | 215.4                |
| Other corporate obligations    | 452.4                 | 421.8                |
|                                | \$ 1,164.2            | \$ 1,013.9           |
| Fair value:                    |                       |                      |
| Government securities/agencies | \$ 515.9              | \$ 381.2             |
| Asset-backed obligations       | 205.7                 | 214.7                |
| Other corporate obligations    | 466.9                 | 432.0                |
|                                | \$ 1,188.5            | \$ 1,027.9           |



Table of Contents

Of the marketable securities on hand at September 30, 2010, 6% mature in 2010, 28% in 2011 and 66% thereafter. Gross realized gains and losses for the three or nine months ended September 30, 2010 and 2009 were not material to the condensed consolidated financial statements.

Some of the Company's asset-backed securities held at September 30, 2010 had credit losses, as defined in the accounting standards. Credit losses of \$2.2 million were recorded through earnings in 2009 and represent the difference between the present value of future cash flows and the amortized cost basis of the affected securities. No additional credit losses were recorded in the first nine months of 2010.

Management does not believe the securities associated with the remaining \$1.7 million unrealized loss recorded in AOCL are "other than temporarily" impaired, as defined in the accounting standards, based on the current facts and circumstances. Management currently does not intend to sell these securities prior to their recovery nor does it believe that it will be more likely than not that the Company would need to sell these securities for liquidity or other reasons.

Gross unrealized gains and losses, including credit losses, at September 30, 2010 are presented in the table below (in millions):

|                                   | Unrealized Losses              |                           |                              |                               | Less:<br>Credit<br>Loss<br>Previously<br>Recorded<br>in<br>Earnings | Net<br>Unrealized<br>Losses in<br>AOCL | Net<br>Unrealized<br>Gains/(Losses)<br>in AOCL | Fair<br>Value of<br>Securities<br>with<br>Unrealized<br>Losses |
|-----------------------------------|--------------------------------|---------------------------|------------------------------|-------------------------------|---|--|--|--|
|                                   | Unrealized<br>Gains in<br>AOCL | Less<br>than 12<br>months | Greater<br>than 12<br>months | Total<br>Unrealized<br>Losses |   |  |  |  |
| Government<br>Securities/Agencies | \$ 9.6                         | \$--                      | \$--                         | \$ --                         | \$ --   | \$ --                                  | \$ 9.6   | \$ 28.0  |
| Asset-backed<br>obligations       | 1.9                            | (0.4 )                    | (3.5 )                       | (3.9 )                        | (2.2 )  | (1.7 )                                 | 0.2  | 65.8   |
| Other corporate<br>obligations    | 14.5                           | --                        | --                           | --                            | --  | --                                     | 14.5   | 18.1   |
| Total                             | \$ 26.0                        | \$(0.4 )                  | \$(3.5 )                     | \$(3.9 )                      | \$(2.2 )  | \$(1.7 )                               | \$ 24.3  | \$ 111.9   |

## Fair Value of Financial Instruments

The majority of the Company's financial instruments are carried at fair value. These include cash, cash equivalents and marketable securities (Note 2); restricted deposits (Note 7); fuel hedge contracts (Note 3); and interest rate swap agreements (Note 3). The Company's long-term fixed-rate debt is not carried at fair value. The estimated fair value of the Company's long-term debt is as follows (in millions):

|   | Carrying<br>Amount | Fair Value |
|---|--------------------|------------|
| Long-term debt at<br>September 30, 2010 | \$ 1,623.9         | \$ 1,665.0 |
| Long-term debt at<br>December 31, 2009  | \$ 1,855.2         | \$ 1,821.3 |

The fair value of cash and cash equivalents approximates carrying values due to the short maturity of these instruments. The fair value of marketable securities is based on market prices. The fair value of fuel hedge contracts is based on commodity exchange prices. The fair value of restricted deposits approximates the carrying amount. The

fair value of interest rate swap agreements is based on quoted market swap rates. The fair value of long-term debt is based on a discounted cash flow analysis using the Company's current borrowing rate.

Table of Contents

## NOTE 3. DERIVATIVE INSTRUMENTS

## Fuel Hedge Contracts

The Company's operations are inherently dependent upon the price and availability of aircraft fuel. To manage economic risk associated with fluctuations in aircraft fuel prices, the Company enters into call options for crude oil and swap agreements for jet fuel refining margins. The Company records these instruments on the balance sheet at their fair value. Changes in the fair value of these fuel hedge contracts are recorded each period in aircraft fuel expense.

The following table summarizes the components of aircraft fuel expense for the three and nine months ended September 30, 2010 and 2009 (in millions):

|                               | Three Months Ended |         | Nine months ended |         |
|-------------------------------|--------------------|---------|-------------------|---------|
|                               | September 30       |         | September 30      |         |
|                               | 2010               | 2009    | 2010              | 2009    |
| Raw or "into-plane" fuel cost | \$233.8            | \$190.9 | \$651.9           | \$491.3 |
| Impact of hedging activity    | (12.9 )            | 8.6     | 31.3              | (5.7 )  |
| Aircraft fuel expense         | \$220.9            | \$199.5 | \$683.2           | \$485.6 |

The net cost from hedges that settled during the period was \$3.8 million and \$15.9 million during the three-month periods ended September 30, 2010 and 2009, respectively. The net benefit of settled hedges in the nine months ended September 30, 2010 was \$2.1 million compared to the net cost of settled hedges in the same period of 2009 of \$51.4 million.

The Company uses the "market approach" in determining the fair value of its hedge portfolio. The Company's fuel hedge contracts consist of over-the-counter contracts, which are not traded on an exchange. The fair value of these contracts is determined based on observable inputs that are readily available in active markets or can be derived from information available in active, quoted markets. Therefore, the Company has categorized these contracts as Level 2 in the fair value hierarchy described in Note 2.

Outstanding future crude oil hedge positions are as follows:

|                     | Approximate % of |                | Weighted-Average    | Weighted-Average |
|---------------------|------------------|----------------|---------------------|------------------|
|                     | Expected Fuel    | Gallons Hedged | Strike Price per    | Premium Cost per |
|                     | Requirements     | (in millions)  | Barrel of Crude Oil | Barrel           |
| Fourth Quarter 2010 | 50%              | 44.5           | \$83                | \$11             |
| Remainder of 2010   | 50%              | 44.5           | \$83                | \$11             |
| First Quarter 2011  | 50%              | 44.9           | \$87                | \$11             |
| Second Quarter 2011 | 50%              | 47.2           | \$86                | \$11             |
| Third Quarter 2011  | 50%              | 49.7           | \$86                | \$11             |
| Fourth Quarter 2011 | 50%              | 45.9           | \$86                | \$11             |
| Full Year 2011      | 50%              | 187.7          | \$86                | \$11             |
| First Quarter 2012  | 43%              | 40.0           | \$86                | \$12             |
| Second Quarter 2012 | 29%              | 27.8           | \$87                | \$13             |
| Third Quarter 2012  | 25%              | 25.6           | \$91                | \$13             |
| Fourth Quarter 2012 | 22%              | 21.0           | \$89                | \$13             |
| Full Year 2012      | 30%              | 114.4          | \$88                | \$13             |
| First Quarter 2013  | 17%              | 15.7           | \$87                | \$13             |
| Second Quarter 2013 | 11%              | 11.0           | \$84                | \$15             |
| Third Quarter 2013  | 6%               | 5.9            | \$86                | \$15             |

Edgar Filing: ALASKA AIR GROUP INC - Form 10-Q

|                |    |      |      |      |
|----------------|----|------|------|------|
| Full Year 2013 | 8% | 32.6 | \$86 | \$14 |
|----------------|----|------|------|------|

Table of Contents

The Company pays a premium to enter into crude oil call option contracts. In order to receive economic benefit from the contract, the market price of crude oil must exceed the total of the contract strike price and the premium cost per barrel at the time of contract settlement.

The Company also has financial swap agreements in place to fix the refining margin component for approximately 50% of fourth quarter 2010 estimated jet fuel purchases at an average price of 30 cents per gallon and 30% of first quarter 2011 estimated purchases at an average price of 35 cents per gallon.

As of September 30, 2010 and December 31, 2009, the net fair values of the Company's fuel hedge positions were as follows (in millions):

|                                  | September 30, 2010 | December 31, 2009 |
|----------------------------------|--------------------|-------------------|
| Crude oil call options or "caps" | \$ 92.5            | \$ 115.9          |
| Refining margin swap contracts   | 4.5                | 1.1               |
| Total                            | \$ 97.0            | \$ 117.0          |

The balance sheet amounts include capitalized premiums paid to enter into the contracts of \$102.3 million and \$88.9 million at September 30, 2010 and December 31, 2009, respectively.

**Interest Rate Swap Agreements**

The Company has interest rate swap agreements with a third party designed to hedge the volatility of the underlying variable interest rate in the Company's aircraft lease agreements for six B737-800 aircraft. The agreements stipulate that the Company pay a fixed interest rate over the term of the contract and receive a floating interest rate. All significant terms of the swap agreement match the terms of the lease agreements, including interest-rate index, rate reset dates, termination dates and underlying notional values. The agreements expire from September 2020 through March 2021 to coincide with the lease termination dates.

The Company has formally designated these swap agreements as hedging instruments and records the effective portion of the hedge as an adjustment to aircraft rent in the condensed consolidated statement of operations in the period of contract settlement. The effective portion of the changes in fair value for instruments that settle in the future is recorded in AOCL in the condensed consolidated balance sheets.

At September 30, 2010, the Company had a liability of \$21.4 million associated with these contracts, with a corresponding unrealized loss in accumulated other comprehensive loss. The Company expects that \$6 million will be reclassified into earnings within the next twelve months. The fair value of these contracts is determined based on the difference between the fixed interest rate in the agreements and the observable LIBOR-based interest forward rates at period end, multiplied by the total notional value. As such, the Company places these contracts in Level 2 of the fair value hierarchy.

**NOTE 4. LONG-TERM DEBT**

Long-term debt obligations were as follows (in millions):

|  | September 30,<br>2010 | December 31,<br>2009 |
|--|-----------------------|----------------------|
| Fixed-rate notes payable due through 2024    | \$ 1,285.5            | \$ 1,440.2           |
| Variable-rate notes payable due through 2024 | 338.4                 | 415.0                |
| Long-term debt                               | 1,623.9               | 1,855.2              |
| Less current portion                         | (233.8 )              | (156.0 )             |
|  | \$ 1,390.1            | \$ 1,699.2           |





Table of Contents

During the first nine months of 2010, the Company had no new debt borrowings and made scheduled debt payments of \$115.8 million. The Company also prepaid the full debt balance on four outstanding aircraft debt agreements and a partial payment on a fifth totaling \$115.5 million. Subsequent to September 30, 2010, the Company prepaid the full balance on two additional aircraft debt agreements totaling \$53.7 million. These amounts, along with an additional debt agreement of approximately \$27 million expected to be prepaid in the first quarter of 2011, are included in the current portion of long-term debt in the condensed consolidated balance sheet.

**Bank Lines of Credit**

The Company has two \$100 million credit facilities. Both facilities have variable interest rates based on LIBOR plus a specified margin. Borrowings on one of the \$100 million facilities, which expires in March 2013, are secured by aircraft. Borrowings on the other \$100 million facility, which expires in March 2014, are secured by certain accounts receivable, spare engines, spare parts and ground service equipment. The Company has no immediate plans to borrow using either of these facilities. These facilities have a requirement to maintain a minimum unrestricted cash and marketable securities balance of \$500 million. The Company is in compliance with this covenant at September 30, 2010.

**Pre-delivery Payment Facility**

Effective March 31, 2010, the Company terminated its variable-rate pre-delivery payment facility that had been used to provide a portion of the pre-delivery funding requirements for the purchase of new Boeing 737-800 aircraft. There were no borrowings on this facility as of December 31, 2009 or September 30, 2010.

**NOTE 5. COMMON STOCK REPURCHASE**

In June 2009, the Board of Directors authorized the Company to repurchase up to \$50 million of its common stock. Under the program, the Company repurchased 1,970,326 shares of its common stock, of which 645,748 shares were purchased for \$26.3 million during 2010. This program expired in June 2010.

In June 2010, the Board of Directors authorized the Company to repurchase up to an additional \$50 million of its common stock. Under this program, the Company has repurchased 102,000 shares of its common stock for \$5 million through September 30, 2010. This program expires in June 2011.

**NOTE 6. EMPLOYEE BENEFIT PLANS****Pension Plans - Qualified Defined Benefit**

Net pension expense for the three and nine months ended September 30, 2010 and 2009 included the following components (in millions):

|                                    | Three Months Ended |         | Nine months ended |         |
|------------------------------------|--------------------|---------|-------------------|---------|
|                                    | September 30       |         | September 30      |         |
|                                    | 2010               | 2009    | 2010              | 2009    |
| Service cost                       | \$ 8.1             | \$ 11.0 | \$ 24.3           | \$ 33.2 |
| Interest cost                      | 16.9               | 16.7    | 50.7              | 50.1    |
| Expected return on assets          | (17.7 )            | (12.8 ) | (53.1 )           | (38.4 ) |
| Amortization of prior service cost | (0.2 )             | 1.1     | (0.6 )            | 3.3     |
| Actuarial loss                     | 5.5                | 7.2     | 16.5              | 21.6    |
| Net pension expense                | \$ 12.6            | \$ 23.2 | \$ 37.8           | \$ 69.8 |

The Company contributed \$15.2 million and \$45.6 million to its qualified defined-benefit plans during the three and nine months ended September 30, 2010, respectively, and is not currently scheduled to contribute

Table of Contents

additional amounts during the remainder of 2010. The Company contributed \$15.9 million and \$47.8 million to its qualified defined-benefit plans during the three and nine months ended September 30, 2009, respectively.

**Pension Plans - Nonqualified Defined Benefit**

Net pension expense for the unfunded, noncontributory defined-benefit plans was \$0.8 million for the three months ended September 30, 2010 and 2009, and \$2.3 million for the nine months ended September 30, 2010 and 2009.

**Post-retirement Medical Benefits**

Net periodic benefit cost for the post-retirement medical plans for the three months ended September 30, 2010 and 2009 was \$3.1 million and \$4 million, respectively. The net periodic benefit cost for the nine months ended September 30, 2010 and 2009 was \$9.3 million and \$12.9 million, respectively.

**NOTE 7. OTHER ASSETS**

Other assets consisted of the following (in millions):

|  | September 30, 2010 | December 31, 2009 |
|--|--------------------|-------------------|
| Restricted deposits (primarily restricted investments) | \$ 86.5            | \$ 86.7           |
| Deferred costs and other*                              | 61.2               | 56.5              |
|  | \$ 147.7           | \$ 143.2          |

\*Deferred costs and other includes deferred financing costs, long-term prepaid rent, lease deposits and other items.

**NOTE 8. MILEAGE PLAN**

Alaska's Mileage Plan deferrals and liabilities are included under the following balance sheet captions (in millions):

|   | September 30, 2010 | December 31, 2009 |
|---|--------------------|-------------------|
| <b>Current Liabilities:</b>                         |                    |                   |
| Other accrued liabilities                           | \$ 287.6           | \$ 267.9          |
| <b>Other Liabilities and Credits (non-current):</b> |                    |                   |
| Deferred revenue                                    | 374.5              | 410.6             |
| Other liabilities                                   | 13.2               | 13.2              |
|   | \$ 675.3           | \$ 691.7          |

Alaska's Mileage Plan revenue is included under the following condensed consolidated statement of operations captions for the three and nine months ended September 30 (in millions):

|                      | Three Months Ended |                   | Nine months ended |                   |
|----------------------|--------------------|-------------------|-------------------|-------------------|
|                      | September 30 2010  | September 30 2009 | September 30 2010 | September 30 2009 |
| Passenger revenues   | \$49.9             | \$54.0            | \$142.0           | \$140.9           |
| Other - net revenues | 47.5               | 39.5              | 138.1             | 109.8             |
|                      | \$97.4             | \$93.5            | \$280.1           | \$250.7           |

**NOTE 9. STOCK-BASED COMPENSATION PLANS**

The Company has stock awards outstanding under a number of long-term incentive equity plans, one of which provides for the grant of stock awards to directors, officers and employees of the Company and its subsidiaries. Compensation expense is recorded over the shorter of the vesting period or the period between the grant

date and the date the employee becomes retirement-eligible as defined in the applicable plan. All stock-based compensation expense is recorded in wages and benefits in the condensed consolidated statements of operations.

Table of Contents

Stock Options

During the nine months ended September 30, 2010, the Company granted 129,970 options with a weighted-average grant-date fair value of \$18.05 per share. During the same period in the prior year, the Company granted 389,652 options with a weighted-average grant-date fair value of \$14.00 per share.

The Company recorded stock-based compensation expense related to stock options of \$0.7 million and \$0.8 million for the three months ended September 30, 2010 and 2009, respectively. The Company recorded expense of \$3.5 million and \$3.8 million for the nine months ended September 30, 2010 and 2009, respectively. As of September 30, 2010, \$3.2 million of compensation cost associated with unvested stock option awards attributable to future service had not yet been recognized. This amount will be recognized as expense over a weighted-average period of 1.9 years.

As of September 30, 2010, options to purchase 1,372,401 shares of common stock were outstanding with a weighted-average exercise price of \$30.68. Of that total, 725,383 were exercisable at a weighted-average exercise price of \$32.32.

Restricted Stock Awards

During the nine months ended September 30, 2010, the Company awarded 134,864 restricted stock units (RSUs) to certain employees, with a weighted-average grant date fair value of \$34.18. This amount reflects the value of the total RSU awards at the grant date based on the closing price of the Company's common stock.

The Company recorded stock-based compensation expense related to RSUs of \$0.7 million and \$1.1 million for the three-month period ended September 30, 2010 and 2009, respectively, and \$4.5 million and \$4.9 million for the nine-month period ended September 30, 2010 and 2009, respectively.

As of September 30, 2010, \$4.8 million of compensation cost associated with unvested restricted stock awards attributable to future service had not yet been recognized. This amount will be recognized as expense over a weighted-average period of 1.6 years.

Performance Stock Awards

From time to time, the Company issues performance stock unit awards (PSUs) to certain executives. PSUs are similar to RSUs, but vesting is based on performance or market conditions.

Currently outstanding PSUs were issued in 2008 and in 2010. There are several tranches of PSUs that vest based on differing performance conditions including achieving a specified pretax margin, a market condition tied to the Company's total shareholder return relative to an airline peer group, and based on certain performance goals established by the Compensation Committee of the Board of Directors. The total grant-date fair value of PSUs issued during the first nine months of 2010 was \$3.6 million.

The Company recorded \$0.4 million and \$2.1 million of compensation expense related to PSUs in the third quarter and first nine months of 2010, respectively. No expense was recorded in 2009.

Deferred Stock Awards

In the second quarter of 2010, the Company awarded 6,328 Deferred Stock Unit awards (DSUs) to members of its Board of Directors as a portion of their retainers. The underlying common shares are issued upon retirement from the Board, but require no future service period. As a result, the entire intrinsic value of the awards on the date of grant was expensed in the quarter granted. The total amount of compensation expense recorded in the first nine months of 2010 was \$0.3 million.



Table of Contents

## Employee Stock Purchase Plan

Compensation expense recognized under the Employee Stock Purchase Plan was \$0.1 million and \$0.4 million for the three months ended September 30, 2010 and September 30, 2009, respectively, and \$0.2 and \$1.2 million for the nine months ended September 30, 2010 and September 30, 2009, respectively.

## Summary of Stock-Based Compensation

The table below summarizes the components of total stock-based compensation for the three and nine months ended September 30 (in millions):

|                              | Three<br>Months<br>Ended<br>September<br>30 |       | Nine months<br>ended<br>September 30 |        |
|------------------------------|---|-------|--------------------------------------|--------|
|                              | 2010  | 2009  | 2010                                 | 2009   |
| Stock options                | \$0.7                                       | \$0.8 | \$3.5                                | \$3.8  |
| Restricted stock units       | 0.7   | 1.1   | 4.5                                  | 4.9    |
| Performance share units      | 0.4   | ---   | 2.1                                  | ---    |
| Deferred stock units         | ---   | 0.3   | 0.3                                  | 0.3    |
| Employee stock purchase plan | 0.1   | 0.4   | 0.2                                  | 1.2    |
|                              | \$1.9                                       | \$2.6 | \$10.6                               | \$10.2 |

## NOTE 10. HORIZON RESTRUCTURING AND FLEET TRANSITION

## Horizon Restructuring Charges

During the third quarter, the Company announced its decision to outsource the remaining heavy maintenance functions for Horizon aircraft. As a result of this decision, Horizon has eliminated approximately 100 positions in the maintenance division through either early-out packages or voluntary furloughs. These actions resulted in a charge of \$2.9 million in the three-month period ended September 30, 2010 for separation pay, all of which was paid during the third quarter of 2010.

## Horizon Transition to All-Q400 Fleet

Horizon's long-term goal is to transition to an all-Q400 fleet. As of September 30, 2010, Horizon operated 13 CRJ-700 aircraft, which the Company plans to remove from its fleet in the future. During 2010, the Company removed five CRJ-700 aircraft through either a sublease or lease assignment to third parties. The total charge associated with removing these aircraft from operations was \$10.3 million in the first nine months of 2010.

The Company has signed a letter of intent to deliver eight additional CRJ-700 aircraft to a third-party carrier through either sublease or lease assignment during the first half of 2011. As a result, the Company has accelerated the delivery of eight new Bombardier Q-400 aircraft from 2012 and 2013 into the first half of 2011. Depending on the ultimate disposition of the eight CRJ-700 aircraft and the remaining five CRJ-700 aircraft in the operating fleet, there will likely be further fleet transition charges. The nature, timing or amount of any potential gain or loss on any future potential transactions on the remaining aircraft cannot be reasonably estimated at this time.

During 2009, Horizon had either terminated its remaining Q200 leases or subleased Q200 aircraft to a third party. The total charge associated with removing these aircraft from operations in the first nine months of 2009 was \$10 million, which represented the losses under the disposal transactions.





Table of Contents

Horizon has 16 Q200 aircraft that are subleased to a third-party carrier, for which an accrual for the estimated sublease loss has been recorded. The Company is evaluating alternatives to the existing sublease arrangements for these aircraft. The Company may be required to record a charge if the original lease or sublease arrangements are modified in the future. However, the nature, timing or amount of any such charge cannot be reasonably estimated at this time.

## NOTE 11. NEW PILOT CONTRACT TRANSITION COSTS

On May 19, 2009, Alaska announced that its pilots ratified a new four-year contract. Among other items, the contract has a provision that allows for pilots to receive, at retirement, a cash payment equal to 25% of their accrued sick leave balance multiplied by their hourly rate. The transition expense associated with establishing this sick-leave payout program was \$15.5 million. Pilots also received a one-time cash bonus following ratification of the contract of \$20.3 million in the aggregate. These items have been combined and reported as “New pilot contract transition costs” in the condensed consolidated statements of operations.

## NOTE 12. OPERATING SEGMENT INFORMATION

Operating segment information for Alaska and Horizon for the three- and nine-month periods ended September 30 was as follows (in millions):

|                                      | Three Months Ended September 30 |          | Nine months ended September 30 |            |
|--------------------------------------|---------------------------------|----------|--------------------------------|------------|
|                                      | 2010                            | 2009     | 2010                           | 2009       |
| Operating revenues:                  |                                 |          |                                |            |
| Alaska – mainline (1)                | \$ 866.8                        | \$ 776.9 | \$ 2,317.3                     | \$ 2,049.8 |
| Alaska – purchased capacity (1)      | 89.3                            | 81.9     | 248.9                          | 211.4      |
| Total Alaska                         | 956.1                           | 858.8    | 2,566.2                        | 2,261.2    |
| Horizon                              | 180.9                           | 178.2    | 510.4                          | 482.9      |
| Other (2)                            | 0.3                             | 0.3      | 0.8                            | 0.8        |
| Elimination of intercompany revenues |                                 |          |                                |            |
|                                      | (69.8 )                         | (69.9 )  | (203.6 )                       | (191.2 )   |
| Consolidated                         | \$ 1,067.5                      | 967.4    | \$ 2,873.8                     | 2,553.7    |
| Income (loss) before income tax:     |                                 |          |                                |            |
| Alaska – mainline                    | \$ 172.4                        | \$ 117.6 | \$ 273.3                       | \$ 143.5   |
| Alaska – purchased capacity          | 14.6                            | 7.2      | 27.4                           | 5.1        |
| Total Alaska                         | 187.0                           | 124.8    | 300.7                          | 148.6      |
| Horizon                              | 11.7                            | 19.1     | 4.3                            | 15.1       |
| Other (2)                            | (0.5 )                          | (1.1 )   | (2.6 )                         | (2.8 )     |
| Consolidated                         | \$ 198.2                        | \$ 142.8 | \$ 302.4                       | \$ 160.9   |

|                                      | September 30, 2010 | December 31, 2009 |
|--------------------------------------|--------------------|-------------------|
| Total assets at end of period:       |                    |                   |
| Alaska                               | \$ 4,715.8         | \$ 4,541.3        |
| Horizon                              | 694.0              | 735.3             |
| Other (2)                            | 1,301.1            | 1,052.4           |
| Elimination of intercompany accounts | (1,590.8 )         | (1,332.8 )        |
| Consolidated                         | \$ 5,120.1         | \$ 4,996.2        |

(1) Alaska mainline revenue represents revenue from passengers aboard Alaska jets, freight and mail revenue, and all other revenue. Purchased capacity revenue represents revenue earned by Alaska on capacity purchased from and provided by Horizon and a small third party under a capacity purchase arrangement.

(2) Includes the parent company, Alaska Air Group, Inc., including its investments in Alaska and Horizon, which are eliminated in consolidation.

Table of Contents

NOTE 13. CONTINGENCIES

The Company is a party to routine litigation matters incidental to its business. Management believes the ultimate disposition of these matters is not likely to materially affect the Company's financial position or results of operations. This forward-looking statement is based on management's current understanding of the relevant law and facts, and it is subject to various contingencies, including the potential costs and risks associated with litigation and the actions of arbitrators, judges and juries.

20

---

Table of Contents

ITEM 2. MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS

OVERVIEW

The following Management's Discussion and Analysis of Financial Condition and Results of Operations (MD&A) is intended to help the reader understand our Company, our operations and our present business environment. MD&A is provided as a supplement to – and should be read in conjunction with – our condensed consolidated financial statements and the accompanying notes. All statements in the following discussion that are not statements of historical information or descriptions of current accounting policy are forward-looking statements. Please consider our forward-looking statements in light of the risks referred to in this report's introductory cautionary note and the risks mentioned in the Company's filings with the Securities and Exchange Commission, including those listed in Part I, "Item 1A. Risk Factors" in our Annual Report on Form 10-K for the year ended December 31, 2009. This overview summarizes MD&A, which includes the following sections:

- Third Quarter in Review – highlights from the third quarter of 2010 outlining some of the major events that happened during the period and how they affected our financial performance.
- Results of Operations – an in-depth analysis of the results of operations of Alaska and Horizon for the three and nine months ended September 30, 2010. We believe this analysis will help the reader better understand our condensed consolidated statements of operations. This section also includes forward-looking statements regarding our view of the remainder of 2010.
- Liquidity and Capital Resources – an analysis of cash flows, sources and uses of cash, contractual obligations, and commitments, and an overview of financial position.

Our filings with the Securities and Exchange Commission, including our annual report on Form 10-K, quarterly reports on Form 10-Q, current reports on Form 8-K and amendments to those reports are accessible free of charge at [www.alaskaair.com](http://www.alaskaair.com). The information contained on our website is not a part of this quarterly report on Form 10-Q.

THIRD QUARTER IN REVIEW

Our consolidated pretax income was \$198.2 million during the third quarter of 2010 compared to \$142.8 million in the third quarter of 2009. The increase in our pretax earnings was primarily due to the \$100.1 million increase in operating revenues, partially offset by increases in aircraft fuel and other operating costs.

- Consolidated unit revenues increased 4% over the third quarter of 2009, stemming from increases in passenger unit revenues that were driven by higher load factors at both Alaska and Horizon.
- Economic fuel averaged \$2.37 per gallon in the third quarter of 2010, compared to \$2.16 per gallon in 2009. This resulted in a \$30.8 million increase in our economic fuel expense compared to the third quarter of 2009.

Other significant developments during the third quarter of 2010 and through the filing of this Form 10-Q are described below.

## Table of Contents

### Common Stock Repurchase

On June 15, 2010, our Board of Directors authorized the Company to repurchase up to \$50 million of our common stock. Through September 30, 2010, we have repurchased 102,000 shares of our common stock for \$5 million under this new program, bringing the total 2010 purchases under existing and expired programs to 747,748 shares for \$31.2 million. Since 2007, we have repurchased approximately \$165 million of our common stock through similar programs. The repurchased shares have been recorded as treasury shares in our condensed consolidated balance sheets.

### Operational Performance

Our operational results continue to be among the best in the industry. Alaska has held the No. 1 spot in the U.S. Department of Transportation on-time performance among the 10 largest U.S. airlines for 16 of the 17 months ended August 2010.

### Tentative Agreement with Horizon Pilots

Horizon and the International Brotherhood of Teamsters (IBT) reached a tentative agreement on a new collective bargaining agreement for Horizon's pilots. The IBT has advised Horizon that it expects the pilots will be voting on the contract in November 2010. If the tentative agreement is ratified, Horizon is expected to record a fourth-quarter charge for a signing bonus to Horizon's pilots and for the addition of Horizon's pilots to the Performance-Based Pay incentive pay program for 2010 and beyond.

### New Markets

Since our second quarter 10-Q filing, Alaska announced new service between San Jose, Calif. and Guadalajara, Mexico three times weekly beginning December 15, 2010 and between Sacramento, Calif. and Guadalajara three times weekly beginning December 16, 2010. This is in addition to new service between Bellingham, Wash. and Honolulu beginning in January 2011 and service between San Jose, Calif. and Los Cabos, Mexico beginning in December 2010 announced earlier in the third quarter.

### Horizon Restructuring and Fleet Transition

Horizon outsourced its remaining aircraft heavy maintenance function during the third quarter of 2010. This resulted in the termination of approximately 100 mechanics and other personnel through voluntary furlough or early retirement. We recorded a \$2.9 million charge associated with related separation pay, all of which was paid during the third quarter of 2010.

Horizon has a long-term plan to transition to an all-Q400 fleet. The market for regional aircraft has been weak in the past two years resulting in difficulty marketing the CRJ-700 regional jet aircraft. However, we have had some success recently. In the third quarter, Horizon assigned leases of four CRJ-700 aircraft to a third-party carrier. We recorded a charge of \$6.9 million associated with the lease assignments. We now have 13 CRJ-700 aircraft remaining in our operating fleet as of September 30, 2010. We have signed a letter of intent to dispose of eight additional CRJ-700 aircraft in the first half of 2011 through either sublease or lease assignment to a third-party carrier, leaving five aircraft in the operating fleet. The disposition of those remaining five aircraft has not yet been determined.

### Outlook

We are encouraged that passenger traffic is increasing despite the continued economic uncertainty. Given our estimated 7% increase in capacity for the fourth quarter of 2010 compared to 2009, we are pleased that our advance-booked load factors across the Air Group network are up, on average, for November 2010 and down slightly for December 2010 as compared to the same periods in 2009.



Table of Contents

## RESULTS OF OPERATIONS

## COMPARISON OF THREE MONTHS ENDED SEPTEMBER 30, 2010 TO THREE MONTHS ENDED SEPTEMBER 30, 2009

Our consolidated net income for the third quarter of 2010 was \$122.4 million, or \$3.32 per diluted share, compared to a net income of \$87.6 million, or \$2.46 per diluted share, in the third quarter of 2009. Significant items impacting the comparability between the periods are as follows:

- Both periods include adjustments to reflect the timing of net unrealized mark-to-market gains or losses related to our fuel hedge positions. In the third quarter of 2010 we recognized net mark-to-market gains of \$16.7 million (\$10.4 million after tax, or \$0.28 per share) compared to gains of \$7.3 million (\$4.6 million after tax, or \$0.13 per share) in the third quarter of 2009.
- The third quarter of 2010 includes Horizon restructuring and CRJ-700 fleet transition costs of \$9.8 million (\$6.1 million after tax, or \$0.17 per share).

We believe disclosure of the impact of these individual charges is useful information to investors and other readers because:

- It is consistent with how we present information in our quarterly earnings press releases;
- We believe it is the basis by which we are evaluated by industry analysts;
- Our results excluding these items are most often used in internal management and board reporting and decision-making;
- Our results excluding these adjustments serve as the basis for our various employee incentive plans, and thus the information allows investors to better understand the changes in variable incentive pay expense in our condensed consolidated statements of operations; and
- It is useful to monitor performance without these items as it improves a reader's ability to compare our results to those of other airlines.

Although we are presenting these non-GAAP amounts for the reasons above, investors and other readers should not necessarily conclude that these amounts are non-recurring, infrequent, or unusual in nature.

Excluding the mark-to-market adjustments and other noted items shown in the following table, our adjusted consolidated net income for the third quarter of 2010 was \$118.1 million, or \$3.21 per diluted share, compared to an adjusted consolidated net income of \$83 million, or \$2.33 per share, in the third quarter of 2009.

| (in millions except per-share amounts)                               | Three Months Ended September 30, |         |         |             |
|--|----------------------------------|---------|---------|-------------|
|  | 2010                             | Diluted |         | 2009        |
|  | Dollars                          | EPS     | Dollars | Diluted EPS |
| Net income and diluted EPS, excluding noted items                    | \$118.1                          | \$3.21  | \$83.0  | \$2.33      |
| Horizon restructuring and CRJ-700 fleet transition costs, net of tax | (6.1 )                           | (0.17 ) | -       | -           |
| Mark-to-market fuel hedge adjustments, net of tax                    | 10.4                             | 0.28    | 4.6     | 0.13        |
| Net income and diluted EPS as reported under GAAP                    | \$122.4                          | \$3.32  | \$87.6  | \$2.46      |

Our consolidated results are primarily driven by the results of our two operating carriers. Alaska reported pretax income of \$187 million in the third quarter of 2010, while Horizon reported pretax income of \$11.7 million. Financial and statistical data for Alaska and Horizon and an in-depth discussion of their results follow.



Table of ContentsAlaska Airlines Financial and Statistical Data  
(unaudited)

| Financial Data (in<br>millions):                  | Three Months Ended September 30 |         |          | Nine Months Ended September 30 |           |          |
|---|---------------------------------|---------|----------|--------------------------------|-----------|----------|
|   | 2010                            | 2009    | % Change | 2010                           | 2009      | % Change |
| <b>Operating Revenues:</b>                        |                                 |         |          |                                |           |          |
| Passenger   | \$779.2                         | \$702.0 | 11.0     | \$2,068.5                      | \$1,844.3 | 12.2     |
| Freight and mail                                  | 28.4                            | 26.5    | 7.2      | 77.3                           | 69.0      | 12.0     |
| Other - net                                       | 59.2                            | 48.4    | 22.3     | 171.5                          | 136.5     | 25.6     |
| Total mainline operating revenues                 | 866.8                           | 776.9   | 11.6     | 2,317.3                        | 2,049.8   | 13.1     |
| Passenger - purchased capacity                    | 89.3                            | 81.9    | 9.0      | 248.9                          | 211.4     | 17.7     |
| Total Operating Revenues                          | 956.1                           | 858.8   | 11.3     | 2,566.2                        | 2,261.2   | 13.5     |
| <b>Operating Expenses:</b>                        |                                 |         |          |                                |           |          |
| Wages and benefits                                | 193.8                           | 199.1   | (2.7 )   | 575.9                          | 594.9     | (3.2 )   |
| Variable incentive pay                            | 19.3                            | 20.8    | (7.2 )   | 52.0                           | 44.0      | 18.2     |
| Aircraft fuel, including hedging gains and losses | 188.1                           | 166.6   | 12.9     | 574.3                          | 405.9     | 41.5     |
| Aircraft maintenance                              | 42.1                            | 36.5    | 15.3     | 124.2                          | 129.4     | (4.0 )   |
| Aircraft rent                                     | 24.0                            | 27.2    | (11.8 )  | 74.2                           | 81.8      | (9.3 )   |
| Landing fees and other rentals                    | 44.9                            | 43.0    | 4.4      | 129.7                          | 124.4     | 4.3      |
| Contracted services                               | 32.0                            | 31.1    | 2.9      | 94.1                           | 92.7      | 1.5      |
| Selling expenses                                  | 36.3                            | 29.4    | 23.5     | 93.7                           | 76.8      | 22.0     |
| Depreciation and amortization                     | 47.3                            | 45.1    | 4.9      | 140.6                          | 132.6     | 6.0      |
| Food and beverage service                         | 15.0                            | 12.0    | 25.0     | 40.5                           | 34.9      | 16.0     |
| Other   | 37.1                            | 36.6    | 1.4      | 108.6                          | 115.2     | (5.7 )   |
| New pilot contract transition costs               | -                               | -       | NM       | -                              | 35.8      | NM       |
| Total mainline operating expenses                 | 679.9                           | 647.4   | 5.0      | 2,007.8                        | 1,868.4   | 7.5      |
| Purchased capacity costs                          | 74.7                            | 74.7    | (0.0 )   | 221.5                          | 206.3     | 7.4      |
| Total Operating Expenses                          | 754.6                           | 722.1   | 4.5      | 2,229.3                        | 2,074.7   | 7.5      |
| Operating Income                                  | 201.5                           | 136.7   |          | 336.9                          | 186.5     |          |
| Interest income                                   | 8.9                             | 9.6     |          | 27.0                           | 29.2      |          |
| Interest expense                                  | (26.7 )                         | (22.4 ) |          | (72.3 )                        | (67.5 )   |          |
| Interest capitalized                              | 1.4                             | 1.4     |          | 4.7                            | 5.7       |          |
| Other - net                                       | 1.9                             | (0.5 )  |          | 4.4                            | (5.3 )    |          |
|   | (14.5 )                         | (11.9 ) |          | (36.2 )                        | (37.9 )   |          |
| Income Before Income Tax                          | \$187.0                         | \$124.8 |          | \$300.7                        | \$148.6   |          |

Edgar Filing: ALASKA AIR GROUP INC - Form 10-Q

| Mainline Operating Statistics:                           |        |   |        |   |          |  |        |   |        |          |
|--|--------|---|--------|---|----------|--|--------|---|--------|----------|
| Revenue passengers (000)                                 | 4,562  |   | 4,240  |   | 7.6      |  | 12,373 |   | 11,796 | 4.9      |
| RPMs (000,000) "traffic"                                 | 5,580  |   | 5,020  |   | 11.2     |  | 15,124 |   | 13,812 | 9.5      |
| ASMs (000,000) "capacity"                                | 6,544  |   | 6,097  |   | 7.3      |  | 18,197 |   | 17,469 | 4.2      |
| Passenger load factor                                    | 85.3   | % | 82.3   | % | 3.0pts   |  | 83.1   | % | 79.1   | % 4.0pts |
| Yield per passenger mile                                 | 13.96  | ¢ | 13.98  | ¢ | (0.1 )   |  | 13.68  | ¢ | 13.35  | ¢ 2.5    |
| Operating revenue per ASM (RASM)                         | 13.25  | ¢ | 12.74  | ¢ | 4.0      |  | 12.73  | ¢ | 11.73  | ¢ 8.5    |
| Passenger revenue per ASM (PRASM)                        | 11.91  | ¢ | 11.51  | ¢ | 3.5      |  | 11.37  | ¢ | 10.56  | ¢ 7.7    |
| Operating expenses per ASM (CASM)                        | 10.39  | ¢ | 10.62  | ¢ | (2.2 )   |  | 11.03  | ¢ | 10.70  | ¢ 3.1    |
| CASM, excluding fuel and pilot contract transition costs | 7.52   | ¢ | 7.89   | ¢ | (4.7 )   |  | 7.88   | ¢ | 8.17   | ¢ (3.5 ) |
| Aircraft fuel cost per gallon                            | \$2.21 |   | \$2.07 |   | 6.8      |  | \$2.41 |   | \$1.77 | 36.2     |
| Economic fuel cost per gallon                            | \$2.37 |   | \$2.15 |   | 10.2     |  | \$2.30 |   | \$1.98 | 16.2     |
| Fuel gallons (000,000)                                   | 85.5   |   | 80.1   |   | 6.7      |  | 237.4  |   | 229.9  | 3.3      |
| Average number of full-time equivalent employees         | 8,737  |   | 9,002  |   | (2.9 )   |  | 8,631  |   | 8,987  | (4.0 )   |
| Aircraft utilization (blk hrs/day)                       | 10.4   |   | 9.9    |   | 5.1      |  | 9.9    |   | 9.9    | -        |
| Average aircraft stage length (miles)                    | 1,089  |   | 1,044  |   | 4.3      |  | 1,078  |   | 1,027  | 5.0      |
| Operating fleet at period-end                            | 115    |   | 116    |   | (1 ) a/c |  | 115    |   | 116    | (1 ) a/c |
| Purchased Capacity Operating Statistics:                 |        |   |        |   |          |  |        |   |        |          |
| RPMs (000,000)   | 308    |   | 298    |   | 3.4      |  | 863    |   | 777    | 11.1     |
| ASMs (000,000)   | 382    |   | 383    |   | (0.3 )   |  | 1,127  |   | 1,058  | 6.5      |
| Passenger load factor                                    | 80.6   | % | 77.8   | % | 2.8pts   |  | 76.6   | % | 73.4   | % 3.2pts |
| Yield per passenger mile                                 | 28.99  | ¢ | 27.48  | ¢ | 5.5      |  | 28.84  | ¢ | 27.21  | ¢ 6.0    |
| RASM   | 23.38  | ¢ | 21.38  | ¢ | 9.4      |  | 22.09  | ¢ | 19.98  | ¢ 10.6   |
| CASM   | 19.55  | ¢ | 19.50  | ¢ | 0.3      |  | 19.65  | ¢ | 19.50  | ¢ 0.8    |

NM = Not Meaningful

Table of Contents

## ALASKA AIRLINES

Alaska reported income before income taxes of \$187 million during the third quarter of 2010 compared to \$124.8 million in the third quarter of 2009.

Excluding the mark-to-market adjustments in each period as noted in the table below, Alaska's adjusted pretax income was \$173 million in the third quarter of 2010, compared to an adjusted pretax income of \$118.7 million in the same period of 2009.

| (in millions)                                     | Three Months Ended September 30 |          |
|---|---------------------------------|----------|
|   | 2010                            | 2009     |
| Income before income taxes, excluding items below | \$ 173.0                        | \$ 118.7 |
| Mark-to-market fuel hedge adjustments             | 14.0                            | 6.1      |
| Income before income taxes as reported under GAAP | \$ 187.0                        | \$ 124.8 |

## ALASKA REVENUES

Total operating revenues increased \$97.3 million, or 11.3%, during the third quarter of 2010 as compared to the same period in 2009. The changes are summarized in the following table:

| (in millions)                          | Three Months Ended September 30 |          |          |
|--|---------------------------------|----------|----------|
|  | 2010                            | 2009     | % Change |
| Passenger revenue - mainline           | \$ 779.2                        | \$ 702.0 | 11.0     |
| Freight and mail                       | 28.4                            | 26.5     | 7.2      |
| Other - net                            | 59.2                            | 48.4     | 22.3     |
| Total mainline revenues                | \$ 866.8                        | \$ 776.9 | 11.6     |
| Passenger revenue - purchased capacity | 89.3                            | 81.9     | 9.0      |
| Total operating revenues               | \$ 956.1                        | \$ 858.8 | 11.3     |

## Operating Revenues – Mainline

Mainline passenger revenue increased 11% on a 7.3% increase in capacity and a 3.5% increase in passenger revenue per available seat mile (PRASM). The increase in PRASM was driven by a 3-point increase in load factor on relatively flat ticket yields. Chronologically through the quarter, PRASM increased 4.5% in July, 2% in August, and 3.8% in September, compared with 2009.

Our load factor in October 2010 was 81.8%, compared to 77% in October 2009. Our advance bookings currently suggest that load factors will be up about 2.5 points in November and down a half point in December compared to the prior year.

Freight and mail revenue increased by \$1.9 million, or 7.2%, primarily as a result of higher yields and higher fuel and security surcharges, partially offset by lower freight and mail volumes somewhat due to a slower fishing season in Alaska.

Other – net revenues increased \$10.8 million, or 22.3%. The increase is primarily due to receiving a higher rate for miles sold to our affinity card partner and an increase in the number of miles sold. To a lesser extent, the increase is due to higher sales of our onboard food and beverage products stemming from increased volumes and sales price, which were substantially offset by higher food and beverage costs as further described below.



Table of Contents

## Passenger Revenue – Purchased Capacity

Passenger revenue – purchased capacity increased by \$7.4 million to \$89.3 million because of a 9.4% increase in unit revenues on 0.3% less capacity compared to the prior year. Unit revenues have increased as a result of a 2.8-point increase in load factor and a 5.5% increase in yield.

## ALASKA EXPENSES

For the third quarter, total operating expenses increased \$32.5 million compared to the same period in 2009 mostly as a result of an increase in fuel expense. We believe it is useful to summarize operating expenses as follows, which is consistent with the way expenses are reported internally and evaluated by management:

| (in millions)                        | Three Months Ended September 30 |          |          |
|--------------------------------------|---------------------------------|----------|----------|
|                                      | 2010                            | 2009     | % Change |
| Mainline fuel expense                | \$ 188.1                        | \$ 166.6 | 12.9     |
| Mainline non-fuel operating expenses | 491.8                           | 480.8    | 2.3      |
| Mainline operating expenses          | 679.9                           | 647.4    | 5.0      |
| Purchased capacity costs             | 74.7                            | 74.7     | 0.0      |
| Total Operating Expenses             | \$ 754.6                        | \$ 722.1 | 4.5      |

## Mainline Operating Expenses

Total mainline operating costs for the third quarter of 2010 increased \$32.5 million, or 5%, compared to the same period of 2009. Significant individual expense variances from the third quarter of 2009 are described more fully below.

## Wages and Benefits

Wages and benefits declined \$5.3 million, or 2.7%, compared to the third quarter of 2009. The primary components of wages and benefits are shown in the following table:

| (in millions)  | Three Months Ended September 30 |          |          |
|--|---------------------------------|----------|----------|
|  | 2010                            | 2009     | % Change |
| Wages  | \$ 136.5                        | \$ 137.5 | (0.7 )   |
| Pension and defined-contribution retirement benefits | 20.9                            | 29.4     | (28.9 )  |
| Medical benefits                                     | 21.8                            | 19.8     | 10.1     |
| Other benefits and payroll taxes                     | 14.6                            | 12.4     | 17.7     |
| Total wages and benefits                             | \$ 193.8                        | \$ 199.1 | (2.7 )   |

Wages decreased 0.7% on a 2.9% reduction in full-time equivalent employees (FTE) compared to the third quarter of 2009. Wages have not declined in step with the FTE reduction primarily because of higher average wage rates following recent furloughs, which are generally seniority-based, and average wage increases across many work groups.

The 28.9% decline in pension and other retirement-related benefits is primarily due to a \$10.6 million decline in our defined-benefit pension cost driven by the improved funded status at the end of 2009 as compared to the previous year and the closing of the defined-benefit pension plan to new pilot entrants effective with their new contract in 2009. All of our defined-benefit pension plans are now closed to new entrants.



Table of Contents

Medical benefits increased 10.1% from the prior-year period primarily as a result of higher healthcare costs.

We expect wages and benefits to be relatively flat during the fourth quarter of 2010 compared to the fourth quarter of 2009 for the reasons mentioned above.

Variable Incentive Pay

Variable incentive pay expense decreased from \$20.8 million in the third quarter of 2009 to \$19.3 million in the third quarter of 2010. Quarterly expense is based on our expectation of full-year performance as of the quarter-end date. Currently on a year-to-date basis, we have expensed more incentive pay in 2010 than in 2009 reflecting our expectations for profitability and other metrics under the Air Group Performance-Based Pay incentive plan (PBP) for the full year.

Aircraft Fuel

Aircraft fuel expense includes both raw fuel expense (as defined below) plus the effect of mark-to-market adjustments to our fuel hedge portfolio included in our condensed consolidated statement of operations as the value of that portfolio increases and decreases. Our aircraft fuel expense is very volatile, even between quarters, because it includes these gains or losses in the value of the underlying instrument as crude oil prices and refining margins increase or decrease. Raw fuel expense is defined as the price that we generally pay at the airport, or the “into-plane” price, including taxes and fees. Raw fuel prices are impacted by world oil prices and refining costs, which can vary by region in the U.S. Raw fuel expense approximates cash paid to suppliers and does not reflect the effect of our fuel hedges.

Aircraft fuel expense increased \$21.5 million, or 12.9%, compared to the third quarter of 2009. The elements of the change are illustrated in the following table:

| (in millions, except per-gallon amounts)  | Three Months Ended September 30 |          |          |
|---|---------------------------------|----------|----------|
|   | 2010                            | 2009     | % Change |
| Fuel gallons consumed   | 85.5                            | 80.1     | 6.7      |
| Raw price per gallon  | \$ 2.33                         | \$ 1.99  | 17.1     |
| Total raw fuel expense  | \$ 198.9                        | \$ 159.5 | 24.7     |
| Net impact on fuel expense from changes in value of the fuel hedge portfolio (gain) | (10.8 )                         | 7.1      | NM       |
| Aircraft fuel expense, as reported  | \$ 188.1                        | \$ 166.6 | 12.9     |

NM = Not Meaningful

Fuel gallons consumed increased by 6.7% primarily as a result of the 7.3% increase in third-quarter capacity as compared to the 2009 third quarter, partially offset by better fuel efficiency stemming from longer average aircraft stage lengths as we continue to add more capacity to long-haul transcontinental and Hawaii routes.

The raw fuel price per gallon increased by 17.1% as a result of higher West Coast jet fuel prices driven by an increase in crude oil costs and refining margins.

We also evaluate economic fuel expense, which we define as raw fuel expense less the cash we receive from hedge counterparties for hedges that settle during the period, offset by the premium expense that we paid for those contracts. A key difference between aircraft fuel expense and economic fuel expense is the timing of gain or loss recognition on our hedge





Table of Contents

portfolio. When we refer to economic fuel expense, we include gains and losses only when they are realized for those contracts that were settled during the period based on their original contract terms. We believe this is the best measure of the effect that fuel prices are currently having on our business because it most closely approximates the net cash outflow associated with purchasing fuel for our operations. Accordingly, many industry analysts evaluate our results using this measure, and it is the basis for most internal management reporting and incentive pay plans.

Our economic fuel expense is calculated as follows:

| (in millions, except per-gallon amounts)  | Three Months Ended September 30 |         |          |
|---|---------------------------------|---------|----------|
|   | 2010                            | 2009    | % Change |
| Raw fuel expense  | \$198.9                         | \$159.5 | 24.7     |
| Plus or minus: net of cash settlement for settled hedges and premium expense recognized | 3.2                             | 13.2    | NM       |
| Economic fuel expense   | \$202.1                         | \$172.7 | 17.0     |
| Fuel gallons consumed   | 85.5                            | 80.1    | 6.7      |
| Economic fuel cost per gallon   | \$2.37                          | \$2.15  | 10.2     |

NM = Not meaningful

As noted in the above table, the total net expense recognized for hedges that settled during the period was \$3.2 million in the third quarter of 2010, compared to \$13.2 million in 2009. These amounts represent the net of the premium expense recognized for those hedges and any cash received or paid upon settlement.

We currently expect economic fuel expense to be higher for the remainder of 2010 than in 2009 because of higher jet fuel prices and increased consumption.

#### Aircraft Maintenance

Aircraft maintenance increased by \$5.6 million, or 15.3%, compared to the prior-year quarter because of a higher number of engine maintenance events and costs associated with the return of leased aircraft, offset by lower airframe maintenance costs. Our current expectation is that aircraft maintenance costs will be relatively flat to slightly higher in the fourth quarter of 2010 compared to 2009 due to the timing of certain airframe events.

#### Aircraft Rent

Aircraft rent declined \$3.2 million, or 11.8%, compared with the 2009 third quarter. The decrease is due to the removal of five leased aircraft from our operations since September 2009.

#### Selling Expenses

Selling expenses increased by \$6.9 million, or 23.5%, compared to the third quarter of 2009 as a result of higher credit card and travel agency commissions and ticket distribution costs resulting from the increase in passenger traffic. We expect fourth quarter 2010 selling expenses to be higher compared to the fourth quarter of 2009 due to these same reasons.

Table of Contents

## Food and Beverage Service

Food and beverage costs increased \$3 million, or 25%, from the third quarter of 2009 due to an increased number of passengers, the higher cost of some of our fresh food items sold on board, and increased costs associated with food delivery.

## Mainline Unit Costs per Available Seat Mile (ASM)

Our mainline operating costs per ASM are summarized below:

|  | Three Months Ended September 30 |         |          |
|--|---------------------------------|---------|----------|
|  | 2010                            | 2009    | % Change |
| Total mainline operating expenses per ASM (CASM) | 10.39 ¢                         | 10.62 ¢ | (2.2 )   |
| Less the following components:                   |                                 |         |          |
| Aircraft fuel cost per ASM                       | 2.87 ¢                          | 2.73 ¢  | 5.1      |
| CASM, excluding fuel                             | 7.52 ¢                          | 7.89 ¢  | (4.7 )   |

We have listed separately in the above table our fuel costs per ASM and our unit costs, excluding fuel and other noted items. These amounts are included in CASM, but for internal purposes we consistently use unit cost metrics that exclude fuel and certain special items to measure our cost-reduction progress. We believe that such analysis may be important to investors and other readers of these financial statements for the following reasons:

- By eliminating fuel expense and certain special items from our unit cost metrics, we believe that we have better visibility into the results of our non-fuel cost-reduction initiatives. Our industry is highly competitive and is characterized by high fixed costs, so even a small reduction in non-fuel operating costs can result in a significant improvement in operating results. In addition, we believe that all domestic carriers are similarly impacted by changes in jet fuel costs over the long run, so it is important for management (and thus investors) to understand the impact of (and trends in) company-specific cost drivers such as labor rates and productivity, airport costs, maintenance costs, etc., which are more controllable by management.
- Cost per ASM excluding fuel and certain special items is one of the most important measures used by managements of both Alaska and Horizon and by our Board of Directors in assessing quarterly and annual cost performance. For Alaska, these decision-makers evaluate operating results of the “mainline” operation, which includes the operation of the B737 fleet branded in Alaska Airlines livery. The revenue and expenses associated with purchased capacity are evaluated separately.
- Cost per ASM excluding fuel (and other items as specified in our incentive pay plan documents) is an important metric for the PBP incentive plan that covers the majority of our employees.
- Cost per ASM excluding fuel and certain special items is a measure commonly used by industry analysts, and we believe it is the basis by which they compare our airlines to others in the industry. The measure is also the subject of frequent questions from investors.
- Disclosure of the individual impact of certain noted items provides investors the ability to measure and monitor performance both with and without these special items. We believe that disclosing the impact of certain items such as fleet transition costs, new pilot contract transition costs, and restructuring charges is important because it provides information on significant items that are not necessarily indicative of future performance. Industry analysts and investors consistently measure our performance without these items for better comparability between periods and among other airlines.



Table of Contents

- Although we disclose our “mainline” passenger unit revenue for Alaska, we do not (nor are we able to) evaluate mainline unit revenue excluding the impact that changes in fuel costs have had on ticket prices. Fuel expense represents a large percentage of our total mainline operating expenses. Fluctuations in fuel prices often drive changes in unit revenue in the mid-to-long term. Although we believe it is useful to evaluate non-fuel unit costs for the reasons noted above, we would caution readers of these financial statements not to place undue reliance on unit costs excluding fuel as a measure or predictor of future profitability because of the significant impact of fuel costs on our business.

Our third quarter CASM, excluding fuel and other special items, declined 4.7% as capacity increased over 7%. Our goal is to keep downward pressure on absolute costs as we grow our capacity in order to see reductions in our unit costs. We achieved this in the third quarter of 2010 through an increase in productivity and continued reduction in overhead costs. We currently forecast our mainline CASM, excluding fuel and other special items, to be down approximately 4% to 6% for the fourth quarter of 2010 and 4% for the full year as compared to 2009.

**Purchased Capacity Costs**

Purchased capacity costs were flat compared to the third quarter of 2009. Of the total \$74.7 million, \$69 million was paid to Horizon under the capacity purchase arrangement between Horizon and Alaska (CPA) for 367 million ASMs, a slight decline from the third quarter of 2009. This expense is eliminated in consolidation.

Table of ContentsHorizon Air Financial  
and Statistical Data  
(unaudited)

| Financial Data (in<br>millions):                  | Three Months Ended September 30 |              |             | Nine Months Ended September 30 |              |             |
|---|---------------------------------|--------------|-------------|--------------------------------|--------------|-------------|
|   | 2010                            | 2009         | %<br>Change | 2010                           | 2009         | %<br>Change |
| <b>Operating Revenues:</b>                        |                                 |              |             |                                |              |             |
| Passenger - brand flying                          | \$ 109.2                        | \$ 105.4     | 3.6         | \$ 299.4                       | \$ 283.7     | 5.5         |
| Passenger - Alaska capacity purchase arrangement  | 69.0                            | 69.9         | (1.3 )      | 202.8                          | 191.2        | 6.1         |
| Total passenger revenue                           | 178.2                           | 175.3        | 1.7         | 502.2                          | 474.9        | 5.7         |
| Freight and mail                                  | 0.6                             | 0.7          | (14.3 )     | 1.9                            | 2.0          | (5.0 )      |
| Other - net                                       | 2.1                             | 2.2          | (4.5 )      | 6.3                            | 6.0          | 5.0         |
| <b>Total Operating Revenues</b>                   | <b>180.9</b>                    | <b>178.2</b> | <b>1.5</b>  | <b>510.4</b>                   | <b>482.9</b> | <b>5.7</b>  |
| <b>Operating Expenses:</b>                        |                                 |              |             |                                |              |             |
| Wages and benefits                                | 43.8                            | 44.4         | (1.4 )      | 135.2                          | 137.0        | (1.3 )      |
| Variable incentive pay                            | 3.7                             | 3.2          | 15.6        | 10.5                           | 8.2          | 28.0        |
| Aircraft fuel, including hedging gains and losses | 32.8                            | 32.9         | (0.3 )      | 108.9                          | 79.7         | 36.6        |
| Aircraft maintenance                              | 13.2                            | 13.2         | -           | 41.9                           | 39.6         | 5.8         |
| Aircraft rent                                     | 9.9                             | 11.1         | (10.8 )     | 32.1                           | 33.6         | (4.5 )      |
| Landing fees and other rentals                    | 15.2                            | 14.6         | 4.1         | 44.8                           | 42.4         | 5.7         |
| Contracted services                               | 8.5                             | 8.4          | 1.2         | 25.0                           | 23.8         | 5.0         |
| Selling expenses                                  | 8.0                             | 7.6          | 5.3         | 22.4                           | 20.5         | 9.3         |
| Depreciation and amortization                     | 10.3                            | 10.2         | 1.0         | 30.6                           | 28.8         | 6.3         |
| Food and beverage service                         | 0.6                             | 0.7          | (14.3 )     | 1.7                            | 1.8          | (5.6 )      |
| Other   | 9.3                             | 9.4          | (1.1 )      | 26.3                           | 29.0         | (9.3 )      |
| Restructuring and CRJ-700 fleet transition costs  | 9.8                             | -            | NM          | 13.2                           | -            | NM          |
| Fleet transition costs - Q200                     | -                               | (1.2 )       | NM          | -                              | 8.8          | NM          |
| <b>Total Operating Expenses</b>                   | <b>165.1</b>                    | <b>154.5</b> | <b>6.9</b>  | <b>492.6</b>                   | <b>453.2</b> | <b>8.7</b>  |
| <b>Operating Income</b>                           | <b>15.8</b>                     | <b>23.7</b>  |             | <b>17.8</b>                    | <b>29.7</b>  |             |
| Interest income                                   | 1.1                             | 0.5          |             | 2.6                            | 1.5          |             |
| Interest expense                                  | (5.1 )                          | (5.1 )       |             | (15.8 )                        | (16.2 )      |             |

Edgar Filing: ALASKA AIR GROUP INC - Form 10-Q

|   |         |          |          |         |         |          |
|---|---------|----------|----------|---------|---------|----------|
| Interest capitalized  | -       | -        | -        | 0.3     |         |          |
| Other - net   | (0.1 )  | -        | (0.3 )   | (0.2 )  |         |          |
|   | (4.1 )  | (4.6 )   | (13.5 )  | (14.6 ) |         |          |
| Income Before<br>Income Tax   | \$ 11.7 | \$ 19.1  | \$ 4.3   | \$ 15.1 |         |          |
| Combined Operating<br>Statistics: (a)   |         |          |          |         |         |          |
| Revenue passengers<br>(000)   | 1,827   | 1,815    | 0.7      | 5,116   | 5,055   | 1.2      |
| RPMs (000,000)<br>"traffic"   | 668     | 666      | 0.3      | 1,857   | 1,799   | 3.2      |
| ASMs (000,000)<br>"capacity"  | 835     | 855      | (2.3 )   | 2,461   | 2,470   | (0.4 )   |
| Passenger load factor   | 80.0 %  | 77.9 %   | 2.1pts   | 75.5 %  | 72.8 %  | 2.7pts   |
| Yield per passenger<br>mile   | 26.68 ¢ | 26.32 ¢  | 1.4      | 27.04 ¢ | 26.40 ¢ | 2.4      |
| Operating revenue per<br>ASM (RASM)   | 21.66 ¢ | 20.84 ¢  | 3.9      | 20.74 ¢ | 19.55 ¢ | 6.1      |
| Passenger revenue per<br>ASM (PRASM)  | 21.34 ¢ | 20.50 ¢  | 4.1      | 20.41 ¢ | 19.23 ¢ | 6.1      |
| Operating expenses<br>per ASM (CASM)  | 19.77 ¢ | 18.07 ¢  | 9.4      | 20.02 ¢ | 18.35 ¢ | 9.1      |
| CASM, excluding<br>fuel, restructuring and<br>CRJ-700 fleet<br>transition costs | 14.67 ¢ | 14.22 ¢  | 3.2      | 15.05 ¢ | 15.12 ¢ | (0.5 )   |
| Q200 fleet transition<br>costs per ASM  | -       | (0.14 )¢ | NM       | -       | 0.35 ¢  | NM       |
| Aircraft fuel cost per<br>gallon  | \$ 2.22 | \$ 2.11  | 5.2      | \$ 2.49 | \$ 1.76 | 41.5     |
| Economic fuel cost<br>per gallon  | \$ 2.40 | \$ 2.19  | 9.6      | \$ 2.34 | \$ 1.98 | 18.2     |
| Fuel gallons (000,000)  | 14.8    | 15.6     | (5.1 )   | 43.7    | 45.1    | (3.1 )   |
| Average number of<br>full-time equivalent<br>employees                          | 2,985   | 3,269    | (8.7 )   | 3,081   | 3,320   | (7.2 )   |
| Aircraft utilization<br>(blk hrs/day)   | 8.3     | 8.4      | (1.2 )   | 7.9     | 8.3     | (4.8 )   |
| Average aircraft stage<br>length (miles)  | 340     | 334      | 1.8      | 333     | 326     | 2.1      |
| Operating fleet at<br>period-end  | 53      | 55       | (2 ) a/c | 53      | 55      | (2 ) a/c |

NM = Not Meaningful

Table of Contents

## HORIZON AIR

Horizon reported income before income taxes of \$11.7 million during the third quarter of 2010 compared to \$19.1 million in the third quarter of 2009. The \$7.4 million decline is primarily due to higher restructuring and fleet transition costs, partially offset by an increase in operating revenues.

Excluding the mark-to-market adjustments in each period as noted in the table below and restructuring and CRJ-700 fleet transition costs in 2010, Horizon's adjusted pretax income was \$18.8 million in the third quarter of 2010, compared to an adjusted pretax income of \$17.9 million in the same period of 2009.

| (in millions)                                     | Three Months Ended September 30 |         |
|---|---------------------------------|---------|
|   | 2010                            | 2009    |
| Income before income taxes, excluding items below | \$ 18.8                         | \$ 17.9 |
| Restructuring and CRJ-700 fleet transition costs  | (9.8 )                          | -       |
| Mark-to-market fuel hedge adjustments             | 2.7                             | 1.2     |
| Income before income taxes as reported under GAAP | \$ 11.7                         | \$ 19.1 |

## HORIZON REVENUES

For the third quarter of 2010, operating revenues increased \$2.7 million, or 1.5%, compared to 2009. Horizon's passenger revenues are summarized in the table below:

| (dollars in millions)                         | Three Months Ended September 30 |        |          |        |
|---|---------------------------------|--------|----------|--------|
|   | 2010                            |        | 2009     |        |
|   | Revenues                        | % ASMs | Revenues | % ASMs |
| Passenger revenue from Horizon "brand" flying | \$109.2                         | 56     | \$105.4  | 57     |
| Revenue from CPA with Alaska                  | 69.0                            | 44     | 69.9     | 43     |
| Total Passenger revenue and % of ASMs         | \$178.2                         | 100    | \$175.3  | 100    |

Line-of-business information is presented in the table below. In the CPA with Alaska, Alaska assumes the market revenue risk and pays Horizon an agreed-upon rate based on capacity. As a result, yield and load factor information for the CPA are not presented.

|                   | Three Months Ended September 30, 2010 |                                    |                 |                       |                          |        |                 |        |                 |         |
|-------------------|---------------------------------------|------------------------------------|-----------------|-----------------------|--------------------------|--------|-----------------|--------|-----------------|---------|
|                   | Capacity and Mix                      |                                    |                 | Load Factor           |                          | Yield  |                 | RASM   |                 |         |
|                   | 2010<br>Actual<br>(in<br>millions)    | 2009<br>Actual<br>(in<br>millions) | Change<br>Y-O-Y | Current<br>%<br>Total | Point<br>Change<br>Y-O-Y | Actual | Change<br>Y-O-Y | Actual | Change<br>Y-O-Y |         |
| Brand Flying      | 468                                   | 487                                | (3.9 %)         | 56 %                  | 79.1 %                   | 1.2    | 29.46 ¢         | 5.9 %  | 23.88 ¢         | 7.3 %   |
| Alaska CPA System | 367                                   | 368                                | (0.3 %)         | 44 %                  | NM                       | NM     | NM              | NM     | 18.78 ¢         | (1.0 %) |
| Total             | 835                                   | 855                                | (2.3 %)         | 100 %                 | 80.0 %                   | 2.1    | 26.68 ¢         | 1.4 %  | 21.66 ¢         | 3.9 %   |

NM = Not Meaningful

Horizon brand flying includes those routes in the Horizon system not included in the Alaska CPA. Horizon has the inventory and revenue risk in those markets. Passenger revenue from Horizon brand flying increased \$3.8 million, or

3.6%, on a 7.5% increase in PRASM, partially offset by a 3.9% reduction in brand capacity. The increase in PRASM is primarily due to a 5.9% increase in yield and a 1.2-point increase in load factor for those markets.



Table of Contents

Revenue from the CPA with Alaska totaled \$69 million during the third quarter of 2010 compared to \$69.9 million in the third quarter of 2009. The decline is primarily due to a modest decline in capacity provided under this arrangement. Under the CPA, the fee paid by Alaska is based on an agreed-upon capacity rate, which we expect to be adjusted in the future as we move closer to market rates. The CPA revenue is eliminated in consolidation.

Beginning January 1, 2011, Horizon will move to an all-CPA structure with Alaska.

**HORIZON EXPENSES**

Total operating expenses increased \$10.6 million, or 6.9%, as compared to the same period in 2009. Significant period-over-period changes in the components of operating expenses are as follows:

**Aircraft Fuel**

Aircraft fuel, although relatively flat compared to the third quarter of 2009, had several elements with large variations as illustrated in the following table:

| (in millions, except per-gallon amounts)                                     | Three Months Ended September 30 |         |          |
|--|---------------------------------|---------|----------|
|  | 2010                            | 2009    | % Change |
| Fuel gallons consumed  | 14.8                            | 15.6    | (5.1 )   |
| Raw price per gallon   | \$ 2.36                         | \$ 2.01 | 17.4     |
| Total raw fuel expense   | \$ 34.9                         | \$ 31.4 | 11.1     |
| Impact on fuel expense from value changes in the fuel hedge portfolio (gain) | (2.1 )                          | 1.5     | NM       |
| Aircraft fuel expense  | \$ 32.8                         | \$ 32.9 | (0.3 )   |

NM = Not Meaningful

Fuel gallons consumed declined by 5.1% primarily due to the decline in third quarter flying, in terms of both capacity and departures. The raw fuel price per gallon increased by 17.4% as a result of higher West Coast jet fuel prices. Based on the current price of jet fuel, we expect that the raw price per gallon in 2010 will be higher than in 2009.

Our economic fuel cost is calculated as follows:

| (in millions, except per-gallon amounts)  | Three Months Ended September 30 |         |          |
|---|---------------------------------|---------|----------|
|   | 2010                            | 2009    | % Change |
| Raw fuel expense  | \$ 34.9                         | \$ 31.4 | 11.1     |
| Plus or minus: net of cash settlement for settled hedges and premium expense recognized | 0.6                             | 2.7     | NM       |
| Economic fuel expense   | \$ 35.5                         | \$ 34.1 | 4.1      |
| Fuel gallons consumed   | 14.8                            | 15.6    | (5.1 )   |
| Economic fuel cost per gallon   | \$ 2.40                         | \$ 2.19 | 9.6      |

NM = Not meaningful

Table of Contents

As noted in the table above, the total net expense recognized for hedges that settled during the period was \$0.6 million in the third quarter of 2010, compared to \$2.7 million in the third quarter of 2009. These amounts represent the net of the premium expense recognized for those hedges and any cash received or paid upon settlement.

We currently expect economic fuel expense to be relatively flat in the fourth quarter 2010 as compared to the prior period due to lower consumption, offset by higher jet fuel prices.

**Restructuring and Fleet Transition Costs**

We recorded a \$6.9 million charge during the third quarter of 2010 related to the removal of four CRJ-400 aircraft from our operations through lease assignments to a third-party carrier. We also recorded \$2.9 million of restructuring charges associated with the voluntary separation of a number of employees resulting from the decision to outsource the remaining aircraft heavy maintenance function to a third party.

During the third quarter of 2009, we recognized a \$1.2 million favorable adjustment to our expected Q200 fleet transition costs associated with the removal of those aircraft from the operating fleet.

**Operating Costs per Available Seat Mile (CASM)**

Our operating costs per ASM are summarized below:

|  | Three Months Ended September 30 |          |          |
|--|---------------------------------|----------|----------|
|  | 2010                            | 2009     | % Change |
| Total operating expenses per ASM (CASM)                                | 19.77 ¢                         | 18.07 ¢  | 9.4      |
| CASM includes the following components:                                |                                 |          |          |
| Aircraft fuel cost per ASM   | 3.93 ¢                          | 3.85 ¢   | 2.1      |
| Restructuring and CRJ-700 fleet transition costs per ASM               | 1.17 ¢                          | 0.00 ¢   | NM       |
| CASM, excluding fuel, restructuring and CRJ-700 fleet transition costs | 14.67 ¢                         | 14.22 ¢  | 3.2      |
| Q-200 fleet transition costs per ASM                                   | 0.00 ¢                          | (0.14) ¢ | NM       |
| CASM, excluding fuel, restructuring and all fleet transition costs     | 14.67 ¢                         | 14.36 ¢  | 2.2      |

NM = Not Meaningful

We currently forecast our CASM, excluding fuel and fleet transition costs, to be flat to up 2% for the fourth quarter of 2010 and relatively flat for the full year as compared to the same periods in 2009.

**CONSOLIDATED NONOPERATING INCOME (EXPENSE)**

Net nonoperating expense was \$18.2 million in the third quarter of 2010 compared to \$17 million for the same period of 2009. Interest expense increased \$3.6 million primarily resulting from the write off of deferred financing costs and prepayment penalties on the prepayment of two aircraft debt instruments and the partial prepayment of a third, partially offset by lower interest rates on our variable-rate debt and a lower average debt balance. Other – net nonoperating income (expense) improved by \$3.1 million compared to the prior-year period primarily due to larger realized gains on the sale of marketable securities.

**CONSOLIDATED INCOME TAX EXPENSE (BENEFIT)**

See discussion below under “Comparison of Nine Months Ended September 30, 2010 to Nine Months Ended September 30, 2009.”



Table of Contents

## COMPARISON OF NINE MONTHS ENDED SEPTEMBER 30, 2010 TO NINE MONTHS ENDED SEPTEMBER 30, 2009

Our consolidated net income for the nine months ended September 30, 2010 was \$186.3 million, or \$5.08 per diluted share, compared to net income of \$97.5 million, or \$2.69 per diluted share, for the first nine months of 2009. Items that impact the comparability between the periods are as follows:

- Both periods include adjustments to reflect timing of gain and loss recognition resulting from mark-to-market fuel hedge accounting. For the first nine months of 2010, we recognized net mark-to-market losses of \$33.4 million (\$20.7 million after tax, or \$0.57 per share), compared to net gains of \$57.1 million (\$35.7 million after tax, or \$0.98 per share) in the same period of 2009.
- The first nine months of 2010 include Horizon restructuring and CRJ-700 fleet transition costs of \$13.2 million (\$8.2 million after tax, or \$0.22 per share).
- The first nine months of 2009 include new pilot contract transition costs of \$35.8 million (\$22.3 million after tax, or \$0.61 per share).

See why we believe disclosure of these individual charges is useful to investors in the “Comparison of Three Months Ended September 30, 2010 to Three Months Ended September 30, 2009” section of this Form 10-Q.

Excluding the mark-to-market adjustments and other noted items shown in the following table, our adjusted consolidated net income for the first nine months of 2010 was \$215.2 million, or \$5.87 per diluted share, compared to an adjusted consolidated net income of \$84.1 million, or \$2.32 per share, in the first nine months of 2009.

| (in millions except per-share amounts)                               | Nine Months Ended September 30 |                |         |                |
|--|--------------------------------|----------------|---------|----------------|
|  | 2010                           | 2009           |         |                |
|  | Dollars                        | Diluted<br>EPS | Dollars | Diluted<br>EPS |
| Net income and diluted EPS, excluding noted items                    | \$215.2                        | \$5.87         | \$84.1  | \$2.32         |
| New pilot contract transition costs, net of tax                      | -                              | -              | (22.3 ) | (0.61 )        |
| Horizon restructuring and CRJ-700 fleet transition costs, net of tax | (8.2 )                         | (0.22 )        | -       | -              |
| Mark-to-market fuel hedge adjustments, net of tax                    | (20.7 )                        | (0.57 )        | 35.7    | 0.98           |
| Net income and diluted EPS as reported as GAAP                       | \$186.3                        | \$5.08         | \$97.5  | \$2.69         |

Table of Contents

## ALASKA AIRLINES

Alaska reported income before income taxes of \$300.7 million during the first nine months of 2010 compared to \$148.6 million in the first nine months of 2009.

Excluding the mark-to-market adjustments in each period as noted in the table below and the pilot contract transition costs in 2009, Alaska's adjusted pretax income was \$327.6 million in the first nine months of 2010, compared to adjusted pretax income of \$137 million in the same period of 2009.

| (in millions)                                     | Nine Months Ended September 30 |          |
|---|--------------------------------|----------|
|   | 2010                           | 2009     |
| Income before income taxes, excluding items below | \$ 327.6                       | \$ 137.0 |
| New pilot contract transition costs               | -                              | (35.8 )  |
| Mark-to-market fuel hedge adjustments             | (26.9 )                        | 47.4     |
| Income before income taxes as reported under GAAP | \$ 300.7                       | \$ 148.6 |

## ALASKA REVENUES

Total operating revenues increased \$305 million, or 13.5%, during the first nine months of 2010 compared to the same period in 2009. The changes are summarized in the following table:

| (in millions)                          | Nine Months Ended September 30 |            |          |
|--|--------------------------------|------------|----------|
|  | 2010                           | 2009       | % Change |
| Passenger revenue - mainline           | \$ 2,068.5                     | \$ 1,844.3 | 12.2     |
| Freight and mail                       | 77.3                           | 69.0       | 12.0     |
| Other - net                            | 171.5                          | 136.5      | 25.6     |
| Total mainline revenues                | \$ 2,317.3                     | \$ 2,049.8 | 13.1     |
| Passenger revenue - purchased capacity | 248.9                          | 211.4      | 17.7     |
| Total operating revenues               | \$ 2,566.2                     | \$ 2,261.2 | 13.5     |

## Operating Revenues – Mainline

Mainline passenger revenue for the first nine months of 2010 improved by 12.2% on a 4.2% increase in capacity and a 7.7% increase in PRASM compared to the same period in 2009. The increase in PRASM was driven by a 2.5% rise in ticket yield compared to the prior-year period and a four-point increase in load factor.

Ancillary revenue included in passenger revenue increased from \$93.5 million in the first nine months of 2009 to \$135.2 million in the same period of 2010. The increase is primarily due to the implementation of our first checked bag fee in the third quarter of 2009 and growth in the number of passengers.

Freight and mail revenue increased \$8.3 million, or 12%, primarily as a result of higher volumes and yields and higher fuel and security surcharges.

Other – net revenues increased \$35 million, or 25.6%. The increase is primarily due to Mileage Plan revenues rising by \$28.3 million stemming from a larger number of miles sold to our affinity card partner and a contractual rate increase for those sold miles.



Table of Contents

## Passenger Revenue – Purchased Capacity

Passenger revenue - purchased capacity flying increased \$37.5 million over the same period last year because of a 6.5% rise in capacity combined with a 10.6% increase in unit revenue compared to the prior year. Unit revenues increased as a result of a 3.2-point increase in load factor and a 6% increase in yield.

## ALASKA EXPENSES

For the nine months ended September 30, 2010, total operating expenses increased \$154.6 million, or 7.5%, compared to the same period in 2009 mostly as a result of higher aircraft fuel expense. We believe it is useful to summarize operating expenses as follows, which is consistent with the way expenses are reported internally and evaluated by management:

| (in millions)                        | Nine Months Ended September 30 |            |          |
|--------------------------------------|--------------------------------|------------|----------|
|                                      | 2010                           | 2009       | % Change |
| Mainline fuel expense                | \$ 574.3                       | \$ 405.9   | 41.5     |
| Mainline non-fuel operating expenses | 1,433.5                        | 1,462.5    | (2.0 )   |
| Mainline operating expenses          | 2,007.8                        | 1,868.4    | 7.5      |
| Purchased capacity costs             | 221.5                          | 206.3      | 7.4      |
| Total operating expenses             | \$ 2,229.3                     | \$ 2,074.7 | 7.5      |

## Mainline Operating Expenses

Total mainline operating expenses increased \$139.4 million, or 7.5%, during the first nine months of 2010 compared to the same period last year. The increase was mostly due to the \$168.4 million increase in aircraft fuel expense, offset by charges for the new pilot contract recorded in the prior-year period. Significant operating expense variances from the first nine months of 2009 are more fully described below.

## Wages and Benefits

Wages and benefits were down \$19 million, or 3.2%, compared to the first nine months of 2009. The primary components of wages and benefits are shown in the following table:

| (in millions)  | Nine Months Ended September 30 |          |          |
|--|--------------------------------|----------|----------|
|  | 2010                           | 2009     | % Change |
| Wages  | \$ 404.8                       | \$ 405.9 | (0.3 )   |
| Pension and defined-contribution retirement benefits | 63.0                           | 87.6     | (28.1 )  |
| Medical benefits                                     | 66.3                           | 60.1     | 10.3     |
| Other benefits and payroll taxes                     | 41.8                           | 41.3     | 1.2      |
| Total wages and benefits                             | \$ 575.9                       | \$ 594.9 | (3.2 )   |

Wages were relatively flat on a 4% reduction in FTEs compared to the first nine months of 2010. Wages have not declined in step with the FTE reduction because of higher wage rates for the pilot group in connection with their new contract effective April 1, 2009 and higher average wages for other employees after recent furloughs, which are generally seniority-based.

The 28.1% decline in pension and other retirement-related benefits is primarily due to a significant reduction in our defined-benefit pension cost driven by the improved funded status at the end of 2009 as compared to the previous year and the closing of the defined-benefit pension plan to new pilot entrants with their new contract in 2009.





Table of Contents

Medical benefits increased 10.3% from the prior-year period primarily as a result of an increase in the post-retirement medical cost for the pilot group in connection with their new contract and higher healthcare costs.

## Variable Incentive Pay

Variable incentive pay expense increased from \$44 million in the first nine months of 2009 to \$52 million in the same period of 2010. The increase is primarily due to the addition of ramp service agents to PBP in the fourth quarter of 2009, not reflected in the expense for the first nine months of 2009. The increase also reflects our expectations for profitability and other metrics under the plan for the full year as of the end of the third quarter this year compared to where our expectations were at the end of the third quarter of 2009.

## Aircraft Fuel

Aircraft fuel expense increased \$168.4 million, or 41.5%, compared to the first nine months of 2009. The elements of the change are illustrated in the following table:

| (in millions, except per-gallon amounts)  | Nine Months Ended September 30 |          |          |
|---|--------------------------------|----------|----------|
|   | 2010                           | 2009     | % Change |
| Fuel gallons consumed   | 237.4                          | 229.9    | 3.3      |
| Raw price per gallon  | \$ 2.31                        | \$ 1.79  | 29.1     |
| Total raw fuel expense  | \$ 549.2                       | \$ 410.6 | 33.8     |
| Net impact on fuel expense from (gains) and losses arising from fuel-hedging activities | 25.1                           | (4.7 )   | NM       |
| Aircraft fuel expense   | \$ 574.3                       | \$ 405.9 | 41.5     |

NM = Not Meaningful

Fuel gallons consumed increased 3.3%, primarily as a result of the 4.2% increase in year-to-date capacity, partially offset by better fuel efficiency stemming from longer average aircraft stage lengths.

The raw fuel price per gallon increased 29.1% as a result of higher West Coast jet fuel driven by higher crude oil costs and refining margins.

Our economic fuel expense is calculated as follows:

| (in millions, except per-gallon amounts)   | Nine Months Ended September 30 |          |          |
|--|--------------------------------|----------|----------|
|  | 2010                           | 2009     | % Change |
| Raw fuel expense   | \$ 549.2                       | \$ 410.6 | 33.8     |
| Plus or minus: net of cash received from settled hedges and premium expense recognized | (1.8 )                         | 42.7     | NM       |
| Economic fuel expense  | \$ 547.4                       | \$ 453.3 | 20.8     |
| Fuel gallons consumed  | 237.4                          | 229.9    | 3.3      |
| Economic fuel cost per gallon  | \$ 2.30                        | \$ 1.98  | 16.2     |

NM = Not meaningful

The total net benefit recognized for hedges that settled during the period was \$1.8 million in the first nine months of 2010, compared to a net expense of \$42.7 million in the same period of 2009. These amounts represent the net of the premium expense recognized for those hedges and any cash received or paid upon settlement. The increase is primarily due to the increase in crude oil prices over the past year.



Table of Contents

Aircraft Maintenance

Aircraft maintenance decreased by \$5.2 million, or 4%, compared to the prior-year period because of a lower number of airframe events and lower component costs, partially offset by higher costs associated with the return of leased aircraft.

Aircraft Rent

Aircraft rent declined \$7.6 million, or 9.3%, compared with the first nine months of 2009. The decrease was the result of the return of five leased aircraft since September 2009.

Landing Fees and Other Rents

Landing fees and other rents increased \$5.3 million, or 4.3%, compared to the first nine months of 2009. The increase is attributable to higher rates in many airports across our network, partially offset by fewer departures. Airport rent and landing fee rates have generally increased across the system as airport costs are allocated to fewer departures because of industry-wide capacity reduction over the past two years. We have experienced rate decreases in Seattle, our largest airport, and we continue to work with other airports on ways to reduce costs.

Selling Expenses

Selling expenses increased by \$16.9 million, or 22%, compared to the first nine months of 2009 as a result of higher credit card and travel agency commissions and ticket distribution costs resulting from the increase in passenger traffic.

Depreciation and Amortization

Depreciation and amortization increased \$8 million, or 6%, compared to the first nine months of 2009. This is primarily due to the additional B737-800 aircraft delivered in the first nine months of 2010 and a full period of depreciation for aircraft delivered in the first nine months of 2009.

Food and Beverage Service

Food and beverage costs increased \$5.6 million, or 16%, from the first nine months of 2009 due to an increased number of passengers, the higher cost of some of our fresh food items served on board, and increased costs associated with food delivery.

Other Operating Expenses

Other operating expenses declined \$6.6 million, or 5.7%, compared to the prior-year period. The decline is primarily driven by a reduction in professional services and lower personnel non-wage costs such as hotels, partially offset by higher property taxes.

New Pilot Contract Transition Costs

During the prior-year period, in connection with a new four-year contract, Alaska's pilots received a one-time aggregate bonus of \$20.3 million. The transition expense associated with establishing the new sick-leave payout program previously described was \$15.5 million.

Table of Contents

## Mainline Unit Costs per Available Seat Mile

Our mainline operating costs per ASM are summarized below:

|  | Nine Months Ended September 30 |         |          |
|--|--------------------------------|---------|----------|
|  | 2010                           | 2009    | % Change |
| Total mainline operating expenses per ASM (CASM) | 11.03 ¢                        | 10.70 ¢ | 3.1      |
| CASM includes the following components:          |                                |         |          |
| Aircraft fuel cost per ASM                       | 3.15 ¢                         | 2.32 ¢  | 35.8     |
| New pilot contract transition costs per ASM      | 0.00 ¢                         | 0.21 ¢  | NM       |
| CASM, excluding fuel and noted items             | 7.88 ¢                         | 8.17 ¢  | (3.5 )   |

NM = Not Meaningful

## Purchased Capacity Costs

Purchased capacity costs increased \$15.2 million, from \$206.3 million for the first nine months of 2009 to \$221.5 million for the nine months ended September 30, 2010. Of the total, \$202.8 million was paid to Horizon under the CPA for 1.1 billion ASMs. This expense is eliminated in consolidation.

## HORIZON AIR

Horizon reported income before income taxes of \$4.3 million during the first nine months of 2010 compared to \$15.1 million in the first nine months of 2009. The decline in earnings is primarily due to higher aircraft fuel costs and higher restructuring and fleet transition costs, partially offset by an increase in operating revenues.

Excluding the mark-to-market adjustments in each period and the restructuring and CRJ-700 fleet transition charges in 2010 as noted in the table below, Horizon would have reported pretax income of \$24 million in the first nine months of 2010, compared to pretax income of \$5.4 million in the same period of 2009.

| (in millions)   | Nine Months Ended September 30 |         |
|---|--------------------------------|---------|
|   | 2010                           | 2009    |
| Income before income taxes, excluding items noted below | \$ 24.0                        | \$ 5.4  |
| Restructuring and CRJ-700 fleet transition costs        | (13.2 )                        | -       |
| Mark-to-market fuel hedge adjustments                   | (6.5 )                         | 9.7     |
| Income before income taxes as reported                  | \$ 4.3                         | \$ 15.1 |

## HORIZON REVENUES

During the nine months ended September 30, 2010, operating revenues increased \$27.5 million, or 5.7%, compared to the first nine months of 2009. Horizon's passenger revenues are summarized in the table below:

| (in millions)                                 | Nine Months Ended September 30 |          |          |
|---|--------------------------------|----------|----------|
|   | 2010                           | 2009     | % Change |
| Passenger revenue from Horizon "brand" flying | \$ 299.4                       | \$ 283.7 | 5.5      |
| Revenue from CPA with Alaska                  | 202.8                          | 191.2    | 6.1      |
| Total passenger revenue                       | \$ 502.2                       | \$ 474.9 | 5.7      |



Table of Contents

Line-of-business information for the first nine months of 2010 and 2009 is presented in the table below:

|                     | Nine Months Ended September 30, 2010 |                                    |                 |                       |        |                          |         |                 |                            |                 |
|---------------------|--------------------------------------|------------------------------------|-----------------|-----------------------|--------|--------------------------|---------|-----------------|----------------------------|-----------------|
|                     | Capacity and Mix                     |                                    |                 | Load Factor           |        | Yield                    |         | RASM            |                            |                 |
|                     | 2010<br>Actual<br>(in<br>millions)   | 2009<br>Actual<br>(in<br>millions) | Change<br>Y-O-Y | Current<br>%<br>Total | Actual | Point<br>Change<br>Y-O-Y | Actual  | Change<br>Y-O-Y | Actual<br>(in<br>millions) | Change<br>Y-O-Y |
| Brand Flying Alaska | 1,385                                | 1,463                              | (5.3 %)         | 56                    | 74.0 % | 1.9                      | 29.21 ¢ | 8.6 %           | 22.19 ¢                    | 11.3 %          |
| CPA System          | 1,076                                | 1,007                              | 6.9 %           | 44                    | 0.0 %  | NM                       | NM      | NM              | 18.85 ¢                    | (0.7 %)         |
| Total               | 2,461                                | 2,470                              | (0.4 %)         | 100                   | 75.5 % | 2.7                      | 27.04 ¢ | 2.4 %           | 20.74 ¢                    | 6.1 %           |

NM = Not Meaningful

Passenger revenue from Horizon brand flying increased \$15.7 million, or 5.5%, on an 11.3% increase in passenger unit revenues, partially offset by a 5.3% decline in brand capacity. The increase in unit revenues is primarily due to a 1.9-point increase in brand load factor and an 8.6% improvement in yield in those markets.

Revenue from flying performed on behalf of Alaska pursuant to the CPA totaled \$202.8 million during the first nine months of 2010 compared to \$191.2 million in the first nine months of 2009. The increase is primarily due to a nearly 7% increase in capacity provided under this arrangement. This revenue is eliminated in consolidation.

**HORIZON EXPENSES**

Total operating expenses increased \$39.4 million, or 8.7%, as compared to the same period in 2009. Significant period-over-period changes in the components of operating expenses are as follows.

**Aircraft Fuel**

Aircraft fuel increased \$29.2 million, or 36.6%, compared to the same period in 2009. The elements of the change are illustrated in the following table:

| (in millions, except per-gallon amounts)  | Nine Months Ended September 30 |         |          |
|---|--------------------------------|---------|----------|
|   | 2010                           | 2009    | % Change |
| Fuel gallons consumed   | 43.7                           | 45.1    | (3.1 %)  |
| Raw price per gallon  | \$ 2.35                        | \$ 1.79 | 31.3     |
| Total raw fuel expense  | \$ 102.7                       | \$ 80.7 | 27.3     |
| Net impact on fuel expense from (gains) and losses arising from fuel-hedging activities | 6.2                            | (1.0)   | NM       |
| Aircraft fuel expense   | \$ 108.9                       | \$ 79.7 | 36.6     |

NM = Not Meaningful

The raw fuel price per gallon increased by 31.3% as a result of higher West Coast jet fuel prices.

Table of Contents

Our economic fuel expense is calculated as follows:

| (in millions, except per-gallon amounts)   | Nine Months Ended September 30 |         |          |
|--|--------------------------------|---------|----------|
|  | 2010                           | 2009    | % Change |
| Raw fuel expense   | \$ 102.7                       | \$ 80.7 | 27.3     |
| Plus or minus: net of cash received from settled hedges and premium expense recognized | (0.3 )                         | 8.7     | NM       |
| Economic fuel expense  | \$ 102.4                       | \$ 89.4 | 14.5     |
| Fuel gallons consumed  | 43.7                           | 45.1    | (3.1 )   |
| Economic fuel cost per gallon  | \$ 2.34                        | \$ 1.98 | 18.2     |

NM = Not meaningful

The total net benefit recognized for hedges that settled during the period was \$0.3 million, compared to a net expense of \$8.7 million in 2009. These amounts represent the net of the premium expense recognized for those hedges and any cash received or paid upon settlement.

**Restructuring and Fleet Transition Costs**

We recorded \$10.3 million in the first nine months of 2010 related to the removal of five CRJ-700 aircraft from our operations under sublease or lease assignment to third-party carriers. We also recorded \$2.9 million of restructuring charges associated with the voluntary separation of a number employees resulting from the decision to outsource the remaining aircraft heavy maintenance function to a third party.

In the first nine months of 2009, fleet transition costs associated with the removal of Q200 aircraft from the operating fleet was \$8.8 million as the final Q200 aircraft were removed from operation.

**Operating Costs per Available Seat Mile (CASM)**

|  | Nine Months Ended September 30 |         |          |
|--|--------------------------------|---------|----------|
|  | 2010                           | 2009    | % Change |
| Total operating expenses per ASM (CASM)                                | 20.02 ¢                        | 18.35 ¢ | 9.1      |
| CASM includes the following components:                                |                                |         |          |
| Aircraft fuel cost per ASM   | 4.43 ¢                         | 3.23 ¢  | 37.2     |
| Restructuring and CRJ-700 fleet transition costs per ASM               | 0.54 ¢                         | 0.00 ¢  | NM       |
| CASM, excluding fuel, restructuring and CRJ-700 fleet transition costs | 15.05 ¢                        | 15.12 ¢ | (0.5 )   |
| Q-200 fleet transition costs per ASM                                   | 0.00 ¢                         | 0.35 ¢  | NM       |
| CASM, excluding fuel, restructuring and all fleet transition costs     | 15.05 ¢                        | 14.77 ¢ | 1.9      |

NM = Not Meaningful

**CONSOLIDATED NONOPERATING INCOME (EXPENSE)**

Net nonoperating expense was \$49.9 million in the first nine months of 2010 compared to \$53.7 million in the same period of 2009. The reasons for the changes to the components of nonoperating expense are consistent with those in the three-month discussion.





Table of Contents

**CONSOLIDATED INCOME TAX EXPENSE (BENEFIT)**

We provide for income taxes based on either our estimate of the effective tax rate for the full year or the actual year-to-date effective tax rate if it is our best estimate of our annual rate. For the first nine months of 2010, we used the estimated income tax rate based on our current full-year estimate of pretax earnings. Our effective income tax rate on pretax income for the first nine months of 2010 was 38.4%, compared to 39.4% for the first nine months of 2009. In arriving at this rate, we considered a variety of factors, including our forecasted full-year pretax results, the U.S. federal rate of 35%, expected nondeductible expenses and estimated state income taxes. We evaluate our tax rate each quarter and make adjustments when necessary. Our final effective tax rate for the full year is highly dependent on the level of pretax income or loss and the magnitude of any nondeductible expenses in relation to that pretax amount.

**CRITICAL ACCOUNTING ESTIMATES**

For information on our critical accounting estimates, see Item 7 of our Annual Report on Form 10-K for the year ended December 31, 2009.

**LIQUIDITY AND CAPITAL RESOURCES**

Our primary sources of liquidity are our existing cash and marketable securities balance of \$1.3 billion (which represents 35% of trailing twelve months revenue) and our expected cash flow from operations. We also have other sources of liquidity such as the ability to finance unencumbered aircraft, our combined \$200 million bank line-of-credit facilities, and a “forward sale” of mileage credits to our affinity card bank partner.

Because of the severe economic uncertainty in 2009 and the volatility of fuel prices in recent years, we intentionally increased our balance of cash and marketable securities to current levels. As the economic climate stabilizes, we have implemented a plan to reduce our cash and marketable securities balance to between 25% and 30% of revenues over the next two years, through debt repayment, share repurchases, pension funding, or a combination thereof. During the first nine months of 2010, we paid off the outstanding debt balances associated with four B737-800 aircraft and a portion of a fifth aircraft loan totaling approximately \$115.5 million. Subsequent to the end of the third quarter, we paid off outstanding balances on two additional aircraft loans totaling \$53.7 million. We anticipate completing our current \$200 million debt prepayment plan in early 2011. In addition to debt prepayments, we have repurchased \$31.2 million of our common stock this year through the end of the third quarter. We will continue to focus on preserving a strong liquidity position and evaluate our cash needs as conditions change.

We believe that our current cash and marketable securities balance of over \$1.3 billion combined with future cash flows from operations and other sources of liquidity will be sufficient to fund our operations for the foreseeable future.

In our cash and marketable securities portfolio, we invest only in U.S. government securities, certain asset-backed obligations and corporate debt securities. We do not invest in equities or auction-rate securities. As of September 30, 2010, we had a \$24.3 million net unrealized gain on our \$1.3 billion cash and marketable securities balance.

Table of Contents

The table below presents the major indicators of financial condition and liquidity.

|   | September 30,<br>2010 | December 31,<br>2009 | Change      |
|---|-----------------------|----------------------|-------------|
| (dollars in millions)   |                       |                      |             |
| Cash and marketable securities  | \$ 1,317.7            | \$ 1,192.1           | \$ 125.6    |
| Cash and marketable securities as a percentage of last twelve months revenue                                | 35 %                  | 35 %                 | --          |
| Long-term debt, net of current portion  | \$ 1,390.1            | \$ 1,699.2           | \$ (309.1 ) |
| Shareholders' equity  | \$ 1,073.5            | \$ 872.1             | \$ 201.4    |
| Long-term debt-to-capital assuming aircraft operating leases are capitalized at seven times annualized rent | 68%: 32%              | 76%:24%              | (8) pts     |

The following discussion summarizes the primary drivers of the increase in our cash and marketable securities balance and our expectation of future cash requirements.

**ANALYSIS OF OUR CASH FLOWS****Cash Provided by Operating Activities**

During the first nine months of 2010, net cash provided by operating activities was \$506.4 million, compared to \$305.4 million generated during the same period of 2009. The increase in operating cash flow was primarily due to the improvement in earnings and increase of cash inflows from advance ticket sales compared to the prior-year period. These increases were partially offset by the payment of 2009 incentive pay in the first quarter of 2010, which was significantly larger than the payment of 2008 incentive pay in the first quarter of 2009.

We typically generate positive cash flows from operations and expect to do so in 2010, but historically we have consumed substantially all of that cash plus additional debt proceeds for capital expenditures and debt payments. In 2010, however, we anticipate much lower capital expenditures than in the past several years due to fewer aircraft deliveries, and will use our operating cash flow to prepay long-term debt, provide funding to our pension plans, and repurchase our common stock.

**Cash Used in Investing Activities**

Cash used in investing activities was \$299 million during the first nine months of 2010, compared to \$593.3 million during the same period of 2009. Our capital expenditures were \$153.9 million, or \$193.4 million lower than in the same period of 2009, as we purchased four B737-800 aircraft compared to ten B737-800 aircraft and two Q400 aircraft in the first nine months of 2009.

We currently expect gross capital expenditures for 2010 to be as follows (in millions):

|                 | Aircraft-related | Non-aircraft | Total  |
|-----------------|------------------|--------------|--------|
| Alaska          | \$ 126           | \$ 60        | \$ 186 |
| Horizon         | 20               | 5            | 25     |
| Total Air Group | \$ 146           | \$ 65        | \$ 211 |

Currently, we expect to have gross aircraft capital expenditures of approximately \$310 million and \$185 million in 2011 and 2012, respectively.



Table of Contents**Cash Provided by Financing Activities**

Net cash used for financing activities was \$242.4 million during the first nine months of 2010 compared to cash provided by financing activities of \$174.8 million during the same period of 2009. The change is primarily due to proceeds from the sale-leaseback transaction of six B737-800 aircraft and debt proceeds during the first quarter of 2009 compared to no borrowings in 2010, combined with \$115.5 million of debt prepayments in 2010.

**Bank Line-of-Credit Facilities**

We terminated our previous \$185 million credit facility effective March 30, 2010. That facility was replaced with two new \$100 million credit facilities. Both facilities have variable interest rates based on LIBOR plus a specified margin. Borrowings on one of the \$100 million facilities, which expires in March 2013, are secured by aircraft. Borrowings on the other \$100 million facility, which expires in March 2014, are secured by certain accounts receivable, spare engines, spare parts and ground service equipment. We have no immediate plans to borrow using either of these facilities.

**Pre-delivery Payment Facility**

We terminated our pre-delivery payment facility in the second quarter of 2010. There were no outstanding borrowings under this facility at the time of termination.

**CONTRACTUAL OBLIGATIONS AND, COMMITMENTS****Aircraft Purchase Commitments**

We have firm orders to purchase 21 aircraft requiring future aggregate payments of approximately \$537 million, as set forth below. Alaska has options to acquire 38 additional B737s and Horizon has options to acquire 10 Q400s.

The following table summarizes aircraft purchase commitments as of September 30, 2010, and payments by year:

| Aircraft                  | Delivery Period - Firm Orders  |          |          |         |         |         |          | Total |
|---------------------------|--------------------------------|----------|----------|---------|---------|---------|----------|-------|
|                           | October - December<br>31, 2010 | 2011     | 2012     | 2013    | 2014    | 2015    |          |       |
| Boeing 737-800            | -                              | 3        | 4        | 2       | 2       | 2       | 13       |       |
| Bombardier Q400           | -                              | 8        | -        | -       | -       | -       | 8        |       |
| <b>Total</b>              | -                              | 11       | 4        | 2       | 2       | 2       | 21       |       |
| Payments (in millions) \$ | 33.1                           | \$ 231.6 | \$ 108.9 | \$ 76.1 | \$ 55.1 | \$ 32.2 | \$ 537.0 |       |

We expect to pay for the firm orders beyond 2010 and the option aircraft, if exercised, through internally generated cash, long-term debt, or operating lease agreements.

Table of Contents

## Contractual Obligations

The following table provides a summary of our principal payments under current and long-term debt obligations, operating lease commitments, aircraft purchase commitments and other obligations as of September 30, 2010.

| (in millions)                          | Oct. 1 - Dec. |          |          |          |          | Beyond     |            | Total |
|--|---------------|----------|----------|----------|----------|------------|------------|-------|
|  | 31, 2010      | 2011     | 2012     | 2013     | 2014     | 2014       |            |       |
| Current and long-term debt obligations | \$ 89.6       | \$ 196.3 | \$ 219.1 | \$ 178.1 | \$ 144.4 | \$ 796.4   | \$ 1,623.9 |       |
| Operating lease commitments            |               |          |          |          |          |            |            |       |
| (1)                                    | 36.3          | 220.5    | 217.5    | 166.0    | 148.5    | 419.2      | 1,208.0    |       |
| Aircraft purchase commitments          | 33.1          | 231.6    | 108.9    | 76.1     | 55.1     | 32.2       | 537.0      |       |
| Interest obligations (2)               | 17.4          | 78.1     | 70.4     | 58.5     | 49.8     | 155.0      | 429.2      |       |
| Other purchase obligations (3)         | 19.9          | 51.9     | 52.2     | 42.2     | 54.3     | --         | 220.5      |       |
| Total                                  | \$ 196.3      | \$ 778.4 | \$ 668.1 | \$ 520.9 | \$ 452.1 | \$ 1,402.8 | \$ 4,018.6 |       |

(1) Operating lease commitments generally include aircraft operating leases, airport property and hangar leases, office space, and other equipment leases. The aircraft operating leases include lease obligations for 16 leased Q200 aircraft and three CRJ-700 aircraft, all of which are no longer in our operating fleets. We have accrued for these lease commitments based on their discounted future cash flows and we remain obligated under the existing lease contracts on these aircraft.

(2) For variable-rate debt, future obligations are shown above using interest rates in effect as of September 30, 2010.

(3) Includes minimum obligations under our long-term power-by-the-hour maintenance agreements for all B737 engines other than the B737-800.

## Pension Obligations

The "Contractual Obligations" table above excludes contributions to our various defined-benefit pension plans, which could be approximately \$45 million to \$75 million per year based on our historical funding practice. There is no minimum required contribution in 2010, although the company has contributed \$45.6 million to the plans in 2010.

## ITEM 3. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK

There have been no material changes in market risk from the information provided in Item 7A "Quantitative and Qualitative Disclosure About Market Risk" in our Annual Report on Form 10-K for the year ended December 31, 2009 except as follows:

## Market Risk – Aircraft Fuel

We hedge our exposure to the volatility of jet fuel prices using crude oil call options and, recently, jet fuel refining margin swap contracts. Call options are designed to effectively cap our cost of the crude oil component of fuel prices, allowing us to limit our exposure to increasing fuel prices. With these call option contracts, we still benefit from the decline in crude oil prices as there is no downward exposure other than the premiums that we pay to enter into the contracts. We believe there is risk in not hedging against the possibility of fuel price increases. We estimate that a 10% increase or decrease in crude oil prices as of September 30, 2010 would increase or decrease the fair value of our crude oil hedge portfolio by approximately \$39.4 million and \$31.8 million, respectively.

We continue to believe that our fuel hedge program is an important part of our strategy to reduce our exposure to volatile fuel prices. We expect to continue to enter into these types of contracts prospectively, although significant changes in market conditions could affect our decisions. For more discussion, see Note 3 to our condensed

consolidated financial statements.

46

---

Table of Contents

Financial Market Risk

We have exposure to market risk associated with changes in interest rates related primarily to our debt obligations and short-term investment portfolio. Our debt obligations include variable-rate instruments, which have exposure to changes in interest rates. This exposure is somewhat mitigated through our variable-rate investment portfolio. We have investments in marketable securities, which are exposed to market risk associated with changes in interest rates and market values. We do not invest in equity securities or auction-rate securities, only government and corporate bond obligations.

ITEM 4. CONTROLS AND PROCEDURES

Evaluation of Disclosure Controls and Procedures

As of September 30, 2010 an evaluation was performed under the supervision and with the participation of our management, including our chief executive officer and chief financial officer (collectively, our “certifying officers”), of the effectiveness of the design and operation of our disclosure controls and procedures. These disclosure controls and procedures are designed to ensure that the information required to be disclosed by us in our periodic reports filed with or submitted to the Securities and Exchange Commission (the SEC) is recorded, processed, summarized and reported within the time periods specified by the SEC’s rules and forms, and includes, without limitation, controls and procedures designed to ensure that such information is accumulated and communicated to our management, including our certifying officers, as appropriate to allow timely decisions regarding required disclosure. Our certifying officers concluded, based on their evaluation, that disclosure controls and procedures were effective as of September 30, 2010.

Changes in Internal Control over Financial Reporting

We made no changes in our internal control over financial reporting during the quarter ended September 30, 2010 that have materially affected, or are reasonably likely to materially affect, our internal control over financial reporting.

PART II. OTHER INFORMATION

ITEM 1. LEGAL PROCEEDINGS

We are a party to routine litigation matters incidental to our business. We believe the ultimate disposition of these matters is not likely to materially affect our financial position or results of operations. This forward-looking statement is based on management’s current understanding of the relevant law and facts; and it is subject to various contingencies, including the potential costs and risks associated with litigation and the actions of judges and juries.

The Securities and Exchange Commission is conducting an inquiry into trading in the securities of Puget Energy Inc. (“PSE”) by Donald Smith & Co., an investment firm. William Ayer, our Chief Executive Officer, serves on the board of PSE. Mr. Ayer and the Company are cooperating voluntarily in that inquiry. Mr. Ayer has stated that he never provided any non-public information about PSE to Donald Smith & Co.

ITEM 1A. RISK FACTORS

There have been no material changes to the risk factors affecting our business, financial condition or future results from those set forth in Part I, “Item 1A. Risk Factors” in our Annual Report on Form 10-K for the year ended December 31, 2009. However, you should carefully consider the factors discussed in such section of our Annual Report on Form 10-K, which could materially affect our business, financial condition or future results. Additional risks and uncertainties not currently known to us or that we currently deem to be immaterial also may materially adversely affect our business, financial condition and/or operating results.

Table of Contents

## ITEM 2. UNREGISTERED SALES OF EQUITY SECURITIES AND USE OF PROCEEDS

This table provides certain information with respect to our purchases of shares of our common stock during the third quarter of 2010.

| Issuer Purchases of Equity Securities         | Total number<br>of shares<br>purchased | Average price<br>paid per share | Maximum approximate<br>remaining dollar value of<br>shares that can be repurchased<br>under the plan (2) |
|---|--|---------------------------------|--|
| July 1, 2010 – July 31, 2010 (1)              | 4,000                                  | 51.46                           |  |
| August 1, 2010 – August 31, 2010 (1)          | 47,000                                 | 50.54                           |  |
| September 1, 2010 – September 30, 2010<br>(1) | 51,000                                 | 46.60                           |  |
| Total   | 102,000                                | \$48.61                         | \$45,042,241   |

(1) Pursuant to a \$50 million repurchase plan authorized by the Board of Directors on June 15, 2010. The plan expires on June 11, 2011.

## ITEM 3. DEFAULTS UPON SENIOR SECURITIES

None.

## ITEM 5. OTHER INFORMATION

None.

## ITEM 6. EXHIBITS

See Exhibit Index on page 50.



Table of Contents

SIGNATURES

Pursuant to the requirements of the Securities Exchange Act of 1934, the registrant has duly caused this report to be signed on its behalf by the undersigned thereunto duly authorized.

ALASKA AIR GROUP, INC.

Registrant

Date: November 5, 2010

By: /s/ Brandon S. Pedersen

Brandon S. Pedersen

Vice President/Finance and Chief Financial Officer

(Principal Financial Officer and Principal Accounting Officer)

Table of Contents

EXHIBIT INDEX

Pursuant to Item 601(a)(2) of Regulation S-K, this Exhibit Index immediately precedes the exhibits.

The following exhibits are numbered in accordance with Item 601 of Regulation S-K.

| Exhibit No.   | Description  |
|---------------|--|
| <u>31.1*</u>  | <u>Section 302 Certification of Chief Executive Officer Pursuant to 18 U.S.C. Section 1350</u> |
| <u>31.2*</u>  | <u>Section 302 Certification of Chief Financial Officer Pursuant to 18 U.S.C. Section 1350</u> |
| <u>32.1**</u> | <u>Section 906 Certification of Chief Executive Officer Pursuant to 18 U.S.C. Section 1350</u> |
| <u>32.2**</u> | <u>Section 906 Certification of Chief Financial Officer Pursuant to 18 U.S.C. Section 1350</u> |
| 101.INS**     | XBRL Instance Document   |
| 101.SCH**     | XBRL Taxonomy Extension Schema Document  |
| 101.CAL**     | XBRL Taxonomy Extension Calculation Linkbase Document  |
| 101.DEF**     | XBRL Taxonomy Extension Definition Linkbase Document   |
| 101.LAB**     | XBRL Taxonomy Extension Labels Linkbase Document   |
| 101.PRE**     | XBRL Taxonomy Extension Presentation Linkbase Document   |

\* Filed herewith.

\*\* Exhibits are being furnished pursuant to 18 U.S.C. Section 1350 and shall not be deemed to be “filed” or purposes of Section 18 of the Securities Exchange Act of 1934, as amended (“Exchange Act”), or otherwise subject to the liability of that section. Such exhibits shall not be deemed to be incorporated by reference into any filing of the Company under the Securities Act of 1933, as amended, or the Exchange Act, whether made before or after the date hereof, regardless of any general incorporation language in such filing.

