

ALASKA AIR GROUP INC  
Form 10-Q  
August 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 June 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

Accelerated filer

Non-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

**APPLICABLE ONLY TO CORPORATE ISSUERS:**

Indicate the number of shares outstanding of each of the issuer's classes of common stock, as of the latest practicable date: The registrant has 35,817,109 common shares, par value \$1.00, outstanding at July 31, 2010.

---

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

TABLE OF CONTENTS

<u>PART I. FINANCIAL INFORMATION</u>	<u>4</u>
<u>ITEM 1. CONDENSED CONSOLIDATED FINANCIAL STATEMENTS</u>	<u>4</u>
<u>ITEM 2. MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS</u>	<u>20</u>
<u>ITEM 3. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK</u>	<u>46</u>
<u>ITEM 4. CONTROLS AND PROCEDURES</u>	<u>46</u>
<u>PART II. OTHER INFORMATION</u>	<u>47</u>
<u>ITEM 1. LEGAL PROCEEDINGS</u>	<u>47</u>
<u>ITEM 1A. RISK FACTORS</u>	<u>47</u>
<u>ITEM 2. UNREGISTERED SALES OF EQUITY SECURITIES AND USE OF PROCEEDS</u>	<u>47</u>
<u>ITEM 3. DEFAULTS UPON SENIOR SECURITIES</u>	<u>48</u>
<u>ITEM 4. SUBMISSION OF MATTERS TO A VOTE OF SECURITY HOLDERS</u>	<u>48</u>
<u>ITEM 5. OTHER INFORMATION</u>	<u>48</u>
<u>ITEM 6. EXHIBITS</u>	<u>48</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 Contents

## PART I. FINANCIAL INFORMATION

## ITEM 1. CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

CONDENSED CONSOLIDATED BALANCE SHEETS (unaudited)  
Alaska Air Group, Inc.

## ASSETS

(in millions)	June 30, 2010	December 31, 2009
Current Assets		
Cash and cash equivalents	\$ 108.1	\$ 164.2
Marketable securities	1,164.6	1,027.9
Total cash and marketable securities	1,272.7	1,192.1
Receivables - net	145.2	111.8
Inventories and supplies - net	48.5	45.8
Deferred income taxes	137.4	120.3
Fuel hedge contracts	31.7	66.2
Prepaid expenses and other current assets	103.7	98.1
Total Current Assets	1,739.2	1,634.3
Property and Equipment		
Aircraft and other flight equipment	3,810.8	3,660.1
Other property and equipment	628.4	631.3
Deposits for future flight equipment	147.6	215.5
	4,586.8	4,506.9
Less accumulated depreciation and amortization	1,422.9	1,339.0
Total Property and Equipment - Net	3,163.9	3,167.9
Fuel Hedge Contracts	41.2	50.8
Other Assets	162.7	143.2
Total Assets	\$ 5,107.0	\$ 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)	June 30, 2010	December 31, 2009
<b>Current Liabilities</b>		
Accounts payable	\$ 58.0	\$ 63.3
Accrued aircraft rent	43.4	54.0
Accrued wages, vacation and payroll taxes	137.8	155.4
Other accrued liabilities	518.2	474.5
Air traffic liability	529.0	366.3
Current portion of long-term debt	154.3	156.0
<b>Total Current Liabilities</b>	<b>1,440.7</b>	<b>1,269.5</b>
<b>Long-Term Debt, Net of Current Portion</b>	<b>1,570.0</b>	<b>1,699.2</b>
<b>Other Liabilities and Credits</b>		
Deferred income taxes	207.8	151.1
Deferred revenue	407.1	435.1
Obligation for pension and postretirement medical benefits	409.7	421.0
Other liabilities	131.8	148.2
	1,156.4	1,155.4
<b>Commitments and Contingencies</b>		
<b>Shareholders' Equity</b>		
<b>Preferred stock, \$1 par value</b>		
Authorized: 5,000,000 shares, none issued or outstanding	-	-
<b>Common stock, \$1 par value</b>		
Authorized: 100,000,000 shares		
Issued: 2010 - 36,457,646 shares		
2009 - 35,843,092 shares	36.5	35.8
<b>Capital in excess of par value</b>	<b>792.0</b>	<b>767.0</b>
<b>Treasury stock (common), at cost: 2010 - 747,411 shares</b>		
2009 - 252,084 shares	(27.8 )	(5.7 )
<b>Accumulated other comprehensive loss</b>	<b>(239.7 )</b>	<b>(240.0 )</b>
<b>Retained earnings</b>	<b>378.9</b>	<b>315.0</b>
	939.9	872.1
<b>Total Liabilities and Shareholders' Equity</b>	<b>\$ 5,107.0</b>	<b>\$ 4,996.2</b>

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 June		Six Months Ended June	
	30 2010	2009	30 2010	2009
Operating Revenues				
Passenger	\$881.5	\$757.2	\$1,629.9	\$1,441.3
Freight and mail	28.1	25.2	51.1	44.6
Other - net	66.8	61.5	125.3	100.4
Total Operating Revenues	976.4	843.9	1,806.3	1,586.3
Operating Expenses				
Wages and benefits	239.6	247.1	478.9	493.1
Variable incentive pay	21.6	18.9	39.5	28.2
Aircraft fuel, including hedging gains and losses	255.0	128.4	462.3	286.1
Aircraft maintenance	53.8	59.6	110.8	119.3
Aircraft rent	35.4	39.1	72.4	77.1
Landing fees and other rentals	57.9	54.4	113.8	108.6
Contracted services	41.1	36.8	80.7	75.2
Selling expenses	38.2	35.3	71.8	60.3
Depreciation and amortization	58.0	53.9	114.2	106.7
Food and beverage service	14.3	12.4	26.6	24.0
Other	48.2	50.3	96.0	107.1
New pilot contract transition costs	-	35.8	-	35.8
Fleet transition costs - CRJ-700	3.4	-	3.4	-
Fleet transition costs - Q200	-	5.2	-	10.0
Total Operating Expenses	866.5	777.2	1,670.4	1,531.5
Operating Income	109.9	66.7	135.9	54.8
Nonoperating Income (Expense)				
Interest income	7.6	7.8	15.1	16.1
Interest expense	(26.3 )	(25.1 )	(51.9 )	(51.9 )
Interest capitalized	1.6	1.8	3.3	4.6
Other - net	1.2	(3.5 )	1.8	(5.5 )
	(15.9 )	(19.0 )	(31.7 )	(36.7 )
Income before income tax	94.0	47.7	104.2	18.1
Income tax expense	35.4	18.6	40.3	8.2
Net Income	\$58.6	\$29.1	\$63.9	\$9.9
Basic Earnings Per Share:				
	\$1.64	\$0.80	\$1.79	\$0.27
Diluted Earnings Per Share:				
	\$1.60	\$0.79	\$1.74	\$0.27
Shares used for computation:				
Basic	35.698	36.354	35.683	36.340
Diluted	36.697	36.591	36.631	36.742

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 in Excess of Par Value	Accumulated		Retained Earnings	Total
	Shares Outstanding	Common Stock		Treasury Stock at Cost	Other Comprehensive Loss		
Balances at December 31, 2009	35.591	\$ 35.8	\$ 767.0	\$ (5.7 )	\$ (240.0 )	\$ 315.0	\$ 872.1
Net income for the six months ended June 30, 2010						63.9	63.9
Other comprehensive income (loss):							
Related to marketable securities:							
Change in fair value					8.3		
Reclassification to earnings					(3.7 )		
Income tax effect					(1.8 )		
					2.8		2.8
Adjustments related to employee benefit plans:						10.8	
Income tax effect					(3.7 )		
					7.1		7.1
Related to interest rate derivative instruments:							
Change in fair value					(15.5 )		
Income tax effect					5.9		
					(9.6 )		(9.6 )
Total comprehensive income							64.2
Purchase of treasury stock	(0.646 )			(26.3 )			(26.3 )
Stock-based compensation			8.7				8.7
Treasury stock issued under stock plans	0.150			4.2			4.2
Stock issued for employee stock	0.016	0.1	0.3				0.4

purchase plan							
Stock issued under							
stock plans	0.599	0.6	16.0				16.6
Balances at June 30,							
2010	35.710	\$ 36.5	\$ 792.0	\$ (27.8 )	\$ (239.7 )	\$ 378.9	\$ 939.9

See accompanying notes to condensed consolidated financial statements.

Table of Contents

## CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS (unaudited)

Alaska Air Group, Inc.

(in millions)	Six Months Ended June	
	2010	2009
Cash flows from operating activities:		
Net income	\$63.9	\$9.9
Adjustments to reconcile net income to net cash provided by operating activities:		
Fleet transition costs	3.4	10.0
Non-cash impact of pilot contract transition costs	-	15.5
Depreciation and amortization	114.2	106.7
Stock-based compensation	8.7	7.6
Increase in air traffic liability	162.7	48.8
Changes in other assets and liabilities - net	(19.3 )	(75.3 )
Net cash provided by operating activities	333.6	123.2
Cash flows from investing activities:		
Property and equipment additions:		
Aircraft and aircraft purchase deposits	(45.3 )	(269.1 )
Other flight equipment	(52.6 )	(19.6 )
Other property and equipment	(13.9 )	(19.8 )
Total property and equipment additions	(111.8 )	(308.5 )
Proceeds from disposition of assets	3.3	4.2
Purchases of marketable securities	(578.1 )	(515.0 )
Sales and maturities of marketable securities	446.2	361.0
Restricted deposits and other	0.5	(4.3 )
Net cash used in investing activities	(239.9 )	(462.6 )
Cash flows from financing activities:		
Proceeds from issuance of long-term debt	-	162.6
Proceeds from sale-leaseback transactions, net	-	230.0
Long-term debt payments	(130.9 )	(166.8 )
Purchase of treasury stock	(26.3 )	(11.8 )
Proceeds and tax benefit from issuance of common stock	21.0	2.8
Other financing activities	(13.6 )	2.8
Net cash provided by (used for) financing activities	(149.8 )	219.6
Net change in cash and cash equivalents	(56.1 )	(119.8 )
Cash and cash equivalents at beginning of year	164.2	283.1
Cash and cash equivalents at end of period	\$108.1	\$163.3
Supplemental disclosure of cash paid (received) during the period for:		
Interest (net of amount capitalized)	\$50.1	\$48.3
Income taxes	(4.8 )	(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 June 30, 2010, as well as the results of operations for the three and six months ended June 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 is currently evaluating the impact of this new standard on the Company's financial position, results of operations, cash flows, and 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 new standard 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 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, although the significance of that impact cannot be estimated at this time.

- Proposed ASU – Revenue Recognition – was issued in June 2010. This proposed standard 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 changes how fair value is determined for certain assets and liabilities and requires 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 enhances financial statement disclosure surrounding certain loss contingencies such as legal disputes, environmental remediation liabilities, 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 this proposed standard to impact the Company's financial position or results of operations.

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 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.



Table of Contents

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 June 30, 2010 are as follows (in millions):

	Level 1	Level 2	Level 3	Total
Cash and cash equivalents	\$76.8	\$31.3	\$—	\$108.1
Marketable securities	176.1	988.5	—	1,164.6
Total	\$252.9	\$1,019.8	\$—	\$1,272.7

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):

	June 30, 2010	December 31, 2009
Amortized cost:		
Government securities/agencies	\$ 462.8	\$ 376.7
Asset-backed obligations	211.3	215.4
Other corporate obligations	471.9	421.8
	\$ 1,146.0	\$ 1,013.9
Fair value:		
Government securities/agencies	\$ 470.6	\$ 381.2
Asset-backed obligations	211.0	214.7
Other corporate obligations	483.0	432.0
	\$ 1,164.6	\$ 1,027.9

Of the marketable securities on hand at June 30, 2010, 14% mature in 2010, 27% in 2011 and 59% thereafter. Gross realized gains and losses for the three months ended June 30, 2010 and 2009 were not material to the condensed consolidated financial statements.

Some of the Company’s asset-backed securities held at June 30, 2010 had credit losses, as defined in the accounting standards. These credit losses total \$2.2 million and 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 six months of 2010.





Table of Contents

Management does not believe the securities associated with the remaining \$2.8 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 June 30, 2010 are presented in the table below (in millions):

	Unrealized Losses				Less: Credit Loss Previously Recorded in Earnings	Net Unrealized Losses in AOCL	Net Unrealized Gains/(Losses) in AOCL	Fair Value of Securities with Unrealized Losses
	Unrealized Gains in AOCL	Less than 12 months	Greater than 12 months	Total Unrealized Losses				
Government Securities/Agencies	\$ 7.8	\$--	\$--	\$ --	\$ --	\$ --	\$ 7.8	\$ 22.6
Asset-backed obligations	2.1	(0.5 )	(4.1 )	(4.6 )	(2.2 )	(2.4 )	(0.3 )	80.7
Other corporate obligations	11.5	(0.4 )	--	(0.4 )	--	(0.4 )	11.1	57.4
Total	\$ 21.4	\$(0.9 )	\$(4.1 )	\$(5.0 )	\$(2.2 )	\$(2.8 )	\$ 18.6	\$ 160.7

## 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 Amount	Fair Value
Long-term debt at June 30, 2010	\$ 1,724.3	\$ 1,748.5
Long-term debt at 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.

## 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 periodically 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.

12

---

Table of Contents

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

	Three Months Ended June 30		Six Months Ended June 30	
	2010	2009	2010	2009
Raw or "into-plane" fuel cost	\$222.9	\$158.5	\$418.1	\$300.4
Impact of hedging activity	32.1	(30.1)	44.2	(14.3)
Aircraft fuel expense	\$255.0	\$128.4	\$462.3	\$286.1

The net benefit from hedges that settled during the period was \$5.5 million and \$5.9 million during the three and six months ended June 30, 2010, respectively. The net cost of settled hedges in the three and six months ended June 30, 2009 was \$9.7 million and \$35.5 million, respectively.

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 fuel hedge positions are as follows:

	Approximate % of Expected Fuel Requirements		Gallons Hedged (in millions)	Average Crude Oil Price per Barrel	Average Premium Cost per Barrel
Third Quarter 2010	50	%	48.3	\$ 74	\$ 10
Fourth Quarter 2010	50	%	44.5	\$ 83	\$ 11
Remainder of 2010	50	%	92.8	\$ 78	\$ 11
First Quarter 2011	50	%	44.9	\$ 87	\$ 11
Second Quarter 2011	50	%	47.2	\$ 86	\$ 11
Third Quarter 2011	43	%	42.7	\$ 86	\$ 11
Fourth Quarter 2011	36	%	32.9	\$ 87	\$ 10
Full Year 2011	45	%	167.7	\$ 86	\$ 11
First Quarter 2012	30	%	27.7	\$ 87	\$ 12
Second Quarter 2012	21	%	20.9	\$ 89	\$ 13
Third Quarter 2012	19	%	19.2	\$ 92	\$ 12
Fourth Quarter 2012	17	%	15.7	\$ 89	\$ 12
Full Year 2012	22	%	83.5	\$ 89	\$ 12
First Quarter 2013	11	%	10.5	\$ 87	\$ 12
Second Quarter 2013	5	%	5.5	\$ 83	\$ 15
Full Year 2013	4	%	16.0	\$ 86	\$ 13

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.



Table of Contents

The Company also has financial swap agreements in place to fix the refining margin component for approximately 50% and 10% of third and fourth quarter 2010 jet fuel purchases, respectively, at an average price per gallon of 30 cents per gallon and 31 cents per gallon, respectively.

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

	June 30, 2010	December 31, 2009
Crude oil call options or "caps"	\$ 71.7	\$ 115.9
Refining margin swap contracts	1.2	1.1
Total	\$ 72.9	\$ 117.0

The balance sheet amounts include capitalized premiums paid to enter into the contracts of \$94.8 million and \$88.9 million at June 30, 2010 and December 31, 2009, respectively.

**Interest Rate Swap Agreements**

In the third quarter of 2009, the Company entered into 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 beginning in June 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 June 30, 2010, the Company had a liability of \$13.2 million associated with these contracts, \$6.4 million of which is expected to 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):

	June 30, 2010	December 31, 2009
Fixed-rate notes payable due through 2024	\$ 1,381.4	\$ 1,440.2
Variable-rate notes payable due through 2024	342.9	415.0
Long-term debt	1,724.3	1,855.2
Less current portion	(154.3 )	(156.0 )
	\$ 1,570.0	\$ 1,699.2

During the first six months of 2010, the Company had no new debt borrowings and made scheduled debt payments of \$76.9 million. The Company also prepaid the full debt balance on two outstanding aircraft debt agreements totaling

\$54.0 million. Subsequent to June 30, 2010, the Company paid off the outstanding balance on a third aircraft debt agreement of \$27.1 million.

Table of Contents

## Bank Lines of Credit

The Company terminated its 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. 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 June 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 June 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. In the first six months of 2010, 645,748 shares were purchased for \$26.3 million.

In June 2010, the Board of Directors authorized the Company to repurchase up to an additional \$50 million of its common stock. There were no share repurchases under this program in the second quarter of 2010. This program expires in June 2011.

## NOTE 6. EMPLOYEE BENEFIT PLANS

## Pension Plans - Qualified Defined Benefit

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

	Three Months Ended June		Six Months Ended June	
	2010	2009	2010	2009
Service cost	\$8.1	\$11.1	\$16.2	\$22.2
Interest cost	16.9	16.7	33.8	33.4
Expected return on assets	(17.7 )	(12.8 )	(35.4 )	(25.6 )
Amortization of prior service cost	(0.2 )	1.1	(0.4 )	2.2
Actuarial loss	5.5	7.2	11.0	14.4
Net pension expense	\$12.6	\$23.3	\$25.2	\$46.6

The Company contributed \$15.2 million and \$30.4 million to its qualified defined-benefit plans during the three and six months ended June 30, 2010, respectively, and expects to contribute an additional \$15.2 million to these plans during the remainder of 2010. The Company made \$21.3 million and \$31.9 million in contributions to its qualified defined-benefit pension plans during the three and six months ended June 30, 2009, respectively.

## Pension Plans - Nonqualified Defined Benefit

Net pension expense for the unfunded, noncontributory defined-benefit plans was \$0.8 million and \$0.7 million for the three months ended June 30, 2010 and 2009 and \$1.6 million and \$1.5 million for the six months ended June 30, 2010 and 2009.





Table of Contents

## Post-retirement Medical Benefits

Net periodic benefit cost for the post-retirement medical plans for the three months ended June 30, 2010 and 2009 was \$3.1 million and \$5.6 million, respectively. The net periodic benefit cost for the six months ended June 30, 2010 and 2009 was \$6.2 million and \$8.9 million, respectively.

## NOTE 7. OTHER ASSETS

Other assets consisted of the following (in millions):

	June 30, 2010	December 31, 2009
Restricted deposits (primarily restricted investments)	\$ 86.2	\$ 86.7
Deferred costs and other*	76.5	56.5
	\$ 162.7	\$ 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):

	June 30, 2010	December 31, 2009
Current Liabilities:		
Other accrued liabilities	\$ 286.0	\$ 267.9
Other Liabilities and Credits (non-current):		
Deferred revenue	384.0	410.6
Other liabilities	12.2	13.2
	\$ 682.2	\$ 691.7

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

	Three Months Ended		Six Months Ended	
	June 30		June 30	
	2010	2009	2010	2009
Passenger revenues	\$51.0	\$48.2	\$92.1	\$86.9
Other - net revenues	48.6	45.8	90.6	70.3
	\$99.6	\$94.0	\$182.7	\$157.2

## NOTE 9. STOCK-BASED COMPENSATION PLANS

The Company has stock awards outstanding under a number of long-term incentive equity plans, one of which continues to provide 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.

## Stock Options

During the six months ended June 30, 2010, the Company granted 129,970 options with a weighted-average fair value of \$18.05 per share. During the same period in the prior year, the Company granted 384,268 options with a weighted-average fair value of \$14.00 per share.

### Table of Contents

The Company recorded stock-based compensation expense related to stock options of \$1.0 million and \$0.7 million for the three months ended June 30, 2010 and 2009, respectively. The Company recorded expense of \$2.8 million and \$3.0 million for the six months ended June 30, 2010 and 2009, respectively. As of June 30, 2010, \$2.5 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 1.6 years.

As of June 30, 2010, options to purchase 1,703,828 shares of common stock were outstanding with a weighted-average exercise price of \$29.94. Of that total, 992,309 were exercisable at a weighted-average exercise price of \$30.28.

### Restricted Stock Awards

During the six months ended June 30, 2010, the Company awarded 131,646 restricted stock units (RSUs) to certain employees, with a weighted-average grant date fair value of \$33.87. 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 \$1.3 million and \$1.1 million for the three-month period ended June 30, 2010 and 2009, respectively, and \$3.8 million in both six-month periods ended June 30, 2010 and 2009.

As of June 30, 2010, \$5.8 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 1.8 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 in 2010 was \$3.6 million.

The Company recorded \$1.1 million and \$1.7 million of compensation expense related to PSUs in the second quarter and first six 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 second quarter of 2010 was \$0.3 million.

### Employee Stock Purchase Plan

Compensation expense recognized under the Employee Stock Purchase Plan was \$0.5 million for the three months ended June 30, 2009, and \$0.1 million and \$0.8 million for the six months ended June 30, 2009 and 2008, respectively. There was no compensation expense recognized under the Plan for the three months ended June 30, 2010 as the Plan was discontinued in February 2010. A new Employee Stock Purchase Plan was approved by the shareholders at the Company's 2010 annual meeting and will begin later in 2010.



Table of Contents

## Summary of Stock-Based Compensation

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

	Three Months Ended		Six Months Ended	
	2010	June 30 2009	2010	June 30 2009
Stock options	\$1.0	\$0.7	\$2.8	\$3.0
Restricted stock units	1.3	1.1	3.8	3.8
Performance share units	1.1	---	1.7	---
Deferred stock units	0.3	---	0.3	---
Employee stock purchase plan	--	0.5	0.1	0.8
	\$3.7	\$2.3	\$8.7	\$7.6

## NOTE 10. FLEET TRANSITION

## Horizon Transition to All-Q400 Fleet

Horizon's long-term goal is to transition to an all-Q400 fleet. As of June 30, 2010, Horizon operated 17 CRJ-700 aircraft, which the Company plans to remove from its fleet in the future. Market conditions have hindered the remarketing efforts for these CRJ-700 aircraft resulting in a delay of the fleet transition plan. The Company did remove one of the CRJ-700 aircraft from operations and subleased it to a third party during the second quarter of 2010, resulting in a sublease loss of \$3.4 million. Management expects to remove four additional CRJ-700 aircraft from operations in the third quarter of 2010 and dispose of them, either through sublease or lease assignment. Management expects this will result in a total charge of approximately \$7 million to \$9 million to be recorded when Horizon ceases use of the aircraft. Two of these aircraft were delivered to a third party in July 2010 and the other two are expected to be delivered in August. Depending on the ultimate disposition of the 13 CRJ-700 aircraft remaining in the operating fleet after the removal of the aforementioned aircraft, there may be further associated exit 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. Including the second quarter transaction, Horizon subleases three CRJ-700 aircraft to a third-party carrier.

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 operation in the first quarter of 2009 was \$4.8 million with an additional \$5.2 million charge in the second quarter of 2009. This charge represented the losses under the disposal transactions.

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, represented by the Air Line Pilots Association, 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.

Table of Contents

## NOTE 12. OPERATING SEGMENT INFORMATION

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

	Three Months Ended June		Six Months Ended June	
	2010	2009	2010	2009
Operating revenues:				
Alaska – mainline (1)	\$789.4	\$681.6	\$1,450.5	\$1,272.9
Alaska – purchased capacity (1)	83.1	67.7	159.6	129.5
Total Alaska	872.5	749.3	1,610.1	1,402.4
Horizon	171.1	157.9	329.5	304.7
Other (2)	0.2	0.2	0.5	0.5
Elimination of intercompany revenues	(67.4 )	(63.5 )	(133.8 )	(121.3 )
Consolidated	\$976.4	\$843.9	\$1,806.3	\$1,586.3
Income (loss) before income tax:				
Alaska – mainline	\$87.7	\$43.3	\$100.9	\$25.9
Alaska – purchased capacity	8.8	(1.2 )	12.8	(2.1 )
Total Alaska	96.5	42.1	113.7	23.8
Horizon	(1.2 )	6.5	(7.4 )	(4.0 )
Other (2)	(1.3 )	(0.9 )	(2.1 )	(1.7 )
Consolidated	\$94.0	\$47.7	\$104.2	\$18.1
Total assets at end of period:				
			June 30, 2010	December 31, 2009
Alaska			\$ 4,708.9	\$ 4,541.3
Horizon			721.7	735.3
Other (2)			1,145.7	1,052.4
Elimination of intercompany accounts			(1,469.3 )	(1,332.8 )
Consolidated			\$ 5,107.0	\$ 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 that 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.

## NOTE 13. CONTINGENCIES

## Other items

The Company is a party to routine litigation matters incidental to its business. Management believes the ultimate disposition of the matters discussed above 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.





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 the 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:

- Second Quarter in Review – highlights from the second quarter of 2010 outlining 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 six months ended June 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, commitments and off-balance sheet arrangements, and an overview of financial position.

Air Group's filings with the Securities and Exchange Commission, including its 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.

SECOND QUARTER IN REVIEW

Our consolidated pretax income was \$94.0 million during the second quarter of 2010 compared to \$47.7 million in the second quarter of 2009. The increase in our pretax earnings was primarily due to the \$132.5 million increase in operating revenues and a \$35.8 million charge in the second quarter of 2009 related to the new pilot contract, partially offset by an increase in aircraft fuel cost on relatively flat non-fuel operating costs.

- Consolidated unit revenues increased 11% over the second quarter of 2009, stemming from significant increases in passenger unit revenues that were driven by higher load factors at both Alaska and Horizon. Baggage fees contributed over \$27 million to the revenue improvement, reflecting the benefit of our first bag fee that was introduced during the third quarter of 2009.
- Economic fuel averaged \$2.31 per gallon in the second quarter of 2010, compared to \$1.84 in 2009. This resulted in a \$49.2 million increase in our economic fuel expense compared to the second quarter of 2009.
- In the second quarter of 2009, Alaska entered into a new four-year agreement with their pilots. Among other contract items, the pilots received a one-time bonus of approximately \$20.3 million, including taxes, and transitioned to a new sick-leave payment program resulting in a transition charge of \$15.5 million.



### Table of Contents

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

#### Recent Awards

For the third year in a row, Alaska Airlines ranked “Highest in Customer Satisfaction among Traditional Network Carriers” in 2010 by J.D. Power & Associates.

In July 2010, Aviation Week Magazine named Alaska Airlines the “Top-Performing Airline” in the world among mainline/legacy carriers.

#### 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 June 30, 2010, we had not yet repurchased any shares of our common stock under this new program. Purchases began in July 2010 and we have repurchased 14,000 shares for approximately \$0.7 million through August 3, 2010. Since 2007, we have repurchased approximately \$160 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 13 of the 14 months ended May 2010. Horizon also continues to rank at the top of the industry in on-time performance.

#### New Markets

Alaska recently announced new non-stop service between San Jose, Calif. and Los Cabos, Mexico three times weekly beginning November 20, 2010 and daily non-stop service between Bellingham, Wash. and Honolulu beginning January 7, 2011. In the second quarter, Alaska also announced daily non-stop service between Seattle and St. Louis beginning on September 27, 2010 and service from San Jose and Oakland to Kauai beginning March 2011. This is in addition to new service announced previously to the Hawaiian Islands from Portland, San Diego, San Jose and Sacramento, beginning this fall.

#### Changes to Certain Fees

We previously announced changes to certain fees effective June 16, 2010. We now charge \$20 for each of the first three checked bags, which is an increase from the previous \$15 charge for the first bag, but a decrease in the charge for the second and third bags. We also reduced and simplified fees for unaccompanied minors and eliminated free same-day standby travel and courtesy holds on tickets purchased through reservations or our websites. We expect these changes to provide incremental revenue of approximately \$30 million annually.

#### Horizon Fleet Transition

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. In the second quarter, Horizon did sublease one additional CRJ-700 aircraft to a third-party carrier. We recorded a charge of \$3.4 million associated with this sublease agreement. We now have three CRJ-700 aircraft subleased to a third-party carrier.

### Table of Contents

We expect further charges in the third quarter as Horizon disposes of an additional four CRJ-700 aircraft to a third-party carrier through sublease or lease assignment. We expect these charges to total approximately \$7 million to \$9 million.

### Outlook

We have a positive outlook for the last half of 2010. Advance bookings across the Air Group network are up, on average, for August through October as compared to 2009. We are experiencing a very good summer season thus far as we focus on operating safe, compliant and on-time airlines.

### Horizon Changes

We recently announced our decision to outsource the remaining heavy maintenance functions for Horizon aircraft. All of the CRJ-700 aircraft heavy maintenance is currently provided by an outside vendor. We believe this change will result in approximately \$3 million in cost savings annually. As a result of this decision, we will be eliminating a number of positions in the maintenance division. This will be done through either acceptance of early-out packages or voluntary and involuntary furloughs. These events will result in an estimated third-quarter charge of less than \$3 million associated with severance pay and continuing medical benefits.

Over the course of the next several months, we will evaluate further changes in Horizon's business model and operational structure as we focus on improving profitability. A number of alternatives and strategies are being considered, including:

- accelerating our transition to an all-Q400 fleet;
- further consolidation of operational functions with Alaska;
- finalizing the agreement in principle to lower pilot costs to better match current market costs;
- evaluating the benefits of moving to an all-capacity-purchase model instead of our current mixed model that includes both capacity-purchase flying and Horizon brand flying; and
- evaluating the costs and benefits of maintaining the Horizon brand from an external marketing perspective.

Many of these activities or strategies could result in additional costs in the coming quarters related to disposing of the CRJ aircraft, employee furloughs or other events. These costs cannot be reasonably estimated at this time, except for the expected charges mentioned previously related to the four CRJ-700 aircraft to be disposed of in the third quarter.

## RESULTS OF OPERATIONS

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

Our consolidated net income for the second quarter of 2010 was \$58.6 million, or \$1.60 per diluted share, compared to net income of \$29.1 million, or \$0.79 per diluted share, in the second quarter of 2009. Items that impact the comparability between the periods are as follows:

- Both periods include adjustments to reflect the timing of gain or loss recognition resulting from mark-to-market accounting related to our fuel hedge portfolio. In the second quarter of 2010 we recognized net mark-to-market losses of \$37.6 million (\$23.3 million after tax, or \$0.63 per share), compared to gains of \$39.8 million (\$24.9 million after tax, or \$0.68 per share) in the second quarter of 2009.
- The second quarter of 2010 includes CRJ-700 fleet transition costs of \$3.4 million (\$2.1 million after tax, or \$0.06 per share).
- The second quarter of 2009 includes new pilot contract transition costs of \$35.8 million (\$22.3 million after tax, or \$0.61 per share).



Table of Contents

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, 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 and as shown in the following table, our consolidated net income for the second quarter of 2010 was \$84.0 million, or \$2.29 per diluted share, compared to an adjusted consolidated net income of \$26.5 million, or \$0.72 per share, in the second quarter of 2009.

(in millions except per-share amounts)	2010		Three Months Ended June 30, 2009	
	Dollars	Diluted EPS	Dollars	Diluted EPS
Net income and diluted EPS, excluding noted items	\$84.0	\$2.29	\$26.5	\$0.72
New pilot contract transition costs, net of tax	-	-	(22.3 )	(0.61 )
Fleet transition costs - CRJ-700, net of tax	(2.1 )	(0.06 )	-	-
Mark-to-market fuel hedge adjustments, net of tax	(23.3 )	(0.63 )	24.9	0.68
Net income and diluted EPS as reported	\$58.6	\$1.60	\$29.1	\$0.79

Our consolidated results are primarily driven by the results of our two operating carriers. Alaska reported pretax income of \$96.5 million in the second quarter of 2010, while Horizon reported a pretax loss of \$1.2 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 millions):	Three Months Ended June 30			Six Months Ended June 30		
	2010	2009	% Change	2010	2009	% Change
<b>Operating Revenues:</b>						
Passenger	\$ 702.3	\$ 602.5	16.6	\$ 1,289.3	\$ 1,142.3	12.9
Freight and mail	26.9	24.2	11.2	48.9	42.5	15.1
Other - net	60.2	54.9	9.7	112.3	88.1	27.5
<b>Total mainline operating revenues</b>	<b>789.4</b>	<b>681.6</b>	<b>15.8</b>	<b>1,450.5</b>	<b>1,272.9</b>	<b>14.0</b>
Passenger - purchased capacity	83.1	67.7	22.7	159.6	129.5	23.2
<b>Total Operating Revenues</b>	<b>872.5</b>	<b>749.3</b>	<b>16.4</b>	<b>1,610.1</b>	<b>1,402.4</b>	<b>14.8</b>
<b>Operating Expenses:</b>						
Wages and benefits	190.9	198.4	(3.8 )	382.1	395.8	(3.5 )
Variable incentive pay	17.9	16.1	11.2	32.7	23.2	40.9
Aircraft fuel, including hedging gains and losses	214.5	107.4	99.7	386.2	239.3	61.4
Aircraft maintenance	40.0	46.6	(14.2 )	82.1	92.9	(11.6 )
Aircraft rent	24.3	28.1	(13.5 )	50.2	54.6	(8.1 )
Landing fees and other rentals	43.1	40.6	6.2	84.8	81.4	4.2
Contracted services	31.5	28.4	10.9	62.1	58.9	5.4
Selling expenses	30.7	28.3	8.5	57.4	47.4	21.1
Depreciation and amortization	47.6	44.2	7.7	93.3	87.5	6.6
Food and beverage service	13.7	11.9	15.1	25.5	22.9	11.4
Other	36.7	38.5	(4.7 )	71.5	81.3	(12.1 )
New pilot contract transition costs	-	35.8	NM	-	35.8	NM
<b>Total mainline operating expenses</b>	<b>690.9</b>	<b>624.3</b>	<b>10.7</b>	<b>1,327.9</b>	<b>1,221.0</b>	<b>8.8</b>
Purchased capacity costs	74.3	68.9	7.8	146.8	131.6	11.6
<b>Total Operating Expenses</b>	<b>765.2</b>	<b>693.2</b>	<b>10.4</b>	<b>1,474.7</b>	<b>1,352.6</b>	<b>9.0</b>
<b>Operating Income</b>	<b>107.3</b>	<b>56.1</b>		<b>135.4</b>	<b>49.8</b>	
Interest income	9.5	9.5		18.1	19.6	
Interest expense	(23.5 )	(22.1 )		(45.6 )	(45.1 )	

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

Interest capitalized	1.6	1.8		3.3	4.3	
Other - net	1.6	(3.2 )		2.5	(4.8 )	
	(10.8 )	(14.0 )		(21.7 )	(26.0 )	

Income Before Income Tax	\$ 96.5	\$ 42.1		\$ 113.7	\$ 23.8	
-----------------------------	---------	---------	--	----------	---------	--

Mainline Operating  
Statistics:

Revenue passengers (000)	4,170	3,983	4.7	7,811	7,556	3.4
RPMs (000,000) "traffic"	5,072	4,613	10.0	9,544	8,792	8.6
ASMs (000,000) "capacity"	6,112	5,852	4.4	11,653	11,372	2.5
Passenger load factor	83.0 %	78.8 %	4.2pts	81.9 %	77.3 %	4.6pts
Yield per passenger mile	13.85 ¢	13.06 ¢	6.0	13.51 ¢	12.99 ¢	4.0
Operating revenue per ASM (RASM)	12.92 ¢	11.65 ¢	10.9	12.45 ¢	11.19 ¢	11.3
Passenger revenue per ASM (PRASM)	11.49 ¢	10.30 ¢	11.6	11.06 ¢	10.04 ¢	10.2
Operating expenses per ASM (CASM)	11.30 ¢	10.67 ¢	5.9	11.40 ¢	10.74 ¢	6.1
CASM, excluding fuel and pilot contract transition costs	7.79 ¢	8.22 ¢	(5.2 )	8.08 ¢	8.32 ¢	(2.9 )
Aircraft fuel cost per gallon	\$ 2.70	\$ 1.41	91.5	\$ 2.55	\$ 1.60	59.4
Economic fuel cost per gallon	\$ 2.30	\$ 1.84	25.0	\$ 2.28	\$ 1.88	21.3
Fuel gallons (000,000)	79.6	76.5	4.1	151.9	149.8	1.4
Average number of full-time equivalent employees	8,621	8,937	(3.5 )	8,579	8,979	(4.5 )
Aircraft utilization (blk hrs/day)	10.0	9.9	1.0	9.7	9.9	(2.0 )
Average aircraft stage length (miles)	1,076	1,020	5.5	1,072	1,018	5.3
Operating fleet at period-end	116	116	0 a/c	116	116	0 a/c

Purchased Capacity

Operating Statistics:

RPMs (000,000)	284	264	7.6	555	479	15.9
ASMs (000,000)	376	359	4.7	745	675	10.4
Passenger load factor	75.5 %	73.5 %	2.0pts	74.5 %	71.0 %	3.5pts
Yield per passenger mile	29.26 ¢	25.64 ¢	14.1	28.76 ¢	27.04 ¢	6.4



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

RASM	22.10 ¢	18.86 ¢	17.2	21.42 ¢	19.19 ¢	11.6
CASM	19.76 ¢	19.19 ¢	3.0	19.70 ¢	19.50 ¢	1.0

NM = Not  
Meaningful

Table of Contents

## ALASKA AIRLINES

Alaska reported income before income taxes of \$96.5 million during the second quarter of 2010 compared to \$42.1 million in the second quarter of 2009.

Excluding the mark-to-market adjustments in each period as noted in the table below, Alaska would have reported pretax income of \$128.1 million in the second quarter of 2010, compared to a pretax income of \$44.9 million in the same period of 2009.

(in millions)	Three Months Ended June	
	2010	2009
Income before income taxes, excluding items below	\$ 128.1	\$ 44.9
New pilot contract transition costs	-	(35.8 )
Mark-to-market fuel hedge adjustments	(31.6 )	33.0
Income before income taxes as reported	\$ 96.5	\$ 42.1

## ALASKA REVENUES

Total operating revenues increased \$123.2 million, or 16.4%, during the second quarter of 2010 as compared to the same period in 2009. The changes are summarized in the following table:

(in millions)	Three Months Ended June 30		
	2010	2009	% Change
Passenger revenue - mainline	\$ 702.3	\$ 602.5	16.6
Freight and mail	26.9	24.2	11.2
Other - net	60.2	54.9	9.7
Total mainline revenues	\$ 789.4	\$ 681.6	15.8
Passenger revenue - purchased capacity	83.1	67.7	22.7
Total operating revenues	\$ 872.5	\$ 749.3	16.4

## Operating Revenues – Mainline

Mainline passenger revenue increased 16.6% on a 4.4% increase in capacity and an 11.6% increase in passenger revenue per available seat mile (PRASM). The increase in PRASM was driven by a 6% increase in yield and a 4.2-point increase in load factor. Chronologically through the quarter, PRASM increased 11.4% in April, 13.3% in May, and 10.7% in June, compared with 2009.

Our load factor in July 2010 was 87.4%, compared to 84.3% in July 2009. Our advance bookings currently suggest that load factors will be up approximately 1 ½ points in August and September, and nearly three points in October compared to the same periods in the prior year.

Ancillary revenue included in passenger revenue increased from \$24.7 million in the second quarter of 2009 to \$43.6 million in the second quarter of 2010. The increase is primarily due to the implementation of a first checked bag fee in the third quarter of 2009. Revenue from the first bag charge for mainline operations was \$19.9 million in the second quarter of 2010. We do not expect significant year-over-year increases in ancillary revenues in the last six months of

2010 as we have now annualized our first bag charge.

25

---

Table of Contents

Freight and mail revenue increased by \$2.7 million, or 11.2%, primarily as a result of higher mail volumes and yields, higher freight yields and higher fuel and security surcharges, partially offset by lower freight volumes due to a slower fishing season in Alaska.

Other – net revenues increased \$5.3 million, or 9.7%. 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.

**Passenger Revenue – Purchased Capacity**

Passenger revenue – purchased capacity increased by \$15.4 million to \$83.1 million because of a 4.7% increase in capacity and a 17.2% increase in unit revenues compared to the prior year. Unit revenues have increased as a result of a two-point increase in load factor and a 14.1% increase in yield. The increase in yield was supported partially by \$3.1 million revenue from the first bag service charge.

**ALASKA EXPENSES**

For the quarter, total operating expenses increased \$72.0 million compared to the same period in 2009 mostly as a result of an increase in fuel expense, partially offset by the lack of new pilot contract transition costs recorded in the prior-year period. 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 March 31		
	2010	2009	% Change
Mainline fuel expense	\$ 214.5	\$ 107.4	99.7
Mainline non-fuel expenses	476.4	516.9	(7.8 )
Mainline operating expenses	690.9	624.3	10.7
Purchased capacity costs	74.3	68.9	7.8
Total Operating Expenses	\$ 765.2	\$ 693.2	10.4

**Mainline Operating Expenses**

Total mainline operating costs for the second quarter of 2010 increased \$66.6 million compared to the same period of 2009. Significant individual expense variances from the second quarter of 2009 are described more fully below.

**Wages and Benefits**

Wages and benefits declined \$7.5 million, or 3.8%, compared to the second quarter of 2009. The components of wages and benefits are shown in the following table:

(in millions)	Three Months Ended June 30		
	2010	2009	% Change
Wages	\$ 134.6	\$ 133.8	0.6
Pension and defined-contribution retirement benefits	20.9	29.2	(28.4 )
Medical benefits	22.8	21.4	6.5
Other benefits and payroll taxes	12.6	14.0	(10.0 )
Total wages and benefits	\$ 190.9	\$ 198.4	(3.8 )



Table of Contents

Wages increased 0.6% on a 3.5% reduction in full-time equivalent employees (FTE) compared to the second 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 28.4% decline in pension and other retirement-related benefits is primarily due to a \$10.7 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. The defined-benefit pension plan is now closed to all new entrants

Medical benefits increased 6.5% from the prior-year period primarily as a result of generally higher healthcare costs.

We expect wages and benefits to be relatively flat in the last half of 2010 compared to the last half of 2009 for reasons mentioned above.

**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 \$107.1 million, or 99.7%, compared to the second quarter of 2009. The elements of the change are illustrated in the following table:

(in millions, except per-gallon amounts)	Three Months Ended June 30		
	2010	2009	% Change
Fuel gallons consumed	79.6	76.5	4.1
Raw price per gallon	\$2.36	\$1.73	36.4
Total raw fuel expense	\$187.6	\$132.3	41.8
Net impact on fuel expense from (gains) and losses arising from fuel-hedging activities	26.9	(24.9 )	NM
Aircraft fuel expense	\$214.5	\$107.4	99.7

Fuel gallons consumed increased by 4.1% primarily as a result of a 4.4% increase in capacity, partially offset by longer average aircraft stage lengths as we continue to add more capacity to long-haul routes such as Hawaii.

The raw fuel price per gallon increased by 36.4% 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. The realized gains or losses include any cash settlement paid to or received from the hedge counterparties and the recognition of any premiums originally paid for the settled contracts. 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 June 30		
	2010	2009	% Change
Raw fuel expense	\$187.6	\$132.3	41.8
Plus or minus: net of cash received from settled hedges and premium expense recognized	(4.7 )	8.1	NM
Economic fuel expense	\$182.9	\$140.4	30.3
Fuel gallons consumed	79.6	76.5	4.1
Economic fuel cost per gallon	\$2.30	\$1.84	25.0

NM = Not meaningful

As noted in the above table, the total net benefit recognized for hedges that settled during the period was \$4.7 million in the second quarter of 2010, compared to a net expense of \$8.1 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.

#### Aircraft Maintenance

Aircraft maintenance decreased by \$6.6 million, or 14.2%, compared to the prior-year quarter because of fewer maintenance events and lower component costs, partially offset by higher costs associated with the return of leased aircraft. The number of events is mostly due to timing and we expect that the full-year maintenance expense will be slightly higher than in 2009.

#### Aircraft Rent

Aircraft rent declined \$3.8 million, or 13.5%, compared with the 2009 second quarter. The decrease is due to the removal of four leased aircraft from our operations since June 2009.

#### Depreciation and Amortization

Depreciation and amortization expense increased by \$3.4 million from the same period in 2009 primarily as a result of the delivery of four new B737-800 aircraft in the second quarter of 2010 and four aircraft late in the second quarter of 2009.



Table of Contents

## New Pilot Contract Transition Costs

During the second quarter of 2009, 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.

## Mainline Unit Costs per Available Seat Mile

Our mainline operating costs per ASM are summarized below:

	Three Months Ended June 30		
	2010	2009	% Change
Total mainline operating expenses per ASM (CASM)	11.30 ¢	10.67 ¢	5.9
Less the following components:			
Aircraft fuel cost per ASM	3.51 ¢	1.84 ¢	90.8
New pilot contract transition costs per ASM	-	0.61 ¢	NM
CASM, excluding fuel and noted items	7.79 ¢	8.22 ¢	(5.2 )

NM = Not Meaningful

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.
- CASM excluding fuel and certain special items is one of the most important measures used by management of both Alaska and Horizon and by the board of directors in assessing quarterly and annual cost performance. For Alaska Airlines, 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.
  - CASM excluding fuel (and other items as specified in our plan documents) is an important metric for the employee incentive plan that covers the majority of our employees.
- CASM 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.
- Although we disclose our "mainline" passenger unit revenues for Alaska, we do not (nor are we able to) evaluate mainline unit revenues excluding the impact that changes in fuel costs have had on ticket



Table of Contents

prices. Fuel expense represents a large percentage of our total mainline operating expenses. Fluctuations in fuel prices often drive changes in unit revenues 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.

We currently forecast our mainline CASM, excluding fuel and other special items, to be down approximately 3% - 4% for both the third quarter and full year of 2010 compared to 2009.

**Purchased Capacity Costs**

Purchased capacity costs increased \$5.4 million, or 7.8%, compared to the second quarter of 2009. Of the total, \$67.4 million was paid to Horizon under the CPA for 356 million ASMs, a capacity increase of 4.7% from the second quarter of 2009. This expense is eliminated in consolidation.

Table of ContentsHorizon Air Financial and Statistical  
Data (unaudited)

Financial Data (in millions):	Three Months Ended June 30			Six Months Ended June 30		
	2010	2009	% Change	2010	2009	% Change
<b>Operating Revenues:</b>						
Passenger - brand flying	\$ 100.9	\$ 91.7	10.0	\$ 190.2	\$ 178.3	6.7
Passenger - Alaska capacity purchase arrangement	67.4	63.5	6.1	133.8	121.3	10.3
Total passenger revenue	168.3	155.2	8.4	324.0	299.6	8.1
Freight and mail	0.7	0.6	16.7	1.3	1.3	-
Other - net	2.1	2.1	0.0	4.2	3.8	10.5
<b>Total Operating Revenues</b>	<b>171.1</b>	<b>157.9</b>	<b>8.4</b>	<b>329.5</b>	<b>304.7</b>	<b>8.1</b>
<b>Operating Expenses:</b>						
Wages and benefits	46.0	46.2	(0.4 )	91.4	92.6	(1.3 )
Variable incentive pay	3.7	2.8	32.1	6.8	5.0	36.0
Aircraft fuel, including hedging gains and losses	40.5	21.0	92.9	76.1	46.8	62.6
Aircraft maintenance	13.8	13.0	6.2	28.7	26.4	8.7
Aircraft rent	11.1	11.0	0.9	22.2	22.5	(1.3 )
Landing fees and other rentals	15.1	14.1	7.1	29.6	27.8	6.5
Contracted services	8.2	7.9	3.8	16.5	15.4	7.1
Selling expenses	7.5	7.0	7.1	14.4	12.9	11.6
Depreciation and amortization	10.1	9.4	7.4	20.3	18.6	9.1
Food and beverage service	0.6	0.5	20.0	1.1	1.1	-
Other	7.5	8.6	(12.8 )	17.0	19.6	(13.3 )
Fleet transition costs - CRJ-700	3.4	-	NM	3.4	-	NM
Fleet transition costs - Q200	-	5.2	NM	-	10.0	NM
<b>Total Operating Expenses</b>	<b>167.5</b>	<b>146.7</b>	<b>14.2</b>	<b>327.5</b>	<b>298.7</b>	<b>9.6</b>
<b>Operating Income</b>	<b>3.6</b>	<b>11.2</b>		<b>2.0</b>	<b>6.0</b>	
Interest income	1.0	0.6		1.5	1.0	
Interest expense	(5.6 )	(5.2 )		(10.7 )	(11.1 )	

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

Interest capitalized	0.0	0.0		-	0.3	
Other - net	(0.2 )	(0.1 )		(0.2 )	(0.2 )	
	(4.8 )	(4.7 )		(9.4 )	(10.0 )	
Income (Loss) Before Income Tax	\$ (1.2 )	\$ 6.5		\$ (7.4 )	\$ (4.0 )	
Combined Operating Statistics: (a)						
Revenue passengers (000)	1,705	1,694	0.6	3,289	3,240	1.5
RPMs (000,000) "traffic"	623	609	2.3	1,189	1,133	4.9
ASMs (000,000) "capacity"	833	828	0.6	1,626	1,615	0.7
Passenger load factor	74.8 %	73.6 %	1.2pts	73.1 %	70.2 %	2.9pts
Yield per passenger mile	27.01 ¢	25.48 ¢	6.0	27.25 ¢	26.44 ¢	3.1
Operating revenue per ASM (RASM)	20.54 ¢	19.07 ¢	7.7	20.26 ¢	18.87 ¢	7.4
Passenger revenue per ASM (PRASM)	20.20 ¢	18.74 ¢	7.8	19.93 ¢	18.55 ¢	7.4
Operating expenses per ASM (CASM)	20.11 ¢	17.72 ¢	13.5	20.14 ¢	18.50 ¢	8.9
CASM, excluding fuel and CRJ-700 fleet transition costs	14.84 ¢	15.18 ¢	(2.2 )	15.25 ¢	15.60 ¢	(2.2 )
Q200 fleet transition costs per ASM	-	0.63 ¢	NM	-	0.62 ¢	NM
Aircraft fuel cost per gallon	\$ 2.76	\$ 1.41	95.7	\$ 2.64	\$ 1.58	67.1
Economic fuel cost per gallon	\$ 2.35	\$ 1.86	26.3	\$ 2.32	\$ 1.87	24.1
Fuel gallons (000,000)	14.7	15.0	(2.0 )	28.9	29.5	(2.0 )
Average number of full-time equivalent employees	3,096	3,308	(6.4 )	3,128	3,345	(6.5 )
Aircraft utilization (blk hrs/day)	7.9	8.3	(4.8 )	7.8	8.3	(6.0 )
Operating fleet at period-end	57	55	2 a/c	57	55	2 a/c

NM = Not  
Meaningful

Table of Contents**HORIZON AIR**

Horizon reported a loss before income taxes of \$1.2 million during the second quarter of 2010 compared to income of \$6.5 million in 2009. The \$7.7 million decline is primarily due to higher aircraft fuel, partially offset by an increase in operating revenues.

Excluding the mark-to-market adjustments in each period as noted in the table below and the CRJ-700 fleet transition costs in 2010, Horizon would have reported pretax income of \$8.2 million in the second quarter of 2010, compared to a pretax loss of \$0.3 million in the same period of 2009.

(in millions)	Three Months Ended June 30	
	2010	2009
Income (loss) before income taxes, excluding items below	\$ 8.2	\$ (0.3 )
Fleet transition costs - CRJ-700	(3.4 )	-
Mark-to-market fuel hedge adjustments	(6.0 )	6.8
Income (loss) before income taxes as reported	\$ (1.2 )	\$ 6.5

**HORIZON REVENUES**

For the second quarter of 2010, operating revenues increased \$13.2 million, or 8.4%, compared to 2009. Horizon's passenger revenues are summarized in the table below:

(dollars in millions)	Three Months Ended June 30			
	2010		2009	
	Revenues	% ASMs	Revenues	% ASMs
Passenger revenue from Horizon "brand" flying	\$100.9	57	\$91.7	59
Revenue from CPA with Alaska	67.4	43	63.5	41
Total Passenger revenue and % of ASMs	\$168.3	100	\$155.2	100

Line-of-business information is presented in the table below. In the CPA arrangement, 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 arrangement are not presented.

	Three Months Ended June 30, 2010										
	Capacity and Mix			Load Factor		Yield		RASM			
	2010	2009	Change Y-O-Y	Current	Point	Change Y-O-Y	Change Y-O-Y	Actual (in millions)	Change Y-O-Y	Actual (in millions)	Change Y-O-Y
	Actual (in millions)	Actual (in millions)		% Total	% Change						
Brand Flying	477	488	(2.3 %)	57	73.1 %	0.2	28.91 ¢	12.2 %	21.74 ¢	12.4 %	
Alaska CPA	356	340	4.7 %	43	NM	NM	NM	NM	18.97 ¢	1.5 %	
System Total	833	828	0.6 %	100	74.8 %	1.2	27.01 ¢	6.0 %	20.54 ¢	7.7 %	

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 \$9.2 million, or 10.0%, on a 12.6% increase in PRASM, partially offset by a 2.3% reduction in brand capacity. The increase in PRASM is primarily due to a 12.2% increase in yield on relatively flat load factor in those markets.



Table of Contents

Revenue from the CPA with Alaska totaled \$67.4 million during the second quarter of 2010 compared to \$63.5 million in the second quarter of 2009. The increase is primarily due to a 4.7% increase 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 to closer to market rates. This revenue is eliminated in consolidation.

**HORIZON EXPENSES**

Total operating expenses increased \$20.8 million, or 14.2%, 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 \$19.5 million, or 92.9%, compared to the second quarter of 2009. The elements of the change are illustrated in the following table:

(in millions, except per-gallon amounts)	Three Months Ended June 30		
	2010	2009	% Change
Fuel gallons consumed	14.7	15.0	(2.0 )
Raw price per gallon	\$ 2.40	\$ 1.75	37.1
Total raw fuel expense	\$ 35.3	\$ 26.2	34.7
Impact on fuel expense from (gains) and losses arising from fuel-hedging activities	5.2	(5.2 )	NM
Aircraft fuel expense	\$ 40.5	\$ 21.0	92.9

The raw fuel price per gallon increased by 34.7% 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 June 30		
	2010	2009	% Change
Raw fuel expense	\$35.3	\$26.2	34.7
Plus or minus: net of cash received from settled hedges and premium expense recognized	(0.8 )	1.6	NM
Economic fuel expense	\$34.5	\$27.8	24.1
Fuel gallons consumed	14.7	15.0	(2.0 )
Economic fuel cost per gallon	\$2.35	\$1.86	26.3

NM = Not meaningful

As noted in the table above, the total net benefit recognized for hedges that settled during the period was \$0.8 million in the second quarter of 2010, compared to a net expense of \$1.6 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 full year of 2010 than for 2009 because of higher jet fuel prices.



Table of Contents

## Fleet Transition Costs

We recorded \$3.4 million during the second quarter of 2010 related to the removal of a CRJ-700 aircraft from our operations through a sublease to a third-party carrier. We expect to record additional expenses related to the sublease of four CRJ-700 aircraft in the third quarter. At this time, we estimate the charge in the third quarter will be approximately \$7 million to \$9 million.

During the second quarter of 2009, fleet transition costs associated with the removal of Q200 aircraft from the operating fleet were \$5.2 million.

## Operating Costs per Available Seat Mile (CASM)

Our operating costs per ASM are summarized below:

	Three Months Ended June 30		
	2010	2009	% Change
Total operating expenses per ASM (CASM)	20.11 ¢	17.72 ¢	13.5
Less the following components:			
Aircraft fuel cost per ASM	4.86 ¢	2.54 ¢	91.3
CRJ-700 fleet transition costs per ASM	0.41 ¢	-	NM
CASM, excluding fuel and CRJ-700 fleet transition costs	14.84 ¢	15.18 ¢	(2.2 )
Q-200 fleet transition costs per ASM	-	0.63 ¢	NM
CASM, excluding fuel and all fleet transition costs	14.84 ¢	14.55 ¢	2.0

We currently forecast our CASM, excluding fuel and fleet transition costs, to be up 5% for the third quarter and flat to down 1% for the full year compared to 2009.

## CONSOLIDATED NONOPERATING INCOME (EXPENSE)

Net nonoperating expense was \$15.9 million in the second quarter of 2010 compared to \$19.0 million for the same period of 2009. Interest expense increased \$1.2 million primarily resulting from the write off of deferred financing costs and prepayment penalties on our prepayment of two aircraft debt instruments, partially offset by lower interest rates on our variable-rate debt and a lower average debt balance. Other – net nonoperating income (expense) improved by \$4.7 million compared to the prior-year period primarily due to larger realized gains on the sale of marketable securities.

## CONSOLIDATED INCOME TAX EXPENSE

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

## COMPARISON OF SIX MONTHS ENDED JUNE 30, 2010 TO SIX MONTHS ENDED JUNE 30, 2009

Our consolidated net income for the six months ended June 30, 2010 was \$63.9 million, or \$1.74 per diluted share, compared to net income of \$9.9 million, or \$0.27 per diluted share, for the first six 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 six months of 2010, we recognized net mark-to-market losses of \$50.1 million

(\$31.1 million after tax, or \$0.85 per share), compared to net gains of \$49.8 million (\$31.1 million after tax, or \$0.85 per share) in the same period of 2009.

Table of Contents

- The first six months of 2010 include CRJ-700 fleet transition costs of \$3.4 million (\$2.1 million after tax, or \$0.06 per share).
- The first six months of 2009 include new pilot contract transition costs of \$35.8 million (\$22.3 million after tax, or \$0.61 per share) discussed previously.

Excluding the mark-to-market adjustments and other noted items, and as shown in the following table, our consolidated net income for the first six months of 2010 was \$97.1 million, or \$2.65 per diluted share, compared to an adjusted consolidated net income of \$1.1 million, or \$0.03 per share, in the first six months of 2009.

(in millions except per-share amounts)	Six Months Ended June 30,			
	2010		2009	
	Dollars	Diluted EPS	Dollars	Diluted EPS
Net income and diluted EPS, excluding noted items	\$97.1	\$2.65	\$1.1	\$0.03
New pilot contract transition costs, net of tax	-	-	(22.3 )	(0.61 )
Fleet transition costs - CRJ-700, net of tax	(2.1 )	(0.06 )	-	-
Mark-to-market fuel hedge adjustments, net of tax	(31.1 )	(0.85 )	31.1	0.85
Net income and diluted EPS as reported	\$63.9	\$1.74	\$9.9	\$0.27

**ALASKA AIRLINES**

Alaska reported income before income taxes of \$113.7 million during the first six months of 2010 compared to \$23.8 million in the first six 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 would have reported pretax income of \$154.6 million in the first six months of 2010, compared to pretax income of \$18.3 million in the same period of 2009.

(in millions)	Six Months Ended June 30	
	2010	2009
Income before income taxes, excluding items below	\$ 154.6	\$ 18.3
New pilot contract transition costs	-	(35.8 )
Mark-to-market fuel hedge adjustments	(40.9 )	41.3
Income before income taxes as reported	\$ 113.7	\$ 23.8

Table of Contents

## ALASKA REVENUES

Total operating revenues increased \$207.7 million, or 14.8%, during the first six months of 2010 compared to the same period in 2009. The changes are summarized in the following table:

(in millions)	Six Months Ended June 30		
	2010	2009	% Change
Passenger revenue - mainline	\$ 1,289.3	\$ 1,142.3	12.9
Freight and mail	48.9	42.5	15.1
Other - net	112.3	88.1	27.5
Total mainline revenues	\$ 1,450.5	\$ 1,272.9	14.0
Passenger revenue - purchased capacity	159.6	129.5	23.2
Total operating revenues	\$ 1,610.1	\$ 1,402.4	14.8

## Operating Revenues – Mainline

Mainline passenger revenue for the first six months of 2010 improved by 12.9% on a 2.5% increase in capacity and a 10.2% increase in PRASM compared to the first half of 2009. The increase in PRASM was driven by a 4% rise in ticket yield compared to the prior-year period and a 4.6-point increase in load factor.

Ancillary revenue included in passenger revenue increased from \$49.0 million in the first six months of 2009 to \$81.6 million in the current year. 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 \$6.4 million, or 15.1%, primarily as a result of higher volumes and yields and higher fuel and security surcharges.

Other – net revenues increased \$24.2 million, or 27.5%. Mileage Plan revenues increased by \$20.3 million primarily because of an increase in number of miles sold to our affinity card partner and a contractual rate increase for those sold miles.

## Passenger Revenue – Purchased Capacity

Passenger revenue - purchased capacity flying increased \$30.1 million over the same period last year because of a 10.4% rise in capacity combined with an 11.6% increase in unit revenue compared to the prior year.

Table of Contents

## ALASKA EXPENSES

For the six months ended June 30, 2010, total operating expenses increased \$122.1 million, or 9.0%, compared to the same period in 2009 mostly as a result of a 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)	Six Months Ended June 30		
	2010	2009	% Change
Mainline fuel expense	\$ 386.2	\$ 239.3	61.4
Mainline non-fuel expenses	941.7	981.7	(4.1 )
Mainline operating expenses	1,327.9	1,221.0	8.8
Purchased capacity costs	146.8	131.6	11.6
Total Operating Expenses	\$ 1,474.7	\$ 1,352.6	9.0

NM = Not Meaningful

## Mainline Operating Expenses

Total mainline operating expenses increased \$106.9 million, or 8.8%, during the first six months of 2010 compared to the same period last year. The increase was mostly due to the \$146.9 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 six months of 2009 are more fully described below.

## Wages and Benefits

Wages and benefits were down \$13.7 million, or 3.5 %, compared to the first six months of 2009. The primary components of wages and benefits are shown in the following table:

(in millions)	Six Months Ended June 30		
	2010	2009	% Change
Wages	\$ 268.3	\$ 268.5	(0.1 )
Pension and defined-contribution retirement benefits	42.1	58.4	(27.9 )
Medical benefits	44.5	40.3	10.4
Other benefits and payroll taxes	27.2	28.6	(4.9 )
Total wages and benefits	\$ 382.1	\$ 395.8	(3.5 )

Wages were flat on a 4.5% reduction in FTEs compared to the first six months of 2009. 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 27.9% decrease in pension and other retirement-related benefits is primarily due to a significant 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 with their new contract in 2009.

Table of Contents

Medical benefits increased 10.4% 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 generally higher healthcare costs.

## Variable Incentive Pay

Variable incentive pay expense increased from \$23.2 million in the first six months of 2009 to \$32.7 million in the same period of 2010. The increase is primarily due to the addition of mechanics and ramp service agents to the Air Group Performance-Based Pay Plan in the last half of 2009, not reflected in the expense for the first six 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 second quarter this year compared to where our expectations were at the end of the second quarter of 2009.

## Aircraft Fuel

Aircraft fuel expense increased \$146.9 million, or 61.4%, compared to the first six months of 2009. The elements of the change are illustrated in the following table:

(in millions, except per-gallon amounts)	Six Months Ended June 30		
	2010	2009	% Change
Fuel gallons consumed	151.9	149.8	1.4
Raw price per gallon	\$ 2.31	\$ 1.68	37.5
Total raw fuel expense	\$ 350.3	\$ 251.1	39.5
Net impact on fuel expense from (gains) and losses arising from fuel-hedging activities	35.9	(11.8 )	NM
Aircraft fuel expense	\$ 386.2	\$ 239.3	61.4

NM = Not Meaningful

Fuel gallons consumed increased 1.4%, primarily as a result of a 2.5% increase in capacity, partially offset by longer average aircraft stage lengths.

The raw fuel price per gallon increased 37.5% 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)	Six Months Ended June 30		
	2010	2009	% Change
Raw fuel expense	\$350.3	\$251.1	39.5
Plus or minus: net of cash received from settled hedges and premium expense recognized	(5.0 )	29.5	NM
Economic fuel expense	\$345.3	\$280.6	23.1
Fuel gallons consumed	151.9	149.8	1.4
Economic fuel cost per gallon	\$2.28	\$1.88	21.3

NM = Not meaningful

The total net benefit recognized for hedges that settled during the period was \$5.0 million in the first six months, compared to a net expense of \$29.5 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 \$10.8 million, or 11.6%, 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 \$4.4 million, or 8.1%, compared with the first six months of 2009. The decrease was the result of the return of four leased aircraft since June 2009.

Landing Fees and Other Rents

Landing fees and other rents increased \$3.4 million, or 4.2%, compared to the first two quarters of 2009. The increase is attributable to more passengers and 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 are working with other airports on ways to reduce costs.

Selling Expenses

Selling expenses increased by \$10.0 million, or 21.1%, compared to the first six 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 and average fares. We expect selling expenses to be higher in 2010 than in 2009 for these same reasons.

Depreciation and Amortization

Depreciation and amortization increased \$5.8 million, or 6.6%, compared to the first six months of 2009. This is primarily due to the additional B737-800 aircraft delivered in the first six months of 2010 and a full period of depreciation for aircraft delivered in the first half of 2009.

Other Operating Expenses

Other operating expenses declined \$9.8 million, or 12.1%, compared to the prior year. The decline is primarily driven by a reduction in professional services, lower de-icing costs stemming from a milder winter on the West Coast, lower personnel non-wage costs such as hotels, a decline in passenger inconvenience costs, and lower legal costs.

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:

	Six Months Ended June 30		
	2010	2009	% Change
Total mainline operating expenses per ASM (CASM)	11.40 ¢	10.74 ¢	6.1
Less the following components:			
Aircraft fuel cost per ASM	3.32 ¢	2.11 ¢	57.3
New pilot contract transition costs per ASM	-	0.31 ¢	NM
CASM, excluding fuel and noted items	8.08 ¢	8.32 ¢	(2.9 )

NM = Not Meaningful

## Purchased Capacity Costs

Purchased capacity costs increased \$15.2 million, from \$131.6 million for the first six months of 2009 to \$146.8 million for the six months ended June 30, 2010. Of the total, \$133.8 million was paid to Horizon under the CPA for 709 million ASMs. This expense is eliminated in consolidation.

## HORIZON AIR

Horizon reported a loss before income taxes of \$7.4 million during the first six months of 2010 compared to a loss of \$4.0 million in 2009. The decline in earnings is primarily due to higher aircraft fuel costs, partially offset by an increase in operating revenues.

Excluding the mark-to-market adjustments in each period and the CRJ-700 fleet transition charges in 2010 as noted in the table below, Horizon would have reported pretax income of \$5.2 million in the first six months of 2010, compared to a pretax loss of \$12.5 million in the same period of 2009.

(in millions)	Six Months Ended June 30	
	2010	2009
Income (loss) before income taxes, excluding items below	\$ 5.2	\$ (12.5 )
Fleet transition charges - CRJ-700	(3.4 )	-
Mark-to-market fuel hedge adjustments	(9.2 )	8.5
Loss before income taxes as reported	\$ (7.4 )	\$ (4.0 )

## HORIZON REVENUES

During the six months ended June 30, 2010, operating revenues increased \$24.8 million, or 8.1%, compared to 2009. Horizon's passenger revenues are summarized in the table below:

(dollars in millions)	Six Months Ended June 30			
	2010		2009	
	Revenues	% ASMs	Revenues	% ASMs
Passenger revenue from Horizon "brand" flying	\$190.2	56	\$178.3	60
Revenue from CPA with Alaska	133.8	44	121.3	40
Total Passenger revenue and % of ASMs	\$324.0	100	\$299.6	100



Table of Contents

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

	Six Months Ended June 30, 2010											
	Capacity and Mix			Load Factor			Yield			RASM		
	2010 Actual (in millions)	2009 Actual (in millions)	Change Y-O-Y	Current % Total	Actual %	Point Change Y-O-Y	Actual %	Change Y-O-Y	Actual %	Actual (in millions)	Change Y-O-Y	
Brand Flying	917	976	(6.0 %)	56	71.3 %	2.1	29.07 ¢	10.2 %	21.33 ¢	13.6 %		
Alaska CPA	709	639	11.0 %	44	NM	NM	NM	NM	18.89 ¢	(0.5 %)		
System Total	1,626	1,615	0.7 %	100	73.1 %	2.9	27.25 ¢	3.1 %	20.26 ¢	7.4 %		

NM = Not Meaningful

Passenger revenue from Horizon brand flying increased \$11.9 million, or 6.7%, on a 13.5% increase in passenger unit revenues, partially offset by a 6% decline in brand capacity. The increase in unit revenues is primarily due to a 2.1-point increase in brand load factor and a 10.2% improvement in yield in those markets.

Revenue from the CPA flying performed on behalf of Alaska totaled \$133.8 million during the first six months of 2010 compared to \$121.3 million in the first six months of 2009. The increase is primarily due to an 11% increase in capacity provided under this arrangement. This revenue is eliminated in consolidation.

**HORIZON EXPENSES**

Total operating expenses increased \$28.8 million, or 9.6%, 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 \$29.3 million, or 62.6%, compared to the same period in 2009. The elements of the change are illustrated in the following table:

(in millions, except per-gallon amounts)	Six Months Ended June 30		
	2010	2009	% Change
Fuel gallons consumed	28.9	29.5	(2.0 )
Raw price per gallon	\$ 2.35	\$ 1.67	40.7
Total raw fuel expense	\$ 67.8	\$ 49.3	37.5
Net impact on fuel expense from (gains) and losses arising from fuel-hedging activities	8.3	(2.5 )	NM
Aircraft fuel expense	\$ 76.1	\$ 46.8	62.6

NM = Not Meaningful

The raw fuel price per gallon increased by 40.7% 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)	Six Months Ended June 30		
	2010	2009	% Change
Raw fuel expense	\$67.8	\$49.3	37.5
Plus or minus: net of cash received from settled hedges and premium expense recognized	(0.9 )	6.0	NM
Economic fuel expense	\$66.9	\$55.3	21.0
Fuel gallons consumed	28.9	29.5	(2.0 )
Economic fuel cost per gallon	\$2.32	\$1.87	24.1

NM = Not meaningful

The total net benefit recognized for hedges that settled during the period was \$0.9 million, compared to a net expense of \$6.0 million in 2009. These amounts represent the net of the premium expense recognized for those hedges and any cash received or paid upon settlement.

**Fleet Transition Costs**

We recorded \$3.4 million in the first six months of 2010 related to the removal of a CRJ-700 aircraft from our operations through a sublease to a third-party carrier.

In the first six months of 2009, fleet transition costs associated with the removal of Q200 aircraft from the operating fleet was \$10.0 million as the six final Q200 aircraft were removed from operation.

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

	Six Months Ended June 30		
	2010	2009	% Change
Total operating expenses per ASM (CASM)	20.14 ¢	18.50 ¢	8.9
Less the following components:			
Aircraft fuel cost per ASM	4.68 ¢	2.90 ¢	61.4
CRJ-700 fleet transition costs per ASM	0.21 ¢	-	NM
CASM, excluding fuel and CRJ-700 fleet transition costs	15.25 ¢	15.60 ¢	(2.2 )
Q-200 fleet transition costs per ASM	-	0.62 ¢	NM
CASM, excluding fuel and all fleet transition costs	15.25 ¢	14.98 ¢	1.8

NM = Not Meaningful

**CONSOLIDATED NONOPERATING INCOME (EXPENSE)**

Net nonoperating expense was \$31.7 million in the first six months of 2010 compared to \$36.7 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.

**CONSOLIDATED INCOME TAX EXPENSE**

We provide for income taxes based on our estimate of the effective tax rate for the full year. Our effective income tax rate on pretax income for the first six months of 2010 was 38.7%, compared to 45.3% for the first six 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.

Table of Contents

## 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 plan to reduce our cash and marketable securities to 25% to 30% of revenues over the next two years, through debt repayment, share repurchases, pension funding, or a combination thereof. During the second quarter of 2010, we paid off the outstanding debt balances associated with two B737-800 aircraft, totaling approximately \$54 million and our Board authorized a new \$50 million share repurchase program. 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 combined with future cash flows from operations and other sources of liquidity will be more than adequate to fund our operations, meet our capital commitments and debt obligations for at least the next 12 months and would continue to be sufficient if we reduce our cash balance further as described above.

In our cash and marketable securities portfolio, we invest only in U.S. government securities, asset-backed obligations and corporate debt securities. We do not invest in equities or auction-rate securities. As of June 30, 2010, we had an \$18.6 million net unrealized gain associated with our cash and marketable securities balance.

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

	June 30, 2010	December 31, 2009	Change
(dollars in millions)			
Cash and marketable securities	\$ 1,272.7	\$ 1,192.1	\$ 80.6
Cash and marketable securities as a percentage of last twelve months revenue	35 %	35 %	--
Long-term debt, net of current portion	1,570.0	1,699.2	(129.2 )
Shareholders' equity	939.9	872.1	67.8
Long-term debt-to-capital assuming aircraft operating leases are capitalized at seven times annualized rent	73%: 27%	76%:24%	NA

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

Table of Contents

## ANALYSIS OF OUR CASH FLOWS

## Cash Provided by Operating Activities

During the first six months of 2010, net cash provided by operating activities was \$333.6 million, compared to \$123.2 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 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 \$239.9 million during the first six months of 2010, compared to \$462.6 million during the same period of 2009. Our capital expenditures were \$111.8 million, or \$196.7 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 six months of 2009.

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

	Aircraft-related	Non-aircraft	Total
Alaska	\$ 126	\$ 75	\$ 201
Horizon	4	5	9
Total Air Group	\$ 130	\$ 80	\$ 210

Currently, we expect to have gross aircraft capital expenditures of approximately \$110 million and \$180 million in 2011 and 2012, respectively, which is significantly less than the average over the past several years. We believe this will allow us to apply more of our operating cash flow to reduce our outstanding debt balance and decrease our leverage.

## Cash Provided by Financing Activities

Net cash used for financing activities was \$149.8 million during the first six months of 2010 compared to cash provided by financing activities of \$219.6 million during the same period of 2009. The decrease 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.

## 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.

Table of Contents

## 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, Commitments and Off-Balance Sheet Arrangements

## Aircraft Purchase Commitments

We have firm orders to purchase 21 aircraft requiring future aggregate payments of approximately \$571 million, as set forth below. Alaska recently converted two options into firm orders for B737-800 aircraft to be delivered in 2012. Alaska has remaining options to acquire 38 additional B737s and Horizon has options to acquire 10 Q400s.

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

## Delivery Period - Firm Orders

Aircraft	July 1 – December 31, 2010	2011	2012	2013	2014	2015	Total
Boeing 737-800	-	3	4	2	2	2	13
Bombardier Q400	-	-	4	4	-	-	8
<b>Total</b>	<b>-</b>	<b>3</b>	<b>8</b>	<b>6</b>	<b>2</b>	<b>2</b>	<b>21</b>
Payments (in millions)	\$ 46.1	\$ 112.1	\$ 182.4	\$ 143.1	\$ 55.1	\$ 32.2	\$ 571.0

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.

## 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 June 30, 2010.

(in millions)	July 1 – Dec. 31, 2010	2011	2012	2013	2014	Beyond 2014	Total
Current and long-term debt obligations	\$ 76.0	\$ 185.5	\$ 230.3	\$ 189.8	\$ 156.6	\$ 886.1	\$ 1,724.3
Operating lease commitments (1)	81.9	216.8	216.4	158.4	140.6	425.5	1,239.6
Aircraft purchase commitments	46.1	112.1	182.4	143.1	55.1	32.2	571.0
Interest obligations (2)	46.1	95.4	85.2	70.4	59.4	179.0	535.5
Other purchase obligations (3)	36.1	51.9	52.2	42.2	54.3	--	236.7
<b>Total</b>	<b>\$ 286.2</b>	<b>\$ 661.7</b>	<b>\$ 766.5</b>	<b>\$ 603.9</b>	<b>\$ 466.0</b>	<b>\$ 1,522.8</b>	<b>\$ 4,307.1</b>

(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 two leased MD-80 aircraft, 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. Subsequent to June 30, 2010, we have disposed of two additional CRJ-700 aircraft under lease assignments and we have arranged to terminate the leases on the two MD-80 aircraft.



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

Table of Contents

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 does plan to contribute approximately \$45 million to the plans in 2010.

Effect of Inflation - Inflation and price changes other than for aircraft fuel and passenger fares do not have a significant effect on our operating revenues, operating expenses and operating income.

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 2009 10-K 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 June 30, 2010 would increase or decrease the fair value of our crude oil hedge portfolio by approximately \$33.0 million and \$25.7 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.

Financial Market Risk

In this current economic environment, significant volatility in market values and interest rates is common. 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 currently 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 June 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,

Table of Contents

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 June 30, 2010.

## Changes in Internal Control over Financial Reporting

We made no changes in our internal control over financial reporting during the quarter ended June 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.

## ITEM 1A. RISK FACTORS

In addition to the other information set forth in this report, you should carefully consider the factors discussed in Part I, "Item 1A. Risk Factors" in our Annual Report on Form 10-K for the year ended December 31, 2009, 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.

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

	Total number of shares purchased	Average price paid per share	Maximum approximate remaining dollar value of shares that can be repurchased under the plan (2)
Issuer Purchases of Equity Securities			
February 11, 2010 – February 28, 2010 (1)	72,000	\$34.39	
March 1, 2010 – March 31, 2010 (1)	206,900	38.76	
April 1, 2010 – April 30, 2010 (1)	189,000	42.34	
May 1, 2010 – May 28, 2010 (1)	177,848	43.72	
Total	645,748	\$40.69	\$50,000,000

(1) Purchased pursuant to a \$50 million repurchase plan authorized by the Board of Directors in June 2009. The plan expired in June 2010.

(2) Pursuant to a \$50 million repurchase plan authorized by the Board of Directors in June 2010. No purchases had been made as of June 30, 2010. The plan expires in June 2011.

Table of Contents

ITEM DEFAULTS UPON SENIOR SECURITIES

3.

None.

ITEM 4. SUBMISSION OF MATTERS TO A VOTE OF SECURITY HOLDERS

The Company's Annual Meeting of Stockholders was held on May 18, 2010. Results of the voting on the proposals were included in the Company's Form 8-K filed on May 21, 2010.

ITEM 5. OTHER INFORMATION

None.

ITEM 6. EXHIBITS

See Exhibit Index on page 49.

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: August 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>10.1*</u>	<u>Agreement, dated as of July 30, 2010, between Alaska Air Group, Inc. and Glenn Johnson</u>
<u>10.2</u>	<u>Agreement, dated as of June 9, 2010, between Horizon Air Industries, Inc. and Jeff Pinneo (filed as Exhibit 10.1 to Registrant's Current Report on Form 8-K, filed on June 14, 2010 and incorporated herein by reference.)</u>
<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.

