THOMSON REUTERS STREETEVENTS

EDITED TRANSCRIPT

ALK - Q1 2015 Alaska Air Group Inc Earnings Call

EVENT DATE/TIME: APRIL 23, 2015 / 3:30PM GMT

OVERVIEW:

Co. reported 1Q15 earnings (adjusted pre-tax basis) of $240m, net profit of $149m and diluted EPS of $1.12.

THOMSON REUTERS

CORPORATE PARTICIPANTS

Lavanya Sareen *Alaska Air Group Inc - Managing Director of IR*

Brad Tilden *Alaska Air Group Inc - CEO*

Andrew Harrison *Alaska Air Group Inc - Chief Revenue Officer*

Brandon Pedersen *Alaska Air Group Inc - CFO*

Mark Eliasen *Alaska Air Group Inc - VP Finance and Treasurer*

Ben Minicucci *Alaska Air Group Inc - COO and EVP Operations*

CONFERENCE CALL PARTICIPANTS

Savi Syth *Raymond James & Associates, Inc. - Analyst*

Hunter Keay *Wolfe Research - Analyst*

Joe DeNardi *Stifel Nicolaus - Analyst*

Duane Pfennigwerth *Evercore ISI - Analyst*

Helane Becker *Cowen and Company - Analyst*

Jamie Baker *JPMorgan - Analyst*

Darryl Genovesi *UBS Securities LLC - Analyst*

David Fintzen *Barclays Capital - Analyst*

Mike Linenberg *Deutsche Bank - Analyst*

Dan McKenzie *Buckingham Research Group - Analyst*

George Ferguson *Bloomberg Intelligence - Analyst*

Tom Banse *KUOW Radio Seattle - Analyst*

PRESENTATION

Operator

Good morning. My name is Laurel, and I will be your conference operator today. At this time, I would like to welcome everyone to the Alaska Air Group first quarter 2015 earnings conference call. Today's call is being recorded, and will be accessible for future playback at www.alaskaair.com. All lines have been placed on mute to prevent any background noise. After the speakers' remarks, there will be a question-and-answer session for analysts and journalists.

(Operator Instructions)

Thank you. I'd now like to turn the call over to Alaska Air Group's Managing Director of Investor Relations, Lavanya Sareen. Please go ahead, sir.

Lavanya Sareen - *Alaska Air Group Inc - Managing Director of IR*

Thanks, Laurel. Good morning everyone, and thank you for joining us for Alaska Air Group's first quarter 2015 earnings call. Our CEO, Brad Tilden, our CFO, Brandon Pedersen, and our Chief Revenue Officer, Andrew Harrison, will provide highlights from the first quarter and our outlook for the second quarter. Several members of our Senior Management Team are also on hand to help answer your questions.

Our comments today will include forward-looking statements regarding our future expectations, which may differ significantly from actual results. Information on risk factors that could affect our business can be found in our SEC filings. We will refer to certain non-GAAP financial measures, such as adjusted earnings, unit costs, excluding fuel, and we have provided a reconciliation between the most directly comparable GAAP and non-GAAP measures in our earnings release.

This morning, Alaska Air Group reported a record first net profit -- first quarter net profit of $149 million, or $1.12 per diluted share. This result compares to First Call consensus of $1.10 per share, and exceeds last year's Adjusted Net Income of $89 million, or $0.64 per diluted share. Additional information about cost expectations, capacity plans, fuel hedging, capital expenditures and other items can be found in our investor update, included in our form 8-K issued this morning, and available on our website at alaskaair.com.

And now, I'll turn the call over to Brad.

Brad Tilden - *Alaska Air Group Inc - CEO*

Thanks, Lavanya, and good morning, everyone. On our fourth quarter call, I told you all about a host of initiatives that we're focusing on in 2015, to further strengthen our competitive advantage. Or to borrow a term from Warren Buffet, the economic mote between us and the competition. I'm really proud of our 14,000 people, who have made great strides on these initiatives right out of the gate. We're performing as well on many fronts, and our people are as focused on providing great service to our customers as I've ever seen. Thanks to their efforts, we're off to a great start this year, and this should set us up very well for the rest of 2015.

Our strong results are driven by several things. By our approach to scheduled planning, by our consistent and reliable operation, by effective marketing, by our long term and cultural emphasis on high productivity and low cost, and most importantly, by a strong focus on customers by everyone here. Given this, I thought it might make sense to focus on some of these underlying drivers of success, before I get into the financials.

Our people continue to do a great job of running a strong operation. 85% of our flights arrived on time in the first quarter, and we expect that this will result in Alaska and Hawaiian being tied for the best on time performance in the industry.

Our completion rate of 99.4% was the highest among the seven largest domestic carriers. Horizon's completion improved 0.5%, to 97.3%. We have room for improvement here, and this is a focus area. Alaska's completion rate of 99.4% means that we cancelled just 233 flights during the quarter, or about 2.5 flights per day. 60% of these cancellations were due to weather, which we view as non-controllable, at least in the short run.

Our customers are delivering -- or our employees are delivering on our promise of taking care of our customers. We recently launched our new on board product, Alaska Beyond, which includes our custom built Recaro seats, seat power, streaming movies, signature food dishes by chef Tom Douglas, and prominent Northwest wines. Alaska Beyond has been very well received, as reflected in our customer satisfaction scores.

And on that subject, our customer satisfaction score was 86% for the first quarter, up 3% versus 2014, which is the highest score since we started tracking this metric in 2007. If it sounds like we're repeating ourselves, we are. Our fourth-quarter score was also a record. In fact, our people have raised the bar for customer service and customer satisfaction every year since 2007, when we started collecting this data.

Our people and our culture are being recognized. Forbes just named Alaska one of America's best employers. This affirms that our people are aligned with our goals and engaged in achieving them. And most importantly, that they're proud to work here. We are only one of three airlines that made the Top 100, and we're in great Company with Southwest and Jet Blue. They're both ranked ahead of Alaska, and that gives us a goal to work towards.

These strengths, together with the low cost structure and low fares, have allowed us to grow consistently, while increasing the reach and utility of our network for our customers. We added three new markets in the first quarter, including Seattle to Dulles and San Diego to Kona. As we look at our network more broadly, Alaska has added 19 new markets in the last 12 months, and 73 new markets in the last five years. In fact, 40% of our revenue and profit in the last year has come from markets that we did not serve in the year 2000.

The point is this: our strategy is working. Our people are doing a good job of deploying capital in the right markets, where that capital is producing returns that are materially greater than our cost of capital, and these returns are the driver of the financial results you see today.

In looking at the numbers now, it's not surprising to see that our folks turned in outstanding financial results for the quarter. Our net profit for the quarter was $149 million, which is 67% higher than 2014. When we factor share repurchases, our earnings per share of $1.12 increased 75% over 2014.

We had an 18.9% pretax margin, which is more than 700 basis points higher than last year. This is our best ever quarter performance -- the best ever first-quarter performance, and we expect our margin performance to be one of the best in the industry. The strong financial quarterly performance resulted in a 12 month ROIC of 20.1%, which is roughly 1,200 basis points higher than our cost of capital. And even factoring out the head start the lower fuel cost did give us, this was our sixth consecutive year of profitability in the first quarter, which as you all know is seasonally our weakest quarter.

We believe these results, together with our track record, demonstrate that this leadership team is committed to managing our business for profitability and returns, regardless of the setting. We're confident that our business will continue to perform well throughout the business cycle.

And finally, on the financial front, Brandon will talk with you in just a moment about the very robust cash flow from operations that we earned this quarter, and that we expect to earn for the full year, as well as the strong cash flows and the shareholder-friendly uses of capital that we've had for several years now.

As we look forward, we see continued strength in our business. Our folks are doing well with the things that matter most to customers, and customers are choosing to fly with us. The economies where we operate are strong, and our financial model is working, as evidenced by these near industry-leading results. As our model performs, we're returning a substantial amount of cash to shareholders. There may be some capacity trends that we need to do, as we look beyond the summer, but I would think of those as normal course of business adjustments.

That's my summary for the quarter. I want to thank everyone here, both the leadership team and the dedicated employees throughout Alaska and Horizon, who are working very hard to produce these results. I'll now turn the call over to Andrew.

Andrew Harrison - *Alaska Air Group Inc - Chief Revenue Officer*

Thanks, Brad, and good morning, everyone. Our first-quarter passenger revenue grew by $47 million, or about 5%, on 10.8% increase in capacity. Now this growth primarily came from four areas. First, we added capacity to markets that were generating high returns, and needed more capacity. Secondly, we increased capacity in existing markets out of Seattle to give our customers more utility and maintain schedule superiority versus the competition.

And third, we've increased the gauge of our aircraft, as a result of last year's cabin improvement project, and the addition of ten new 737-900 ERs since the end of Q1 last year. And lastly, we've introduced service to 19 new markets since the end of Q1 last year, and this enhances our network reach and diversifies our revenue. In fact, since 2010, we've launched 73 new markets. Our newest routes started in the last 24 months, with at least one year of history, actually saw PRASM growth of 5%. That's well above our system average. These markets continue to mature in line with our expectations.

Our underlying revenue performance continues to be solid. A testament to that fact was that three of our regions, representing one-quarter of our Q1 capacity, grew 14%, and still returned positive unit revenue growth in our seasonally weakest quarter. Competitive capacity was up 16% in our markets. It's the highest increase we've seen. But looking ahead at published schedules, this looks to be the high watermark for competitive capacity growth.

We actually expect total capacity increases in our markets to build 12 points in the second quarter, and only 7 points in the third quarter. If you exclude Alaska's own growth, this translates to only a 6 point increase in the second quarter, and 4 points in the third, as other airline capacity increases in our network annualize. Now, we ran a free checked bag promotion in January for all of our Mileage Plan members, and then transitioned this promotion to only Affinity card holders, starting February 1. Several of you have asked us questions about this, so I'd like to spend a few moments to walk you through our rationale.

Our Mileage Plan actually generates over $0.5 billion in revenue, and $600 million in cash flows. Growing this important program is a key focus for us. It not only brings in new loyalty members, but moves customers up the lifetime value chain and enhances future cash flows.

Our Mileage Plan and the Affinity card program are both mature programs. And it has actually been remarkable that our Affinity card holders grew 10%, and our loyalty program grew by 15% in the first quarter, outpacing passenger growth of 10%. More importantly, the attrition in our loyalty program declined 20%. And I'm very pleased to say that the program's penetration in the Pacific Northwest has never been stronger.

As it pertains to our card program, the absolute number of cards added this quarter far exceeded what we've seen in any of the past seven years. Based on these results, we've made the decision to structurally add a free first bag benefit for card holders, while continuing to offer an annual companion pass.

Our long time and strategic partner Bank of America has agreed to co-sponsor this change, which will mitigate the revenue impact this year, so that RASM impact is no longer big enough to talk about. That's a win-win. Our customers get what we believe is the industry's leading credit card, while Alaska is able to generate greater revenues from a stronger card program.

Want to shift our focus now to the second quarter, and Alaska's capacity will be up about 10.5%. About one-third of this growth is driven by efficient gauge and stage length changes, along with new markets. That said, we do have some headwinds in the second quarter, especially in April. First, last year's Q2 PRASM growth of 2.6% was the strongest for the year, making our Q2 comps harder this year. Secondly, due to the shift in the Easter holiday, a portion of Easter traffic shifted into March. Additionally, Easter overlapped spring break this year, meaning we lost the second holiday travel period. We expect the combined impact of this to be about 2.5% for April PRASM.

And lastly, total seats into Hawaii from the West Coast will be up 12% for the quarter, which will pressure unit revenues in those markets. Given these headwinds, April may be our lowest PRASM result for the year. But that said, as we look beyond the next few months, we continue to have confidence in the strength of our results for the remainder of 2015, and here is why. 90% of our capacity is deployed in domestic markets, nearly all US point of sale. The US economy continues to grow, and is arguably one of the strongest economies in the world right now.

Demand in our core market is robust, and new markets are maturing in line with our expectations. We are debuting preferred seating later next month, as we begin to explore further segmentation of our cabin. Customers will enjoy extra leg room, accompanied by a free drink and priority boarding. This initiative is expected to add $15 million a year in revenue, without any incremental capital expenditure. Our third-quarter capacity growth will slow to 7.5% during our peak travel period, with one-third of this growth representing stage and gauge increases, along with new markets.

As we move beyond Summer, and as Brad alluded to earlier, we're going to enter into a softer demand period in September, and we are planning to make modest capacity reductions in certain markets, without compromising our schedule. We will achieve this by more aggressively reducing day of week and fringe flying. We're in the process of working through these schedule adjustments.

The upgrade of our revenue management system went smoothly in the first quarter, and has allowed us to expand our P fare offerings, which are a discounted first class booking, across our entire system. Results have been very encouraging with our system-wide first class PRASM, up 2.2% in the first quarter. That's well above our system results.

All in all, we feel good about the revenue side of the business. Even in the face of unprecedented competitive capacity additions, revenue was still up by $47 million. Our network is growing. Our revenues are more diverse. We're giving our loyal customers great utility and low fares. Our Affinity card program is very strong. Our customer service continues to improve, and we are introducing new products.

All of these combined will widen our customer mote, and help us continue to drive strong future revenues. And with that, I'll turn the call over to Brandon.

Brandon Pedersen - *Alaska Air Group Inc - CFO*

Thanks, Andrew, and good morning, everybody. Air Group's adjusted net profit improved by 67%, and as Brad said, earnings per share improved by 75%, because of the significant share repurchases since the end of Q1 of last year. On an adjusted pretax basis, we earned $240 million, a nearly $100 million increase over prior year. Our revenues grew by $47 million, non-fuel costs increased by $73 million, and fuel costs declined by $131 million.

Non-operating income declined only because last year's result included $13 million in gains from the sale of our stake in an IFE provider and stock received in a bankruptcy settlement. Andrew covered revenue, so I'll provide some context on costs. Consolidated non-fuel unit costs were down 0.6% on the 10.8% increase in capacity. The cost performance includes higher depreciation from our significant investments in the fleet, higher pension costs, and planned increases and maintenance.

But it also reflects purposeful investments that we're making, such as our branded Beyond service, including advertising to support the launch, better food and drink offerings, and free content during the introduction of our new streaming in-flight entertainment. Our costs also include the impact of our new flight attendant contract, signed in Q4 of last year. It's important to remind folks, however, that we have long term agreements in place with all of our large work groups.

With full-year capacity now expected to be up 10%, we're able to spread costs over more flying than originally planned, and now expect non-fuel CASMex to decline by about 0.5%. This would make 2015 the sixth year in a row, and for the main line operation, the 13th year out of the last 14 of cost reductions. We expect CASMex to be about flat in the second quarter.

We recognize that low costs are a key competitive advantage for us, and we're focused on driving costs down further. Productivity is a big part of that. Productivity was up another 2.7% this quarter, on a passengers per FTE basis. We view productivity as a sustainable advantage that we can continue to build on.

Turning to fuel. Our economic fuel cost per gallon was $1.98, down from $3.32 in Q1 of last year. Although different airlines use different techniques to manage fuel price risk, we remain committed to our simple, low risk, low volatility program that uses only call options as a form of insurance. And as a result, we fully benefit from lower oil prices.

We've also created a natural and permanent hedge with our highly fuel efficient fleet. Our fuel burn, on an ASM per gallon basis, improved by another 3% since Q1 of last year. This will just continue to get better, and grow our total cost advantage as we retire the rest of the 737-400 fleet over the next 30 months.

Cash flow from operations was a very strong $500 million in the first quarter. To give you a sense of how our business has changed, this is about the same amount as we generated in all of 2010. In fact, dating back to 2010, our operating cash flow has exceeded $5 billion. On balance sheet debt is now less than $1 billion, debt-to-cap stands at 29%, and we're in a net cash position of more than $300 million, even after adjusting for leases. Net interest expense on our P&L is negligible.

We've talked on several occasions about the 23% unit cost advantage we have compared to the legacy carriers, but the fact that we have virtually no net interest enhances our cost advantage even further. For example, last year, on a per ASM basis, the legacy carriers incurred between $0.27 and $0.38 per ASM of net interest cost, versus $0.02 for us. This represents another key component of our economic mote, and it is another reason we believe we can continue to produce very strong profits into the future. Our trailing 12 month after-tax ROIC of 20.1% is 530 basis points higher than at this point last year.

Our ROIC is now higher than 80% of the companies included in the S&P 500. With our returns substantially exceeding our cost of capital, investing in our business is the right thing to do. We'll take delivery of 11 Boeing 737-900 ERs this year, and return one 737-400, for a net increase of 10 aircraft. We expect our full year CapEx to be $735 million, a bit less than our previous guidance. Again, looking at the longer term trend, we'll have invested more than $3 billion since the beginning of 2010 on larger, newer, more cost efficient and customer friendly airplanes, and on technology that will help us be more productive and improve the customer experience.

Even with the $3 billion of capital investment, we still have been able to produce nearly $2 billion of free cash flow since the beginning of 2010. We want to deploy our capital in a balanced fashion, to strengthen the balance sheet, so that it looks like other high quality, investment grade industrial companies, grow the business, improve service, cultivate loyalty, and expand our customer base. And we're doing just that.

But we also want to build our track record of being leaders in returning capital to shareholders. To that end, we increased our dividend earlier this year by 60%, and have doubled the dividend since its inception in 2013. Our dividend yield is currently right at about 1.3%.

During the quarter, we repurchased $102 million of our stock, or 1.2% of total shares outstanding. This brings our cumulative share buyback to 31% of outstanding shares since the beginning of 2007. And on average, we've purchased -- repurchased more than 4% of our shares annually since that time. Given our very strong cash flow, we're increasing our total full-year shareholder return target from at least $420 million to at least $550 million, or what should be about 120% of 2015 free cash flow, based on current consensus estimates.

Assuming a quarterly dividend consistent with current levels, and the $100 million that we've repurchased to date, the math implies we'll repurchase an additional $350 million of our stock, or more than 4% of the Company at today's market cap, by the end of the year. There's a strategy here. Give our owners great returns, both through a meaningful dividend that we want to increase over time, and through EPS growth that comes from retiring a meaningful percentage of our outstanding shares annually.

We're off to a strong start in 2015, and I want to join Brad in thanking all of our employees for their many contributions. And with that, we would like to open it up to questions that you may have.

QUESTIONS AND ANSWERS

Operator

(Operator Instructions)

Your first question comes from the line of Savi Syth with Raymond James.

Savi Syth - *Raymond James & Associates, Inc. - Analyst*

Hi, good morning. Just Andrew, if I might ask you to elaborate a little bit on what you were talking about, the four different types of growth that you have? Could you break out what the mix is, between the capacity and high return markets of the other three? And just maybe the trends, as you go forward through the year, in those groups?

Andrew Harrison - *Alaska Air Group Inc - Chief Revenue Officer*

Yes. Hi Savi, it's Andrew. I think probably, most simplistically, to look at it is really thinking about one-third of it is the gauge and stage in new markets. So the new revenue streams and the efficiency. And then I don't really have specifics on the other two categories, which is high margin return markets, which I, of course, wouldn't share, and also new utility. So -- and then as we move into Q3, it gets more like 50/50. So basically half of it's new revenue and stage and gauge, and then the rest is adding to our core.

Savi Syth - *Raymond James & Associates, Inc. - Analyst*

Got it. And just on that, does the Affinity card program that's done, does that improve corporate share? Or is that more leisure share that you're gaining from that?

Andrew Harrison - *Alaska Air Group Inc - Chief Revenue Officer*

I think what it does is, it improves share across all aspects of our business. And essentially, why we're so excited about it, is that it just demonstrates to us that our product, our fares, what we provide the customer is a good proposition, and people are joining our family and our loyalty program, and coming back to us more and more. And this growth, and the economics that it produces, is really a win for us.

Brad Tilden - *Alaska Air Group Inc - CEO*

Savi, I think in our markets, it's the same person. They are a business person on Monday, Tuesday, Wednesday. On Saturday night, when they're out to dinner using the credit card, they're leisure. They fly us to Cabo; they fly us to New York for business. It's -- as you move around town, I think it's the same people that flies both business and leisure.

Savi Syth - *Raymond James & Associates, Inc. - Analyst*

Got it. And then as my last question, on the hedging front, I understand that the cost of hedging with options has moved up. Is there any change in your thinking on the hedging strategy front there?

Mark Eliasen - *Alaska Air Group Inc - VP Finance and Treasurer*

Hi, Savi, this is Mark. There really isn't any change. We've -- our program, as you know, has performed well through the 2008 run-up and collapse. It performed well as fuel ran up through the 2010-2013. And then the current collapse, we're fully participating. It is a little more expensive, but think about it. It went -- it's going from maybe $10 million a year to possibly $19 million or $20 million, so that's about $0.04 a gallon. We think that's insurance money well spent.

Savi Syth - *Raymond James & Associates, Inc. - Analyst*

All right, great, thank you.

Brad Tilden - *Alaska Air Group Inc - CEO*

Thanks, Savi.

Operator

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

Hunter Keay - *Wolfe Research - Analyst*

Thank you, good morning.

Brad Tilden - *Alaska Air Group Inc - CEO*

Good morning.

Hunter Keay - *Wolfe Research - Analyst*

Brad, please pick one of these two, and my follow-up depends on your answer. (laughter) Tell me what you're more frustrated about, your earnings multiple or the amount that investors focus on PRASM?

Brad Tilden - *Alaska Air Group Inc - CEO*

(laughter) Oh, my gosh. Hunter, I -- maybe I'm not going to answer. Our -- the way we look at the world is, our job is to run a great business. Our job is to build alignment with our employees, get people all sort of -- since -- have an orientation around low cost and low fares and high productivity, great service to our customers, and then turn that into money.

Turn that into earnings, get a machine going where we can buy airplanes, and make money with them and all of that. People want -- the multiple has been where it's been for a long time. It would be nice if it was higher. The PRASM is down a bit. But the -- as we were pointing out this morning, the absolute returns are stunning. So it's -- we -- our mentality is, we need to control what we can control, and let you guys worry about the things that we can't control.

Hunter Keay - *Wolfe Research - Analyst*

I appreciate that, and the reason why -- if you had said PRASM, I was going to say, then why do you even talk about it? Why don't you just guide to a full-year earnings number, a full-year margin number, and then give us a fuel number. And then change the conversation. Because we, as analysts, model what you talk about.

And if you do that, your multiple will go up. And then if you had said multiple, Brad, I would have told you, why are you not buying back 10% of your stock this year, if you think your stock is cheap? It's a no-brainer to borrow at 2% with an 8% earnings yield. I'd argue that 4% buyback is great, relative to other airlines, but you're trying to distinguish yourself to other industrials, not their airlines. Why aren't you buying back 10% of your stock this year?

Brad Tilden - *Alaska Air Group Inc - CEO*

It's a good question. We are steady Eddie. We're -- who knows what environment we have in the years ahead? And Hunter, as you know, we talk to a lot of folks about what they would like to see us do.

Would they like to see a dividend? Would they like to see share repurchases? Would they like to see us borrow up and buy now, or buy regularly, as we produce cash flow? I actually think what we're doing is in the sweet spot of what our investors are telling us, and I'm proud of it. If you look at what we're doing, we're going to produce $500 million of operating cash flow in first quarter. Brandon, what will we produce for the full year?

Brandon Pedersen - *Alaska Air Group Inc - CFO*

$1.2 billion, based on consensus.

Brad Tilden - *Alaska Air Group Inc - CEO*

$1.2 billion for full year, and we'll return over $0.5 billion to shareholders. So I get the question, but I think what we're doing is in the sweet spot of what the majority of our owners would like to see us do.

Hunter Keay - *Wolfe Research - Analyst*

Okay. And then as I think about you guys as being one of really only two airlines that have pretty much clear visibility on labor costs over the next four years, can you -- you guys are expectation managers, if there ever was a manager of expectations, it's you. So help talk me out of why your cost advantage can't get at least 10% bigger, over the next four years? As your labor contracts don't really move that much, and everyone else around you is pretty much granting pay raises?

Ben Minicucci - *Alaska Air Group Inc - COO and EVP Operations*

Yes, Hunter, it's Ben Minicucci. You've actually nailed it. We've got -- with our big labor groups, we've got deals that average over four years. And the annual increases on those deals are only about 1.5%. So we have a strong level of confidence that we will be able to control labor costs over the next five years.

And with our continued focus on productivity, every labor group is focused on productivity. It's what we do going into labor negotiations. It says, we want to pay well, but that's all in exchange for high productivity. So we've got a tremendous amount of confidence in our operations teams that will keep our labor cost really well in check over the next four or five years.

Brandon Pedersen - *Alaska Air Group Inc - CFO*

Hunter, it's Brandon. Just one follow-up on that, to elaborate on what Ben is saying. And we tried to illustrate it at Investor Day. But you're on the right track, which is as others increase not only their labor cost, but just generally, their costs go up over the next few years, and we're able to drive cost reduction, our margin gap between us and the competition just continues to get wider.

Hunter Keay - *Wolfe Research - Analyst*

Yes. Okay, it's going in the model. Thanks a lot.

Brad Tilden - *Alaska Air Group Inc - CEO*

Thank you, Hunter.

Operator

Your next question comes from the line of Joe DeNardi with Stifel Nicolaus.

Joe DeNardi - *Stifel Nicolaus - Analyst*

Thanks, good morning.

Brad Tilden - *Alaska Air Group Inc - CEO*

Hey, Joe.

Joe DeNardi - *Stifel Nicolaus - Analyst*

Maybe just following on Hunter's question about capital deployment. I guess even with the $500 million target now, there still looks to be some cash left over. Are there other sources of cash that we should think about, beyond the buyback for this year?

Brandon Pedersen - *Alaska Air Group Inc - CFO*

Joe, it's Brandon. Maybe I'll start, and Mark can chime in if I don't finish the thought. It's at least $550 million, just for the record, and that's up from $420 million. So today, we made a statement that we were going to do 30% more than we had on record. That's a pretty big number. And the other thing I'll add is that we said at least $550 million. We've tried to be really balanced, in terms of how we deploy capital. And I think we're continuing to do so, and it shows in the amount of capital that we're returning to shareholders, both through the dividend and through the share repurchase program.

Joe DeNardi - *Stifel Nicolaus - Analyst*

Okay. And then on the CapEx side, going forward, how should we think about, I guess, your willingness to exercise some of these options, with margins where they are? If margins stay in this elevated range, should we just assume that all of these options are going to be exercised?

Brad Tilden - *Alaska Air Group Inc - CEO*

Mark, do you want to take that?

Mark Eliasen - *Alaska Air Group Inc - VP Finance and Treasurer*

I would just say that we'll continue to do what we've been doing. We are in a fleet transition, as you know. We're getting -- we're moving out 27 classics, so we'll be all NG and Max fleet. And so we take -- we look at our options as they come up, and we evaluate what the business conditions are. Of course, we only exercise options when we can fly those airplanes profitably. So I think we'll just stay the course, as we have been, and we're up -- over the next three years, we're up 15 airplanes net.

Brandon Pedersen - *Alaska Air Group Inc - CFO*

Joe, just one other thought on that. The next airplanes that we have that are under option are for 2018 deliveries. That's an eternity in our business, so we'll just -- as Mark said, we'll continue to watch it, but they're a long way off.

Brad Tilden - *Alaska Air Group Inc - CEO*

And 2016 -- this year, Brandon, we're going to grow, what, by a net of ten airplanes? Next year, 2016, the fleet growth is going to be about flat.

Brandon Pedersen - *Alaska Air Group Inc - CFO*

That's right, up a couple.

Brad Tilden - *Alaska Air Group Inc - CEO*

Up two?

Brandon Pedersen - *Alaska Air Group Inc - CFO*

Yes.

Joe DeNardi - *Stifel Nicolaus - Analyst*

Okay, thanks very much.

Operator

Your next question comes from the line of Duane Pfennigwerth with Evercore ISI.

Duane Pfennigwerth - *Evercore ISI - Analyst*

Hi, good morning, guys.

Brandon Pedersen - *Alaska Air Group Inc - CFO*

Good morning.

Duane Pfennigwerth - *Evercore ISI - Analyst*

So when you net out, I guess, lower competitive capacity growth into the second quarter, in what should be a seasonally stronger period, 2Q, 3Q, how would you characterize the revenue environment now, versus what we just experienced in first quarter?

Andrew Harrison - *Alaska Air Group Inc - Chief Revenue Officer*

It's Andrew. I would say that, without giving forward guidance here, that we continue to see similar conditions as we have seen in March. And March was a growing stronger period, as is April. There's been a shift in the holidays back and forth, but we're growing at 13% in April. We're growing at -- grew 13% in March. There's some things moving back and forward. But overall, we see good, continued strength, as we get more demand under us into the seasonally stronger periods.

Duane Pfennigwerth - *Evercore ISI - Analyst*

Okay, thanks for that. And then, just on your comment on the bag fee, can you maybe expand on that a little bit, in terms of what we saw in the first quarter? And maybe the difference between passenger and total unit revenue? Is there a trend change that you'd expect there? Or do we expect other revenue to re-accelerate, based on this co-sponsorship?

Andrew Harrison - *Alaska Air Group Inc - Chief Revenue Officer*

I think big picture, the way to look at this is that, on a per passenger basis, our ancillary revenues were down actually 9%. All of that was due to bag fees and the promotions that we ran. Most of the other categories were up on a per passenger basis, double digit.

And at the end of the day, we're going to be offering a card, like many other carriers do, a free bag with our card, as well as a companion pass. And as we shared in our prepared remarks, with Bank of America working with us, we feel like we are in a really good place, and that any economic impact will not be significant, going forward, on ancillary revenues.

Duane Pfennigwerth - *Evercore ISI - Analyst*

Okay, and then just my last one I'll sneak in here. On the CapEx, it looks like maybe a $15 million push from 2015 to 2016, but maybe modestly higher in the out years. Can you just provide some detail as to why that's continuing to creep up? Thanks.

Brandon Pedersen - *Alaska Air Group Inc - CFO*

Duane, it's Brandon. Nothing in the out years that should be new disclosure. I think some of that probably relates to the airplanes that we acquired back in February, and we changed our CapEx disclosure in a February investor update. But there wasn't anything new in out years, with this most recent investor update.

Duane Pfennigwerth - *Evercore ISI - Analyst*

Okay, maybe I'll follow up with you offline. Thank you.

Brad Tilden - *Alaska Air Group Inc - CEO*

Thanks, Duane.

Operator

Your next question comes from the line of Helane Becker with Cowen and Company.

Helane Becker - *Cowen and Company - Analyst*

(multiple speakers) Hi, guys.

Brad Tilden - *Alaska Air Group Inc - CEO*

Hi, Helane.

Helane Becker - *Cowen and Company - Analyst*

Hi. So I just have a question about aircraft maintenance. So since the fleet is getting younger and more fuel efficient, how come maintenance is up 24% in the quarter?

Ben Minicucci - *Alaska Air Group Inc - COO and EVP Operations*

Helane, it's Ben. A couple of engine -- so our NG fleet, the Next Generation fleet, is not covered by a power by the hour, which we will hopefully have in place by the end of this year. So a lot of our NGs, we took the honeymoon period here in the first ten years of life, which are phenomenal engines by GE. So we did have a couple of URs -- unexpected URs in the first quarter. But that's something we're going to address here, by the end of the year.

Helane Becker - *Cowen and Company - Analyst*

Okay. And then I just had one other question. With capacity growth getting -- I guess slowing competitive capacity growth in Seattle, slowing in the -- like as you get through the summer months, do you think you'll see -- are you seeing benefit on pricing, in some of your core markets?

Andrew Harrison - *Alaska Air Group Inc - Chief Revenue Officer*

Hey, Helane, it's Andrew. We are finding, as you would expect, where there is excess seats in a market, that we're having downward pressure on unit revenues. I think as I look at the environment, it's a mixed bag, with the general strength of domestic travel with some major changes in some of our other markets.

As we look forward, I can't see much out into the future. But what I will say is that the pricing environment is behaving exactly how we would expect it to behave, given the current economy, our capacity and others' capacity. And as I shared in my prepared remarks, we're going to look at some adjustments we may need to make, to help shore some things up there, as we move into the fourth quarter.

Helane Becker - *Cowen and Company - Analyst*

Okay. And then can I just sneak in one last one?

Brad Tilden - *Alaska Air Group Inc - CEO*

Sure.

Helane Becker - *Cowen and Company - Analyst*

What's your paid first class? What percent of your first class is paid for, versus upgrades?

Brad Tilden - *Alaska Air Group Inc - CEO*

I think it's nudging up -- it was roughly one-third, Helane. If you go back a few years ago, before we put in our new strategy, it was basically one customer per flight. So first class is typically 16 seats, some airplanes it's 12, and we're up to 5 or 6 customers a flight. Andrew, I think it might even have popped up a little bit more in the last quarter or two.

Andrew Harrison - *Alaska Air Group Inc - Chief Revenue Officer*

Right. And I -- that's right. And Helane, one thing that competition teaches one is, we have probably not been as focused on either the unit revenues, the service or the benefits that first class cabin, which was like 10% of our seats, has been performing at. So we are actually more focused on that cabin, and it's paying off.

Brad Tilden - *Alaska Air Group Inc - CEO*

Yes. And just to be really clear, there's three ways to get into first class. A, you buy a first class fare, and that's what we're talking about. Second, you buy a qualifying upgrade fare. And third, you buy a non-qualifying upgrade fare. And we have been focused on offering great value with the F fare, and that's why we've done well with getting a lot of folks up into the front part of the airplane.

Helane Becker - *Cowen and Company - Analyst*

Great, thank you. Thanks very much for the time.

Operator

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

Jamie Baker - *JPMorgan - Analyst*

Hey, good morning everybody. Actually following up on that, should we really think about paid first class as the next act of ancillary evolution? Insofar as that historically, it was a product that was largely just given away?

Andrew Harrison - *Alaska Air Group Inc - Chief Revenue Officer*

Hey Jamie, it's Andrew. A couple of things I would say. I would absolutely concur with that statement. And then secondly, we will be launching some preferred seating ancillary revenues coming online in the next month. And what I will tell you is, we are looking really hard at how we segment our passengers, and how we can look at getting more revenue out of our cabin, while offering customers things that they would like to have. So we are actively looking at our cabin, and ancillary revenue models.

Jamie Baker - *JPMorgan - Analyst*

Got it. My initial question, before that last topic came up. In a bit of a departure, United announced today that it was beginning to look at a package of used aircraft, and they are certainly not alone in this regard. It's easy to see how it's beneficial to ROIC. And I realize that's a metric you do not struggle with. But you guys were so far ahead of the curve years ago. You cancelled the CRJ700s, pursued the Q400. I'm just wondering why used aircraft aren't part of the fleet fabric at Alaska?

Ben Minicucci - *Alaska Air Group Inc - COO and EVP Operations*

I'm going to start, Jamie, on the operations side. It's Ben. There are a few things. One, old airplanes -- for example, our classic fleet -- in terms of maintenance costs, is significantly higher than our NGs. There's just no question about it.

From a reliability perspective, this fleet is less than one0third our size, it drives half the operational issues we have [on the line]. So we like keeping our costs -- our operational costs low, our reliability high. And I think it just makes sense not keeping airplanes past a certain life span. So that's principally in operations. That's how we think about it. And fortunately, my friends in network and finance agree with me.

Andrew Harrison - *Alaska Air Group Inc - Chief Revenue Officer*

The other thing I would add -- this is Andrew -- is that honestly, the ER and the Next Generation aircraft are perfectly suited for our network, where we want to fly. And that the older classic versions are actually negative on our ability to increase revenues and provide great service. So this works really well for us, to continue to keep the fleet fresh.

Jamie Baker - *JPMorgan - Analyst*

Okay. And if I could just really quickly squeeze in a third one. You talked about maintaining schedule superiority in Seattle. That may simply mean more domestic capacity than the next guy. Or are you actually arguing that your schedule is somehow better optimized to passenger demand than the competition? I'm not beating you guys up, if this is just a -- may just be a catch phrase, like award winning in-flight magazine. (laughter) I'm just wondering if there's any analysis to actually back it up?

Andrew Harrison - *Alaska Air Group Inc - Chief Revenue Officer*

It's a couple of things. The number one, we are working very -- with all the growth we've had in Seattle, and the very expansive feed network that we have, we are doing a much better job at lining those up. But we are making sure that, if you want to fly to California, or where you want to go, that we have the best times. And the other big thing is -- and it's going to continue, I'll share that with you on the phone today -- is that moving into new revenue markets out of the Pacific Northwest has served us extremely well. And so when you bring all of those things together, we think that it's a winning model.

Jamie Baker - *JPMorgan - Analyst*

Excellent. Thank you, everybody.

Andrew Harrison - *Alaska Air Group Inc - Chief Revenue Officer*

Thanks, Jamie.

Operator

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

Darryl Genovesi - *UBS Securities LLC - Analyst*

Hi, good morning, guys. Maybe just one on your comments around growth. Understanding that overall, your returns are higher than your return on invested capital. But just wondering, when you're thinking about the marginal growth that you're putting in, can you share anything with us around perhaps what return you're earning on that? So that we can get a sense of just how extended the forward growth trajectory is?

Brandon Pedersen - *Alaska Air Group Inc - CFO*

Darryl, it's Brandon. Hi, how are you this morning? The answer to your question is, we do think about return targets. We're not going to share those on the call, as we're producing superior returns. But I think what you're suggesting is, or what you're asking, maybe is, is the marginal capacity addition going to have the same return as the system average? I think the answer to that is no. But I can assure you, we are looking at the returns on incremental aircraft, and in incremental markets. And they do have to pass a hurdle that we have internally.

Brad Tilden - *Alaska Air Group Inc - CEO*

Darryl, there's a normal run-up. It might be one, two, maybe three years in a market. But I think what we can say is that all those new servers we've added, it is maturing. And as it does mature in two or three years, it's producing very robust returns that do exceed our cost and capital. I think we -- I shared, in my part of the remarks, that if you look at our growth in the last 12 or 14 years, which picks up trans con and mid con and Hawaii, and some of that -- what I would call single-flight cities out of Seattle, it's 40% of revenues and 40% of profit. So if -- so it's -- the new growth, over that longer period of time, is earning its fair share of the profits.

Darryl Genovesi - *UBS Securities LLC - Analyst*

So you think when, understanding that the less mature stuff will not earn the same return as the more mature capacity will. But when you're thinking about your projections for new markets that you're entering out, two to three years down the road, starting today, does it look like those -- that incremental capacity that you're putting in will eventually mature to the system-wide average return? Or is it dilutive, just because you've already addressed the very attractive markets? And now you're addressing the next most attractive markets?

Brandon Pedersen - *Alaska Air Group Inc - CFO*

Darryl, it's Brandon. Maybe I misspoke just a tiny bit, and Brad corrected me. Out of the gate, they are dilutive. But ultimately, the goal is to have all of these new markets get to system average and produce really strong returns.

Brad Tilden - *Alaska Air Group Inc - CEO*

And I think the markets we're adding now look just like markets we added three years ago, in terms of how we expect them to mature.

Darryl Genovesi - *UBS Securities LLC - Analyst*

Okay. And then maybe just one quick follow-up on Jamie's question, with regard to the -- potential for used aircraft purchases. I think a lot of the used aircraft purchases that we are seeing are current generation aircraft. I think the answer to his question seemed to revolve around the difference between the classics and NGs. But we see Southwest, for instance, is buying a lot of new -- sorry, is buying a lot of used 737-700s up. You've got Air Berlin in Europe right now that has, I think, 50 roughly five-year-old 737-800s that it's looking to take out of its fleet. So it does seem like there are a relatively young, current-generation used aircraft opportunities out there. And just wondering why that wouldn't be a consideration?

Brandon Pedersen - *Alaska Air Group Inc - CFO*

Darryl it's Brandon. I'll take that one, too. We've got a great order book. We've got an order book that's got great NGs through 2017, and then Max is beyond that. We do have a ton of flexibility to get rid of airplanes, if we don't like them. But I don't think you're going to see this team change paths, in terms of our strategy, moving from new airplanes that we've got on the books with Boeing to used aircraft.

Darryl Genovesi - *UBS Securities LLC - Analyst*

Thank you.

Brad Tilden - *Alaska Air Group Inc - CEO*

Thanks, Darryl.

Operator

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

David Fintzen - *Barclays Capital - Analyst*

Hey, good morning, everyone. Maybe a quick, very specific one for Andrew, and I'm thinking more big picture here. In Hawaii, how limited are facilities in the overall Hawaiian airports? And are there specific ones, like at Honolulu, that are a lot tighter? I'm trying to think, to the extent you guys want to grow the franchise over time, or other -- are there some physical limitations we're going to run into soon?

Andrew Harrison - *Alaska Air Group Inc - Chief Revenue Officer*

Hi, David, it's Andrew. From our perspective, there's always limitations in airports, especially off the West Coast to Hawaii. There is a narrow band of times that really work well for one's network. Having said that, we feel very good right now about what we have. And as you may or may not be aware, there are things going on with improvements to Hawaii. But it is tight, like every one of these major airports in a consolidated industry. But nothing we see right now that is actually causing any major issues with our operation, unless Ben has any other view on that.

David Fintzen - *Barclays Capital - Analyst*

Sounds like no. No, that's the only thing I had, thanks, appreciate it.

Brad Tilden - *Alaska Air Group Inc - CEO*

Thank you, David.

Operator

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

Mike Linenberg - *Deutsche Bank - Analyst*

Yes, hey, good morning, everyone.

Brad Tilden - *Alaska Air Group Inc - CEO*

Hey, Mike.

Mike Linenberg - *Deutsche Bank - Analyst*

Two questions here. One to Andrew. When I look at your relationship with American, we're a year and a half since the merger. And you've done a pretty good job, percentage wise, growing the revenue. But it seems like that -- that it could be a much bigger deal.

This recent move to transfer the Mexico City LA authority, it's one of many -- all sorts of types of things that you could envision, at the beginning, that you could accomplish with them. And I'm just -- is it what's maybe preventing it from becoming a bigger deal? Is it the fact that they need to merge their passenger service systems, and that's a gating factor? Or are there restrictions in your agreement with Delta that prevent you from becoming -- or doing a lot more with American? What's holding you back?

Andrew Harrison - *Alaska Air Group Inc - Chief Revenue Officer*

Hi, Mike. I certainly could see where your thoughts are, about being -- holding us back. We feel very good about where we are, and you hit the nail on the head. Until American goes to a single passenger reservation system, single certificate, combining loyalty programs, which basically, at the end of this year, they will be one single organic entity. That's when our ability to do more with them really accelerates. And then you've seen a little bit (technical difficulty) transfer. We are working on some really cool and exciting things. But you'll find that accelerate, from our perspective, once the US and American Airlines become truly one.

Mike Linenberg - *Deutsche Bank - Analyst*

Okay, very good. And then just my second question, and this is to Ben. This last month -- or two months ago, in March, we saw the sizeable increase in Seattle departures. I think you're up about 11% or so. And of course, you have Delta adding, but your numbers are good. Your operating performance is good.

And I'm just curious, as we look into the June quarter, are we running into any saturations at Seattle? Both with what you're adding and what Delta is adding? There's -- how much more room do you have on your gates? It's -- we run into inclement weather conditions, is it going to show up in the numbers? Where are we on, with respect to additional capacity in the airport (technical difficulty)?

Ben Minicucci - *Alaska Air Group Inc - COO and EVP Operations*

Michael, great question. If you rolled back in the Fall, I had a ton of anxiety in the -- for the March time frame. Because in March, our growth, as well as there's a lot of growth in sales. I had a lot of anxiety keeping our operation where it was. But we took a tremendous amount of steps, in modeling and analytics, to make sure -- and working with Andrew's team -- about when flights depart, when they arrive. So we're squeezing them into valleys, and taking away peaks. So we did a really good thing, so we kept our operation at a pretty high level.

We're also working really closely with the port of Seattle. We share our analysis on gate use, runway use. We show them where we think there are spikes in slowdowns. So we're working well with them. What I will say, though, as to your question on increased capacity, we are spread out a little more. So we are using more common use gates than we have in the past. So it is putting a little more strain on us. But the airport is going to be constrained, and they have a very strict formula how they allocate gates.

So it is based on departure seats, and we get over half the gates. But growth in Seattle, at some point, is going to be constrained until there are major capital projects to add more gates. But you won't see that in the next five years. So Seattle will -- is coming to a place where there cannot be the same level of growth that there has been in the last few years. Unless you want to operate in non-optimal times of the day, which Andrew keeps telling me that passengers just won't fly unless you're leaving at between 7:00 and 9:00 in the morning, is where he wants to put all the flights.

I just say, there's no more room between 7:00 and 9:00 in the morning. So we are (technical difficulty). So it's a great question, and we're on top of it, and we're working closely with all stakeholders on that. But it's going to be more limited, going forward.

Mike Linenberg - *Deutsche Bank - Analyst*

Okay, great, thank you.

Brad Tilden - *Alaska Air Group Inc - CEO*

Thank you.

Operator

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

Dan McKenzie - *Buckingham Research Group - Analyst*

Hey, good morning, guys. Andrew, I guess just a couple of house cleaning questions here. Did you say what percent of the ASMs are in markets under 12 months? And I guess I'm wondering how that stat would evolve in 2016?

Andrew Harrison - *Alaska Air Group Inc - Chief Revenue Officer*

No, I did not use that statistic. I think what I was sharing was, was about one-third of our capacity growth was stage, gauge and new markets. I think what you'll find is, this relationship will likely hold true through the rest of 2015. And again, at this point, we don't have much to say about 2016.

Dan McKenzie - *Buckingham Research Group - Analyst*

Understood. And then I guess Brandon, I know Alaska, in the past, has laid out multi-year, longer-term, non-field cost targets. And I'm wondering what kind of line of sight you can share with us today, as you're thinking about that longer term?

Brandon Pedersen - *Alaska Air Group Inc - CFO*

We don't have a specific cost target for 2016 or beyond that we would be willing to share today. What I will say, though, is fundamentally, we recognize that lowering costs is a key to our success. And as we look forward to 2016, we're going to work really hard to leverage the capacity growth that we have in those years. We're going to stay super disciplined on productivity. And we're going to make sure we don't lose our low cost culture we've created over the last few years, both out in the operation and in the back office. So down is the trend, Dan.

Dan McKenzie - *Buckingham Research Group - Analyst*

Very good. And then if I could just squeeze one final one here. And I guess, maybe, this would either be again for you, Brandon, or possibly Andrew. The fleet has evolved, I guess in size, at least, pretty dramatically versus just five years ago. And I guess the domestic critical mass is pretty different versus what it was five years ago. And I guess I'm just wondering if it's increased enough for Alaska to contemplate wide bodies in the fleet? At some point, say, over the coming three to five years?

Brandon Pedersen - *Alaska Air Group Inc - CFO*

It is -- Dan, it's Brandon. No, we love the simplicity of our single fleet operation.

Dan McKenzie - *Buckingham Research Group - Analyst*

Very good. Thanks, guys.

Brad Tilden - *Alaska Air Group Inc - CEO*

Thanks, Dan.

Operator

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

Savi Syth - *Raymond James & Associates, Inc. - Analyst*

Hey, just a quick follow-up. I know earlier in the call, you mentioned Hawaii was weak. Just wondering if you could elaborate a little bit about what you're seeing there? And maybe if you're doing anything that would help alleviate the pressures there?

Andrew Harrison - *Alaska Air Group Inc - Chief Revenue Officer*

Savi, it's Andrew. Essentially, what we've seen is, there's been some Pacific Northwest adds, which is ourself and another competitor. But really, a lot of it is coming from the Bay Area and Southern California. And as I shared in my prepared remarks, overall, across Washington, Oregon and California, it's up about 12%. We've also seen that starting late this year, both Virgin and United will be adding more capacity.

We will continue to look at our network, our capacities, our feed. We have a lot of options and tools available for us, given the breadth and the depth of our Hawaii network up the West Coast. So we are monitoring it, managing it, and we'll do what we need to do to keep it strong.

Savi Syth - *Raymond James & Associates, Inc. - Analyst*

And could you remind me again, Andrew, how much of that Hawaii is your overall system?

Andrew Harrison - *Alaska Air Group Inc - Chief Revenue Officer*

Currently, on a capacity basis, it's 18% of our ASMs for the year ended 2015.

Savi Syth - *Raymond James & Associates, Inc. - Analyst*

Okay, great, thank you.

Brad Tilden - *Alaska Air Group Inc - CEO*

Thanks, Savi.

Operator

(Operator Instructions)

Your next question comes from the line of George Ferguson with Bloomberg Intelligence.

George Ferguson - *Bloomberg Intelligence - Analyst*

Yes, thank you. A question for you on power by the hour contracts. Just curious. I think coming at a power by the hour contract after the honeymoon period, the 10 year honeymoon period, is it really -- when you do the analysis, how worthwhile is it to get inside a power by the hour contract, at that point? Because I'd imagine the engine makers would have wanted the gain from the honeymoon period, when they price the contracts, and now you're going to pay, based on certain near-term expectations of shop visits.

Ben Minicucci - *Alaska Air Group Inc - COO and EVP Operations*

Yes, George, it's Ben. The calculations can be complex. There are companies that take power by the hours when you purchased the airplane. And the rates are different year to year. As the years go by, the rates will change.

What we have found, through our experience is -- and it depends -- it actually depends on the engine, and depends on the airplane. When you look at the 737, it's just a -- Boeing has built a phenomenal airplane, and GE has a phenomenal engine. So based on our experience, we thought the best thing to do is just fly the airplane, and just take the cost advantage you have, until this engine needs an overhaul. And today's engines, compared to when I started, just last on wing way longer, and are just more reliable. So for this airplane and this engine, this makes a lot more sense.

George Ferguson - *Bloomberg Intelligence - Analyst*

Yes, I guess so to follow that up, I guess so then what changes now at 10 years, to make you want to move into a power by the hour contract?

Ben Minicucci - *Alaska Air Group Inc - COO and EVP Operations*

A couple things. One, we purchase the airplanes in batches. So you'll get a huge financial cost spike that we want to level out. So that's one thing. Because what you'll do in a power by the hour is, you'll level out your costs over the next 10 years, so you don't have these huge fluctuations in expenses. So that's one of the big, primary factors in putting up power by the hour.

Brad Tilden - *Alaska Air Group Inc - CEO*

George, from my perspective, an engine overhaul for one engine could be several million dollars. And there's value in building predictability into the business, and being able to create an expectation of the leadership team that we make money and we make predictable margins every quarter of the year. And when you have big expense items that are variable and moving around, it's just -- it's harder to create that expectation of running a successful and profitable business. So a fair bit of those contracts, I'd say, is the financial advantage of just moving from volatility to predictability.

George Ferguson - *Bloomberg Intelligence - Analyst*

Got it. Okay, and one last question. As you move the classics out of the fleet, any sense where your classics are going to go?

Mark Eliasen - *Alaska Air Group Inc - VP Finance and Treasurer*

It's really -- George, this is Mark. It's really up to the leasing companies. 18 of those classics are leased, so we'll just return them back to the lessors, and they will make all of those decisions.

George Ferguson - *Bloomberg Intelligence - Analyst*

Do you ever worry about them ending up in the hands of competition? Of a low cost -- maybe low cost, not hub-and-spoke, but single round competition?

Mark Eliasen - *Alaska Air Group Inc - VP Finance and Treasurer*

Yes, we really just don't have any control over it. So we don't worry about things we're not -- we can't control.

George Ferguson - *Bloomberg Intelligence - Analyst*

Okay I appreciate it, thank you.

Brad Tilden - *Alaska Air Group Inc - CEO*

Thank you, George.

Operator

Your next question comes from the line of Tom Banse with KUOW Radio Seattle.

Tom Banse - *KUOW Radio Seattle - Analyst*

Good morning. I think this is a question for Andrew, but I wonder if we could get just a little more detail for the many Frequent Fliers in the Pacific Northwest, and my audience, about the incremental nature, or fleet-wide rollout, of the premium economy offering next month?

Andrew Harrison - *Alaska Air Group Inc - Chief Revenue Officer*

Yes, we will be -- we won't be changing the seat, per se, but we will be selling our exit rows and our bulkhead rows. And depending on how far you travel, if it's under a thousand miles, we are going to price that at about $15. Then there's mid-continent, and then there's trans con Hawaii, which is much further.

And really, what our customers will enjoy will be much more leg room that they can buy, with a free drink and priority boarding. And so it's something that our customers have been asking for, and so we are really excited to be able to offer that. It's a step into this area. It's not huge. It's only three rows or so. But we continue to look at this. And if we get good uptake, we might expand this.

Tom Banse - *KUOW Radio Seattle - Analyst*

And this would not apply, then, to the Horizon Air? Or would it?

Andrew Harrison - *Alaska Air Group Inc - Chief Revenue Officer*

Correct. It would just be the 737-800s and 737-900s.

Tom Banse - *KUOW Radio Seattle - Analyst*

Great. Thank you.

Brad Tilden - *Alaska Air Group Inc - CEO*

Thanks for calling, Tom.

Operator

Ladies and gentlemen, this brings us to the end of our Q&A session. I now turn the call over to Brad Tilden for closing remarks.

Brad Tilden - *Alaska Air Group Inc - CEO*

All right, that's it. Thanks, everybody. We look forward to talking with you next quarter.

Operator

Thank you for participating in today's conference call. This call will be available for replay beginning at 12:00 PM Pacific Time today, through 11:59 PM Pacific Time on May 22, 2015. The number to dial for the replay is 1-855-859-2056 or 1-404-537-3406, and the conference ID number for the replay is 22988361. Also, the call will be accessible for future playback at www.alaskaair.com. You may now disconnect.
