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ALK - Q3 2013 Alaska Air Group, Inc. Earnings Conference Call

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OVERVIEW:

ALK reported 3Q13 adjusted net income of $157m or $2.21 per share.

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PRESENTATION

Operator

Good morning, my name is Megan, and I will be your conference operator today. At this time, I would like to welcome everyone to the Alaska Air Group third quarter 2013 earnings conference call. Today's call is being recorded and will be accessible for future playback at www.alaskaair.com. All lines have been placed on mute to prevent any background noise. After the speakers' remarks there will be question and answer session for analysts and journalists. (Operator Instructions).

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

Chris Berry *- Alaska Airlines - Manager IR*

Thanks, Megan. Good morning, everyone, and thank you for joining us for Alaska Air Group's third quarter 2013 earnings call.

On the call today our CEO Brad Tilden and our CFO Brandon Pedersen will provide some highlights from the third quarter and our outlook for the fourth quarter. We will also provide capacity growth projections for 2014. Several members of our senior management team are also here to help with the Q&A.

Our comments today will be 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 available on our website.

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

This morning Alaska Air Group reported a third quarter GAAP profit of $289 million. The GAAP result includes a $192 million pre-tax or $120 million after-tax non-cash special revenue item related to the accounting for our recently modified affinity card agreement. Accounting rules required us to revalue the deferred revenue associated with miles previously sold to our bank partner with a corresponding benefit to revenue.

Excluding this special revenue item and the impact of mark-to-market adjustments related to our fuel hedge portfolio, Air Group reported a record adjusted income of $157 million or $2.21 per share. This compares to a first call mean estimate of $2.14 per share and to last year's adjusted net income of $150 million or $2.09 per 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 it over to Brad.

Brad Tilden - *Alaska Airlines - President, CEO*

Thanks, Chris, and good morning, everyone. We're very pleased to report our best quarterly profit ever. Our people worked together to produce these results in the face of significant competitive incursions into our core markets on the West Coast and in the state of Alaska.

I want to thank them all for operating safely and on time, and for continuing to provide J.D. Power-caliber service to our customers. Our people at Alaska led the major airlines in on time performance for the most recent periods available, both for the three- and 12-months ended August 31, 2013. And in the month of September they achieved the highest customer satisfaction score we have received in the seven years that we have been tracking this metric.

Our record adjusted earnings of $157 million marked our 18th consecutive quarterly profit and represents an 18.4% pre-tax margin. We believe this will be one of highest margins in the industry.

Our trailing 12-month return on invested capital is 13%, and 2013 will be our fourth consecutive year in which we'll exceed our 10% after-tax target. As you know, we're also returning significant capital to shareholders, as we continued our share repurchase plan during the quarter, and as we initiated our first quarterly dividend in 21 years.

Let's talk for a moment about the competitive incursions we saw this summer. Although total industry domestic capacity in the third quarter was only up slightly, nearly one third of all additions took place in city pairs where Alaska flies. Specifically, our long haul Alaska routes and our north/south West Coast routes were impacted disproportionately, causing significant yield pressure. In fact, yields were down about 15% in the long haul Alaska markets. In the face of these significant increases, we posted our best quarterly result ever, a result which speaks to the strength and diversification of our route network.

Unit revenues increased in nearly every other region in the quarter, and we were especially pleased with Hawaii. You'll recall that we've talked in the past couple of calls about the surplus of capacity in our California/Hawaii routes. We made schedule adjustments which were effective in late April, and unit revenues in this region responded nicely, especially in the Bay area.

We know that many of you are wondering about Delta's capacity additions in several of our markets, including Seattle/Los Angeles, Seattle/Las Vegas, and Seattle/San Francisco. United has also added capacity to the Seattle/San Francisco market by adding frequency and up-gauging their service to mainline jets. There's really not a lot we can say about this except that we're focused on the situation and we're confident in our ability to deal with it as we've dealt with new competition in the past.

Alliances can be complicated. It's likely that in the future there will be markets where it's in our interest to work together with Delta, and there will be markets we will compete because it is in the best interest of Alaska Air Group to do so. We have a longstanding alliance with Delta, but many of the recent domestic additions are in core Air Group markets, and we intended to compete aggressively and defend them vigorously.

We talked about cash generation and the improvement of balance sheet in other quarters, but it's worth emphasizing again as both continue to improve. For the past 12 months our operation generated $940 million of cash flow. We've used this cash to buy eight new aircraft free and clear, to pay down $175 million of debt and to repurchase $91 million worth of stock.

As we sit here today, we have essentially no net debt, we have $1.4 billion in the bank, we have 46 unencumbered 737s, and our pensions are almost fully funded. This is all made possible by our profitability, and at this point we're expected to post a record full-year result in 2013.

And we're optimistic about 2014. We've been working hard to ensure that we have a plan for next year to continue this strong permanence. As we look forward, we'll have typical inflationary cost pressures and RASM pressure from competitive capacity ads. But these will be offset by baggage and change fee increases, which will take effect in the next couple of weeks; by our cabin upgrade project, which will come online in December; by our new affinity card agreement, which was signed in July; and by what we believe will be a material reduction in pension expense in 2014.

Switching gears, Alaska was recently named the most fuel efficient airline in the US by the International Council on Clean Transportation. This was the first study of its kind done in the US and the recognition is gratifying. Our goal is to be the industry leader in environmental stewardship, and this award validates that the work we've been doing is paying off. Fuel efficiency is important, not only in protecting the environment, but also in protecting our bottom line.

When we declared the dividend back in July, we did so with the confidence that our financial success was sustainable. We have loyal customers who view Alaska as their hometown airline. We earn this loyalty with low fares, with industry leading operational performance, and with award winning customer service.

We have single fleets of fuel efficient aircraft in both Alaska and Horizon that are well-suited to flying in our markets and have better costs than the legacy airlines. And most importantly, we have great employees who have helped us to restructure this company and who are fiercely proud of what we have built. Of course this business is challenging, but we're in this together, and we're very much looking forward to the future, a future where we plan to continue to perform for our customers, our communities, our employees, and our owners.

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

Brandon Pedersen - *Alaska Airlines - CFO*

Thanks, Brad, and hello, everyone.

The $251 million adjusted free-tax profit this quarter represents a $7 million improvement over the third quarter of 2012. Excluding a special revenue item that Chris described, total operating revenues increased by $93 million or 7% on the 7% increase in capacity. Passenger RASM declined by 1.2%, largely on the competitive pressures that Brad described, partially offset by 0.6 points of a PRASM benefit from the modified affinity card agreement.

Total RASM was about flat, helped 1.5 percentage points by the affinity card agreement, including $8 million related to additional compensation received for miles sold in the first half of the year. We'll continue to see favorable impacts to unit revenue comps for the next three quarters as we annualize the deal.

Total non-fuel operating costs increased by 9%, resulting in a 1.4% increase in CASM ex fuel. Wages and benefits were the primary drivers of the year-over-year increase. This was mostly related to the new long-term agreement with Alaska's pilots. The quarter included about half a year's of annual increase because the contract was effective back to April 1, even though it was ratified in July.

Productivity continues to improve. On a passenger per employee basis, Air Group's productivity increased by 4% this quarter. This is consistent with our guiding principle that we want to pay our people well, with a goal of reaching the industry's best productivity over time.

Our productivity today is 43% better than where it was back in 2003. This has been a significant factor in our financial success, and I want to acknowledge our employees' contributions and openness to change that made that kind of progress possible.

Landing fees and other rents were higher in the quarter, as we continued to accrue the higher rates imposed on us by the Port of Seattle that we told you about last quarter. We just recently signed a new lease with the Port that has lower rates than those imposed, but it still needs to be signed by enough carriers for it to be effective in 2013. We'll know more in the fourth quarter, and we're hopeful we can record a favorable adjustment to reflect the lower rates in this fiscal year.

Based on what we see today, we expect full-year non-fuel unit cost to be about flat to up about very, very slightly. Estimated incentive pay has increase, which reflects healthy profits, but puts pressure on CASMex, and we had hoped to have the SeaTac lease resolved sooner.

Looking forward, our system level growth will slow from the pace we've seen recently. For Air Group, we expect capacity growth of just under 5% in the fourth quarter and just over 5% in 2014, with much of that growth coming from larger 900ERairplanes and the impact of extra seats that we'll be adding to the 800 and 900 fleets.

Right now we're deep into the 2014 budgeting process. We're not ready to give guidance on next year's costs just yet, but as our growth slows, bringing unit costs down may be challenging. Some of the head winds are familiar; higher wages, much which is associated with new labor agreements; medical cost inflation; and additional significant investments into important IT infrastructure and innovation projects are all putting pressure on costs.

Our 2014 profit will be helped, however, by the powerful profit drivers we announced back in July. The seats, the bag and fee changes, and the modified affinity deal that together, when fully implemented, are worth $150 million or more per year.

Turning to the balance sheet, we ended the quarter with $1.4 billion in cash and short-term investments. Through the first nine months of the year, we've generated $820 million of operating cash flow compared to $638 million last year. Capital spending was $395 million, resulting in free cash flow of $425 million.

We've used that free cash flow in a balanced and deliberate way to strengthen the business by paying off $139 million of long-term debt, which was all normal maturities, using $14 million to pay the first dividend since 1992, and repurchasing over 1.5 million shares of our common stock for $83 million.

We currently have $150 million remaining under our $250 million authorization. Our goal of finishing the program by next year remains. However, we do have the authority to accelerate buyback activity and may do so, especially if we see any significant pull-back in our share price.

We are now projecting CapEx to be $520 million this year, up a bit because we just exercised options for five aircraft that will be delivered in 2015 through 2017. We also worked with Boeing to move options for five additional aircraft out of 2015 and 2016 and into 2018 and 2019, where we previously had no options. This gives us a bit more flexibility with the fleet in these later years, slows closer-in growth, allowing us to digest all of the recent new markets, and helps us to lower CapEx somewhat in 2014 and 2015 to maximize free cash flow generation.

Our adjusted debt to cap ratio now stands at 47%, which is comparable to high quality industrial companies outside of our industry. Improving operating results and a stronger credit metrics were sited by Standard and Poor's recently when they raised our credit rating a notch to BB. Our strong balance sheet and access to liquidity will continue to and have served this company well.

With the deleveraging basically complete, a larger percentage of future free cash flow will be available to return to capital providers.

I want to mention one other item before we go to Q&A. We're happy to report that our pensions were about 95% funded on a [PBO] basis at September 30. This is because of our multi-pronged strategy to address our pension obligation, including the $575 million that we've contributed to the plans over the last five years, even though none was required, and the plan restructuring that we've done.

As a reminder, all of our defined benefit plans are closed to new entrants, and the management DB plan will be frozen on January 1, 2014. We've also had some help from strong investment income and the recent increase in interest rates.

As a result of all of these factors, we expect a reduction of pension expense next year that could be $40 million or more. That's a very preliminary number, but lower pension costs will offset some of the cost pressures I talked about earlier.

Finally, I hope to see you all at our investor conference on November 14 in New York. If you haven't registered yet and would you like to, please let Chris know. With that, we would now like to open it up to Q&A. Chris?

Chris Berry - *Alaska Airlines - Manager IR*

All right, Megan, go ahead and prompt for questions. Thank you.

QUESTIONS AND ANSWERS

Operator

(Operator Instructions). Your first question comes from the line of Duane Pfennigwerth with Evercore. Your line is open.

Duane Pfennigwerth - *Evercore Partners - Analyst*

Hi, good morning.

Brad Tilden - *Alaska Airlines - President, CEO*

Good morning, Duane.

Duane Pfennigwerth - *Evercore Partners - Analyst*

I'm just wondering, feels like state of Alaska probably a little bit better, but clearly some more competition in the fourth quarter along the West Coast. How much do you think competition cost you -- or incremental competition cost you the third quarter, and how do you view it fourth quarter, first quarter? Is it worse, is it getting better, is it about the same?

Andrew Harrison - *Alaska Airlines - VP Planning & Revenue Management*

Duane, hi, it's Andrew. The competitive pressures from other airlines peaked at about 10% growth in the third quarter. As we see it, it's about 7% growth in the fourth quarter, and then about 8% in the first quarter, so it's reducing. At the end of the day, we've seen good strengthening of our development markets, and we feel very good about our lower capacity in both the fourth quarter and the first quarter to help offset these ads.

Duane Pfennigwerth - *Evercore Partners - Analyst*

Okay, thanks for that. And then you mentioned some favorable cost items in 2014. I may have missed it. How should we be thinking total ex fuel costs looking into next year?

Brandon Pedersen - *Alaska Airlines - CFO*

Good morning, Duane, it's Brandon. We haven't given guidance yet on 2014 ex fuel cost. You can expect more on investor day. I made the comment that has growth slows, it will be difficult to bring down the unit cost.

We are totally focused on it. We're in the midst of the budget season right now. We've had a long track reported of bringing down unit cost. We recognize its importance. We're trying to balance that with the normal inflationary pressures we're dealing with plus our decision to continue to make strategic investments into IT and perhaps the brand as he would have into 2014.

Duane Pfennigwerth - *Evercore Partners - Analyst*

Okay, thanks very much.

Operator

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

Hunter Keay - *Wolfe Trahan & Co. - Analyst*

Hey. The brand, Brandon?

Brandon Pedersen - *Alaska Airlines - CFO*

Brand Brandon, yes.

Hunter Keay - *Wolfe Trahan & Co. - Analyst*

What do you mean by that?

Brandon Pedersen - *Alaska Airlines - CFO*

Well, Hunter, as you know, we've had a project ongoing for about a year, year and a half now to see if there were ways that we could make our brand more energetic and compelling, specifically outside of the Pacific Northwest. We are early in the process, but making good headway. I'll let Joe talk about it more. We may end up spending some money on it in 2014, and wehaven't quantified that. As I said, we're early in the process, but it may cost us something to make changes to the brand.

Hunter Keay - *Wolfe Trahan & Co. - Analyst*

Okay. Well, that's fine. We can talk about it later. But my question was -- well, first of all,I love the commentary on the buyback acceleration potentially. But why -- just to play devil's advocate for a second, why would you wait for a pull-back if your stock is so cheap? You know it, I know it, everyone knows your stock is undervalued. So thestock chart doesn't necessarily mean that a stock is appropriately priced or whatever, so why would you not accelerate the stock buyback now anyway, given where your stock trades in relation to the returns that you're generating?

Brandon Pedersen - *Alaska Airlines - CFO*

We may very well do that.

Hunter Keay - *Wolfe Trahan & Co. - Analyst*

Wonderful. And in terms of the [TRASM] gap to PRASM in the third quarter, it was a little bigger than I though, and my beloved change fees and bag fees don't even kick in until next week. So should we expect the gap with TRASM and PRASM to continue to accelerate into the first quarter of next year?

Brandon Pedersen - *Alaska Airlines - CFO*

Hunter, it's Brandon again. We don't give a lot of guidance on RASM or PRASM numbers. I think you hit on an important topic, which is the change fees do kick in this year, and we'll see it in the first quarter.

Our total revenue number includes some other things like cargo, which has been relatively flat. We did see some growth in the quarter, but relatively flat when compared to overall capacity growth. So it's a comply complicated question. The other thing, and we did mention in our prepared remarks, is that PRASM included $8 million of retro associated with the new bank deal that won't carry over. That's a one-time deal.

Hunter Keay - *Wolfe Trahan & Co. - Analyst*

Very helpful. Thank you very much.

Chris Berry - *Alaska Airlines - Manager IR*

Thanks, Hunter.

Operator

Your next question comes from the line of John Godyn, Morgan Stanley. Your line is now open.

John Godyn - *Morgan Stanley - Analyst*

Hey, guys, thanks for taking my question. Brandon, I was hoping to follow-up on a cost comments earlier. I can appreciate not giving a point estimate for guidance in 2014, but we've heard this commentary in the past where you highlight a whole long list of cost pressures, and then once that guidance comes out, we're still seeing down CASM ex fuel year-over-year. You mentioned a good guy with the pension expense here. Just in broad strokes, are we still -- is the management ideology still in the world where we think we can improve the CASM ex fuel cost structure over year? Are there still opportunities to do that as we look out the next few years?

Brandon Pedersen - *Alaska Airlines - CFO*

Yes, I think the management -- ourhead is totally in continuing to reduce costs as we look forward. As you said, we're not ready to give a specific estimate, but we do think that there's continued opportunity to improve productivity, for example. And while it may slow next year, longer term we do think it's important for us to be able to continue to drive down costs to get our cost structure closer to the low cost carriers.

John Godyn - *Morgan Stanley - Analyst*

Okay, great. That's very helpful. And just on ancillary revenues, kind of big picture. We've seen you guys do some very thoughtful ancillaries recently, and they're very powerful in the sense that they're not the types that necessarily drive a substitution effect with yields or PRASM or how we think about it. Can you just speak to the ancillary strategy, bigger picture? Are there more of these types of opportunities down the line that you guys are investigating? Thanks a lot.

Joseph Sprague - *Alaska Airlines - VP Marketing*

John, this is Joe Sprague from Marketing. I think at a high level the first thing, as you point out, we're wanting for implement and do so successfully with our new bag fee and change fee increases that will go into effect next week. Overall, I think we're actually pleased with, even before those changes take effect, how ancillaries are performing this year.

For the quarter, our ancillaries per passenger were at $11.94, and that was up from $11.78 in the same period last year. And bag fees was a big contributor to that, so they're performing better even before the new increase goes into effect. And we've also seen some great progress with our buy on board food program as well.

So I think, high level, are there other things we can do? You bet, and we absolutely look at those all the time, and as we get the current changes implemented, we'll continue to focus on that.

John Godyn - *Morgan Stanley - Analyst*

Thank you.

Brad Tilden - *Alaska Airlines - President, CEO*

Thanks, John.

Operator

Your next question comes from the line of Savanthi Syth with Raymond James. Your line is now open.

Savanthi Syth - *Raymond James & Associates - Analyst*

Good morning, everybody.

Brandon Pedersen - *Alaska Airlines - CFO*

Hey, Savi.

Savanthi Syth - *Raymond James & Associates - Analyst*

Just a quick question on the topic that's been discussed much, but just with Delta's action, I was just wondering, is the positive aspect of having Delta having more international and therefore needing more feed from you over -- is that business overshadowing the negative impact it's having from a competitive standpoint?

Andrew Harrison - *Alaska Airlines - VP Planning & Revenue Management*

Hi, Savi, it's Andrew. Delta is continuing to grow its international presents. And as we have 55% of the seat share in Seattle, we obviously bring a lot of that traffic into Seattle. But as Brad eloquently put in his opening remarks, we'll work together where there's benefit, as we work with them on the international growth. And then where there is competition, then we work -- head-to-head competition, then we'll vigorously defend our core markets.

Savanthi Syth - *Raymond James & Associates - Analyst*

And then just -- have you taken any kind of move in the near-term in relation to that?

Andrew Harrison - *Alaska Airlines - VP Planning & Revenue Management*

As far as the competitive, we have. We have increased our market presents in both Seattle/LA, Seattle/Las Vegas, Seattle/San Francisco, so we absolutely have and are working to vigorously defend that. We also -- Joe's team did a double miles earning elite qualifying status on those markets as well.

Savanthi Syth - *Raymond James & Associates - Analyst*

And one last question, just on the West Coast markets. So the pressure you saw in the summer, is that continuing into the fall as well?

Andrew Harrison - *Alaska Airlines - VP Planning & Revenue Management*

The specific pressure that goes on into the fall, Savi, is not so much in the state of Alaska but more up and down the West Coast, the Seattle/LA, Seattle/Vegas, Seattle/San Francisco.

Savanthi Syth - *Raymond James & Associates - Analyst*

So that continues at the same magnitude?

Andrew Harrison - *Alaska Airlines - VP Planning & Revenue Management*

If not a little bit more.

Savanthi Syth - *Raymond James & Associates - Analyst*

Okay, understood. Great, thanks so much.

Brad Tilden - *Alaska Airlines - President, CEO*

Thanks, Savi.

Operator

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

Helane Becker - *Cowen Securties LLC - Analyst*

Thanks very much. Hi, everybody, thanks for the time. I actually wanted to know one kind of housekeeping item, or maybe two. Landing fees were up 16% and -- so there's a two-part question. One is the drivers for that, and two is, with all of the new capacity going into Seattle, I know that's historically been a high cost airport for you. Does that help that line item slow growth?

I probably asked that backwards. Does that help in terms of lower cost increases going forward?

Brandon Pedersen - *Alaska Airlines - CFO*

Helane, it's Brandon. Maybe I'll start with the first part, and then Ben can help with the second part. On the landing fee increase, much of that increase is relate to the increase that we saw at Seattle. You might be back -- remember back at the end of the second quarter we told you that the Port of Seattle had imposed rates on us in the absence of a lease agreement that goes back to January 1. We're still accruing at the higher rate, so if you carve that out, the increase is basically a volume related increase, as well as just what I would consider a normalized increases at other locations.

As I mentioned, we did sign a new lease with the Port, and once enough airlines are able to sign that, we're hopeful that will be reflected in 2013 as a favorable adjustment, because the new lease has rates that are lower than those imposed.

In terms of the growth in Seattle and how that might help us, Ben, do you want to talk about that?

Ben Minicucci - *Alaska Airlines - COO*

Helane, what I can tell you just about cost is that year -- before resolution rates, rates are increasing, so it's a volume and rate equation that is causing our rates to go up. So even with increased capacity, we'll see higher costs for ourselves in Seattle.

Brad Tilden - *Alaska Airlines - President, CEO*

More volume theoretically helps. I don't think it will actually help, Helane.

Helane Becker - *Cowen Securties LLC - Analyst*

Okay.

Brandon Pedersen - *Alaska Airlines - CFO*

Does that help?

Helane Becker - *Cowen Securties LLC - Analyst*

Yes. So that's fine, I don't have a problem with that. And then my other question is, with respect to fuel hedging, given -- I know you guys believe it in and so on, but any thoughts to changing the amount you hedge going forward maybe, with fuel costs coming down?

Mark Eliasen - *Alaska Airlines - VP Finance, Treasurer*

Hi, Helane, this is Mark.

Helane Becker - *Cowen Securties LLC - Analyst*

Hi, Mark.

Mark Eliasen - *Alaska Airlines - VP Finance, Treasurer*

We're satisfied with our program. It's worked for us, as you know, for 13 years. We've made adjustments with the deductibles, but overall we're happy with the program, and I think we're going to stay the course.

Brad Tilden - *Alaska Airlines - President, CEO*

And, Helane, [let me remind you and everyone on the call] --

Helane Becker - *Cowen Securties LLC - Analyst*

Great. Thank you.

Brad Tilden - *Alaska Airlines - President, CEO*

This is Brad. We have gone from hedging 50% of our fuel with basically at the money call options to 50% -- and starting three years out to 50% of our capacity with 20% out of the money call options starting, what, Mark, 12 or 18 months out?

Mark Eliasen - *Alaska Airlines - VP Finance, Treasurer*

Yes. Well, we're at six months.

Brad Tilden - *Alaska Airlines - President, CEO*

Six months?

Mark Eliasen - *Alaska Airlines - VP Finance, Treasurer*

Yes.

Brad Tilden - *Alaska Airlines - President, CEO*

So our -- Helane, our premium expense, that's -- it may not sound like it, but that's a material change in the premium money that we're spending to hedge, and that's happened in the over 18 months.

Mark Eliasen - *Alaska Airlines - VP Finance, Treasurer*

Yes, that's right. And the premium should go down about $45 million so far year-to-date down to about $20 million to $25 million a year.

Helane Becker - *Cowen Securties LLC - Analyst*

Great. Very helpful. Thank you.

Mark Eliasen - *Alaska Airlines - VP Finance, Treasurer*

Sure.

Operator

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

Dave Fintzen - *Barclays Capital - Analyst*

Hey, good morning, everyone.

Brandon Pedersen - *Alaska Airlines - CFO*

Good morning, David.

Dave Fintzen - *Barclays Capital - Analyst*

Question. I think,Brad, you kind of referenced this in your opening comments, but I'm just curious how Southern California and some of the new flying you added about a year ago is developing, particularly some of those transcons, and then how San Diego, et cetera, kind of fits into your growth plans going forward?

Brad Tilden - *Alaska Airlines - President, CEO*

Thanks, David. We'll ask Andrew to give some color on that.

Andrew Harrison - *Alaska Airlines - VP Planning & Revenue Management*

David, we're seeing continued improvement in our transcon markets. We just recently moved our San Diego/Orlando to a daytime flight from a red eye, and we're seeing very nice unit revenue increases moving out.

As far as San Diego goes in general, we just look for opportunistic things to do there. We have a decent presence there. We've served that market for a long, long time, and again, a lot of new markets, but they're basically developing in line where we expect. It will take a few years to mature

Dave Fintzen - *Barclays Capital - Analyst*

Okay. And just -- did I understand the comments, the 5%-ish was a 2014 ASM growth? Was that -- I think that was in Brandon's comments.

Brandon Pedersen - *Alaska Airlines - CFO*

Yes. It's actually the Q4 number and the basically 2014 number as we see it today. AndI made the point in the prepared remarks, but it's worth mentioning again, that a lot of that comes from the gauge of the 900ERs that are coming in as well as the additional row of seats we'll be adding to the 800s and 900s. So unit growth -- or airplane growth maybe is a better way to say it on the mainline side, we're only up two units next year.

Dave Fintzen - *Barclays Capital - Analyst*

Okay. Just remind us, I think you had said this before. The added seats, what does that translate into the ASM? Is that a full point?

Brandon Pedersen - *Alaska Airlines - CFO*

Yes, 1 point in 2014 and 1 point in 2015, just because we'll be working through 2014 to get project done.

Dave Fintzen - *Barclays Capital - Analyst*

Great. All right, thank you.

Operator

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

Michael Linenberg - *Deutsche Bank - Analyst*

Good morning, everyone. Two questions here. Just back on the pension expense. I think you indicated it was going to be down -- it could be down, rough estimates, $40 million. What is the base?

Brandon Pedersen - *Alaska Airlines - CFO*

What is the base? In current year pensionexpense? It's right around $50 million.

Michael Linenberg - *Deutsche Bank - Analyst*

Oh wow, so that could fall like 80%. Okay.

Brandon Pedersen - *Alaska Airlines - CFO*

Yes, and accounting rules us to snap the line as of December 31, and that sets the bar going forward. So that is a preliminary number, but based on what we're seeing today, we're encouraged that our costs are going to go down a lot in that area.

Michael Linenberg - *Deutsche Bank - Analyst*

Okay, very good. And then second question, whenyou look at the new flights that Delta is putting in, and you're adding additional markets, are those markets that you co-chair or are you not co-chairing on them now? Can you talk about that?

Brad Tilden - *Alaska Airlines - President, CEO*

Mike, this is Brad. I'll chime in about the Delta relationship for a bit. First of all, the new flights that Delta is that into some of our north/south West Coast markets are markets that we will not be co-chairing on.

A lot of folks are asked questions about Delta, and I guess one of the things that I want folks to know that we're trying to do here is to take the emotion out of this process and make the best decisions that we possibly can. I would think that as we move forward there will be places where it is going to be in our interest to work with Delta, and we're going to support them. They're growing internationally. By itself, that should be a good thing for both of us, and so we're going work with them to grow our -- the connections between the two airlines.

And then there are places where they are growing in north/south markets that have been long-term core markets for Alaska Air Group, and in those markets we will compete, and we'll defend what we've built over the years. But we have got a longstanding relationship with these folks. We've had a lot of competition north/south on the West Coast over the years. It will be a little complicated, but that's the world we're moving into, and I think it's going to be okay.

Michael Linenberg - *Deutsche Bank - Analyst*

Brad is there -- just a follow-up, is there -- I mean, there's a lot of players in these markets. I mean, is there the possibility that maybe someone else besides you or Delta or even United may end up actually scaling back supply? And is there anything out in the forward schedule data that maybe suggests that there are pull-backs maybe by some who are being hurt disproportionately by this?

Brad Tilden - *Alaska Airlines - President, CEO*

I might get Andrew to talk about forward schedules in particular, but to your first question, I would say absolutely. If you look at just the way the West Coast make up has gone over five, 10, 15, 20 years, it's changing all the time in terms of who is doing what flying. And to think, net-net, Alaska has been a winner in all of those moves for a long, long time now.

But absolutely, markets -- new capacity comes in and someone pull -- maybe that new capacity comes out again or somebody else comes out, but absolutely. I would not expect somebody makes an announce that -- it won't be right to say, okay, that's the permanent structure of the market. People are moving all of the time, and the water will find its level again at some point here.

Michael Linenberg - *Deutsche Bank - Analyst*

Okay, great.

Brad Tilden - *Alaska Airlines - President, CEO*

Andrew, do you want to talk -- is there any data that we see in forward schedules?

Andrew Harrison - *Alaska Airlines - VP Planning & Revenue Management*

Nothing significant. We've seen Virgin move out of Portland/LA and put that into San Francisco. We've seen winter capacity reductions, but on the whole we haven't seen any changes yet.

Michael Linenberg - *Deutsche Bank - Analyst*

Okay, great, thank you.

Brad Tilden - *Alaska Airlines - President, CEO*

Thanks, Mike.

Operator

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

Jamie Baker - *JPMorgan Chase & Co. - Analyst*

Hey, good afternoon, everyone. The relationships between airlines -- well, big airlines and their regional partners, are pretty well disclosed. In terms breakage policies, there's typically a notification period, limits on how many aircraft you can rollout per year. There might be some early out provisions related to work stoppages or operational metrics, but the details are out there.

But this is not the case with co-chair relationships. Who really wears the pants in those agreements? Or put differently, if one of your partners simply decided to call it quits, how easily can they do so? Can they walk away at a moment's notice? And the same thing applies to you -- to Alaska, of course, unilaterally deciding to call it quits?

Brad Tilden - *Alaska Airlines - President, CEO*

Jamie, it's Brad. This is -- as you say, it's a co-chair relationship. It's got marketing, it's got other features to it. The basic relationship is the long-term agreement, and I don't think we've said publicly and probably not going to say now exactly what duration is, but it is a long-term agreement that does contain certain contractual minimums. So that's the nature of the deal.

As I said in the last question, our thinking now, I mean, our -- as you know, Jamie, our alliance structure has changed a lot over the 20-year history of this company, and if it needs to change, it will change. Our thinking now is to sort of keep the emotion out of this thing, deal with the facts that are in front of us, deal with what we see is happening in the marketplace, and make decisions at every juncture that are in the best long-term interest of Alaska Air Group. So that's how we're thinking about it.

Jamie Baker - *JPMorgan Chase & Co. - Analyst*

And would you be willing to quantify as a percentage of your total co-chair business -- and whether you want to answer this in passengers or preferably revenue -- well, actually, preferably profitable -- the component that AMR makes up?

Brad Tilden - *Alaska Airlines - President, CEO*

You mean Delta or AMR?

Jamie Baker - *JPMorgan Chase & Co. - Analyst*

AMR.

Brad Tilden - *Alaska Airlines - President, CEO*

Okay. I don't -- here's what we'll tell you, Jamie. Interline revenues in total are about 13% of our revenues. About 4% comes -- is enabled by Delta, either by co-chair or miles or interline agreements. American would be a little less than that.

Jamie Baker - *JPMorgan Chase & Co. - Analyst*

Okay, excellent disclosure. Thank you very much, gentlemen.

Operator

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

Glenn Engel - *BofA Merrill Lynch - Analyst*

The Seattle, if you get a new airport agreement, how much is that worth, and would that be another good guy for 2014?

Brandon Pedersen - *Alaska Airlines - CFO*

Glenn, it's Brandon. Good morning. Yes, it would be a good guy for us in the fourth quarter and into 2014. And the 2013 impact could be in the neighborhood of $8 million, and that's probably a fair representation of the benefit that we would see going into 2014 as well.

Glenn Engel - *BofA Merrill Lynch - Analyst*

So the higher cost guidance in the fourth quarter is Seattle now being included in the higher incentive pay?

Brandon Pedersen - *Alaska Airlines - CFO*

The higher costs in the fourth quarter is incentive pay, and it includes the existing rate structure. If we are able to get this pushed over the goal line in the fourth quarter it, would be a favorable -- it has a favorable impact to Q4 costs.

Glenn Engel - *BofA Merrill Lynch - Analyst*

And, Brad, not to beat a dead horse on this Delta issue, but it does seem like you're subsidizing a competitor by co-chairing with them on his international flights, making him stronger in a market that he's going against you. Why don't you want to make it more painful for Delta to not dump on you?

THOMSON REUTERS

Brad Tilden - *Alaska Airlines - President, CEO*

Hey, Glenn, it's Brad. Good question. I think what I'd say is that we're looking at this closely. We're studying it. There's all sorts of things -- actions that Alaska could take. It's just probably not in our interest to talk a lot on a quarterly conference call about what those actions might be. I think the best thing for us to do is to look at this and make whatever decisions we make and execute those decisions in the market.

Glenn Engel - *BofA Merrill Lynch - Analyst*

Thank you.

Brad Tilden - *Alaska Airlines - President, CEO*

Yes.

Operator

(Operator Instructions). Your next question comes from the line of Dan McKenzie with Buckingham Research. Your line is now open.

Dan McKenzie - *Buckingham Research - Analyst*

Hey, thanks. Good morning, guys. One quick clarification. I think I heard you say the new ancillary revenues were enough to you offset the competitive capacity from Delta, but did you say that you thought it would be enough to offset the anticipated cost pressures as well heading into next year?

Brandon Pedersen - *Alaska Airlines - CFO*

Good morning, Dan, it's Brandon. No, we did not say that directly. What we said was the impact of the new ancillary structure, plus the new seats, plus the modified agreement, they would all work together to offset or certainly at least mitigate some of the impact we're seeing from competitive capacity incursions as well as cost pressures in other areas.

Dan McKenzie - *Buckingham Research - Analyst*

Got it. Okay, thank you. And then I guess, Brandon, while I have you here, for purposes of evaluating the return of capital, can you remind us, are you using a gross CapEx number? Or if it's a net CapEx number, whatare the adjustments that you're making to that gross number exactly?

And I guess related to that, does the corporate finance math suggest that it could make some sense to add a small amount of debt to the balance sheet for potential share buybacks?

Brandon Pedersen - *Alaska Airlines - CFO*

There's two questions there, so I'll try to take them one by one. One is just your question about gross CapEx versus net CapEx. All CapEx numbers are gross. We really don't have a lot of proceeds from the sales of any assets, certainly nothing material, and so it's all gross to answer the question.

On the corporate finance math question, we get the whole cost to capital question and how if we raised more debt it would theoretically reduce our cast to capital. We're definitely mindful of that. We do that calculation.

The history of the airline industry though -- and I've said it in prior calls -- is that there's been way too much debt. So we really like where we're at, kind of in this 40% to 50% range. Not saying that we would always be there necessarily, but maybe it's a longwinded way to answer your question to say we are looking at that. We may raise debt to manage the capital structure. We wouldn't keep that cash just in the checking account, and so you can do the math from there.

Dan McKenzie - *Buckingham Research - Analyst*

Okay, thanks, appreciate it.

Operator

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

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

Hi, good afternoon.

Brad Tilden - *Alaska Airlines - President, CEO*

Hey, Steve.

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

I was curious, in terms of the $150 million or so from the change fees and credit card, I mean, itseems like that's around $5 a share in terms -- or I'm sorry, $5 a passenger in terms of ancillary. Am close on that? And it seems like it does a pretty good job of vaulting you guys higher. And I think -- I don't know if you mentioned this yet, but maybe you could talk about if you've seen any customer reaction in terms of the change bag fees, and maybe it's hard to determine given kind of what's going on competitively.

Brandon Pedersen - *Alaska Airlines - CFO*

Good morning, Steve, it's Brandon. I'll start, then give it to Joe.

Just in terms of how we measure ancillaries, theimpact of the fees, that would come through passenger revenue. Even the mileage plan or the affinity card deal, that would -- that gets split between passenger revenue and other revenue. We don't count that in our ancillary numbers. Just the modifications to the bag fee policy and change fee policies would get included in ancillary revenues. So that's just kind of how we think about it and how we do the math.

Joe, you want to take part two?

Joseph Sprague - *Alaska Airlines - VP Marketing*

The bag fees, in terms of customer reactions, that's a good question, Steve, thanks. We're going $20 to $25 for each of the first three bags. We've always felt we had a good value proposition, if there is such a thing, when it comes bag fees, because, number one, our simplicity, relatively low rate structure. In both cases we believe we're maintaining that with $25 for each of the first three bags. And then we still have the industry's only baggage service guarantee, which gives customers truly something in value for checking their bag with us.

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

Okay. And then I guess maybe as a follow-up, you guys talked about being on the forefront of technology. I mean, can you just give us a preview of what you see down the road that [maybe] would cut costs or further drive ancillary revenue?

Ben Minicucci - *Alaska Airlines - COO*

Hi, Steve, it's Ben Minicucci. So we have --I think in the last quarter we announced a Vice President of Innovation and Technology that has put a team together that's going to drive a lot of innovation into our operation and into our Company. So at investor day we're going give you a preview of that looks like, but we have definitely a pretty set goal by 2017 of being the most hassle-free airline in the world, and we're on track to be there.

Joseph Sprague - *Alaska Airlines - VP Marketing*

And, Steve, this is Joe again. I might just add --Ben is exactly right. One area that has been particularly encouraging -- we'll talk more on investor day -- is our efforts with our mobile apps. We think we have the industry's leading mobile apps. We had our 1 millionth download of a mobile app. And importantly how it affects productivity and makes our operation efficient, we're now just under 10% all check-ins happening via our mobile app, so that's good.

And if I could just correct one thing I said to you, Steve, on the bag fees, our first three are $25, $25, and $75. Still a good value proposition and simple to understand for customers.

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

Okay. Thank you very much.

Operator

Your next question comes from the line of Steve Wilhelm of Puget Sound Business. Your line is now open.

Steve Wilhelm - *Puget Sound Business Journal - Analyst*

Hello, gentlemen, thanks for taking my call. One of the questions just went away, so I guess I have two. One is I've heard that this redesign might include shedding the Eskimo motif? I was wondering if you could discuss that or say what -- where that might be leading? And then one more after that.

Joseph Sprague - *Alaska Airlines - VP Marketing*

Steve, this is Joe. We're -- asBrandon mentioned earlier, we're in a relatively early phrase at looking at our brand. Our particular goal is to make certain that our brand expression is more consistent across all different touch points. There maybe possible changes to the design. We're not ready to talk about that just yet.

I would just say that the Eskimo is a beloved part of our brand expression and something that customers and employees resonate and relate to very closely.

Steve Wilhelm - *Puget Sound Business Journal - Analyst*

Okay. And then secondly, I know you've touched on this before, but in terms of the Delta competition, there'sdiscussion that this might lead to a merger/acquisition at some point, because things are different now. Can you refresh where you're at in terms of that?

Brad Tilden - *Alaska Airlines - President, CEO*

Sure, Steve, this is Brad. I guess what I would tell you is that we're very happy with our strategy. We've proven over the years that us being independent has been a good ownership structure for our customers, for our communities, for our employees, and most importantly for our owners. So we like our strategy a lot, and our plan is to continue to executing it.

Steve Wilhelm - *Puget Sound Business Journal - Analyst*

Okay, thank you.

Operator

Your next question comes from the line of Tom Banse of [KUOW] Public Radio.

Tom Banse - *KUOW Radio - Analsyt*

Hi, just one last question on the Delta competition. I'm wondering if you think there's anything materially different from Delta attacking your West Coast core routes compared to Alaska's earlier expansions at Delta's hubs, like Salt Lake, Atlanta and Minneapolis?

Andrew Harrison - *Alaska Airlines - VP Planning & Revenue Management*

Hi, Tom, this is Andrew. I don't think so.

Tom Banse - *KUOW Radio - Analsyt*

Is there any aspect of payback here?

Andrew Harrison - *Alaska Airlines - VP Planning & Revenue Management*

I'm not going to answer that question. What I will tell you, though, is that part of the relationship we enjoy is that we connect into each others hubs and connect our traffic beyond each others hubs, and that will continue to evolve over time, and there will be adjustments made down the road. But as Brad has very well said, we're going focus on our instrument panel, and what we need to do, we'll do, and guide through this to make sure that things work for the best of Air Group shareholders, customers and employees.

Tom Banse - *KUOW Radio - Analsyt*

Then just a question in terms about the past history and the present. Were your expansions what you might call Delta's core territory friendlier than just what's happened here on the West Coast?

Brad Tilden - *Alaska Airlines - President, CEO*

Tom, it's Brad. I don't know that it makes a lot of sense for us to talk about that. Competition is the nature of the industry. It's been this way for 80 years, and it will continue to be. People go into each others markets. Our deal is just to deal with the facts that we have in front of us.

Tom Banse - *KUOW Radio - Analsyt*

Thank you.

Operator

Your next question comes from the line of Glenn Farley with King Television. Your line is open.

Glenn Farley - *KingTelevision - Analyst*

Hi, guys, how are you doing this morning? My question goes to fleet planning. We were looking at the -- you guysnever owned 757s before, but there's been some sort of increasing buzz within the industry about bringing something with those performance characteristics back. And with your route structure now, with your 737-800s and 900s, do you feel like -- I know you're getting MAXs going forward -- do you feel like you're sort of pushing the envelope there? Could you see getting a larger airplane, a longer range airplane than what those -- the 9 MAX and 900 offer?

Brandon Pedersen - *Alaska Airlines - CFO*

Good morning, Glenn, it's Brandon. We have worked really, really hard to get both the fleets in Alaska and Horizon down to a single fleet type within even 737 family. As you well know, there's a number of different variations. The 900ER is a big plane, and that's a super, super plane for us right now, so we have no plans to move to a larger airplane at this time.

Glenn Farley - *KingTelevision - Analyst*

Okay, thanks.

Brad Tilden - *Alaska Airlines - President, CEO*

Thanks, Glenn.

Operator

And there are no further questions at this time. I turn the call back over to Brad Tilden.

Brad Tilden - *Alaska Airlines - President, CEO*

Thanks very much, Megan, and thanks, everybody, for joining us. We look forward -- we do look forward to seeing you all in New York on November 14 for our investor day.

Operator

Thank you for participating in today's conference call. This will be available for replay beginning at 1.30 PM Eastern Time today through 11.59 PM Eastern Time on November 24, 2013. The conference ID number for the replay will be 37718015. The number to dial for the replay is 1-800-585-8367 or 404-537-3406. Also the call will be available for future playback at www.alaskaair.com. You may now disconnect.