THOMSON REUTERS STREETEVENTS

EDITED TRANSCRIPT

ALK - Q2 2012 Alaska Air Group, Inc. Earnings Conference Call

EVENT DATE/TIME: JULY 26, 2012 / 4:00PM GMT

OVERVIEW:

ALK reported 2Q12 GAAP profit of $67.5m.

CORPORATE PARTICIPANTS

Chris Berry *Alaska Air Group Inc - Managing Director, IR*

Brad Tilden *Alaska Air Group Inc - CEO*

Brandon Pedersen *Alaska Air Group Inc - CFO*

Andrew Harrison *Alaska Air Group Inc - VP Planning & Revenue Management*

Ben Minicucci *Alaska Air Group Inc - COO*

Joe Sprague *Alaska Air Group Inc - VP Marketing*

Glenn Johnson *Alaska Air Group Inc - President, Horizon Air*

CONFERENCE CALL PARTICIPANTS

Hunter Keay *Wolfe Trahan - Analyst*

Helane Becker *Dahlman Rose & Co. - Analyst*

Michael Linenberg *Deutsche Bank - Analyst*

Duane Pfennigwerth *Evercore Partners - Analyst*

Jamie Baker *JPMorgan Chase & Co. - Analyst*

John Godyn *Morgan Stanley - Analyst*

Savi Syth *Raymond James - Analyst*

David Fintzen *Barclays Capital - Analyst*

Glenn Engel *BofA Merrill Lynch - Analyst*

Kevin Crissey *UBS - Analyst*

Steve O'Hara *Sidoti & Company - Analyst*

Dan Mckenzie *Rodman & Renshaw - Analyst*

PRESENTATION

Operator

Good morning. My name is Sara and I will be your conference operator today. At this time, I'd like to welcome everyone to the Alaska Air Group second quarter 2012 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 speaker's remarks there will be a question-and-answer session for analysts and journalist.

(Operator Instructions)

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

Chris Berry - *Alaska Air Group Inc - Managing Director, IR*

Thanks, Sara. Good morning everyone, and thank you for joining us for Alaska Air Group's second quarter 2012 earnings call. Today our CEO, Brad Tilden, and our CFO, Brandon Pederson, will share their thoughts on our second quarter financial results, our operations, and our outlook for the remainder of the year. Several members of our senior management team are also here to help answer your questions. Our discussion 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 available on our website.

We will refer often to certain non-GAAP financial measures, such as adjusted earnings or unit cost 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 second-quarter GAAP profit of $67.5 million. Excluding the impact of mark-to-market adjustments related to our fuel hedge portfolio, we reported an adjusted net income of $110.8 million, or $1.53 per share. This compares to a First Call mean estimate of $1.51 per share, and to last year's adjusted net income of $89.6 million, or $1.22 per share. Additional information about our unit cost expectations, capacity plans, future fuel hedge positions, 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. Now I'll turn the call over to Brad.

Brad Tilden - *Alaska Air Group Inc - CEO*

Thanks Chris, and good morning everyone. We're pleased to report a record second quarter adjusted profit of nearly $111 million, and this is our 13th consecutive quarterly profit. Despite ongoing concerns about the macroeconomic environment, demand during the quarter was strong, and that led to a 9.3% or $103 million increase in operating revenues. We again posted record load factors, continuing a trend that stretches back to 2009. Against a backdrop of 6% ASM growth, we posted a 2.2 point increase in load factor and a 3.7% increase in consolidated PRASM, giving us confidence that we are managing capacity effectively.

Our pretax margin also improved from 13% last year to 14.7% this year. The margin increase was due to revenue gains that were sufficient to cover increases in both fuel and nonfuel costs. With our leadership transition, some of you have asked that if there will be changes in the strategic direction of the Company. The quick answer is no. We put the 2010 plan together roughly nine years ago, and it has been an excellent road map for the Company and has led to much of the success we're enjoying today. So we know the importance of having a clear plan and clear goals that we can all align around. As we move forward, the 2010 plan is the big picture plan, but underneath this overall plan there are five strategic initiatives that we're focusing on.

These are, first, safety and compliance. Nothing is more important. Second, people. We want to better connect with our employees and preserve our small company feel, even as we grow. Third, over the next several years our goal is to become the easiest airline to fly with, and to become known for a hassle-free customer experience. Fourth is brand. We want to strengthen our brand and make it more attractive to our evolving customer base. Finally, low fares. We want to be known for our low fares, and as we've said before, we can't have low fares without low cost. So we will continue to move toward a cost structure that allows us to complete with a growing number of low-cost carriers.

If we do these things and meet our profit goals, it will make sense to further grow the network. You'll hear more about each of these areas in the quarters and years ahead. Our belief is that successfully executing against these five focus areas will help us meet the needs of our three stakeholder groups. For customers, we'll run a great airline and provide compelling value. For employees, we'll be recognized as a great place for people to work. For shareholders and other capital providers, ALK will be an investment that our owners will be happy to have in their portfolio for the long-term because we will provide returns that exceed our cost of capital over the cycle. This is the goal. It's been done for short periods of time, but not on a sustained basis, and that's what we're attempting to do.

During the second quarter we won our fifth consecutive JD Power Award for Highest in Customer Satisfaction Among Traditional Network Carriers. This is wonderful recognition of how our customers feel about us, and while we're celebrating the award, we're also diving into the scores to make sure we find ways to further improve our customer experience. Our exceptional operational reliability, customer friendly technology, and improvements to our onboard experience all contributed to this award. Yet what we always hear about Alaska, and what this survey confirms, is that our people and their commitment to our customers and communities is what sets us apart. One relatively small example of this is our Portland station employees who recently spent hundreds, if not thousands, of hours constructing what proved to be the award-winning float in the Portland Rose Festival Parade.

Again, this is just one example. All around our system, our people are involved, making a positive difference. We realize that every company believes they have the best people. In our case, our belief is validated by our customers. On the network growth front, we during the quarter we initiated service from Seattle to Philadelphia and from San Diego to Santa Rosa, Monterey, and Fresno. We've also announced new service from Seattle to San Antonio, and from Portland to Reagan National, both of which will start in the third quarter. In the fourth quarter, we'll begin flying from San Diego to Orlando, from Portland to Kauai, from Bellingham to Maui, and from Anchorage to Kona, with several of these markets having a limited number of frequencies per week.

We had some good news this quarter on the people front as well. Our ramp and stores' agent represented by the IAM ratified a six-year contract by a 91% margin, and they did this before the contract amendable date. The agreement provides for an initial wage increase of 2.5%, followed by a 1.5% annual increases. The contract included productivity improvements, and it also offers both Alaska and our employees the certainty that comes with a long-term agreement. We are very pleased we were able to get this contract done, and we want to congratulate and thank everyone who sat at the bargaining table during the negotiations. In light of this agreement, and the five-year contract ratified by our technicians last year, we're hopeful that we will be able to achieve long-term contracts with all of our work groups at both Alaska and Horizon that provide fair wages, generous profit-sharing, and enhanced productivity.

Operationally, both Alaska and Horizon had another strong quarter. Alaska was number one in on-time performance among the top 10 airlines in the US for the 12 months ended May 2012, and more impressively, Horizon was number one among all US airlines for each month of the quarter. In closing, I'm very proud of our people and the tremendous effort they put forth every day to take extraordinary care of our customers. By continuing to work together, like we're doing right now, we will grow stronger and be even better prepared to handle the inevitable opportunities and challenges that come our way. With that, I'll turn the call over to Brandon.

Brandon Pedersen - *Alaska Air Group Inc - CFO*

Thanks Brad, and hello everyone. As Chris said, Air Group reported a record adjusted net profit of $110.8 million, compared to an $89.6 million profit last year. This result brings our trailing 12-month return on invested capital to 12.3%, nearly a full point higher than the 11.5% at the end of the second quarter of last year. While I'm certainly not providing earnings guidance, it appears very likely that we'll exceed our 10% after-tax ROIC target again this year. This would be the third year in a row that we've been able to do so. Our growing track record gives me confidence that we are making the right changes to our business that will enable us to reach our goal of an average 10% ROIC across the peaks and valleys of the business cycle.

Adjusted pretax profit improved by nearly $35 million compared to last year. The improvement was driven by a $103 million increase in operating revenues, partially offset by a $36 million increase in economic fuel costs, and a $37 million increase in adjusted nonfuel operating expenses. As Brad mentioned, our pretax margin increased from 13% in 2011 to 14.7% in 2012, and our operating margin was just over 15%. Notably, this is the first time we've had year-over-year pretax margin expansion since the first quarter of 2011. Consolidated passenger revenues grew by $97 million, or 10.2%, on the 6.3% increase in capacity and a 3.7% increase in PRASM. Yields were up just under a point during the quarter, with a 2.2 point increase in load factor being the main driver of the PRASM gain.

The mainline business performed well this quarter. Mainline PRASM was up by 4.8%, even with a 4% increase in stage length. The industry, ex-Alaska, was up 6% on a slight reduction in capacity and flat stage length. When adjusting for changes in stage length, we think are mainline PRASM compared favorably to the industry. Unit revenues were strong in Alaska, Hawaii, and our mid-con markets. We mentioned last quarter that Alaska long-haul flying had a negative impact on unit revenues because we had too much capacity in that market. We did a much better job matching supply and demand this quarter, leading to a nice bump in load factor. Although the regional business posted a slight decline in unit revenues, putting pressure on systemwide PRASM, we are pleased with the overall revenue performance during the quarter.

As we look to the third quarter, advanced bookings for July are about flat, August is up about a 1.5 points, and September is up about 1 point. The revenue environment remained relatively stable in our view, despite the headline risks and the uncertainty economic environment. Turning to cost, our nonfuel operating expenses, excluding fleet transition charges in 2011, increased by $37 million or 6% on the 6.3% increase in capacity. This resulted in a small decline in our consolidated nonfuel CASM, which was consistent with her latest guidance. You might have noticed in our investor update that our full-year nonfuel unit cost guidance is up from previous disclosures.

We now believe CASM ex will be about flat, versus down slightly, which was our previous guidance. The increase is due to higher projected incentive pay expense, which accounts for the entire one-tenth of a cent increase. As a reminder, we have a broad based performance incentive plan that pays based on how we do compared to financial and operational goals set annually by our Board. Because projected full-year profitability is shaping up to be quite good, and because our people are exceeding goals in safety and customer satisfaction metrics as well, our incentive pay forecast is up significantly. This is a cost increase that we're willing to accept, because it benefits all of our major stakeholders, employees, customers, and shareholders, and is an important part of our strategy to align the interests of these groups.

Overall, however, I am disappointed that we're not better able to leverage our planned 6% full-year ASM growth to lower unit costs. We know we need to find more ways to keep driving unit costs down, and as we move into the 2013 budget cycle, we'll be making sure our leaders develop plans that are consistent with this objective. Economic fuel costs were up $36 million, or 11% versus last year. The increase reflects a 3.7% increase in our economic price per gallon, a 6.7% increase in consumption. The change in economic fuel cost includes a nearly $29 million year-over-year swing in the impact of our hedges, from a net benefit of $17 million last year to a net cost of $12 million this year. In the second quarter of last year, we were in the money at $97 per barrel, including premium costs, whereas this year our breakeven price was $110 per barrel.

For the remainder of the year, we have 50% of our planned consumption capped at $100 per barrel, at an average premium cost of $10 per barrel. We also maintain short-term swaps on the refining margins, and we are 50% hedged for the third quarter at $31 per barrel. As a reminder, we're buying call options for WTI crude oil positions that give us 100% of the benefit of falling oil prices, limiting our exposure to the upfront cash we pay for premiums. In the fourth quarter of last year, we moved to purchasing options that are 10% out of money, given the strength of our balance sheet and our ability to take on more risk. This move is helping us reduce our annual spend on premiums by approximately $15 million to $20 million.

Moving to our balance sheet, we ended the quarter with $1.2 billion in cash and short-term investments. We've generated $455 million of operating cash flow in the first half of the year, compared to $370 million last year. Capital spending was about $255 million as we took delivery of three Boeing 737-800s and two Q-400s, resulting in roughly $200 million of free cash flow during the first half of this year. We've used that free cash flow to pay off $165 million of long-term debt, including $80 million of prepayments in the second quarter, improving our debt to cap ratio to 58%. We also purchased over 755,000 shares of our common stock for $26 million. As of June 30, we were $23 million into our current $50 million repurchase program.

Looking forward, we're projecting full-year gross capital spending to be $470 million. This is a slight reduction from our previous guidance, and reflects our decision to defer two 900-ER aircraft from 2013 to 2014 to better align deliveries with aircraft retirements and our growth plans. At the same time, we also agreed to advance the delivery date of one 900-ER by one month to December 2012. During the quarter we also finalized a deal to sell and lease back three 737-700s and exercised options for three 737-900-ERs that will be delivered at roughly the same time the 700s leave the fleet in late 2013 and early 2014. This is a good transaction for us, as the economics of replacing a 700 with 124-seats with a 900-ER, that has 181 seats is compelling.

Upguaging to the 900-ER is a very efficient, lower risk way to approach growth, and allows us to maintain our position as the leader in the airline industry when it comes to lower carbon emissions and better fuel efficiency on a per seat basis. Since the beginning of 2010 our business has generated $1.7 billion of operating cash flow. We've invested in the business by buying ten 737-800s and four Q-400s free and clear that we're deploying to markets that are performing well, yet we've still managed to produce nearly $900 million of free cash flow. We've reduced our on-balance sheet debt by over $700 million, and returned capital to shareholders by repurchasing more than $150 million of our common stock over that period.

In fact, we have purchased approximately $285 million of our stock since our buyback program began in 2007. The improvement in our balance sheet was one of the contributing factors to Standard & Poor's recent decision to change our outlook from stable to positive. Our free cash flow generation has improved significantly over the past few years, and investors sometimes ask about our capital allocation plans. We like our balanced approach. Invest in the business, deliver the balance sheet, and provide a return to our shareholders, all of which we're currently doing. I want to close by joining Brad in congratulating our employees for once again posting record results, and for what they do every day to take care of our customers, and with that, I'll turn the call back over to him to kick off the Q&A.

Brad Tilden - *Alaska Air Group Inc - CEO*

Thanks Brandon, and at this time we are ready for your questions.

QUESTIONS AND ANSWERS

Operator

(Operator Instructions)

Hunter Keay, Wolfe Trahan.

Hunter Keay - *Wolfe Trahan - Analyst*

Brad, the five strategic initiatives, which I think he recently unveiled within the last six months or so, they sound a lot like the strategies that are employed by Jet Blue and Southwest, whose products are great, but stocks haven't moved in 10 years, moved up in 10 years. So what would you say if I asserted that there is absolutely no connection between happy customers and shareholder wealth creation in airlines, and to the contrary, it may be the opposite might be true, broadly speaking?

Brad Tilden - *Alaska Air Group Inc - CEO*

I would say good question. One thing I would say is that look at the experience at Alaska Air Group in the last four or five years. What these five focus areas are really talking about are continuing strategies that -- really identifying things that we are good at, places where we can win, and exploiting those. I think there are a lot of what you've seen with the success of the 2010 plan, and we're going to do them going forward. Just to recap them. Safety is an obvious thing. We have to be safe. Alaska, the people one, what we're really saying there is that our size is an advantage for us. With a smaller company, we can be closer to each other, we can be closer to companies, we'll execute better.

Hasslefree, what we're really saying there is it's not an extravagant onboard product. What it is is being the -- it's genuine caring service and it's an easy, hasslefree customer experience. Brand, what we're saying is we've got to find a way to grow the market. The last one, Hunter, I would think you would like. What we're really saying there is get the revenues and get the fares and the costs in line, make sure there's a gap between what we're charging our customers and what it costs us to produce the product. That's what that point's all about. So I think our response has been, what were really talking about is talking about the things where Air Group has some capability today, the things that really helped us over the last few years, and producing what I think are close to industry-leading margins.

Hunter Keay - *Wolfe Trahan - Analyst*

Yes. You've somehow made it work. That was more of a devil's advocate question. So thanks for that, Brad. I guess, as I look at the balance sheet, I can't tell from the release, but I think your net cash right now, for the first time in six years, at least on the balance sheet, your CASM ex-fuel is going to be probably at an all-time low for your Company this year, even with the recent guidance change. You're doing well operationally, you're going to get maybe another 20%-ish EBIT margin in 3Q. So what are the things that the Board considers when evaluating maybe more exotic cash deployment options? Specific metrics, Or is a softer? Is it more of a softer, qualitative discussion?

Brad Tilden - *Alaska Air Group Inc - CEO*

Hunter, I think, I mean, we do regularly at the Board meeting look at all sorts of options to deploy cash from repurchasing stock, paying down debt, investing in aircraft, funding pensions, and other ideas. I think the best practice for us here is to probably say that if and when we have some news there, we'll announce that news, as we've done for the last three or four years, but I think to speculate a lot further isn't probably in our interest.

Hunter Keay - *Wolfe Trahan - Analyst*

Okay, I understand.

Operator

Helane Becker, Dahlman Rose.

Helane Becker - *Dahlman Rose & Co. - Analyst*

So, just a couple of smaller questions with respect to mix. Have you noticed a change in mix in your business, or would you still characterized being heavily leisure versus business? Could you maybe talk a little bit about that?

Andrew Harrison - *Alaska Air Group Inc - VP Planning & Revenue Management*

Helane, it's Andrew. I think what I would characterize that is we're still very heavy leisure travel, and if anything we're actually continuing to increase that. In the second quarter we had a 45% increase in our Hawaii capacity alone.

Helane Becker - *Dahlman Rose & Co. - Analyst*

Can you say what that capacity is now? I mean, Hawaii, Alaska, and then lower 48?

Andrew Harrison - *Alaska Air Group Inc - VP Planning & Revenue Management*

I think at the Air Group level for the full year, Hawaii is going to be 20% of our ASMs. Trans-con and mid- con are going to be about 19%, and California, which is still a very big portion of our business, is going to be a little over 20% as well. Those are the big categories, and then the State of Alaska is about 15% or so.

Helane Becker - *Dahlman Rose & Co. - Analyst*

Okay, and then just one last question with respect to business. Have you seen any shift in Mexico, whether people are going back there again, or are they still avoiding it, especially from the US and going to Hawaii instead?

Andrew Harrison - *Alaska Air Group Inc - VP Planning & Revenue Management*

So, to paths to that question, I suppose. As far as the beach markets, the Puerto Vallarta and the Cabo, we've been very pleased with those markets. We're not seen any issues at all on the demand front. So things are stable and good there. Then on that Guadalajara and Mexico City, we've seen some industry capacity changes, and we're feeling very good about those markets, and they're performing well at this time. So, in short, we haven't seen anything majorly negative as it relates to Mexico.

Operator

Michael Linenberg, Deutsche Bank.

Michael Linenberg - *Deutsche Bank - Analyst*

I got two questions here. The first for Andrew. Can you just run through some of the competitive changes in your core markets, and some of the things that come to mind are some of the new Virgin service in and out of Portland, but when you look out third quarter, fourth quarter, if you can just run through some of the pluses and minuses?

Andrew Harrison - *Alaska Air Group Inc - VP Planning & Revenue Management*

Yes. Mike, in general, I think the third quarter, we look at this as sort of the weighted average capacity changes of other airlines in our markets. I will say this summer is just marginally up as it relates to the summer capacity, but as we look into the fall, we're again continuing to see industry discipline. The fall's traditionally weaker, so we're actually seeing the competitive landscape somewhat flat. Specifically as it relates to competitive pressures there's two areas. The first is Canada, which is less than 3% of our network, but we've seen 10% capacity increase from Canada into the West Coast, which overflies out of Seattle. So we've had some pricing pressures there. You've mentioned, and really it's Portland. I looked, there's sort of a capacity party going on there, which I'm not sure why, but the reality is United, Virgin and Spirit have all increased capacity there, and we're dealing with that, but overall on a network basis, I would say competitive pressures are, other than a few pockets, are fairly stable at this time.

Michael Linenberg - *Deutsche Bank - Analyst*

Okay, good. Then just my second question, and maybe this is more to Brad. Some of the reconfiguration going on at Sea-Tac, it looks like he may be getting some additional gates. How does it shift around your space, and will we see your facility cost go up there, and what's the timing?

Brad Tilden - *Alaska Air Group Inc - CEO*

Mike, this is a good chance for Ben Minicucci, our Chief Operating Officer, to get into the fray.

Ben Minicucci - *Alaska Air Group Inc - COO*

So, we are going to consolidate. We're an three concourses right now. We're going to consolidate to two, and we're not adding more gates. We're actually going to let go of gates and put the majority of our operation on one concourse, and we will do two things. We're going to improve our customer experience, and actually improve our operational efficiencies tremendously. So we don't expect our cost to go up, but LA T-6, for example, with that investment, our costs have actually come down from a cost per emplanement perspective. So we plan to do some investment, but we intend to keep our costs very much under control.

Michael Linenberg - *Deutsche Bank - Analyst*

When is that fully online?

Ben Minicucci - *Alaska Air Group Inc - COO*

We begin next year with airline realignment. We expect this project to probably last four or five years before it's all done.

Operator

Duane Pfennigwerth, Evercore Partners.

Duane Pfennigwerth - *Evercore Partners - Analyst*

Just wondering if you could qualify some of the other comments we've heard on the earnings call, specifically with regard to close-end bookings. Are you seeing any change in the tempo in close-end bookings, and if not, why do you think others might be seeing that?

Andrew Harrison - *Alaska Air Group Inc - VP Planning & Revenue Management*

Duane, this is Andrew. I'm not sure I can specifically comment on what the other carriers are facing. I think for us, summer, we're sort of reaching a little bit of a glass ceiling here on load factor. Summer is extremely full. We ran nearly 89% last year on the mainline. We're going to do the same again this summer. The only changes in our booking pattern is last year where we knew we sold some seats too soon. We've held out a little bit more. So other than that, we're seen nothing unusual at all, other than our own manipulation where we've learned from some lessons last year in the demand patterns. So they're very stable from where I sit, and no major issues.

Brandon Pedersen - *Alaska Air Group Inc - CFO*

Hey, Duane, this is Brandon. I'll chime in with one other thing. Andrew mentioned really high load factors in the summer. This is one reason why we're so excited about the 900-ER coming in. The cost profile of that airplane is going to be great, but for months like July and August it will allow us to add and accommodate more capacity, too.

Duane Pfennigwerth - *Evercore Partners - Analyst*

Thanks for that. Can you give us any qualitative comments on bookings trends in markets where you're going to be competing with Allegiant to Hawaii?

Andrew Harrison - *Alaska Air Group Inc - VP Planning & Revenue Management*

Duane, I suppose a couple of things. We basically compete with them in Las Vegas from Bellingham, as well as Hawaii and their new announced service. I think what I would say is, is that what we've seen, again, as I've shared on earlier calls, Allegiant has helped open our mind to really where there's significant amount of demand in Canada on the lower British Columbia area, where costs are very high out of Vancouver. So even our Bellingham-Maui flight, I can tell you is already booked to 60% in November when we're launching service. So overall, we've found that there's been a good demand for our product, which is actually, in some cases, has higher frequencies than our competitors.

Duane Pfennigwerth - *Evercore Partners - Analyst*

That 60%, is that at an acceptable fare, or are those discounts relative to the rest of your system?

Andrew Harrison - *Alaska Air Group Inc - VP Planning & Revenue Management*

There's obviously the introductory fare in that. So as we move forward, but from history, our Honolulu-Bellingham as well as our Vegas, we've found them to be performing within our guidance and our standards. There's no real concerns.

Operator

Jamie Baker, JP Morgan.

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

Brad, one of your targets is being the, I think you said, the easiest airline to fly, embracing technology and what-have-you. I'm obviously familiar with your track record in this regard, but I was kind of hoping you could add some color on what the ideas might be for incremental improvement going forward? I mean, are these simply going to be aspects that make flying lower hassle, or are there some actual revenue or cost opportunities we should think about? In other words, does this appeal to analysts or merely to customers, passengers?

Ben Minicucci - *Alaska Air Group Inc - COO*

Hey, Jamie. Ben Minicucci here. I'm leading that initiative. The initiative has four pillars. One is a mobile pillar, and I'm working with Joe in terms of taking advantage of all the mobile technology in the next few years. The second pillar is our airport technology, and our airport processes. So what we want to do is get customers from the curb to the gate into the seat very quickly with the least amount of hassle of checking bags, getting through TSA, which is our third pillar, is we're working with TSA to really optimize that experience through TSA. The fourth pillar is just looking internally, looking at all our policies and procedures, our boarding process, our deplaning process, anything that takes up a lot of time that is a customer friction point. So those are basically the four, and we're well on our way.

Brad Tilden - *Alaska Air Group Inc - CEO*

Jamie, I think if you look at the last, look at Air Group for the last couple of years. We've had extraordinary improvement in things like on-time performance, which our customers want, but when on-time performance improves, all of a sudden you can schedule all of your resources a little tighter. You can schedule gates tighter, airplanes tighter, your cruise tighter. I think of other parts of technology which where Alaska's really led. Five, six years ago, ticket counters, it was the big long line with 20 positions upfront. Now customers kind of walk right through the ticket counter area, drop their bag, and keep moving. It's extraordinary. I don't have the number top of mind, but our CSA productivity is something like double what it was 10 years ago. So that's kind of what's underneath all of this, is that there's simply not enough profit in these tickets to deliver airline services the way they used to be delivered, and so let's fully streamline this, give customers exactly what they want, but I think we will also give analyst exactly what they want, as well.

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

Okay, good. Second to follow-up. I'm not interested in your views on consolidation because you've been very forthright, very clear in the past on that topic so I don't want to beat a dead horse. My question is simple. Have you received an NDA from American Airlines?

Brad Tilden - *Alaska Air Group Inc - CEO*

Jamie, our General Counsel's in the room (laughter) shaking his head. So appreciate the question but we're not going to respond. Thank you.

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

All right, fair enough.

Operator

John Godyn, Morgan Stanley.

John Godyn - *Morgan Stanley - Analyst*

I just wanted to kind of reconcile some of the demand commentary we're hearing. Brandon, I think you noted that things look relatively stable, which is kind of a qualified statement, but then Andrew, you mention you're seeing no changes at all, and then on the other hand your advanced book factor guidances is a little bit lower than prior. Is there something going on with yield management that kind of reconciles all this stuff? If you guys could just elaborate a little bit, I think would be helpful.

Brandon Pedersen - *Alaska Air Group Inc - CFO*

John, this is Brandon. I'll start. I guess I'm pleased that you're actually paying attention to what I have to say, because I didn't mean anything specifically by using the qualifier relatively. I think it's fair to say that the demand environment looks good, and I will ask Andrew to elaborate on that, because I think it all does hang together.

Andrew Harrison - *Alaska Air Group Inc - VP Planning & Revenue Management*

John, maybe as you've seen, our load factor gap for July is basically flat where it was up two, three points a number of months ago. The major driver for that is we have such a significant increase in our Hawaii network. They book a lot further out, but we will end up with the same very, very high load factors this summer as we had last year, and because our network is changing, we're just selling some of those seats a little earlier than you saw last year. I will say last year we had some learnings where we held out in certain markets for the fare at the higher level, and it didn't come. So this year we said with fuel abating over a little bit, we've decided to sell that a little earlier, but at the end of the day, we'll be about where we were last year as far as loads.

John Godyn - *Morgan Stanley - Analyst*

Okay, that's really helpful. How much visibility do you have into September?

Andrew Harrison - *Alaska Air Group Inc - VP Planning & Revenue Management*

As far as September goes, we're looking into the eye of the summer demand right now. September is a little ways out for us, but right now I'm not saying anything significant or concerning as it relates to the demand picture, but again, it will become clearer over the next month. It's still a little hazy right now.

Operator

Savi Syth, Raymond James.

Savi Syth - *Raymond James - Analyst*

Just wondering on San Diego if -- noticed that the seats kind of coming out of San Diego have increased quite a bit since 2010, and maybe back above pre-recession levels in that market. You kind of trying to build a hub there, and I was wondering how the progress is going?

Andrew Harrison - *Alaska Air Group Inc - VP Planning & Revenue Management*

Savi, this is Andrew. We've been in San Diego as a long, long time, and what you've seen there is just the continued increase. You've seen Hawaii start, you've seen more Mexico go in, and then more recently you've seen like a San Diego-Orlando, which is a large leisure market that has today no nonstop service. Additionally, you see regional service increasing, and I wouldn't call it we're building up a hub, but I think what we're doing, as we've shared, is continuing to expand our footprint on the West Coast, and in areas that we believe make sense for our brand. I will say just really excitedly that all of our San Diego regional service started right out the gate in a profit, literally. I know it's summer, but that was just very encouraging for us.

Savi Syth - *Raymond James - Analyst*

Sure, and then a follow-up on demand, if I might ask it slightly differently. Is demand looking maybe softer or stronger versus what you saw a couple of months ago?

Andrew Harrison - *Alaska Air Group Inc - VP Planning & Revenue Management*

I think, if I was just to reflect on demand as I sit here today, when I spoke to you a quarter ago, and as I speak to you today, I've seen no change, and I would characterize it as stable and fairly healthy. That's how I would characterize it for our network.

Operator

David Fintzen, Barclays.

David Fintzen - *Barclays Capital - Analyst*

A quick question on the fleet, and I appreciate some of the changes you walked through in the script, but I'm just curious on the role the 737-400s play in your mind. I mean, you're still going to have 16 of them out in 2014, and how much flexibility, and I think most of those are leased. How much flexibility in that fleet do you have to sort of use it to adjust the growth profile, should you feel like you need to, or should the demand environment necessitate? I mean, is that kind of the flexibility in the fleet, or should we think about more sort of deferrals and moving around deliveries, like you've done recently?

Brandon Pedersen - *Alaska Air Group Inc - CFO*

David, it's Brandon. I'll start with that. I think there's a ton of flexibility in our fleet, and I think you're right. The 400s play a part in that. You are also right in that most of them are leased, but to the extent that we see opportunities that we want to take advantage of to smooth out growth a little bit, we can extend those 400s at what are looking to be pretty attractive rates. We also own several that we could sell if we wanted to. We own most of our 700s, we could sell those who wanted to have some flexibility on that side, but we see the 400 staying around here for several more years, and they do offer flexibility for us to adjust capacity up and down.

David Fintzen - *Barclays Capital - Analyst*

Okay, great. I appreciate that. Then just one little one. Can you disclose what the bag fees were in the quarter?

Brandon Pedersen - *Alaska Air Group Inc - CFO*

Sure. Joe Sprague has those numbers handy at his fingertips.

Joe Sprague - *Alaska Air Group Inc - VP Marketing*

Hello, David. Joe Sprague from marketing. Year-to-date, we have generated $76 million off of bag fees. That's down about $4 million from the same period last year. In line with our expectations. I think we're continuing to see some changes in customer behavior when it comes to checking bags, both carrying more on, and then we also have more elite customers that are not charged for bag fee, both from ourselves and our alliance partners as well. So we're addressing that in other areas of ancillary activity, but bag fees' trending about where we expected at this point in the year.

Operator

Glenn Engel, Bank of America.

Glenn Engel - *BofA Merrill Lynch - Analyst*

A couple questions. One, you mentioned Horizon, the RASM slightly down. What's holding Horizon back relative to Alaska?

Andrew Harrison - *Alaska Air Group Inc - VP Planning & Revenue Management*

Glenn, Horizon unit revenues is a little bit complicated, only because you may recall in Q2 of last year we basically did the full fleet transition. So Horizon got out of the CRJs, went down to its 48 aircraft. We actually shrunk the network, shrunk the stage length, and all sorts of things going on. So as you look at the unit revenue performance, we had 15% increase last year. Going forward, it won't be until the fourth quarter that all normalizes. What I will say about the regional business is that the revenues we generated this quarter earned us the same strong profitability as we earned last quarter, and I have no concerns at this time, other than some competitive pressures in Canada on the regional network.

Glenn Engel - *BofA Merrill Lynch - Analyst*

Second question for Brandon. The incentive pay. What has the number gone, from what to what, and is that mainly the biggest increase, is that thrown into the third quarter or is it spread out over the two?

Brandon Pedersen - *Alaska Air Group Inc - CFO*

Yes. The increases is spread out over the two. We took a little bit of that in the second quarter and we'll see a lot come through in the third and the fourth. I think there's a chance that we might see incentive pay at roughly $90 million this year if we continue to track like we're tracking. Just to give you some historical context on that, last year we were at $72 million, and the year before that we were at $92 million. So these are not unprecedented levels, certainly, and it's actually a great thing because it reflects the fact that we're exceeding goals in lots of different areas, and our employees should feel really good about that.

Glenn Engel - *BofA Merrill Lynch - Analyst*

Finally, the excise tax gave you a benefit last year. Can you quanitify that for us?

Andrew Harrison - *Alaska Air Group Inc - VP Planning & Revenue Management*

This is Andrew. I don't quite recall. I think internally, as you know, we didn't charge that. The revenue impact of that was basically spread out, those bookings were spread out up to 330 days. What we believe it gave was more of a brand low-fare presence versus major incremental decrements -- I mean revenues. In short, I don't think it was material.

Brad Tilden - *Alaska Air Group Inc - CEO*

Andrew, I remember. There was an analysis done to say did we make up with volume what we lost in not raising the fare to cover the tax, and I remember it was positive, but to the tune of a few million dollars.

Andrew Harrison - *Alaska Air Group Inc - VP Planning & Revenue Management*

Yes, not significant.

Operator

Kevin Crissey, UBS.

Kevin Crissey - *UBS - Analyst*

Brandon, I think you said that you are somewhat disappointed overall in kind of flattish costs with the amount of capacity growth that you've had. If that's the case, what specifically can you do as you look forward? What areas are opportunities for some cost reductions by line? Thanks.

Brandon Pedersen - *Alaska Air Group Inc - CFO*

I am disappointed, and I am not -- it's a big picture disappointment, It's disappointing, the fact that we're going to be roughly flattish for the year on 6% growth, and I would love for this Company to get to a point where we can have 6% growth and leverage that into 2% unit cost reduction, for example. Unit cost reductions are really hard. It's probably fair to say that all the easy stuff has been gone, but we're not without additional opportunities going forward. I mentioned the 900-ER. I think that's a really powerful thing that we can have to reduce costs going forward. I think there's lots of good stuff happening on the Alaska side and the Horizon side, and I'll ask Ben and Glenn to chime in on that, that will continue to make incremental improvement in unit cost. We know we need lower costs to be successful long-term, but it's a slog, I will tell you that. Ben? Glenn?

Ben Minicucci - *Alaska Air Group Inc - COO*

Hey, Kevin, Ben here. So on the operations side, I can tell you we have CASM readily in our sights, and of course, three levers for us. One is on the labor productivity, aircraft utilization, real estate, and of course the 737-900-ER is going to have a huge benefit. Quickly, productivity, we worked on it for the last three years. We've made significant gains. I'll give you an example. Pilot hard time went from 62% to 66%, a 4% gain, which is about $20 million of cost reduction, and of course we see more of that in the future. Aircraft utilization's up an hour a day over the last three years, and real estate, reducing our footprint, going to lower cost airports, improving gate utilizations, This move from Miami to Ft. Lauderdale took $1 million out of our cost bucket, but those are things, again on the operations side, we know we have a big driver on CASM, and my team, and I'm really grateful to our employees. All of it, what Brad said, because we run such a great operation we're able to tighten things up and we're very laser-like in our focus and making sure we put the emphasis on the right places.

Kevin Crissey - *UBS - Analyst*

Thank you very much.

Brandon Pedersen - *Alaska Air Group Inc - CFO*

Kevin, Glenn wanted to add some --

Kevin Crissey - *UBS - Analyst*

Sorry. Yes, go on.

Brandon Pedersen - *Alaska Air Group Inc - CFO*

Thoughts on that, too.

Glenn Johnson - *Alaska Air Group Inc - President, Horizon Air*

Hi, Kevin. Yes, just thought I might reflect on Horizon's progress here as well. Back in 2001 we had an $0.0185 CASM exit the Verizon level, and we're down to $0.0125 now. A good portion of that has come from the business transformation plans, the simplification to a single fleet type, and a number of other things that we've talked about over the last several quarters. Looking forward, we're still very focused on our pilot productivity and cost efficiency, and in particular there we're moving to five flight attendant and pilot bases from two, which we believe will bring down our costs substantially in terms of hotel cost, improving hard time, and reducing per diem expense, and then on the maintenance side, we put a lot of investment into improving the reliability of the Q-400. Now it's time to start realizing the benefit of that in terms of cost efficiency on the maintenance side.

Brandon Pedersen - *Alaska Air Group Inc - CFO*

Then big picture, you might be interested to know that the thing that we've been talking about internally, we call ROIC line of sight, and basically what that is, is a project what we're saying, let's know with certainty what the invested capital base is going to be over the next couple of years, let's make reasonable revenue assumptions, and then let's have a cost plan that's very connected to that so can ensure that we're delivering on our ROIC commitments. So it's all about knowing where we're going, having a reasonable expectation of revenue, and then having getting the operating folks really connected on the cost side to make sure that that happens.

Operator

Steve O'Hara, Sidoti.

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

Could you just talk about terms of Hawaii? I mean, you said it's going to be about 20% of your ASM this year, I think. I mean, is that something that we should expect to grow kind of at the same rate as your overall capacity going forward, or do you still expect some sort of accelerated growth?

Andrew Harrison - *Alaska Air Group Inc - VP Planning & Revenue Management*

Steve, this is Andrew. Yes. Well, actually on the Hawaii side it was well over 50, and it's been coming down. In short, you should definitely not expect to see Hawaii continue to grow at the rate that we've been growing. I think the opportunity there is becoming largely fulfilled. As I said, we are very committed to the supply of seats to the demand. That's not to say there's not some more opportunity, but I think as we look over the next few years, we're going to be continuing to look for opportunities, but the Hawaii growth will start to abate.

Brad Tilden - *Alaska Air Group Inc - CEO*

Steve, I'm sure you remember March of 2008, both Aloha and ATA filed for bankruptcy, and unlike other bankruptcies, they quit flying almost overnight, within a couple of weeks. 20% of the Hawaii market was gone immediately, and that's really the hole that Alaska has come in and filled. As Andrew says, there still are opportunities in Hawaii, but the hole has largely been filled at this point.

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

Okay, thank you. Then --

Chris Berry - *Alaska Air Group Inc - Managing Director, IR*

Stephen, you there? Hello? There you are. I'm sorry, go ahead.

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

Okay, sorry. In terms of your ancillary revenue per passenger, can you tell us where it is now? Where it's kind of tracked the last year? I mean, it seems like some of the other airlines are maybe -- have higher fees than you guys do, and it seems like maybe there's some quick gains to be made there, if you guys kind of match with a lot of the industry does?

Joe Sprague - *Alaska Air Group Inc - VP Marketing*

Hey, Steve. This is Joe from marketing. On a per passenger basis, we're at about $11.60 today. That is trending down from a little over $12 a year ago for the same period. Yes, we mentioned the bag fees already. We have actually seen some positive gains in ancillary revenue with our buy-on-board food and beverage program where we've made some nice enhancements recently, and also with our hotel sales, our direct hotel sales for hotels and packages that we sell to customers, primarily at alaskaair.com.

We think there is some more that we can do there. We have some guiding principles that we apply to ancillary fees, and one of our primary principles there is to make certain that what we're charging extra fees for provide a major value to our customers, and heck, even with our bag fees, we feel we achieved that because we still have the industry's only baggage service guarantee, and those other areas I mentioned, whether it's food and beverage, hotels, et cetera, certainly check that box as well from a value standpoint. So as we think about fees or other types of fees we might charge, we do apply that filter, and I think that's what we're going to stick with going forward.

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

Okay, and anything in terms of being able to unlock additional -- do you see any close-in, low hanging fruit in terms of unlocking additional ancillary opportunities?

Joe Sprague - *Alaska Air Group Inc - VP Marketing*

I guess the one trend that we have seen, been a little bit encouraging here this year is with hotel sales. We sell both a la carte hotels at alaskaair.com, and then prepackaged sales. As we've grown our presence in Hawaii, obviously a big leisure destination, and most folks going over there on vacation. That's been a nice opportunity for us and we seen significant growth year-over-year in terms of our Hawaii hotel activity, and so there's more we can do. In fact there's a lot more we can do in that area. We're looking at some further enhancements to our website that would enable that, and so I think that's one thing that we're focused on.

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

Okay. I guess, and then just quickly in terms of the way you package hotels and sell them, I mean, is it similar to Allegiant's model of the way they do it, which I am sure you're familiar with?

Joe Sprague - *Alaska Air Group Inc - VP Marketing*

Yes. We have a couple different models that we deploy. One is where we offer a package deal, we get rates from hotels and other ground vendors at our destinations, package them with air and sell one package price. Then we also have sort of an a la carte option that we offer at alaskaair.com where folks can buy hotel and car rental for any destination in our system on just an ad hoc basis, and I think our opportunity going forward is to create a better customer experience in terms of how they purchase those products. We don't currently hold any hotel inventories, so there's no risk there, but that's our current hotel set up.

Brad Tilden - *Alaska Air Group Inc - CEO*

Steve, this is Brad. I might just add to that. I don't think it's a near-term opportunity, but we do kind of fundamentally believe that Alaska is a trusted source, and over time 20% of our revenue dollars are people going to Hawaii, and over time we should be able to grow that business. We should be able to put a lot of hotel and a lot of car volume through alaskaair.com. I don't think it's going to help us in the next -- it's not going to materially change our earnings in the next quarter or two, but over the next several years that's a big business opportunity for us that we should be able to realize that benefit.

Operator

(Operator Instructions)

Dan Mckenzie, Rodman & Renshaw.

Dan Mckenzie - *Rodman & Renshaw - Analyst*

I guess coming back to the ancillary revenue question, perhaps from a different angle here, how are you thinking about the puts and takes of unbundling the product a little further? I guess from an Alaska perspective, does it drive demand in revenues, or given how you've established your brand, is the sense that it might dilute the branded revenue?

Joe Sprague - *Alaska Air Group Inc - VP Marketing*

This is Joe again. I would say, Dan, that we're watching the industry trends very closely. We look at results from a lot of the key industry surveys, the most recent which, of course, is the in-depth JD Power survey that came out. What is obvious is that customers continue to have a strong distaste for fees that don't bring value, that don't represent some measurable enhancement in the service. So that is right now a guide for us as we think about different fees that we might charge or this notion of further unbundling of the product. So our model, where we do charge some fees, we try and track them to something that brings value to the customer. That's worked well for us, and we think there are, as Brad mentioned on the hotel side, some additional opportunity to grow some of those specific areas, but I think a further unbundling has some risks associated with it from a customer acceptance standpoint, and as we try and grow our brand, grow our presence in some new markets and help to get Alaska better known, I think the position that we have right now with fees is where we want to stick.

Dan Mckenzie - *Rodman & Renshaw - Analyst*

Understood, I appreciate that. I guess given the focus on unit costs as you look ahead, does that rule out for you folks economy-plus longer term?

Brad Tilden - *Alaska Air Group Inc - CEO*

Hey Dan, it's Brad. No, I don't think it does rule that out. I think this whole unbundling question and products like that, I think the right answer for us is to be -- we need to be students of the industry, we need to be thinking about this stuff and learning. So if economy-plus was something that we believe that there was a demand for with our customers and that it was profit positive, that's something we should look at. Not trying to hint that we are, but I wouldn't say you should rule out ideas like that.

Operator

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

Brad Tilden - *Alaska Air Group Inc - CEO*

Okay. Thank you all for joining us today, and we look forward to talking with you next quarter. Thanks, bye.

Operator

This concludes today's conference call. Thank you for participating in today's conference. This call will be available for replay beginning at 11.30 pm Eastern time today through 11.59 pm Eastern on August 24, 2012. The conference ID for the replay is 37715975. The number to dial for the replay is 1-800-642-1687 or 1-706-645-9291. Also the call will be accessible for future playback at www.alaskaair.com. You may now disconnect.