

ALASKA AIR GROUP, INC.  
Form 10-Q  
August 06, 2014

UNITED STATES  
SECURITIES AND EXCHANGE COMMISSION  
WASHINGTON, DC 20549

FORM 10-Q

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

For the quarterly period ended June 30, 2014

OR

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

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

Commission File Number 1-8957  
ALASKA AIR GROUP, INC.

Delaware  
(State of Incorporation)

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

19300 International Boulevard, Seattle, Washington 98188  
Telephone: (206) 392-5040

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

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

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

Large accelerated filer T Accelerated filer £ Non-accelerated filer £ Smaller reporting company £

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

The registrant has 134,882,465 common shares, par value \$0.01, outstanding at July 31, 2014.

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ALASKA AIR GROUP, INC.  
FORM 10-Q FOR THE QUARTER ENDED JUNE 30, 2014

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

## CAUTIONARY NOTE REGARDING FORWARD-LOOKING STATEMENTS

### Cautionary Note Regarding Forward-Looking Statements

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

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

You should not place undue reliance on our forward-looking statements because the matters they describe are subject to known and unknown risks, uncertainties and other unpredictable factors, many of which are beyond our control. Our forward-looking statements are based on the information currently available to us and speak only as of the date on which this report was filed with the SEC. We expressly disclaim any obligation to issue any updates or revisions to our forward-looking statements, even if subsequent events cause our expectations to change regarding the matters discussed in those statements. Over time, our actual results, performance or achievements will likely differ from the anticipated results, performance or achievements that are expressed or implied by our forward-looking statements, and such differences might be significant and materially adverse to our shareholders. For a discussion of these and other risk factors, see Item 1A. "Risk Factors" of the Company's annual report on Form 10-K for the year ended December 31, 2013. Please consider our forward-looking statements in light of those risks as you read this report.

## PART I

## ITEM 1. CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

## CONDENSED CONSOLIDATED BALANCE SHEETS (unaudited)

| (in millions)                                  | June 30,<br>2014 | December 31,<br>2013 |
|--|------------------|----------------------|
| <b>ASSETS</b>                                  |                  |                      |
| Current Assets                                 |                  |                      |
| Cash and cash equivalents                      | \$22             | \$80                 |
| Marketable securities                          | 1,488            | 1,250                |
| Total cash and marketable securities           | 1,510            | 1,330                |
| Receivables - net                              | 203              | 152                  |
| Inventories and supplies - net                 | 61               | 60                   |
| Deferred income taxes                          | 112              | 113                  |
| Prepaid expenses and other current assets      | 134              | 107                  |
| Total Current Assets                           | 2,020            | 1,762                |
| Property and Equipment                         |                  |                      |
| Aircraft and other flight equipment            | 4,993            | 4,677                |
| Other property and equipment                   | 867              | 838                  |
| Deposits for future flight equipment           | 431              | 446                  |
|  | 6,291            | 5,961                |
| Less accumulated depreciation and amortization | 2,189            | 2,068                |
| Total Property and Equipment - Net             | 4,102            | 3,893                |
| Other Assets                                   |                  |                      |
|  | 192              | 183                  |
| Total Assets                                   | \$6,314          | \$5,838              |

See accompanying notes to condensed consolidated financial statements.

## ALASKA AIR GROUP, INC.

## CONDENSED CONSOLIDATED BALANCE SHEETS (unaudited)

| (in millions, except share amounts)   | June 30,<br>2014 | December 31,<br>2013 |
|---|------------------|----------------------|
| <b>LIABILITIES AND SHAREHOLDERS' EQUITY</b>   |                  |                      |
| <b>Current Liabilities</b>  |                  |                      |
| Accounts payable  | \$71             | \$64                 |
| Accrued wages, vacation and payroll taxes   | 166              | 211                  |
| Other accrued liabilities   | 706              | 624                  |
| Air traffic liability   | 807              | 564                  |
| Current portion of long-term debt   | 114              | 117                  |
| Total Current Liabilities   | 1,864            | 1,580                |
| Long-Term Debt, Net of Current Portion  | 745              | 754                  |
| <b>Other Liabilities and Credits</b>  |                  |                      |
| Deferred income taxes   | 725              | 709                  |
| Deferred revenue  | 342              | 335                  |
| Obligation for pension and postretirement medical benefits  | 123              | 123                  |
| Other liabilities   | 315              | 308                  |
|   | 1,505            | 1,475                |
| <b>Commitments and Contingencies</b>  |                  |                      |
| <b>Shareholders' Equity</b>   |                  |                      |
| Preferred stock, \$0.01 par value Authorized: 5,000,000 shares, none issued or outstanding  | —                | —                    |
| Common stock, \$0.01 par value, Authorized: 200,000,000 shares, Issued: 2014 - 136,845,596 shares; 2013 - 137,533,382 shares, Outstanding: 2014 - 136,738,034; 2013 - 137,491,906 | 1                | 1                    |
| Capital in excess of par value  | 551              | 606                  |
| Treasury stock (common), at cost: 2014 - 107,562 shares; 2013 - 41,476 shares   | (5               | ) (2                 |
| Accumulated other comprehensive loss  | (178             | ) (183               |
| Retained earnings   | 1,831            | 1,607                |
|   | 2,200            | 2,029                |
| Total Liabilities and Shareholders' Equity  | \$6,314          | \$5,838              |

See accompanying notes to condensed consolidated financial statements.

## ALASKA AIR GROUP, INC.

## CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS (unaudited)

| (in millions, except per share amounts)           | Three Months Ended June 30, |         | Six Months Ended June 30, |         |
|---|-----------------------------|---------|---------------------------|---------|
|   | 2014                        | 2013    | 2014                      | 2013    |
| <b>Operating Revenues</b>                         |                             |         |                           |         |
| <b>Passenger</b>                                  |                             |         |                           |         |
| Mainline  | \$974                       | \$896   | \$1,828                   | \$1,692 |
| Regional  | 200                         | 192     | 386                       | 374     |
| Total passenger revenue                           | 1,174                       | 1,088   | 2,214                     | 2,066   |
| Freight and mail                                  | 32                          | 30      | 56                        | 56      |
| Other - net                                       | 169                         | 138     | 327                       | 268     |
| Total Operating Revenues                          | 1,375                       | 1,256   | 2,597                     | 2,390   |
| <b>Operating Expenses</b>                         |                             |         |                           |         |
| Wages and benefits                                | 281                         | 258     | 553                       | 522     |
| Variable incentive pay                            | 29                          | 21      | 54                        | 42      |
| Aircraft fuel, including hedging gains and losses | 360                         | 372     | 718                       | 753     |
| Aircraft maintenance                              | 57                          | 67      | 108                       | 133     |
| Aircraft rent                                     | 29                          | 30      | 57                        | 59      |
| Landing fees and other rentals                    | 64                          | 75      | 133                       | 136     |
| Contracted services                               | 62                          | 54      | 122                       | 107     |
| Selling expenses                                  | 53                          | 51      | 99                        | 89      |
| Depreciation and amortization                     | 73                          | 68      | 143                       | 136     |
| Food and beverage service                         | 23                          | 21      | 44                        | 41      |
| Other   | 81                          | 65      | 161                       | 133     |
| Total Operating Expenses                          | 1,112                       | 1,082   | 2,192                     | 2,151   |
| Operating Income                                  | 263                         | 174     | 405                       | 239     |
| <b>Nonoperating Income (Expense)</b>              |                             |         |                           |         |
| Interest income                                   | 5                           | 4       | 10                        | 9       |
| Interest expense                                  | (12                         | ) (14   | ) (25                     | ) (29   |
| Interest capitalized                              | 4                           | 5       | 9                         | 9       |
| Other - net                                       | 5                           | —       | 18                        | 1       |
|   | 2                           | (5      | ) 12                      | (10     |
| Income before income tax                          | 265                         | 169     | 417                       | 229     |
| Income tax expense                                | 100                         | 65      | 158                       | 88      |
| Net Income  | \$165                       | \$104   | \$259                     | \$141   |
| <b>Basic Earnings Per Share:</b>                  |                             |         |                           |         |
|   | \$1.20                      | \$0.75  | \$1.88                    | \$1.00  |
| <b>Diluted Earnings Per Share:</b>                |                             |         |                           |         |
|   | \$1.19                      | \$0.74  | \$1.86                    | \$0.99  |
| <b>Shares used for computation:</b>               |                             |         |                           |         |
| Basic   | 137.274                     | 140.504 | 137.304                   | 140.683 |
| Diluted   | 138.711                     | 142.319 | 138.776                   | 142.594 |
| Cash dividend declared per share:                 | \$0.125                     | —       | \$0.250                   | —       |

See accompanying notes to condensed consolidated financial statements.





## ALASKA AIR GROUP, INC.

## CONDENSED CONSOLIDATED STATEMENTS OF COMPREHENSIVE OPERATIONS (unaudited)

| (in millions)   | Three Months Ended June 30, |        | Six Months Ended June 30, |        |
|---|-----------------------------|--------|---------------------------|--------|
|   | 2014                        | 2013   | 2014                      | 2013   |
| Net Income  | \$ 165                      | \$ 104 | \$ 259                    | \$ 141 |
| Other comprehensive income (loss):  |                             |        |                           |        |
| Related to marketable securities:   |                             |        |                           |        |
| Unrealized holding gains (losses) arising during the period                     | 4                           | (11    | ) 7                       | (12    |
| Reclassification of (gains) losses into Other-net nonoperating income (expense) | (1                          | ) (1   | ) (1                      | ) (2   |
| Income tax effect   | (1                          | ) 4    | (2                        | ) 5    |
| Total   | 2                           | (8     | ) 4                       | (9     |
| Related to employee benefit plans:  |                             |        |                           |        |
| Reclassification of net pension expense into Wages and benefits                 | 3                           | 11     | 5                         | 21     |
| Income tax effect   | (1                          | ) (3   | ) (2                      | ) (7   |
| Total   | 2                           | 8      | 3                         | 14     |
| Related to interest rate derivative instruments:                                |                             |        |                           |        |
| Unrealized holding gains (losses) arising during the period                     | (2                          | ) 7    | (5                        | ) 10   |
| Reclassification of (gains) losses into Aircraft rent                           | 1                           | 2      | 3                         | 3      |
| Income tax effect   | —                           | (4     | ) —                       | (6     |
| Total   | (1                          | ) 5    | (2                        | ) 7    |
| Other comprehensive income  | 3                           | 5      | 5                         | 12     |
| Comprehensive income  | \$ 168                      | \$ 109 | \$ 264                    | \$ 153 |

See accompanying notes to condensed consolidated financial statements.

## ALASKA AIR GROUP, INC.

## CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS (unaudited)

| (in millions)   | Six Months Ended June 30, |         |
|---|---------------------------|---------|
|   | 2014                      | 2013    |
| Cash flows from operating activities:   |                           |         |
| Net income  | \$259                     | \$141   |
| Adjustments to reconcile net income to net cash provided by operating activities: |                           |         |
| Depreciation and amortization   | 143                       | 136     |
| Stock-based compensation and other  | 21                        | 17      |
| Changes in certain assets and liabilities:  |                           |         |
| Changes in deferred income taxes  | 14                        | 16      |
| Increase in air traffic liability   | 243                       | 190     |
| Increase (decrease) in deferred revenue   | 7                         | 12      |
| Other - net   | (52)                      | ) 80    |
| Net cash provided by operating activities   | 635                       | 592     |
| Cash flows from investing activities:   |                           |         |
| Property and equipment additions:   |                           |         |
| Aircraft and aircraft purchase deposits   | (255)                     | ) (233) |
| Other flight equipment  | (60)                      | ) (12)  |
| Other property and equipment  | (35)                      | ) (13)  |
| Total property and equipment additions  | (350)                     | ) (258) |
| Purchases of marketable securities  | (628)                     | ) (720) |
| Sales and maturities of marketable securities                                     | 398                       | 465     |
| Proceeds from disposition of assets and changes in restricted deposits            | (2)                       | ) 1     |
| Net cash used in investing activities   | (582)                     | ) (512) |
| Cash flows from financing activities:   |                           |         |
| Proceeds from issuance of debt  | 51                        | —       |
| Long-term debt payments   | (64)                      | ) (109) |
| Common stock repurchases  | (83)                      | ) (51)  |
| Dividends paid  | (34)                      | ) —     |
| Other financing activities  | 19                        | 15      |
| Net cash used in financing activities   | (111)                     | ) (145) |
| Net increase/(decrease) in cash and cash equivalents                              | (58)                      | ) (65)  |
| Cash and cash equivalents at beginning of year                                    | 80                        | 122     |
| Cash and cash equivalents at end of the period                                    | \$22                      | \$57    |
| Supplemental disclosure:  |                           |         |
| Cash paid during the period for:  |                           |         |
| Interest (net of amount capitalized)  | \$16                      | \$21    |
| Income taxes  | 93                        | 6       |

See accompanying notes to condensed consolidated financial statements.

## NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (unaudited)

## NOTE 1. GENERAL AND SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

## Organization and Basis of Presentation

The interim condensed consolidated financial statements include the accounts of Alaska Air Group, Inc. (Air Group or the Company) and its subsidiaries, Alaska Airlines, Inc. (Alaska) and Horizon Air Industries, Inc. (Horizon), through which the Company conducts substantially all of its operations. All intercompany balances and transactions have been eliminated. These financial statements have been prepared in accordance with accounting principles generally accepted in the United States (GAAP) for interim financial information. Consistent with these requirements, this Form 10-Q does not include all the information required by GAAP for complete financial statements. As a result, this Form 10-Q should be read in conjunction with the Consolidated Financial Statements and accompanying Notes in the Form 10-K for the year ended December 31, 2013. In the opinion of management, all adjustments have been made that are necessary to present fairly the Company's financial position as of June 30, 2014, as well as the results of operations for the three and six months ended June 30, 2014 and 2013. The adjustments made were of a normal recurring nature.

In preparing these statements, the Company is required to make estimates and assumptions that affect the reported amounts of assets and liabilities and the disclosure of contingent liabilities, as well as the reported amounts of revenues and expenses. Due to seasonal variations in the demand for air travel, the volatility of aircraft fuel prices, changes in global economic conditions, changes in the competitive environment, and other factors, operating results for the three and six months ended June 30, 2014, are not necessarily indicative of operating results for the entire year.

Certain reclassifications, such as changes in our equity structure, have been made to prior year financial statements to conform with classifications used in the current year.

## Recently Issued Accounting Pronouncements

In May 2014, the FASB issued Accounting Standard Update 2014-09, "Revenue from Contracts with Customers" (ASU 2014-09), which requires an entity to recognize the amount of revenue to which it expects to be entitled for the transfer of promised goods or services to customers. The ASU will replace most existing revenue recognition guidance in U.S. GAAP when it becomes effective. The new standard is effective for the Company on January 1, 2017. Early adoption is not permitted. The standard permits the use of either the retrospective or cumulative effect transition method. The Company is evaluating the effect that ASU 2014-09 will have on its consolidated financial statements and related disclosures. The Company has not yet selected a transition method nor has it determined the effect of the standard on its ongoing financial reporting.

## NOTE 2. CASH, CASH EQUIVALENTS AND MARKETABLE SECURITIES

Components for cash, cash equivalents and marketable securities (in millions):

| June 30, 2014                         | Cost Basis | Unrealized<br>Gains | Unrealized Losses | Fair Value |
|---------------------------------------|------------|---------------------|-------------------|------------|
| Cash                                  | \$2        | \$—                 | \$—               | \$2        |
| Cash equivalents                      | 20         | —                   | —                 | 20         |
| Cash and cash equivalents             | 22         | —                   | —                 | 22         |
| U.S. government and agency securities | 289        | 1                   | (1                | ) 289      |
| Foreign government bonds              | 17         | —                   | —                 | 17         |
| Asset-backed securities               | 186        | —                   | —                 | 186        |

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|                            |         |     |      |           |
|----------------------------|---------|-----|------|-----------|
| Mortgage-backed securities | 171     | 1   | (1   | ) 171     |
| Corporate notes and bonds  | 794     | 6   | —    | 800       |
| Municipal securities       | 25      | —   | —    | 25        |
| Marketable securities      | 1,482   | 8   | (2   | ) 1,488   |
| Total                      | \$1,504 | \$8 | \$(2 | ) \$1,510 |

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| December 31, 2013                     | Cost Basis | Unrealized<br>Gains | Unrealized Losses | Fair Value |
|---------------------------------------|------------|---------------------|-------------------|------------|
| Cash                                  | \$9        | \$—                 | \$—               | \$9        |
| Cash equivalents                      | 71         | —                   | —                 | 71         |
| Cash and cash equivalents             | 80         | —                   | —                 | 80         |
| U.S. government and agency securities | 295        | 1                   | (2                | ) 294      |
| Foreign government bonds              | 11         | —                   | —                 | 11         |
| Asset-backed securities               | 146        | —                   | —                 | 146        |
| Mortgage-backed securities            | 144        | 1                   | (2                | ) 143      |
| Corporate notes and bonds             | 628        | 4                   | (2                | ) 630      |
| Municipal securities                  | 26         | —                   | —                 | 26         |
| Marketable securities                 | 1,250      | 6                   | (6                | ) 1,250    |
| Total                                 | \$1,330    | \$6                 | \$(6              | ) \$1,330  |

Unrealized losses from fixed-income securities are primarily attributable to changes in interest rates. Management does not believe any remaining unrealized losses represent other-than-temporary impairments based on our evaluation of available evidence as of June 30, 2014.

Activity for marketable securities (in millions):

|                                    | Three Months Ended June 30, |       | Six Months Ended June 30, |       |
|------------------------------------|-----------------------------|-------|---------------------------|-------|
|                                    | 2014                        | 2013  | 2014                      | 2013  |
| Proceeds from sales and maturities | \$171                       | \$226 | \$398                     | \$465 |
| Gross realized gains               | 1                           | 1     | 2                         | 3     |
| Gross realized losses              | —                           | —     | (1                        | ) (1  |

Maturities for marketable securities (in millions):

| June 30, 2014                         | Cost Basis | Fair Value |
|---------------------------------------|------------|------------|
| Due in one year or less               | \$205      | \$205      |
| Due after one year through five years | 1,270      | 1,276      |
| Due after five years through 10 years | 7          | 7          |
| Total                                 | \$1,482    | \$1,488    |

### NOTE 3. DERIVATIVE INSTRUMENTS

#### Fuel Hedge Contracts

The Company's operations are inherently dependent upon the price and availability of aircraft fuel. To manage economic risks associated with fluctuations in aircraft fuel prices, the Company periodically enters into call options for crude oil and historically entered into swap agreements for jet fuel refining margins. Effective in July 2014, the Company no longer enters into refining margin swap agreements.

As of June 30, 2014, the Company had outstanding fuel hedge contracts covering 245 million gallons of crude oil that will be settled from July 2014 to March 2016. Refer to the contractual obligations and commitments section of Item 2 for further information.

#### Interest Rate Swap Agreements

The Company has interest rate swap agreements with a third party designed to hedge the volatility of the underlying variable interest rate in the Company's aircraft lease agreements for six Boeing 737-800 aircraft. The agreements stipulate that the Company pay a fixed interest rate over the term of the contract and receive a floating interest rate. All significant terms of the swap agreement match the terms of the lease agreements, including interest-rate index, rate reset dates, termination dates and

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underlying notional values. The agreements expire from February 2020 through March 2021 to coincide with the lease termination dates.

#### Fair Values of Derivative Instruments

Fair values of derivative instruments on the consolidated balance sheet (in millions):

|  | June 30,<br>2014 | December 31,<br>2013 |
|--|------------------|----------------------|
| <b>Derivative Instruments Not Designated as Hedges</b> |                  |                      |
| Fuel hedge contracts                                   |                  |                      |
| Fuel hedge contracts, current assets                   | \$ 15            | \$ 12                |
| Fuel hedge contracts, noncurrent assets                | 2                | 4                    |
| Fuel hedge contracts, current liabilities              | (1               | ) —                  |
| <b>Derivative Instruments Designated as Hedges</b>     |                  |                      |
| Interest rate swaps                                    |                  |                      |
| Other accrued liabilities                              | (6               | ) (7                 |
| Other liabilities                                      | (13              | ) (10                |
| Losses in accumulated other comprehensive loss (AOCL)  | (19              | ) (17                |

The net cash received (paid) for new positions and settlements was \$1 million and \$(9) million during the three months ended June 30, 2014 and 2013, respectively. The net cash received (paid) for new positions and settlements was \$(6) million and \$(9) million during the six months ended June 30, 2014 and 2013, respectively.

Pretax effect of derivative instruments on earnings (in millions):

|   | Three Months Ended June 30, |        | Six Months Ended June 30, |         |
|---|-----------------------------|--------|---------------------------|---------|
|   | 2014                        | 2013   | 2014                      | 2013    |
| <b>Derivative Instruments Not Designated as Hedges</b>        |                             |        |                           |         |
| Fuel hedge contracts  |                             |        |                           |         |
| Gains (losses) recognized in aircraft fuel expense            | \$ 5                        | \$ (25 | ) \$(6                    | ) \$(49 |
| <b>Derivative Instruments Designated as Hedges</b>            |                             |        |                           |         |
| Interest rate swaps   |                             |        |                           |         |
| Losses recognized in aircraft rent                            | (1                          | ) (2   | ) (3                      | ) (3    |
| Gains (losses) recognized in other comprehensive income (OCI) | (2                          | ) 7    | (5                        | ) 10    |

The amounts shown as recognized in aircraft rent for cash flow hedges (interest rate swaps) represent the realized losses transferred out of AOCL to aircraft rent. The amounts shown as recognized in OCI are prior to the losses recognized in the income statement as aircraft rent during the period. The Company expects \$6 million to be reclassified from OCI to aircraft rent within the next twelve months.

#### Credit Risk and Collateral

The Company is exposed to credit losses in the event of nonperformance by counterparties to these derivative instruments. To mitigate exposure, the Company periodically evaluates the counterparties' potential risk of nonperformance by monitoring the absolute exposure levels and credit ratings. The Company maintains security agreements with a number of its counterparties which may require the Company to post collateral if the fair value of the selected derivative instruments fall below specified mark-to-market thresholds. The posted collateral does not

offset the fair value of the derivative instruments and is included in "Prepaid expenses and other current assets" on the consolidated balance sheet.



The Company posted collateral of \$7 million and \$7 million as of June 30, 2014 and December 31, 2013, respectively. The collateral was provided to one counterparty associated with the net liability position of the interest rate swap agreements, offset by the net asset position of the fuel hedge contracts under a master netting arrangement.

#### NOTE 4. FAIR VALUE MEASUREMENTS

##### Fair Value of Financial Instruments on a Recurring Basis

Fair values of financial instruments on the consolidated balance sheet (in millions):

| June 30, 2014                         | Level 1 | Level 2 | Total |
|---------------------------------------|---------|---------|-------|
| Assets                                |         |         |       |
| Marketable securities                 |         |         |       |
| U.S. government and agency securities | \$289   | \$—     | \$289 |
| Foreign government bonds              | —       | 17      | 17    |
| Asset-backed securities               | —       | 186     | 186   |
| Mortgage-backed securities            | —       | 171     | 171   |
| Corporate notes and bonds             | —       | 800     | 800   |
| Municipal securities                  | —       | 25      | 25    |
| Derivative instruments                |         |         |       |
| Fuel hedge call options               | —       | 17      | 17    |
| Liabilities                           |         |         |       |
| Derivative instruments                |         |         |       |
| Fuel hedge swaps                      | —       | (1      | ) (1  |
| Interest rate swap agreements         | —       | (19     | ) (19 |
| December 31, 2013                     | Level 1 | Level 2 | Total |
| Assets                                |         |         |       |
| Marketable securities                 |         |         |       |
| U.S. government and agency securities | \$294   | \$—     | \$294 |
| Foreign government bonds              | —       | 11      | 11    |
| Asset-backed securities               | —       | 146     | 146   |
| Mortgage-backed securities            | —       | 143     | 143   |
| Corporate notes and bonds             | —       | 630     | 630   |
| Municipal securities                  | —       | 26      | 26    |
| Derivative instruments                |         |         |       |
| Fuel hedge call options               | —       | 16      | 16    |
| Liabilities                           |         |         |       |
| Derivative instruments                |         |         |       |
| Fuel hedge swaps                      | —       | —       | —     |
| Interest rate swap agreements         | —       | (17     | ) (17 |

The Company uses the market and income approach to determine the fair value of marketable securities. U.S. government securities are Level 1 as the fair value is based on quoted prices in active markets. Foreign government bonds, asset-backed securities, mortgage-backed securities, corporate notes and bonds, and municipal securities are Level 2 as the fair value is based on industry standard valuation models that are calculated based on observable inputs such as quoted interest rates, yield curves, credit ratings of the security and other observable market information.

The Company uses the market approach and the income approach to determine the fair value of derivative instruments. Fuel hedge contracts that are not traded on a public exchange are Level 2 as the fair value is primarily based on inputs which are readily available in active markets or can be derived from information available in active markets. The fair value for call

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options is determined utilizing an option pricing model based on inputs that are readily available in active markets, or can be derived from information available in active markets. In addition, the fair value considers the exposure to credit losses in the event of nonperformance by counterparties. The fair value of jet fuel refining margins (fuel hedge contracts) is determined based on inputs readily available in public markets and provided by brokers who regularly trade these contracts. Interest rate swap agreements are Level 2 as the fair value of these contracts is determined based on the difference between the fixed interest rate in the agreements and the observable LIBOR-based forward interest rates at period end, multiplied by the total notional value.

The Company has no financial assets that are measured at fair value on a nonrecurring basis at June 30, 2014.

#### Fair Value of Other Financial Instruments

The Company used the following methods and assumptions to determine the fair value of financial instruments that are not recognized at fair value as described below.

Cash and Cash Equivalents: Carried at amortized cost, which approximates fair value.

Debt: The carrying amount of the Company's variable-rate debt approximates fair values. For fixed-rate debt, the Company uses the income approach to determine the estimated fair value, by using discounted cash flow using borrowing rates for comparable debt over the weighted life of the outstanding debt. The estimated fair value of the fixed-rate debt is Level 3 as certain inputs used are unobservable.

Fixed-rate debt that is not carried at fair value on the consolidated balance sheet and the estimated fair value of long-term fixed-rate debt (in millions):

|                 | June 30,<br>2014 | December 31,<br>2013 |
|-----------------|------------------|----------------------|
| Carrying amount | \$659            | \$703                |
| Fair value      | 713              | 762                  |

#### NOTE 5. MILEAGE PLAN

Alaska's Mileage Plan liabilities and deferrals on the consolidated balance sheets (in millions):

|                                | June 30,<br>2014 | December 31,<br>2013 |
|--------------------------------|------------------|----------------------|
| Current Liabilities:           |                  |                      |
| Other accrued liabilities      | \$340            | \$314                |
| Other Liabilities and Credits: |                  |                      |
| Deferred revenue               | 333              | 323                  |
| Other liabilities              | 20               | 19                   |
| Total                          | \$693            | \$656                |

Alaska's Mileage Plan revenue included in the consolidated statements of operations (in millions):

|                      | Three Months Ended June 30, |       | Six Months Ended June 30, |       |
|----------------------|-----------------------------|-------|---------------------------|-------|
|                      | 2014                        | 2013  | 2014                      | 2013  |
| Passenger revenues   | \$62                        | \$50  | \$118                     | \$96  |
| Other - net revenues | 73                          | 56    | 146                       | 110   |
| Total                | \$135                       | \$106 | \$264                     | \$206 |



## NOTE 6. LONG-TERM DEBT

Long-term debt obligations on the consolidated balance sheet (in millions):

|  | June 30,<br>2014 | December 31,<br>2013 |  |   |
|--|------------------|----------------------|--|---|
| Fixed-rate notes payable due through 2024    | \$660            | \$703                |  |   |
| Variable-rate notes payable due through 2025 | 199              | 168                  |  |   |
| Long-term debt                               | 859              | 871                  |  |   |
| Less current portion                         | 114              | 117                  |  |   |
| Total  | \$745            | \$754                |  |   |
| Weighted-average fixed-interest rate         | 5.7              | % 5.7                |  | % |
| Weighted-average variable-interest rate      | 1.6              | % 1.7                |  | % |

During the six months ended June 30, 2014, the Company made debt payments of \$64 million. In addition, the company financed \$51 million for the three Q400's that were delivered in Q4 2013.

At June 30, 2014, long-term debt principal payments for the next five years and thereafter are as follows (in millions):

|                   | Total |
|-------------------|-------|
| Remainder of 2014 | \$56  |
| 2015              | 117   |
| 2016              | 115   |
| 2017              | 121   |
| 2018              | 151   |
| Thereafter        | 299   |
| Total             | \$859 |

## Bank Lines of Credit

The Company has two \$100 million credit facilities. Both facilities have variable interest rates based on LIBOR plus a specified margin. One of the \$100 million facilities, which expires in August 2015, is secured by aircraft. The other \$100 million facility, which expires in March 2017, is secured by certain accounts receivable, spare engines, spare parts and ground service equipment. The Company has no immediate plans to borrow using either of these facilities. These facilities have a requirement to maintain a minimum unrestricted cash and marketable securities balance of \$500 million. The Company is in compliance with this covenant at June 30, 2014.

## NOTE 7. EMPLOYEE BENEFIT PLANS

Net periodic benefit costs recognized included the following components for the three months ended June 30, 2014 (in millions):

|                                      | Three Months Ended June 30, |       |              |      | Postretirement Medical |      |
|--------------------------------------|-----------------------------|-------|--------------|------|------------------------|------|
|                                      | Qualified                   |       | Nonqualified |      | 2014                   | 2013 |
|                                      | 2014                        | 2013  | 2014         | 2013 |                        |      |
| Service cost                         | \$8                         | \$12  | \$—          | \$1  | \$—                    | \$1  |
| Interest cost                        | 20                          | 18    | 1            | —    | 1                      | 1    |
| Expected return on assets            | (29                         | ) (28 | ) —          | —    | —                      | —    |
| Amortization of prior service cost(1 | ) —                         | —     | —            | —    | —                      | —    |
| Recognized actuarial loss (gain)     | 4                           | 11    | —            | —    | —                      | —    |
| Total                                | \$2                         | \$13  | \$1          | \$1  | \$1                    | \$2  |



Net periodic benefit costs recognized included the following components for the six months ended June 30, 2014 (in millions):

|                                    | Six Months Ended June 30, |       |              |      |                        |      |
|------------------------------------|---------------------------|-------|--------------|------|------------------------|------|
|                                    | Qualified                 |       | Nonqualified |      | Postretirement Medical |      |
|                                    | 2014                      | 2013  | 2014         | 2013 | 2014                   | 2013 |
| Service cost                       | 16                        | 23    | —            | 1    | 1                      | 2    |
| Interest cost                      | 40                        | 36    | 1            | 1    | 2                      | 2    |
| Expected return on assets          | (58                       | ) (55 | ) —          | —    | —                      | —    |
| Amortization of prior service cost | (1                        | ) —   | —            | —    | —                      | —    |
| Recognized actuarial loss          | 7                         | 21    | —            | —    | (1                     | ) —  |
| Total                              | 4                         | 25    | 1            | 2    | 2                      | 4    |

#### NOTE 8. COMMITMENTS

Future minimum fixed payments for commitments (in millions):

| June 30, 2014     | Aircraft Leases | Facility Leases | Aircraft Commitments | Capacity Purchase Agreements | Engine Maintenance |
|-------------------|-----------------|-----------------|----------------------|------------------------------|--------------------|
| Remainder of 2014 | \$26            | \$47            | \$149                | \$25                         | \$5                |
| 2015              | 103             | 89              | 423                  | 44                           | 10                 |
| 2016              | 82              | 86              | 359                  | 32                           | —                  |
| 2017              | 52              | 83              | 382                  | 32                           | —                  |
| 2018              | 36              | 36              | 430                  | 14                           | —                  |
| Thereafter        | 43              | 211             | 1,037                | —                            | —                  |
| Total             | \$342           | \$552           | \$2,780              | \$147                        | \$15               |

#### Lease Commitments

At June 30, 2014, the Company had lease contracts for 59 aircraft, which have remaining noncancelable lease terms ranging from 2014 to 2021. Of these aircraft, 16 are non-operating (i.e. not in the Company's fleet) and 14 are subleased to third-party carriers. The majority of airport and terminal facilities are also leased. Rent expense for aircraft and facility leases was \$66 million and \$83 million for the three months ended June 30, 2014 and 2013, respectively, and \$141 million and \$153 million for the six months ended June 30, 2014 and 2013, respectively.

#### Aircraft Commitments

As of June 30, 2014, the Company is committed to purchasing 66 B737 aircraft (29 737-900ER aircraft and 37 737 MAX aircraft), with deliveries in 2014 through 2022. In addition, the Company has options to purchase 58 additional B737 aircraft and seven Q400 aircraft.

#### Capacity Purchase Agreements (CPAs)

At June 30, 2014, Alaska had CPAs with three carriers, including the Company's wholly-owned subsidiary, Horizon. Horizon sells 100% of its capacity to Alaska under a CPA, which is eliminated upon consolidation. In addition, Alaska has CPAs with SkyWest Airlines, Inc. (SkyWest) to fly certain routes and Peninsula Airways, Inc. (PenAir) to fly one route in the state of Alaska. Under these agreements, Alaska pays the third-party carriers an amount which is based on a determination of their cost of operating those flights and other factors. The costs paid by Alaska to Horizon are based on similar data and are intended to approximate market rates for those services. Future payments (excluding those due to Horizon) are based on contractually required minimum levels of flying by the third-party carriers, which

could differ materially due to variable payments based on actual levels of flying and certain costs associated with operating flights, such as fuel.



### Engine Maintenance

The Company has a power-by-the-hour (PBH) maintenance agreement for some of the engines equipped on 737-700 and 737-900 aircraft. This agreement transfers risk to a third-party service provider and fixes the amount the Company pays per flight hour in exchange for maintenance and repairs under a predefined maintenance program. Future payments are based on minimum flight hours.

### NOTE 9. SHAREHOLDERS' EQUITY

#### Common Stock Changes

During the second quarter of 2014, shareholders voted to increase the number of authorized shares from 100 million to 200 million shares, reduce the par value of common stock from \$1 per share to \$0.01 per share, and the Board of Directors declared a two-for-one stock split by means of a stock distribution. The additional shares were distributed on July 9, 2014, to the shareholders of record on June 23, 2014. The stock split increased the Company's outstanding shares from approximately 68.4 million shares to 136.7 million shares as of June 30, 2014. All historical share and per share information has been recast to reflect the changes in the Company's equity structure.

#### Dividends

During the three months ended June 30, 2014, the Company declared and paid a cash dividend of \$0.125 per share, or \$17 million. During the six months ended June 30, 2014, the Company declared and paid cash dividends of \$0.250 per share, or \$34 million.

#### Common Stock Repurchase

In September 2012, the Board of Directors authorized a \$250 million share repurchase program, which was completed in July 2014. In May 2014, the Board of Directors authorized a \$650 million share repurchase program, which began immediately after the \$250 million program was completed.

Share repurchase activity (in millions, except share amounts):

|   | Three Months Ended June 30, |        |           |        | Six Months Ended June 30, |        |           |        |
|---|-----------------------------|--------|-----------|--------|---------------------------|--------|-----------|--------|
|   | 2014                        |        | 2013      |        | 2014                      |        | 2013      |        |
|   | Shares                      | Amount | Shares    | Amount | Shares                    | Amount | Shares    | Amount |
| 2012 Repurchase Program - \$250 million | 1,108,334                   | \$53   | 1,089,194 | \$32   | 1,814,036                 | \$83   | 1,835,564 | \$51   |

#### Accumulated Other Comprehensive Loss

Components of accumulated other comprehensive income (loss), net of tax (in millions):

|                           | June 30,<br>2014 | December 31,<br>2013 |
|---------------------------|------------------|----------------------|
| Marketable securities     | \$4              | \$—                  |
| Employee benefit plans    | (170)            | (173)                |
| Interest rate derivatives | (12)             | (10)                 |
| Total                     | \$(178)          | \$(183)              |

#### Earnings Per Share (EPS)

Diluted EPS is calculated by dividing net income by the average number of common shares outstanding plus the number of additional common shares that would have been outstanding assuming the exercise of in-the-money stock options and restricted stock units, using the treasury-stock method. For the three and six months ended June 30, 2014 and 2013, anti-dilutive shares excluded from the calculation of EPS were not material.

## NOTE 10. OPERATING SEGMENT INFORMATION

Air Group has two operating airlines - Alaska Airlines and Horizon Air. Each is a regulated airline with separate management teams primarily in operational roles. Horizon sells 100% of its capacity to Alaska under a CPA, which is eliminated upon consolidation. In addition, Alaska has CPAs with SkyWest to fly certain routes and PenAir to fly one route in the state of Alaska. The Company attributes revenue between Mainline and Regional based on the coupon fare in effect on the date of issuance relative to the origin and destination of each flight segment. To manage the two operating airlines and the revenues and expenses associated with the CPAs, management views the business in three operating segments.

Alaska Mainline - Flying Boeing 737 jets and all associated revenues and costs.

Alaska Regional - Alaska's CPAs with Horizon, SkyWest and PenAir. In this segment, Alaska Regional records actual on-board passenger revenue, less costs such as fuel, distribution costs, and payments made to Horizon, SkyWest and PenAir under the respective CPAs. Additionally, Alaska Regional includes an allocation of corporate overhead such as IT, finance, and other administrative costs incurred by Alaska on behalf of Horizon.

Horizon - Horizon operates turboprop Q400 aircraft. All of Horizon's capacity is sold to Alaska under a CPA. Expenses include those typically borne by regional airlines such as crew costs, ownership costs, and maintenance costs. The results of Horizon's operations are eliminated upon consolidation.

Additionally, the following table reports "Air Group adjusted," which is not a measure determined in accordance with GAAP. The Company's chief operating decision-makers and others in management use this measure to evaluate operational performance and determine resource allocations. Adjustments are further explained below in reconciling to consolidated GAAP results. Operating segment information is as follows (in millions):

Three Months Ended June 30, 2014

Alaska

|                                    | Mainline | Regional | Horizon | Consolidating | Air Group Adjusted <sup>(a)</sup> | Special Items <sup>(b)</sup> | Consolidated |   |
|------------------------------------|----------|----------|---------|---------------|-----------------------------------|------------------------------|--------------|---|
| Operating revenues                 |          |          |         |               |                                   |                              |              |   |
| Passenger                          |          |          |         |               |                                   |                              |              |   |
| Mainline                           | \$974    | \$—      | \$—     | \$—           | \$ 974                            | \$—                          | \$974        |   |
| Regional                           | —        | 200      | —       | —             | 200                               | —                            | 200          |   |
| Total passenger revenues           | 974      | 200      | —       | —             | 1,174                             | —                            | 1,174        |   |
| CPA revenues                       | —        | —        | 87      | (87           | ) —                               | —                            | —            |   |
| Freight and mail                   | 31       | 1        | —       | —             | 32                                | —                            | 32           |   |
| Other - net                        | 147      | 20       | 2       | —             | 169                               | —                            | 169          |   |
| Total operating revenues           | 1,152    | 221      | 89      | (87           | ) 1,375                           | —                            | 1,375        |   |
| Operating expenses                 |          |          |         |               |                                   |                              |              |   |
| Operating expenses, excluding fuel | 602      | 151      | 86      | (87           | ) 752                             | —                            | 752          |   |
| Economic fuel                      | 324      | 49       | —       | —             | 373                               | (13                          | ) 360        |   |
| Total operating expenses           | 926      | 200      | 86      | (87           | ) 1,125                           | (13                          | ) 1,112      |   |
| Nonoperating income (expense)      |          |          |         |               |                                   |                              |              |   |
| Interest income                    | 5        | —        | —       | —             | 5                                 | —                            | 5            |   |
| Interest expense                   | (9       | ) (1     | ) (2    | ) —           | (12                               | ) —                          | (12          | ) |
| Other                              | 9        | 1        | (1      | ) —           | 9                                 | —                            | 9            |   |
|                                    | 5        | —        | (3      | ) —           | 2                                 | —                            | 2            |   |
| Income (loss) before income tax    | \$231    | \$21     | \$—     | \$—           | \$ 252                            | \$13                         | \$265        |   |



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Three Months Ended June 30, 2013

Alaska

|                                    | Mainline | Regional | Horizon | Consolidating | Air Group Adjusted <sup>(a)</sup> | Special Items <sup>(b)</sup> | Consolidated |   |
|------------------------------------|----------|----------|---------|---------------|-----------------------------------|------------------------------|--------------|---|
| Operating revenues                 |          |          |         |               |                                   |                              |              |   |
| Passenger                          |          |          |         |               |                                   |                              |              |   |
| Mainline                           | \$ 896   | \$—      | \$—     | \$—           | \$ 896                            | \$—                          | \$ 896       |   |
| Regional                           | —        | 192      | —       | —             | 192                               | —                            | 192          |   |
| Total passenger revenues           | 896      | 192      | —       | —             | 1,088                             | —                            | 1,088        |   |
| CPA revenues                       | —        | —        | 91      | (91           | ) —                               | —                            | —            |   |
| Freight and mail                   | 29       | 1        | —       | —             | 30                                | —                            | 30           |   |
| Other - net                        | 120      | 16       | 2       | —             | 138                               | —                            | 138          |   |
| Total operating revenues           | 1,045    | 209      | 93      | (91           | ) 1,256                           | —                            | 1,256        |   |
| Operating expenses                 |          |          |         |               |                                   |                              |              |   |
| Operating expenses, excluding fuel | 569      | 149      | 84      | (92           | ) 710                             | —                            | 710          |   |
| Economic fuel                      | 327      | 44       | —       | —             | 371                               | 1                            | 372          |   |
| Total operating expenses           | 896      | 193      | 84      | (92           | ) 1,081                           | 1                            | 1,082        |   |
| Nonoperating income (expense)      |          |          |         |               |                                   |                              |              |   |
| Interest income                    | 4        | —        | —       | —             | 4                                 | —                            | 4            |   |
| Interest expense                   | (9       | ) —      | (4      | ) (1          | ) (14                             | ) —                          | (14          | ) |
| Other                              | 6        | (1       | ) 1     | (1            | ) 5                               | —                            | 5            |   |
|                                    | 1        | (1       | ) (3    | ) (2          | ) (5                              | ) —                          | (5           | ) |
| Income (loss) before income tax    | \$ 150   | \$ 15    | \$ 6    | \$ (1         | ) \$ 170                          | \$ (1                        | ) \$ 169     |   |

Six Months Ended June 30, 2014

Alaska

|                                    | Mainline | Regional | Horizon | Consolidating | Air Group Adjusted <sup>(a)</sup> | Special Items <sup>(b)</sup> | Consolidated |
|------------------------------------|----------|----------|---------|---------------|-----------------------------------|------------------------------|--------------|
| Operating revenues                 |          |          |         |               |                                   |                              |              |
| Passenger                          |          |          |         |               |                                   |                              |              |
| Mainline                           | \$ 1,828 | \$—      | \$—     | \$—           | \$ 1,828                          | \$—                          | \$ 1,828     |
| Regional                           | —        | 386      | —       | —             | 386                               | —                            | 386          |
| Total passenger revenues           | 1,828    | 386      | —       | —             | 2,214                             | —                            | 2,214        |
| CPA revenues                       | —        | —        | 178     | (178          | ) —                               | —                            | —            |
| Freight and mail                   | 54       | 2        | —       | —             | 56                                | —                            | 56           |
| Other - net                        | 287      | 37       | 3       | —             | 327                               | —                            | 327          |
| Total operating revenues           | 2,169    | 425      | 181     | (178          | ) 2,597                           | —                            | 2,597        |
| Operating expenses                 |          |          |         |               |                                   |                              |              |
| Operating expenses, excluding fuel | 1,178    | 302      | 172     | (178          | ) 1,474                           | —                            | 1,474        |
| Economic fuel                      | 642      | 97       | —       | —             | 739                               | (21                          | ) 718        |
| Total operating expenses           | 1,820    | 399      | 172     | (178          | ) 2,213                           | (21                          | ) 2,192      |

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Nonoperating income  
(expense)

|                                 |       |      |      |      |         |      |       |   |
|---------------------------------|-------|------|------|------|---------|------|-------|---|
| Interest income                 | 10    | —    | —    | —    | 10      | —    | 10    |   |
| Interest expense                | (17   | ) (1 | ) (6 | ) (1 | ) (25   | ) —  | (25   | ) |
| Other                           | 27    | —    | —    | —    | 27      | —    | 27    |   |
|                                 | 20    | (1   | ) (6 | ) (1 | ) 12    | —    | 12    |   |
| Income (loss) before income tax | \$369 | \$25 | \$3  | \$(1 | ) \$396 | \$21 | \$417 |   |

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## Six Months Ended June 30, 2013

## Alaska

|                                       | Mainline | Regional | Horizon | Consolidating | Air Group<br>Adjusted <sup>(a)</sup> | Special<br>Items <sup>(b)</sup> | Consolidated |   |
|---------------------------------------|----------|----------|---------|---------------|--------------------------------------|---------------------------------|--------------|---|
| Operating revenues                    |          |          |         |               |                                      |                                 |              |   |
| Passenger                             |          |          |         |               |                                      |                                 |              |   |
| Mainline                              | \$1,692  | \$—      | \$—     | \$—           | \$1,692                              | \$—                             | \$1,692      |   |
| Regional                              | —        | 374      | —       | —             | 374                                  | —                               | 374          |   |
| Total passenger revenues              | 1,692    | 374      | —       | —             | 2,066                                | —                               | 2,066        |   |
| CPA revenues                          | —        | —        | 186     | (186          | ) —                                  | —                               | —            |   |
| Freight and mail                      | 54       | 2        | —       | —             | 56                                   | —                               | 56           |   |
| Other - net                           | 234      | 31       | 3       | —             | 268                                  | —                               | 268          |   |
| Total operating revenues              | 1,980    | 407      | 189     | (186          | ) 2,390                              | —                               | 2,390        |   |
| Operating expenses                    |          |          |         |               |                                      |                                 |              |   |
| Operating expenses,<br>excluding fuel | 1,116    | 296      | 173     | (187          | ) 1,398                              | —                               | 1,398        |   |
| Economic fuel                         | 650      | 90       | —       | —             | 740                                  | 13                              | 753          |   |
| Total operating expenses              | 1,766    | 386      | 173     | (187          | ) 2,138                              | 13                              | 2,151        |   |
| Nonoperating income<br>(expense)      |          |          |         |               |                                      |                                 |              |   |
| Interest income                       | 9        | —        | —       | —             | 9                                    | —                               | 9            |   |
| Interest expense                      | (21      | ) —      | (7      | ) (1          | ) (29                                | ) —                             | (29          | ) |
| Other                                 | 11       | (1       | ) 1     | (1            | ) 10                                 | —                               | 10           |   |
|                                       | (1       | ) (1     | ) (6    | ) (2          | ) (10                                | ) —                             | (10          | ) |
| Income (loss) before income<br>tax    | \$213    | \$20     | \$10    | \$(1          | ) \$242                              | \$(13                           | ) \$229      |   |

(a) The adjusted column represents the financial information that is reviewed by management to assess performance of operations and determine capital allocations and does not include certain charges.

(b) Includes mark-to-market fuel-hedge accounting charges.

Total assets were as follows (in millions):

|                                       | June 30,<br>2014 | December 31,<br>2013 |
|---------------------------------------|------------------|----------------------|
| Alaska <sup>(a)</sup>                 | \$6,473          | \$5,832              |
| Horizon                               | 857              | 840                  |
| Parent company                        | 3,124            | 2,762                |
| Elimination of inter-company accounts | (4,140           | ) (3,596             |
| Consolidated                          | \$6,314          | \$5,838              |

(a) There are no assets associated with purchased capacity flying at Alaska.

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

### OVERVIEW

The following Management's Discussion and Analysis of Financial Condition and Results of Operations (MD&A) is intended to help the reader understand the Company, our segment operations and our present business environment. MD&A is provided as a supplement to – and should be read in conjunction with – our consolidated financial statements and the accompanying notes. All statements in the following discussion that are not statements of historical information or descriptions of current accounting policy are forward-looking statements. Please consider our forward-looking statements in light of the risks referred to in this report's introductory cautionary note and the risks mentioned in Item 1A. "Risk Factors" of our Annual Report on Form 10-K for the year ended December 31, 2013. This overview summarizes the MD&A, which includes the following sections:

**Second Quarter Review**—highlights from the second quarter of 2014 outlining some of the major events that happened during the period and how they affected our financial performance.

**Results of Operations**—an in-depth analysis of our revenues by segment and our expenses from a consolidated perspective for the three and six months ended June 30, 2014. To the extent material to the understanding of segment profitability, we more fully describe the segment expenses per financial statement line-item. Financial and statistical data is also included here. This section includes forward-looking statements regarding our view of the remainder of 2014.

**Liquidity and Capital Resources**—an overview of our financial position, analysis of cash flows, and relevant contractual obligations and commitments.

### SECOND QUARTER REVIEW

Our consolidated pretax income was \$265 million during the second quarter of 2014, compared to \$169 million in the second quarter of 2013. The increase of \$96 million was mainly due to increased revenues of \$119 million, lower aircraft fuel expense of \$12 million, and non-operating income of \$2 million in the current period compared to non-operating expense of \$5 million in the prior period. These improvements were partially offset by increased non-fuel operating expenses of \$42 million.

See "Results of Operations" below for further discussion of changes in revenues and operating expenses and our reconciliation of non-GAAP measures to the most directly comparable GAAP measure.

#### Accomplishments and Highlights

- Ranked "Highest in Customer Satisfaction Among Traditional Carriers" in 2014 by J.D. Power for the seventh year in a row.
- Ranked highest by frequent fliers in the J.D. Power's first-ever Airline Loyalty/Rewards Program Satisfaction Report.
- Named No. 1 on-time carrier in North America for the fourth year in a row from FlightStats in February 2014.
- Received Airline Business Magazine's 2014 Airline Strategy Award for Technology, Environment and Operations.

#### Operations Performance

During the second quarter, both Alaska and Horizon continued their strong on-time performance, reporting that 88.5% and 93.1% of their flights arrived on time, respectively. For the twelve months ended May 2014, Alaska maintained its ranking as the top carrier among the eight largest U.S. airlines for on-time performance, according to the U.S.



Department of Transportation.

Update on Labor Negotiations

In April 2014, Alaska Airlines' clerical, office, and passenger service employees (COPS), represented by the International Association of Machinist and Aerospace Workers (IAM), ratified a new five-year contract.

In April 2014, Horizon Air's dispatchers, represented by the Transport Workers Union (TWU), ratified a new four-year contract.

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In June 2014, Horizon Air's aircraft technicians and fleet service agents, represented by the International Brotherhood of Teamsters (IBT), ratified a new six-year contract.

Alaska remains in negotiations with its flight attendants, represented by the Association of Flight Attendants (AFA), under the oversight of the National Mediation Board. The contract first became amendable in May 2012 and the parties have been in mediation since July 2013. Under the Railway Labor Act, contracts between airlines and their employees do not expire, but rather become amendable.

#### New Markets

New routes launched and announced in the second quarter are as follows:

| New Non-Stop Routes Launched in Q2     | New Non-Stop Routes Announced in Q2 (Launch Dates) |
|--|--|
| Salt Lake City to Portland, Oregon     | Seattle to Baltimore (9/2/2014)                    |
| Salt Lake City to San Diego            | Seattle to Albuquerque, New Mexico (9/18/2014)     |
| Salt Lake City to Los Angeles          | Portland to Los Cabos, Mexico (11/3/2014)*         |
| Salt Lake City to San Jose, California | Portland to Puerto Vallarta (11/4/2014)*           |
| Salt Lake City to Boise, Idaho         | Seattle to Cancun (11/6/2014)                      |
| Salt Lake City to Las Vegas            |  |
| Salt Lake City to San Francisco        |  |
| Portland to Kalispell, Montana         |  |
| Seattle to New Orleans                 |  |
| Seattle to Tampa, Florida              |  |

\* Subject to government approval.

#### Capital Allocation

During the second quarter of 2014, we paid cash dividends of \$17 million and we repurchased 1,108,334 shares of our common stock for \$53 million under the \$250 million repurchase program authorized by our Board of Directors in September 2012. In May 2014, the Board of Directors authorized a \$650 million share repurchase program, which began in July 2014 immediately after the existing \$250 million program was completed. Since 2007, we have repurchased 44 million shares of common stock under such programs for \$487 million for an average price of \$11 per share. During the month of July, we repurchased 1,878,975 shares of our common stock for \$87 million, resulting in 134,882,465 shares outstanding at July 31, 2014. For 2014, we expect to deploy at least \$350 million through a combination of dividends and share repurchases.

#### Outlook

We expect our capacity to increase ~ 8% in the third quarter and increase ~ 11% in the fourth quarter. In addition to our own capacity growth, competitive capacity is expected to be up ~ 9% in the third quarter and ~ 12% in the fourth quarter (weighted by the concentration of our own capacity in competitive markets), which will put pressure on our yields and load factors. Furthermore, we have made changes to our network to increase the markets served out of Seattle and to redeploy capacity in order to better match demand and optimize revenue. We believe we are well positioned to compete against these competitive incursions because of our low cost structure, award-winning service, and loyal customer base, among other things. We currently expect our unit costs to be higher in the third quarter compared to 2013, but we are now targeting a ~ 0.5% decrease in unit costs for the full year of 2014 compared to 2013.



Our current expectations for capacity and CASM excluding fuel and special items are summarized below:

|                             | Forecast<br>Q3 2014 | Change<br>Y-O-Y | Forecast<br>Full Year 2014 | Change<br>Y-O-Y |
|-----------------------------|---------------------|-----------------|----------------------------|-----------------|
| <b>Consolidated:</b>        |                     |                 |                            |                 |
| ASMs (000,000) "capacity"   | 9,550 - 9,600       | ~ 8.0%          | 36,050 - 36,150            | ~ 7.0%          |
| CASM excluding fuel (cents) | 8.23¢ - 8.28¢       | ~ 1.0%          | 8.42¢ - 8.45¢              | ~ (0.5)%        |
| <b>Mainline:</b>            |                     |                 |                            |                 |
| ASMs (000,000) "capacity"   | 8,575 - 8,625       | ~ 7.0%          | 32,400 - 32,500            | ~ 6.5%          |
| CASM excluding fuel (cents) | 7.42¢ - 7.47¢       | ~ 1.5%          | 7.52¢ - 7.55¢              | ~ flat          |

## RESULTS OF OPERATIONS

### COMPARISON OF THREE MONTHS ENDED JUNE 30, 2014 COMPARED TO THREE MONTHS ENDED JUNE 30, 2013

Our consolidated net income for the second quarter of 2014 was \$165 million, or \$1.19 per diluted share, compared to net income of \$104 million, or \$0.74 per diluted share, in the second quarter of 2013. Significant items impacting the comparability between the periods are as follows:

Both periods include adjustments to reflect the timing of unrealized mark-to-market adjustments related to our fuel hedge positions. For the second quarter of 2014, we recognized mark-to-market unrealized gains of \$13 million (\$8 million after tax, or \$0.06 per diluted share) compared to unrealized losses of \$1 million (\$1 million after tax, or \$0.00 per diluted share) in the second quarter of 2013.

### ADJUSTED (NON-GAAP) RESULTS AND PER-SHARE AMOUNTS

We believe disclosure of earnings excluding the impact of mark-to-market gains or losses or other individual revenues or expenses is useful information to investors because:

• We believe it is the basis by which we are evaluated by industry analysts;

By eliminating fuel expense and certain special items from our unit metrics, we believe that we have better visibility into the results of our non-fuel continuing operations. Our industry is highly competitive and is characterized by high fixed costs, so even a small reduction in non-fuel operating costs can result in a significant improvement in operating results. In addition, we believe that all domestic carriers are similarly impacted by changes in jet fuel costs over the long run, so it is important for management (and thus investors) to understand the impact of (and trends in) company-specific cost drivers such as labor rates and productivity, airport costs, maintenance costs, etc., which are more controllable by management;

• CASM excluding fuel and certain special items is one of the most important measures used by management and by the Air Group Board of Directors in assessing quarterly and annual cost performance;

Our results excluding fuel expense and certain special items serve as the basis for our various employee incentive plans, thus the information allows investors to better understand the changes in variable incentive pay expense in our consolidated statements of operations; and

• It is useful to monitor performance without these items as it improves a reader's ability to compare our results to those of other airlines.

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

Excluding the impact of mark-to-market fuel hedge adjustments, our adjusted consolidated net income for the second quarter of 2014 was \$157 million, or \$1.13 per diluted share, compared to an adjusted consolidated net income of \$105 million, or \$0.74 per diluted share, in the second quarter of 2013.

| (in millions, except per share amounts)           | Three Months Ended June 30, |             |         |             |
|---|-----------------------------|-------------|---------|-------------|
|   | 2014                        | 2013        | 2014    | 2013        |
|   | Dollars                     | Diluted EPS | Dollars | Diluted EPS |
| Net income and diluted EPS as reported            | \$ 165                      | \$ 1.19     | \$ 104  | \$ 0.74     |
| Mark-to-market fuel hedge adjustments, net of tax | ( 8 )                       | ( 0.06 )    | 1       | —           |
| Non-GAAP adjusted income and per-share amounts    | \$ 157                      | \$ 1.13     | \$ 105  | \$ 0.74     |

Our operating costs per ASM are summarized below:

| (in cents)  | Three Months Ended June 30, |         |        | % Change |
|---|-----------------------------|---------|--------|----------|
|   | 2014                        | 2013    |        |          |
| Consolidated:                                     |                             |         |        |          |
| CASM  | 12.37                       | ¢ 12.66 | ¢ (2.3 | )        |
| Less the following components:                    |                             |         |        |          |
| Aircraft fuel, including hedging gains and losses | 4.01                        | 4.35    | (7.8   | )        |
| CASM excluding fuel                               | 8.36                        | ¢ 8.31  | ¢ 0.6  |          |
| Mainline:   |                             |         |        |          |
| CASM  | 11.28                       | ¢ 11.58 | ¢ (2.6 | )        |
| Less the following components:                    |                             |         |        |          |
| Aircraft fuel, including hedging gains and losses | 3.84                        | 4.23    | (9.2   | )        |
| CASM excluding fuel                               | 7.44                        | ¢ 7.35  | ¢ 1.2  |          |

## OPERATING STATISTICS SUMMARY (unaudited)

Alaska Air Group, Inc.

Below are operating statistics we use to measure operating performance. We often refer to unit revenues and adjusted unit costs, which are non-GAAP measures.

|   | Three Months Ended June 30, |        |           | Six Months Ended June 30, |        |           |
|---|-----------------------------|--------|-----------|---------------------------|--------|-----------|
|   | 2014                        | 2013   | Change    | 2014                      | 2013   | Change    |
| Consolidated Operating Statistics: <sup>(a)</sup>                 |                             |        |           |                           |        |           |
| Revenue passengers (000)  | 7,353                       | 6,980  | 5.3%      | 14,002                    | 13,326 | 5.1%      |
| Revenue passenger miles (RPM) (000,000)<br>"traffic"              | 7,755                       | 7,385  | 5.0%      | 14,832                    | 14,181 | 4.6%      |
| Available seat miles (ASM) (000,000)<br>"capacity"                | 8,988                       | 8,547  | 5.2%      | 17,341                    | 16,530 | 4.9%      |
| Load factor   | 86.3%                       | 86.4%  | (0.1) pts | 85.5%                     | 85.8%  | (0.3) pts |
| Yield   | 15.14¢                      | 14.73¢ | 2.8%      | 14.93¢                    | 14.56¢ | 2.5%      |
| Passenger revenue per ASM (PRASM)                                 | 13.06¢                      | 12.73¢ | 2.6%      | 12.77¢                    | 12.49¢ | 2.2%      |
| Revenue per ASM (RASM)  | 15.29¢                      | 14.70¢ | 4.0%      | 14.98¢                    | 14.46¢ | 3.6%      |
| Operating expense per ASM (CASM) excluding<br>fuel <sup>(b)</sup> | 8.36¢                       | 8.31¢  | 0.6%      | 8.50¢                     | 8.46¢  | 0.5%      |
| Economic fuel cost per gallon <sup>(b)</sup>                      | \$3.20                      | \$3.28 | (2.4%)    | \$3.26                    | \$3.38 | (3.6%)    |
| Fuel gallons (000,000)  | 116                         | 113    | 2.7%      | 227                       | 219    | 3.7%      |
| ASMs per fuel gallons   | 77.5                        | 75.6   | 2.5%      | 76.4                      | 75.5   | 1.2%      |
| Average number of full-time equivalent<br>employees (FTEs)        | 12,515                      | 12,059 | 3.8%      | 12,451                    | 12,036 | 3.4%      |
| Mainline Operating Statistics:                                    |                             |        |           |                           |        |           |
| Revenue passengers (000)  | 5,307                       | 5,074  | 4.6%      | 10,044                    | 9,608  | 4.5%      |
| RPMs (000,000) "traffic"  | 7,029                       | 6,729  | 4.5%      | 13,431                    | 12,901 | 4.1%      |
| ASMs (000,000) "capacity"   | 8,095                       | 7,743  | 4.5%      | 15,590                    | 14,946 | 4.3%      |
| Load factor   | 86.8%                       | 86.9%  | (0.1) pts | 86.2%                     | 86.3%  | (0.1) pts |
| Yield   | 13.86¢                      | 13.31¢ | 4.1%      | 13.61¢                    | 13.11¢ | 3.8%      |
| PRASM   | 12.03¢                      | 11.57¢ | 4.0%      | 11.73¢                    | 11.32¢ | 3.6%      |
| RASM  | 14.24¢                      | 13.50¢ | 5.5%      | 13.92¢                    | 13.24¢ | 5.1%      |
| CASM excluding fuel <sup>(b)</sup>                                | 7.44¢                       | 7.35¢  | 1.2%      | 7.56¢                     | 7.47¢  | 1.2%      |
| Economic fuel cost per gallon <sup>(b)</sup>                      | \$3.19                      | \$3.28 | (2.7%)    | \$3.25                    | \$3.37 | (3.6%)    |
| Fuel gallons (000,000)  | 102                         | 100    | 2.0%      | 197                       | 193    | 2.1%      |
| Average number of FTEs  | 9,767                       | 9,457  | 3.3%      | 9,679                     | 9,404  | 2.9%      |
| Aircraft utilization  | 10.5                        | 10.9   | (3.7%)    | 10.4                      | 10.7   | (2.8%)    |
| Average aircraft stage length                                     | 1,181                       | 1,156  | 2.2%      | 1,190                     | 1,188  | 0.2%      |
| Mainline operating fleet at period-end                            | 134                         | 128    | 6 a/c     | 134                       | 128    | 6 a/c     |
| Regional Operating Statistics: <sup>(c)</sup>                     |                             |        |           |                           |        |           |
| Revenue passengers (000)  | 2,046                       | 1,907  | 7.3%      | 3,958                     | 3,718  | 6.5%      |
| RPMs (000,000) "traffic"  | 725                         | 656    | 10.5%     | 1,401                     | 1,280  | 9.5%      |
| ASMs (000,000) "capacity"   | 894                         | 804    | 11.2%     | 1,751                     | 1,584  | 10.5%     |
| Load factor   | 81.2%                       | 81.6%  | (0.4) pts | 80.0%                     | 80.8%  | (0.8) pts |
| Yield   | 27.55¢                      | 29.29¢ | (5.9%)    | 27.54¢                    | 29.19¢ | (5.7%)    |
| PRASM   | 22.37¢                      | 23.91¢ | (6.4%)    | 22.04¢                    | 23.60¢ | (6.6%)    |
| Operating fleet (Horizon only)                                    | 51                          | 48     | 3 a/c     | 51                        | 48     | 3 a/c     |

- (a) Except for FTEs, data includes information related to third-party Regional CPA arrangements.
- (b) See reconciliation of this measure to the most directly related GAAP measure in the "Results of Operations" section.
- (c) Data presented includes information related to Regional CPAs.



## OPERATING REVENUES

Total operating revenues increased \$119 million, or 9%, during the second quarter of 2014 compared to the same period in 2013. The changes are summarized in the following table:

| (in millions)            | Three Months Ended June 30, |         |          |
|--------------------------|-----------------------------|---------|----------|
|                          | 2014                        | 2013    | % Change |
| Passenger                |                             |         |          |
| Mainline                 | \$974                       | \$896   | 9        |
| Regional                 | 200                         | 192     | 4        |
| Total passenger revenue  | 1,174                       | 1,088   | 8        |
| Freight and mail         | 32                          | 30      | 7        |
| Other - net              | 169                         | 138     | 22       |
| Total operating revenues | \$1,375                     | \$1,256 | 9        |

## Passenger Revenue – Mainline

Mainline passenger revenue for the second quarter of 2014 increased by 9% due to a 4.5% increase in capacity and a 4.0% increase in PRASM compared to 2013. The increase in capacity was driven by the annualization of new routes added to expand our service in Seattle, Anchorage, and Portland. The increase in PRASM was driven by a 4.1% increase in ticket yield partially offset by a 0.1 point decrease in load factor compared to the prior-year quarter. Yields increased due to reallocation of capacity to markets with stronger demand and by a change in revenue allocation between Mainline and Regional service because of certain industry pricing changes. Without the industry change, Mainline yields would have increased by 2.9%.

## Passenger Revenue – Regional

Regional passenger revenue increased by \$8 million, or 4%, compared to the second quarter of 2013, due to an 11.2% increase in capacity, partially offset by a 6.4% decrease in PRASM. The increase in capacity was driven by the annualization of new routes, and to a lesser extent, by five new routes launched this quarter. The decrease in PRASM is due to a 5.9% decline in yield, and a decrease in load factor of 0.4 points. The decline in yield was driven mostly by a change in revenue allocation between Mainline and Regional service because of certain industry pricing changes. Without the revenue allocation adjustment yield would have decreased 1.8%. Additionally, the average trip length for our Regional flights increased 3.5%, which also puts downward pressure on yields.

## Other – Net

Other - net revenue increased \$31 million, or 22%, from the second quarter of 2013. Mileage plan revenue increased \$17 million compared to the second quarter of 2013, due to an 11% increase in miles sold, and an 8% increase in cash received per mile, and an increase in the percentage of cash proceeds allocated to the marketing deliverables under the affinity card agreement, which was modified in July 2013. Additionally, bags fees and ticket change fees are up 21% and 11%, respectively, due to changes in our fee structure that took effect in November 2013.

## OPERATING EXPENSES

Total operating expenses increased \$30 million, or 3%, compared to the second quarter of 2013. We believe it is useful to summarize operating expenses as follows, which is consistent with the way expenses are reported internally and evaluated by management:

| (in millions) | Three Months Ended June 30, |      |          |
|---------------|-----------------------------|------|----------|
|               | 2014                        | 2013 | % Change |

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|                          |         |         |    |   |
|--------------------------|---------|---------|----|---|
| Fuel expense             | \$360   | \$372   | (3 | ) |
| Non-fuel expenses        | 752     | 710     | 6  |   |
| Total Operating Expenses | \$1,112 | \$1,082 | 3  |   |

Significant operating expense variances from 2013 are more fully described below.

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## Wages and Benefits

Wages and benefits increased during the second quarter of 2014 by \$23 million. The primary components of wages and benefits are shown in the following table:

| (in millions)                   | Three Months Ended June 30, |       |          |
|---------------------------------|-----------------------------|-------|----------|
|                                 | 2014                        | 2013  | % Change |
| Wages                           | \$211                       | \$187 | 13       |
| Pension - Defined benefit plans | 2                           | 12    | (83)     |
| Defined contribution plans      | 13                          | 11    | 18       |
| Medical and other benefits      | 39                          | 34    | 15       |
| Payroll taxes                   | 16                          | 14    | 14       |
| Total wages and benefits        | \$281                       | \$258 | 9        |

Wages increased 13% with a 3.8% increase in FTEs. The primary driver of the increase in wages was annualization of new labor contracts that included higher rates. FTEs increased across most work groups compared to the prior year due to flight activity growth. Additionally, late last year we started replacing many of our contractors in our Information Technology group with employees.

Pension expense decreased 83%, compared to the same period in the prior year. The decline is largely due to the improved funded status of the plan and the freezing of plan benefits for our non-union employees beginning January 1, 2014.

Medical and other benefits increased approximately 15%, primarily due to increased workers compensation activity and rates.

## Variable Incentive Pay

Variable incentive pay increased \$8 million, or 38% compared to 2013. With our year-to-date results, we are exceeding our incentive plan financial goals by more than we were at this time last year.

## Aircraft Fuel

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

Aircraft fuel expense decreased \$12 million, or 3% compared to 2013. The elements of the change are illustrated in the following table:

| (in millions, except for per gallon amounts) | Three Months Ended June 30, |          |         |          |
|--|-----------------------------|----------|---------|----------|
|  | 2014                        |          | 2013    |          |
|  | Dollars                     | Cost/Gal | Dollars | Cost/Gal |
| Raw or "into-plane" fuel cost                | \$365                       | \$3.13   | \$347   | \$3.07   |
| (Gains) losses on settled hedges             | 8                           | 0.07     | 24      | 0.21     |
| Consolidated economic fuel expense           | 373                         | 3.20     | 371     | 3.28     |
| Mark-to-market fuel hedge adjustments        | (13)                        | (0.11)   | 1       | 0.01     |

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|                   |       |        |       |        |
|-------------------|-------|--------|-------|--------|
| GAAP fuel expense | \$360 | \$3.09 | \$372 | \$3.29 |
| Fuel gallons      | 116   |        | 113   |        |

The raw fuel price per gallon increased 2.0% as a result of higher West Coast jet fuel prices. West Coast jet fuel prices are impacted by both the price of crude oil, as well as refining margins associated with the conversion of crude oil to jet fuel. The increase in raw fuel price per gallon during the second quarter of 2014 was due to higher crude oil prices of 9.4%, partially

offset by a 6.9% decrease in refining margins, as compared to the prior year. Additionally in the second quarter of 2014, we received a refund of certain fuel taxes paid between 2010 and 2014. This refund reduced our cost of fuel by \$0.05/gallon in the second quarter of 2014.

We also evaluate economic fuel expense, which we define as raw fuel expense adjusted for the cash we receive from, or pay to, hedge counterparties for hedges that settle during the period, and for the premium expense that we paid for those contracts. A key difference between aircraft fuel expense and economic fuel expense is the timing of gain or loss recognition on our hedge portfolio. When we refer to economic fuel expense, we include gains and losses only when they are realized for those contracts that were settled during the period based on their original contract terms. We believe this is the best measure of the effect that fuel prices are currently having on our business because it most closely approximates the net cash outflow associated with purchasing fuel for our operations. Accordingly, many industry analysts evaluate our results using this measure, and it is the basis for most internal management reporting and incentive pay plans.

We recognized losses of \$8 million for hedges that settled during the second quarter of 2014, compared to losses of \$24 million in 2013. These amounts represent the net cash paid including the premium expense recognized for those hedges.

#### Aircraft Maintenance

Aircraft maintenance expense decreased by \$10 million, or 15%, compared to the second quarter of 2013. The decrease is primarily due to a reduction in the number of engines covered by power-by-the-hour (PBH) contracts in the prior year, along with reduced flying on the engines that are still under the remaining PBH contract. Additionally, Horizon had fewer scheduled and unscheduled engine events in the current period compared to the prior period. Partially offsetting the decreases were increased rates and volumes for B737 engines that are not covered under the PBH contract and higher component costs.

#### Landing Fees and Other Rentals

Landing fees and other rentals decreased \$11 million, or 15%, compared to the second quarter of 2013. In the prior-year quarter, we recorded the higher rates at SeaTac International Airport that had been imposed on airlines during the time we were in negotiation for a new lease. As a result of these imposed rate increases that were retroactive to January 2013, we recorded an additional \$6 million related to the first quarter of 2013 in the prior-year quarter. As the rates on the actual signed lease were lower than the imposed rates accrued in the prior year, we received a reimbursement from the Port of Seattle for overpayment of rents, landing fees, and revenue sharing of approximately \$9 million in the current quarter. Partially offsetting the impact of items relating to the Port of Seattle were increased volumes and higher rates at other airports throughout the network.

#### Contracted Services

Contracted services expense increased \$8 million, or 15% , compared to the second quarter of 2013. The increase is primarily due to an increase in CPA flying by SkyWest, as well as higher passenger and ramp handling costs to support increased activity.

#### Other Operating Expenses

Other operating expenses increased \$16 million, or 25%, compared to the second quarter of 2013. The increase is largely due to additional professional services, software licenses, and property taxes. The additional professional services and software licenses are due to system modernization initiatives, while the increase in property taxes are due

in part to our increased capital investments.

NONOPERATING INCOME (EXPENSE)

In the current quarter, we generated nonoperating income of \$2 million compared to an expense of \$5 million in the prior-year period. In the current quarter, we recognized a gain from the sale of stock received in connection with a bankruptcy claim. Additionally, our interest expense was \$2 million lower due to lower average debt levels.

We are presenting our line-item expenses below both in absolute dollars and on an ASM basis to highlight areas in which costs have increased or decreased either more or less than capacity.

| (in millions, except CASM)     | Three Months Ended June 30, |                | 2014<br>CASM | 2013<br>CASM | Change |      |
|--------------------------------|-----------------------------|----------------|--------------|--------------|--------|------|
|                                | 2014<br>Amount              | 2013<br>Amount |              |              | CASM   | CASM |
| Wages and benefits             | \$281                       | \$258          | 3.13         | ¢ 3.02       | ¢ 3.6  | %    |
| Variable incentive pay         | 29                          | 21             | 0.32         | 0.25         | 28.0   | %    |
| Aircraft maintenance           | 57                          | 67             | 0.63         | 0.78         | (19.2) | )%   |
| Aircraft rent                  | 29                          | 30             | 0.32         | 0.35         | (8.6)  | )%   |
| Landing fees and other rentals | 64                          | 75             | 0.71         | 0.88         | (19.3) | )%   |
| Contracted services            | 62                          | 54             | 0.69         | 0.63         | 9.5    | %    |
| Selling expenses               | 53                          | 51             | 0.59         | 0.60         | (1.7)  | )%   |
| Depreciation and amortization  | 73                          | 68             | 0.81         | 0.80         | 1.3    | %    |
| Food and beverage service      | 23                          | 21             | 0.26         | 0.25         | 4.0    | %    |
| Other                          | 81                          | 65             | 0.91         | 0.75         | 21.3   | %    |
| Non-fuel Expenses              | \$752                       | \$710          | 8.37         | ¢ 8.31       | ¢ 0.7  | %    |

#### Additional Segment Information

Refer to the Notes of the Condensed Consolidated Financial Statements for a detailed description of each segment. Below is a summary of each segment's profitability.

#### Alaska Mainline

Pretax profit for Alaska Mainline was \$231 million in the second quarter of 2014 compared to \$150 million in the second quarter of 2013. The \$78 million increase in Mainline passenger revenue is described above. Mainline operating expense excluding fuel increased by \$33 million to \$602 million in 2014 driven mainly by increased wages and incentive pay as we are exceeding our goals by more in the current year compared to the prior year, and increased spending on IT infrastructure projects. These increases are partially offset by lower maintenance expenses, and lower airport rents and landing fees. Economic fuel cost decreased due to lower raw fuel costs, partially offset by a 2.0% increase in consumption and losses on settled hedges.

#### Alaska Regional

Pretax profit for Alaska Regional was \$21 million in the second quarter of 2014 compared to \$15 million the second quarter of 2013. The increased Regional revenue was offset by higher expenses to support additional capacity.

#### Horizon

Horizon broke even in the second quarter of 2014 compared to pretax profit of \$6 million in the second quarter of 2013. CPA Revenues (100% of which are from Alaska and eliminated in consolidation) decreased due to lower reimbursable maintenance expenses. The \$2 million increase in Horizon's non-fuel operating expenses was driven largely by increased pilot hiring, a signing bonus related to the labor contract ratified by Horizon's mechanics in June 2014, and higher workers compensation claims.





## COMPARISON OF SIX MONTHS ENDED JUNE 30, 2014 COMPARED TO SIX MONTHS ENDED JUNE 30, 2013

Our consolidated net income for the first six months of 2014 was \$259 million, or \$1.86 per diluted share, compared to net income of \$141 million, or \$0.99 per diluted share, in the first six months of 2013. Significant items impacting the comparability between the periods are as follows:

Both periods include adjustments to reflect the timing of net unrealized mark-to-market gains and losses related to our fuel hedge positions. For the first six months of 2014, we recognized net mark-to-market gains of \$21 million (\$13 million after tax, or \$0.09 per diluted share) compared to losses of \$13 million (\$7 million after tax, or \$0.05 per diluted share) in the first six months of 2013.

Excluding the impact of mark-to-market fuel hedge adjustments, our adjusted consolidated net income for the first six months of 2014 was \$246 million, or \$1.77 per diluted share, compared to an adjusted consolidated net income of \$148 million, or \$1.04 per share, in the first six months of 2013.

| (in millions, except per share amounts)           | Six Months Ended June 30, |             |         |             |
|---|---------------------------|-------------|---------|-------------|
|   | 2014                      |             | 2013    |             |
|   | Dollars                   | Diluted EPS | Dollars | Diluted EPS |
| Net income and diluted EPS as reported            | \$259                     | \$1.86      | \$141   | \$0.99      |
| Mark-to-market fuel hedge adjustments, net of tax | (13                       | ) (0.09     | ) 7     | 0.05        |
| Non-GAAP adjusted income and per-share amounts    | \$246                     | \$1.77      | \$148   | \$1.04      |

Our operating costs per ASM are summarized below:

| (in cents)  | Six Months Ended June 30, |   |       | % Change |
|---|---------------------------|---|-------|----------|
|   | 2014                      |   | 2013  |          |
| Consolidated:                                     |                           |   |       |          |
| CASM  | 12.64                     | ¢ | 13.01 | ¢ (2.8 ) |
| Less the following components:                    |                           |   |       |          |
| Aircraft fuel, including hedging gains and losses | 4.14                      |   | 4.55  | (9.0 )   |
| CASM excluding fuel                               | 8.50                      | ¢ | 8.46  | ¢ 0.5    |
| Mainline:   |                           |   |       |          |
| CASM  | 11.54                     | ¢ | 11.90 | ¢ (3.0 ) |
| Less the following components:                    |                           |   |       |          |
| Aircraft fuel, including hedging gains and losses | 3.98                      |   | 4.43  | (10.2 )  |
| CASM excluding fuel                               | 7.56                      | ¢ | 7.47  | ¢ 1.2    |

## OPERATING REVENUES

Total operating revenues increased \$207 million, or 9%, during the first six months of 2014 compared to the same period in 2013. The changes are summarized in the following table:

| (in millions)           | Six Months Ended June 30, |  |         | % Change |
|-------------------------|---------------------------|--|---------|----------|
|                         | 2014                      |  | 2013    |          |
| Passenger               |                           |  |         |          |
| Mainline                | \$1,828                   |  | \$1,692 | 8        |
| Regional                | 386                       |  | 374     | 3        |
| Total passenger revenue | 2,214                     |  | 2,066   | 7        |
| Freight and mail        | 56                        |  | 56      | —        |

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|                          |         |         |    |
|--------------------------|---------|---------|----|
| Other - net              | 327     | 268     | 22 |
| Total operating revenues | \$2,597 | \$2,390 | 9  |

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## Passenger Revenue – Mainline

Mainline passenger revenue for the first six months of 2014 increased by 8% on a 4.3% increase in capacity and a 3.6% increase in PRASM compared to 2013. The increase in capacity is driven by routes added in the last twelve months. The increase in PRASM was driven by a 3.8% increase in ticket yield and a 0.1 point decrease in load factor compared to the prior-year period. Yields increased due to reallocation of capacity to markets with stronger demand and by a change in revenue allocation between Mainline and Regional service because of certain industry pricing changes. Without the industry change, Mainline yields would have increased by 2.6%.

## Passenger Revenue – Regional

Regional passenger revenue increased by \$12 million, or 3%, compared to the first six months of 2013, due to a 6.6% decrease in PRASM and a 10.5% increase in capacity. The decrease in PRASM was due to a decline in load factor of 0.8 points and a decrease in ticket yield of 5.7%. The decline in yield was driven mostly by a change in revenue allocation between Mainline and Regional service because of certain industry pricing changes. Without the revenue allocation adjustment, yield would have decreased 2.2%. Additionally, the average trip length for our Regional flights increased 3.2%, which also put downward pressure on yields.

## Other – Net

Other - net revenue increased \$59 million, or 22%, from the first six months of 2013. Mileage Plan revenue increased \$36 million, due to an increase in miles sold, an increase in cash received per mile, and an increase in the percentage of cash proceeds allocated to the marketing deliverables under the new affinity card agreement, which was modified in July 2013. Additionally, bags fees and ticket change fees are up 20% and 11%, respectively, due to changes in our fee structure that took effect in November 2013.

## OPERATING EXPENSES

Total operating expenses increased \$41 million, or 2%, compared to the first six months of 2013, mostly as a result of higher non-fuel costs. We believe it is useful to summarize operating expenses as follows, which is consistent with the way expenses are reported internally and evaluated by management:

| (in millions)            | Six Months Ended June 30, |         |          |
|--------------------------|---------------------------|---------|----------|
|                          | 2014                      | 2013    | % Change |
| Fuel expense             | \$718                     | \$753   | (5)      |
| Non-fuel expenses        | 1,474                     | 1,398   | 5        |
| Total Operating Expenses | \$2,192                   | \$2,151 | 2        |

Significant operating expense variances from 2013 are more fully described below.

## Wages and Benefits

Wages and benefits increased during the first six months of 2014 by \$31 million, or 6%, compared to 2013. The primary components of wages and benefits are shown in the following table:

| (in millions)                   | Six Months Ended June 30, |       |          |
|---------------------------------|---------------------------|-------|----------|
|                                 | 2014                      | 2013  | % Change |
| Wages                           | \$421                     | \$380 | 11       |
| Pension - Defined benefit plans | 4                         | 25    | (84)     |
| Defined contribution plans      | 25                        | 21    | 19       |
| Medical and other benefits      | 72                        | 67    | 7        |

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|                          |       |       |   |
|--------------------------|-------|-------|---|
| Payroll taxes            | 31    | 29    | 7 |
| Total wages and benefits | \$553 | \$522 | 6 |

Wages increased 11% on a 3.4% increase in FTEs. The primary driver of the increase in wages was annualization of new labor contracts that included higher rates. The increase in FTEs is to support additional aircraft and passengers.

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Pension expense decreased 84%, compared to the same period in the prior year. The decline is due to the improved funded status of the plan and the freezing of plan benefits for our non-union employees beginning January 1, 2014.

Defined contribution plans increased 19%, due to increased contributions per the new labor agreements.

Medical and other benefits increased 7% compared to the same period in the prior year. The increase was due to higher workers comp claims and rates in the second quarter of 2014 compared to the second quarter of 2013.

We expect wages and benefits to increase for the full year due to the new long term labor deals, more FTEs to support additional aircraft in our fleet, and higher medical and other benefits, slightly offset by lower pension expense.

#### Variable Incentive Pay

Variable incentive pay expense increased during the first six months of 2014 by \$12 million, or 29% compared to 2013. The increase is due to exceeding our incentive plan goals by more than we were exceeding our prior-year goals at this time last year. For the full year of 2014, we currently expect incentive pay to be approximately \$113 million compared to the \$88 million recorded in 2013, but actual amounts could differ based on third and fourth quarter performance.

#### Aircraft Fuel

Aircraft fuel expense increased \$35 million, compared to 2013. The elements of the change are illustrated in the following table:

| (in millions, except for per gallon amounts) | Six Months Ended June 30, |             |         |             |
|--|---------------------------|-------------|---------|-------------|
|  | 2014                      |             | 2013    |             |
|  | Dollars                   | Cost/Gallon | Dollars | Cost/Gallon |
| Raw or "into-plane" fuel cost                | \$712                     | \$3.14      | \$704   | \$3.22      |
| (Gains) losses on settled hedges             | 27                        | 0.12        | 36      | 0.16        |
| Consolidated economic fuel expense           | 739                       | 3.26        | 740     | 3.38        |
| Mark-to-market fuel hedge adjustments        | (21                       | ) (0.09     | ) 13    | 0.06        |
| GAAP fuel expense                            | \$718                     | \$3.17      | \$753   | \$3.44      |
| Fuel gallons                                 | 227                       |             | 219     |             |

The raw fuel price per gallon decreased 2.5% as a result of lower West Coast jet fuel prices. West Coast jet fuel prices are impacted by both the price of crude oil, as well as refining margins associated with the conversion of crude oil to jet fuel. The decrease in raw fuel price per gallon during the first six months of 2014 was due to decreases in refining margins of 24.7%, partially offset by an increase in crude oil prices of 7.1%.

Losses recognized for hedges that settled during the year were \$27 million in 2014, compared to \$36 million in 2013.

These amounts represent the cash paid for premium expense, offset by cash received from those hedges. The decrease in losses on settled hedges is primarily due to the premiums for hedges that we entered into up to three years ago. The majority of these hedges were purchased "at the money" resulting in a higher premium than under our current strategy of purchasing "out of the money" hedges.

Beginning in the third quarter, we have discontinued the hedge program for refining margins. We currently expect our economic fuel price per gallon to be lower in the third quarter of 2014 compared to the third quarter of 2013 due to our current estimate of lower refining margins, offset by higher average crude prices. For the full year, we expect our economic fuel price per gallon to be lower than the prior year primarily due to lower refining margins and a decrease in hedge premium expense, offset by higher average crude prices.

#### Aircraft Maintenance

Aircraft maintenance decreased by \$25 million, or 19%, compared to the prior-year period. The decrease is primarily due to a reduction in the number of engines covered by power-by-the-hour (PBH) contracts in the prior year, along with reduced flying on the engines that are still under the remaining PBH contract. Additionally, we have experienced fewer maintenance events in the current year compared to prior year, and have less lease return provision costs in the current year compared to the prior year.

For the full year, we expect aircraft maintenance to be lower than 2013 for the reasons above.

#### Landing Fees and Other Rentals

Landing fees and other rentals decreased \$3 million, or 2%, compared to the first six months of 2013. The decrease is primarily due to higher imposed rates for the Port of Seattle in the prior year and to the refund we received from Port of Seattle for overpayment in the current year, offset by increased rates in Los Angeles, Portland, and San Diego airports. and increased volumes throughout the network.

For the full year, we expect landing fees and other rents to increase to support increased flying.

#### Contracted Services

Contracted services expense increased \$15 million, or 14%, compared to the first six months of 2013. The increase is primarily due to an increase in CPA flying with SkyWest, and increased contract ramp handling at new stations and rate increases in Seattle. For the full year, we expect contracted services to be higher than 2013, as we fly to more locations that are staffed with outside vendors, and due to an increase in passenger volume.

#### Selling Expenses

Selling expenses increased \$10 million, or 11%, compared to the first six months of 2013. The increase is primarily due to increased promotional and advertising activity most notably in the Seattle area. For the full year, we expect selling expenses to be higher than in 2013, as we continue to build awareness in the communities we serve.

#### Other Operating Expenses

Other operating expenses increased \$28 million, or 21%, compared to the first six months of 2013. The increase is due to higher professional fees, IT costs, and property taxes. For the full year, we expect other expenses to increase due to various IT projects and higher property taxes.

Additionally, we are presenting our line-item expenses below both in absolute dollars and on an ASM basis to highlight areas in which costs have increased or decreased either more or less than capacity.

| (in millions, except CASM)     | Six Months Ended June 30, |                |              |              | %Change |    |
|--------------------------------|---------------------------|----------------|--------------|--------------|---------|----|
|                                | 2014<br>Amount            | 2013<br>Amount | 2014<br>CASM | 2013<br>CASM | CASM    |    |
| Wages and benefits             | \$553                     | \$522          | 3.19         | ¢ 3.16       | ¢ 0.9   | %  |
| Variable incentive pay         | 54                        | 42             | 0.31         | 0.25         | 24.0    | %  |
| Aircraft maintenance           | 108                       | 133            | 0.62         | 0.80         | (22.5)  | )% |
| Aircraft rent                  | 57                        | 59             | 0.33         | 0.36         | (8.3)   | )% |
| Landing fees and other rentals | 133                       | 136            | 0.77         | 0.82         | (6.1)   | )% |
| Contracted services            | 122                       | 107            | 0.70         | 0.65         | 7.7     | %  |
| Selling expenses               | 99                        | 89             | 0.57         | 0.54         | 5.6     | %  |
| Depreciation and amortization  | 143                       | 136            | 0.82         | 0.82         | —       | %  |
| Food and beverage service      | 44                        | 41             | 0.25         | 0.25         | —       | %  |
| Other                          | 161                       | 133            | 0.94         | 0.81         | 16.0    | %  |
| Non-fuel Expenses              | \$1,474                   | \$1,398        | 8.50         | ¢ 8.46       | ¢ 0.5   | %  |





## LIQUIDITY AND CAPITAL RESOURCES

Our primary sources of liquidity are:

- Our existing cash, marketable securities balance of \$1.5 billion;
- Our expected cash from operations;
- Our 73 unencumbered aircraft as of June 30, 2014, in our operating fleet that could be financed, if necessary;
- Our combined \$200 million bank line-of-credit facilities, with no outstanding borrowings.

During the first six months of 2014, we purchased seven 737-900ER aircraft with cash on hand and made debt payments totaling \$64 million. In addition, we continued to return capital to our shareholders by paying \$34 million in quarterly dividends and repurchasing \$83 million of our common stock.

During the second quarter, the Company was rated BBB- by Fitch Ratings, and is now one of two U.S. airlines with investment-grade credit ratings.

In our cash and marketable securities portfolio, we invest only in securities that meet our overall investment policy of maintaining and securing investment principal. Our investment portfolio is managed by reputable firms that adhere to our investment policy that sets forth certain objectives, approved and prohibited investments, and duration and credit quality guidelines. Our policy and the portfolio managers are continually reviewed to ensure that the investments align with our strategy.

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

| (in millions, except per share and debt-to-capital amounts)   | June 30, 2014 | December 31, 2013 | Change  |   |
|---|---------------|-------------------|---------|---|
| Cash and marketable securities  | \$1,510       | \$1,330           | 13.5    | % |
| Cash, marketable securities, and unused lines of credit as a percentage of trailing twelve months revenue | 33            | % 31              | % 2 pts |   |
| Long-term debt, net of current portion  | \$745         | \$754             | (1.2)   | % |
| Shareholders' equity  | \$2,200       | \$2,029           | 8.4     | % |
| Long-term debt-to-capital including net present value of aircraft operating lease payments <sup>(a)</sup> | 32%:68%       | 35%:65%           | (3) pts |   |

<sup>(a)</sup> Calculated using the present value of remaining aircraft lease payments.

Given our strong financial condition, we will continue to evaluate our cash flows from operations, reinvest in the business, and allocate capital to our shareholders, while maintaining a strong liquidity position.

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

## ANALYSIS OF OUR CASH FLOWS

## Cash Provided by Operating Activities

For the first six months of 2014, net cash provided by operating activities was \$635 million, compared to \$592 million during the same period in 2013. The \$43 million increase was primarily attributable to an increase in cash flows from passenger revenues, an increase in our advance ticket sales, and more miles sold under our Mileage Plan program, partially offset by increased operating expenses to support 5.2% more flying and \$87 million more paid in cash taxes.

We typically generate positive cash flows from operations and expect to use that cash flow to buy airplanes and capital equipment, make normal debt payments, and to return capital to shareholders through share repurchases and dividends.

## Cash Used in Investing Activities

Cash used in investing activities was \$582 million during the first six months of 2014, compared to \$512 million during the same period of 2013. Our capital expenditures were \$350 million in the first six months of 2014, due to the delivery of seven 737-900ER aircraft, the exercise of four 737-900ER options, and deposits related to a Q400 that we expect to take delivery of in February 2015. Additionally, we invested \$41 million in our cabin improvement project, where as of June 30, 2014, we have upgraded 39 aircraft with new Recaro seats and power at every seat.

The table below reflects the full-year expectation for total capital expenditures and the additional expenditures if options were exercised. These options will be exercised only if we believe return on invested capital targets can be met.

| (in millions)  | 2014  | 2015  | 2016  | 2017  |
|--|-------|-------|-------|-------|
| Aircraft and aircraft purchase deposits - firm                     | \$340 | \$390 | \$325 | \$355 |
| Other flight equipment   | 125   | 35    | 35    | 25    |
| Other property and equipment                                       | 85    | 80    | 75    | 75    |
| Total property and equipment additions                             | \$550 | \$505 | \$435 | \$455 |
| Option aircraft and aircraft deposits, if exercised <sup>(a)</sup> | \$10  | \$225 | \$260 | \$270 |

We have options to acquire 58 B737 aircraft with deliveries in 2016 through 2024, and options to acquire seven Q400 aircraft with deliveries in 2015 to 2018. Based on current fleet plans, we expect to exercise at least two B737 options for delivery in 2016, which would increase the total capital expenditures noted in the table.

## Cash Used by Financing Activities

Net cash used by financing activities was \$111 million during the first six months of 2014 compared to \$145 million during the same period in 2013. During the first six months of 2014 we made debt payments of \$64 million, stock repurchases of \$83 million, and dividend payments totaling \$34 million. In addition, we financed three Q400 aircraft for \$51 million.

## Bank Line-of-Credit Facilities

We have two \$100 million credit facilities. Both facilities have variable interest rates based on LIBOR plus a specified margin. One of the \$100 million facilities, which expires in August 2015, is secured by aircraft. The other \$100 million facility, which expires in March 2017, is secured by certain accounts receivable, spare engines, spare parts and ground service equipment.

## CONTRACTUAL OBLIGATIONS AND COMMITMENTS

## Aircraft Purchase Commitments

As of June 30, 2014, we have firm orders to purchase 67 aircraft. We also have options to acquire 58 additional B737s and options to acquire seven Q400s.

The following table summarizes expected fleet activity by year:

| Aircraft                              | Actual Fleet Count |              | Expected Fleet Activity <sup>(a)</sup> |              |              |              |
|---------------------------------------|--------------------|--------------|--|--------------|--------------|--------------|
|                                       | Dec 31, 2013       | Jun 30, 2014 | Remaining 2014                         | Dec 31, 2014 | 2015 Changes | Dec 31, 2015 |
| 737 Freighters & Combis               | 6                  | 6            | —                                      | 6            | —            | 6            |
| 737 Passenger Aircraft <sup>(b)</sup> | 125                | 128          | 3                                      | 131          | 4            | 135          |
| Total Mainline Fleet                  | 131                | 134          | 3                                      | 137          | 4            | 141          |

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|       |     |     |   |     |   |     |
|-------|-----|-----|---|-----|---|-----|
| Q400  | 51  | 51  | — | 51  | 1 | 52  |
| Total | 182 | 185 | 3 | 188 | 5 | 193 |

(a) Expected fleet activity includes aircraft deliveries, net of planned retirements and lease returns.

(b) Reflects potential extensions of leased aircraft or postponed retirement of 737-400s.

For future firm orders and if we exercise our options for additional deliveries, we may finance the aircraft through internally generated cash, long-term debt, or lease arrangements.

## Future Fuel Hedge Positions

Historically, we have used both call options on crude oil forwards and swap instruments on refining margins to hedge against price volatility of future jet fuel consumption. Beginning in the third quarter, we have discontinued the hedge program for refining margins. Currently, we have refining margin swaps in place for approximately 23% of our third quarter 2014 estimated jet fuel purchases at an average price of 50 cents per gallon. Our crude oil positions are as follows:

|                     | Approximate % of<br>Expected Fuel<br>Requirements | Weighted-Average<br>Crude Oil Price<br>per Barrel | Average Premium<br>Cost per Barrel |
|---------------------|---|---|------------------------------------|
| Third Quarter 2014  | 50  | % \$104   | \$7                                |
| Fourth Quarter 2014 | 50  | % \$106   | \$5                                |
| Full Year 2014      | 50  | % \$105   | \$6                                |
| First Quarter 2015  | 40  | % \$106   | \$5                                |
| Second Quarter 2015 | 30  | % \$104   | \$5                                |
| Third Quarter 2015  | 20  | % \$106   | \$5                                |
| Fourth Quarter 2015 | 11  | % \$106   | \$5                                |
| Full Year 2015      | 25  | % \$105   | \$5                                |
| First Quarter 2016  | 6   | % \$105   | \$4                                |
| Full Year 2016      | 1   | % \$105   | \$4                                |

All of our future oil positions are call options, which are designed to effectively cap the cost of the crude oil component of our jet fuel purchases. With call options, we benefit from a decline in crude oil prices, as there is no cash outlay other than the premiums we pay to enter into the contracts.

## Contractual Obligations

The following table provides a summary of our principal payments under current and long-term debt obligations, operating lease commitments, aircraft purchase commitments and other obligations as of June 30, 2014:

| (in millions)                              | Remainder<br>of 2014 | 2015  | 2016  | 2017  | 2018  | Beyond<br>2018 | Total   |
|--|----------------------|-------|-------|-------|-------|----------------|---------|
| Current and long-term debt obligations     | \$56                 | \$117 | \$115 | \$121 | \$151 | \$299          | \$859   |
| Operating lease commitments <sup>(a)</sup> | 73                   | 192   | 168   | 135   | 72    | 254            | 894     |
| Aircraft purchase commitments              | 149                  | 423   | 359   | 382   | 430   | 1,037          | 2,780   |
| Interest obligations <sup>(b)</sup>        | 20                   | 37    | 33    | 28    | 22    | 28             | 168     |
| Other obligations <sup>(c)</sup>           | 30                   | 54    | 32    | 32    | 14    | —              | 162     |
| Total                                      | \$328                | \$823 | \$707 | \$698 | \$689 | \$1,618        | \$4,863 |

<sup>(a)</sup> Operating lease commitments generally include aircraft operating leases, airport property and hangar leases, office space, and other equipment leases.

<sup>(b)</sup> For variable-rate debt, future obligations are shown above using interest rates in effect as of June 30, 2014.

<sup>(c)</sup> Includes minimum obligations under our long-term PBH maintenance agreement and obligations associated with third-party CPAs with SkyWest and PenAir. Refer to the "Commitments" note in the condensed consolidated financial statements for further information.

## Credit Card Agreements

We have agreements with a number of credit card companies to process the sale of tickets and other services. Under these agreements, there are material adverse change clauses that, if triggered, could result in the credit card companies holding back a reserve from our credit card receivables. Under one such agreement, we could be required to maintain

a reserve if our credit rating is downgraded to, or below, a rating specified by the agreement or our cash and marketable securities balance falls below \$500 million. Under another such agreement, we could be required to maintain a reserve if our cash and marketable securities balance falls below \$500 million. We are not currently required to maintain any reserve under these agreements, but if we were, our financial position and liquidity could be materially harmed.

#### Deferred Income Taxes

For federal income tax purposes, the majority of our assets are fully depreciated over a seven-year life using an accelerated depreciation method or bonus depreciation, if available. For financial reporting purposes, the majority of our assets are depreciated over 15 to 20 years to an estimated salvage value using the straight-line basis. This difference, along with other deferred liabilities and offset by deferred assets, have created a significant deferred tax liability. At some point in the future the depreciation basis will reverse, potentially resulting in an increase in income taxes paid.

Taxable income and cash taxes payable in the short term are impacted by many items, including the amount of book income generated (which can be volatile depending on revenue and fuel prices), availability of "bonus depreciation", and other legislative changes that are out of our control. We believe that we have the liquidity to make our future tax payments.

#### CRITICAL ACCOUNTING ESTIMATES

There have been no material changes to our critical accounting estimates for the three months ended June 30, 2014. For information on our critical accounting estimates, see Item 7. "Management's Discussion and Analysis of Financial Condition and Results of Operations" of our Annual Report on Form 10-K for the year ended December 31, 2013.

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

There have been no material changes in market risk from the information provided in Item 7A. "Quantitative and Qualitative Disclosure About Market Risk" in our Annual Report on Form 10-K for the year ended December 31, 2013.

#### ITEM 4. CONTROLS AND PROCEDURES

##### Evaluation of Disclosure Controls and Procedures

As of June 30, 2014, an evaluation was performed under the supervision and with the participation of our management, including our chief executive officer and chief financial officer (collectively, our "certifying officers"), of the effectiveness of the design and operation of our disclosure controls and procedures. These disclosure controls and procedures are designed to ensure that the information required to be disclosed by us in our periodic reports filed with or submitted to the Securities and Exchange Commission (the SEC) is recorded, processed, summarized and reported within the time periods specified by the SEC's rules and forms, and includes, without limitation, controls and procedures designed to ensure that such information is accumulated and communicated to our management, including our certifying officers, as appropriate to allow timely decisions regarding required disclosure. Our certifying officers concluded, based on their evaluation, that disclosure controls and procedures were effective as of June 30, 2014.

##### Changes in Internal Control over Financial Reporting

We made no changes in our internal control over financial reporting during the quarter ended June 30, 2014, that have materially affected, or are reasonably likely to materially affect, our internal control over financial reporting.

Our internal control over financial reporting is based on the 1992 framework in Internal Control – Integrated Framework issued by the Committee of Sponsoring Organizations of the Treadway Commission (the COSO

Framework). We began migrating to the 2013 COSO Framework in the second quarter of 2014.



## PART II

## ITEM 1. LEGAL PROCEEDINGS

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

## ITEM 1A. RISK FACTORS

There have been no material changes to the risk factors affecting our business, financial condition or future results from those set forth in Item 1A. "Risk Factors" in our Annual Report on Form 10-K for the year ended December 31, 2013. However, you should carefully consider the factors discussed in such section of our Annual Report on Form 10-K, which could materially affect our business, financial condition or future results. Additional risks and uncertainties not currently known to us or that we currently deem to be immaterial also may materially adversely affect our business, financial condition and/or operating results.

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

This table provides certain information with respect to our purchases of shares of our common stock during the second quarter of 2014.

|                                | Total<br>Number of<br>Shares<br>Purchased | Average Price<br>Paid per Share | Total Number<br>of Shares (or<br>units)<br>Purchased as<br>Part of Publicly<br>Announced<br>Plans or<br>Programs | Maximum<br>remaining<br>dollar value<br>of shares<br>that can be<br>purchased<br>under the plan<br>(in millions) |
|--------------------------------|---|---------------------------------|--|--|
| April 1, 2014 - April 30, 2014 | 194,564                                   | \$46.42                         | 194,564  |  |
| May 1, 2014 - May 31, 2014     | 469,446                                   | 48.28                           | 469,446  |  |
| June 1, 2014 - June 30, 2014   | 444,324                                   | 48.45                           | 444,324  |  |
| Total                          | 1,108,334                                 | \$47.61                         | 1,108,334  | \$650  |

The shares were purchased pursuant to a \$250 million repurchase plan authorized by the Board of Directors in September 2012. In May 2014, the Board of Directors authorized a \$650 million share repurchase program, which began immediately after the \$250 million program was completed in early July 2014.

## ITEM 3. DEFAULTS UPON SENIOR SECURITIES

None

## ITEM 4. MINE SAFETY DISCLOSURES

None

## ITEM 5. OTHER INFORMATION

None

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ITEM 6. EXHIBITS

The following documents are filed as part of this report:

1. Exhibits: See Exhibit Index.

SIGNATURES

Pursuant to the requirements of Section 13 or 15(d) of the Securities Exchange Act of 1934, the registrant has duly caused this report to be signed on its behalf by the undersigned, thereunto duly authorized.

ALASKA AIR GROUP, INC.

/s/ BRANDON S. PEDERSEN

Brandon S. Pedersen

Executive Vice President/Finance and Chief Financial

Officer

(Principal Financial and Accounting Officer)

August 6, 2014

EXHIBIT INDEX

| Exhibit Number | Exhibit Description   |
|----------------|---|
| 31.1           | Certification of Chief Executive Officer Pursuant to Section 302 of the Sarbanes-Oxley Act of 2002  |
| 31.2           | Certification of Chief Financial Officer Pursuant to Section 302 of the Sarbanes-Oxley Act of 2002  |
| 32.1           | Certification of Chief Executive Officer Pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002 |
| 32.2           | Certification of Chief Financial Officer Pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002 |
| 3.1            | Amended and Restated Certificate of Incorporation of Registrant   |
| 101.INS        | XBRL Instance Document  |
| 101.SCH        | XBRL Taxonomy Extension Schema Document   |
| 101.CAL        | XBRL Taxonomy Extension Calculation Linkbase Document   |
| 101.DEF        | XBRL Taxonomy Extension Definition Linkbase Document  |
| 101.LAB        | XBRL Taxonomy Extension Label Linkbase Document   |
| 101.PRE        | XBRL Taxonomy Extension Presentation Linkbase Document  |