

ALASKA AIR GROUP INC  
Form 10-K  
February 20, 2008  
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**UNITED STATES**  
**SECURITIES AND EXCHANGE COMMISSION**  
WASHINGTON, DC 20549

**FORM 10-K**

(Mark One)

- ANNUAL REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934 [NO FEE REQUIRED]**  
For the fiscal year ended December 31, 2007

OR

- TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934 [NO FEE REQUIRED]**  
For the transition period from \_\_\_\_\_ to \_\_\_\_\_

Commission File Number 1-8957

**ALASKA AIR GROUP, INC.**

**A Delaware Corporation**

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

19300 International Boulevard, Seattle, Washington 98188

Telephone: (206) 392-5040

**Securities registered pursuant to Section 12(b) of the Act:**

Title of Each Class	Name of Each Exchange on Which Registered
Common Stock, \$1.00 Par Value	New York Stock Exchange

**Securities registered pursuant to Section 12(g) of the Act: None**

Indicate by check mark if the registrant is a well-known seasoned issuer, as defined in Rule 405 of the Securities Act. Yes   
No

Indicate by check mark if the registrant is not required to file reports pursuant to Section 13 or Section 15(d) of the Act. Yes  No

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

Indicate by check mark if disclosure of delinquent filers pursuant to Item 405 of Regulation S-K is not contained herein, and will not be contained, to the best of registrant's knowledge, in definitive proxy or information statements incorporated by reference in Part III of this Form 10-K or any amendment to this Form 10-K.

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

Large accelerated filer  Accelerated filer  Non-accelerated filer

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

As of December 31, 2007, shares of common stock outstanding totaled 38,050,680. The aggregate market value of the shares of common stock of Alaska Air Group, Inc. held by nonaffiliates on June 29, 2007, was approximately \$1.12 billion (based on the closing price of \$27.86 per share on the New York Stock Exchange on that date).

**DOCUMENTS INCORPORATED BY REFERENCE**

<b>Title of Document</b>	<b>Part Hereof Into Which Document is to be Incorporated</b>
Definitive Proxy Statement Relating to 2008 Annual Meeting of Shareholders	Part III

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ANNUAL REPORT ON FORM 10-K FOR THE YEAR ENDED DECEMBER 31, 2007

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

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**CAUTIONARY NOTE REGARDING FORWARD-LOOKING STATEMENTS**

In addition to historical information, this Form 10-K 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, including fuel, which can be volatile;

labor disputes and our ability to attract and retain qualified personnel;

the amounts of potential lease termination payments with lessors for our remaining MD-80 and Q200 leased aircraft and related sublease payments from sublessees, if applicable;

our significant indebtedness;

compliance with our financial covenants;

potential downgrades of our credit ratings and the availability of financing;

our ability to meet our cost reduction goals;

operational disruptions;

general economic conditions, as well as economic conditions in the geographic regions we serve;

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;

insurance costs;

our inability to achieve or maintain profitability;

fluctuations in our quarterly results;

an aircraft accident or incident;

liability and other claims asserted against us;

our reliance on automated systems and the risks associated with changes made to those systems;

our reliance on third-party vendors and partners;

changes in laws and regulations; and

increases in government fees and taxes.

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 in this Form 10-K, see Item 1A: Risk Factors. Please consider our forward-looking statements in light of those risks as you read this report.



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## **PART I**

### **ITEM 1. OUR BUSINESS**

We are a Delaware corporation incorporated in 1985 and we have two principal subsidiaries: Alaska Airlines, Inc. (Alaska) and Horizon Air Industries, Inc. (Horizon). Through these subsidiaries, we provide passenger air service to approximately 25 million passengers per year to nearly 100 destinations. We also provide freight and mail services, primarily to and within the state of Alaska and on the West Coast. Although Alaska and Horizon both operate as airlines, their business plans, competition, and economic risks differ substantially. Alaska is a major airline that operates an all-jet fleet with an average passenger trip length of 1,051 miles. Horizon is a regional airline, operates turboprop and jet aircraft, and its average passenger trip is 386 miles. Individual financial information about Alaska and Horizon is in Note 15 to the consolidated financial statements and throughout this section, specifically in Management's Discussion and Analysis of Financial Condition and Results of Operations.

Both of our airlines endeavor to distinguish themselves from competitors by providing a higher level of customer service and differentiating amenities. Our outstanding employees and excellent service in the form of advance seat assignments, expedited check-in, attention to customer needs, a generous frequent flyer program, well-maintained aircraft, a first-class section aboard Alaska aircraft, and other amenities are regularly recognized by independent studies, awards, and surveys of air travelers. For example, Horizon was named the 2007 Regional Airline of the Year by Air Transport World, a leading industry publication, and Alaska was named in the top five U.S. carriers for premium service in a recent Zagat survey. We are very proud of these awards and we continue to strive to have the best customer service in the industry.

### **WHERE YOU CAN FIND MORE INFORMATION**

We maintain an Internet website at [www.alaskaair.com](http://www.alaskaair.com). Our filings with the Securities and Exchange Commission, including our annual report on Form 10-K, quarterly reports on Form 10-Q, current reports on Form 8-K and amendments to those reports filed or furnished pursuant to Sections 13(a) or 15(d) of the Securities Exchange Act of 1934, as amended, are available on our website at [www.alaskaair.com](http://www.alaskaair.com), free of charge, as soon as reasonably practicable after the electronic filing of these reports with the Securities and Exchange Commission. The information contained on our website is not a part of this annual report on Form 10-K.

### **OUR AIRLINES**

#### **ALASKA**

Alaska Airlines is an Alaska corporation that was organized in 1932 and incorporated in 1937. We offer extensive north/south service within the western U.S., Canada and Mexico, and passenger and dedicated cargo services to and within the state of Alaska. We also provide long-haul east/west service to eight cities in the continental U.S., primarily from Seattle, where we have our largest concentration of departures; although we do offer long-haul departures from Anchorage, Los Angeles, and Portland, Oregon. During 2007, we also initiated service to Hawaii, with non-stops from Seattle to Honolulu and Lihue and from Anchorage to Honolulu.

In 2007, we carried 17.6 million revenue passengers in our mainline operations, and in each year since 1973, we have carried more passengers between Alaska and the U.S. mainland than any other airline. Based on the

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number of passengers, Alaska's leading airports are Seattle, Los Angeles, Anchorage and Portland. Based on 2007 revenues, the leading nonstop routes are Seattle-Anchorage, Seattle-Los Angeles, and Seattle-San Diego. At December 31, 2007, Alaska's operating fleet consisted of 115 jet aircraft, compared to 114 aircraft as of December 31, 2006.

Alaska's passenger traffic by market is presented below:

	2007	2006
West Coast	46%	45%
Within Alaska and between Alaska and the U.S. mainland	21%	20%
Mexico	11%	11%
Canada	4%	4%
Other, including transcontinental and Hawaii	18%	20%
Total	100%	100%

**HORIZON**

Horizon Air Industries, a Washington corporation that first began service and was incorporated in 1981, and was acquired by Air Group in 1986. It is the largest regional airline in the Pacific Northwest, and serves a number of cities in six states and six cities in Canada under the Horizon brand. In 2008, Horizon began service to Loreto, Mexico, from Los Angeles and will serve its seventh city in Canada when it begins service to Prince George, British Columbia, in May 2008. In addition to operating under its own brand, Horizon operated regional jet service as Frontier JetExpress through the end of November 2007 under an agreement with Frontier Airlines. Horizon terminated this agreement with Frontier at that time and has redeployed the nine CRJ-700s back into the Air Group route structure.

In 2007, Horizon carried 7.6 million revenue passengers. Approximately 92% of Horizon's revenue passenger miles in 2007 were flown domestically, primarily in the states of Washington, Oregon and Idaho, compared to 91% in 2006. The Canada markets accounted for 8% of revenue passenger miles in 2007, compared to 9% in 2006. Based on passenger enplanements, Horizon's leading airports are Seattle, Portland, Boise, and Spokane. Based on revenues in 2007, the leading nonstop routes are Portland-Seattle, Spokane-Seattle, and Ontario-Portland. At December 31, 2007, Horizon's operating fleet consisted of 21 jets and 49 turboprop aircraft. Except for those flights that were operated as Frontier JetExpress, Horizon flights are listed under the Alaska Airlines designator code in airline reservation systems.

Alaska and Horizon integrate their flight schedules to provide convenient, competitive connections between most points served by their systems. In 2007 and 2006, approximately 22% and 24%, respectively, of Horizon's passengers connected to flights operated by Alaska.

**INDUSTRY CONDITIONS**

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Our industry is highly competitive and is characterized by low profit margins and high fixed costs, primarily for wages, aircraft fuel, aircraft ownership costs and facilities rents. Because expenses of a flight do not vary significantly with the number of passengers carried, a relatively small change in the number of passengers or in pricing has a disproportionate effect on an airline's operating and financial results. In other words, a minor shortfall in expected revenue levels could cause a disproportionately negative impact on our results of operations. Passenger demand and ticket prices are, to a large measure, influenced by the general state of the economy in some parts of the United States, current events and available capacity.

In 2007, the airline industry posted its second year of net profits since 2000. However, with the dramatic increase in fuel prices and a softening economy, industry profits were lower than originally predicted by industry experts and analysts. In 2005 and 2006, load factors and unit revenues climbed higher in the wake of strong demand and a healthy economy. That strong demand and a reduction in total capacity in some regions, as other major carriers shifted capacity to international routes, allowed domestic carriers to raise ticket prices. However, there was some softening in demand for air

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travel early in 2007, and unit revenues declined on a year-over-year basis during the first half of the year. Unit revenues rebounded later in the year, principally in response to higher passenger load factors and actions taken to help offset increases in jet fuel prices.

Several traditional or legacy carriers have reorganized through bankruptcy proceedings over the past several years. These carriers have gained a competitive advantage by significantly reducing their costs almost immediately. In addition, so called low-cost carriers (LCCs) have grown significantly since 2001 and currently carry more than 30% of total U.S. domestic passenger traffic. However, the line between the LCCs and legacy carriers is becoming more blurred as the legacy carriers make further reductions in unit costs and the LCCs face cost pressures, and as the legacy carriers reduce service offerings. Because of their unit cost advantage, the LCCs and recently reorganized airlines have and continue to exert downward pressure on ticket prices compared to historical levels. Because of the relatively low barriers to entry and financial success of LCCs, we expect the expansion of low-cost and low-fare carriers to continue. We compete with many of these carriers directly now, and expect to compete with new entrants in the future. For example, Virgin America, a new LCC, has announced plans to offer non-stop service between Seattle and Los Angeles and between Seattle and San Francisco in the spring of 2008.

## FUEL

Our business and financial results are highly affected by the price and, potentially, the availability of jet fuel. Fuel prices have increased dramatically over the past few years and these increases have hurt our financial results. We refer to the price we pay at the airport or into-plane price, including applicable taxes, as our raw fuel price. Raw fuel prices are impacted by world oil prices and refining costs, which can vary by region in the U.S. Generally, West Coast jet fuel prices are somewhat higher and substantially more volatile than prices in the Gulf Coast or on the East Coast, putting both Alaska and Horizon at a competitive disadvantage. Historically, fuel costs have generally represented 10% to 15% of an airline's operating costs. However, in recent years, fuel costs have risen sharply to represent 20% to 30% of total operating costs for airlines. Both the crude oil and refining cost components of jet fuel are volatile and outside of our control, and they can have a significant and immediate impact on our operating results. Our average raw fuel cost per gallon increased 8%, 17%, and 34%, in 2007, 2006, and 2005, respectively.

We almost exclusively use crude oil call options as hedges to decrease our exposure to the volatility of jet fuel prices. Call options effectively cap our pricing on the crude oil component of fuel prices, limiting our exposure to increasing fuel prices on a percentage of our planned fuel consumption. With these call option contracts, we still benefit from the decline in crude oil prices, as there is no downward exposure other than the premiums we pay to enter into the contracts. We also use collar structures in limited instances for fuel hedging purposes. Additionally, we enter into fuel purchase contracts that fix the refining margin we pay on a certain percentage of our fuel consumption.

Fuel costs, including gains and losses stemming from changes in the value of our hedge portfolio, were approximately 27% of our total operating expenses in 2007, 26% in 2006, and 20% in 2005. Currently, a one-cent change in our hedged fuel price per gallon affects annual fuel costs by approximately \$4.0 million. In addition

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to our hedging program, we believe that operating fuel-efficient aircraft helps to mitigate the effect of high fuel prices.

Due to the competitive nature of the airline industry, airlines often have been unable to immediately pass on increased fuel prices to customers by increasing fares. Conversely, any potential benefit of lower fuel prices could be offset by increased fare competition and lower revenues.

Although we do not currently anticipate a significant reduction in jet fuel availability, dependency on foreign imports of crude oil and the possibility of changes in government policy on jet fuel production, transportation and marketing make it impossible to predict the future availability of jet fuel. In the event of significant hostilities or other conflicts in oil-producing areas, there could be reductions in the production and/or importation of crude oil resulting in price increases, which could adversely affect our business. If there were major reductions in the availability of jet fuel, our business would be adversely affected.

**MARKETING AND COMPETITION**

**ALLIANCES WITH OTHER AIRLINES**

We have marketing alliances with several other airlines that provide reciprocal frequent flyer mileage credit and redemption privileges as well as code sharing on certain flights as shown in the table below. Alliances enhance our revenues by:

offering our customers more travel destinations and better mileage credit/redemption opportunities;

giving us access to more connecting traffic from other airlines; and

providing members of our alliance partners frequent flyer programs an opportunity to travel on Alaska and Horizon while earning mileage credit in our partners programs.

Most of our codeshare relationships are free-sell codeshares, where the marketing carrier sells seats on the operating carrier's flights from the operating carrier's inventory, but takes no inventory risk. Our marketing agreements have various termination dates, and at any time, one or more may be in the process of renegotiation.

Our marketing alliances with other airlines as of December 31, 2007 are as follows:

**Frequent  
Flyer  
Agreement**

**Codeshare  
Alaska  
Flight #  
on Flights**

**Codeshare  
Other Airline  
Flight # On  
Flights**

		Operated by Other Airline	Operated by Alaska/ Horizon
<b>Major U.S. or International Airlines</b>			
American Airlines/American Eagle	Yes	Yes	Yes
Air France	Yes	No	Yes
British Airways	Yes	No	No
Cathay Pacific Airways	Yes	No	No
Continental Airlines	Yes	Yes	Yes
Delta/Delta Connection**	Yes	Yes	Yes
KLM	Yes	No	Yes
Lan S.A.	Yes	No	Yes
Northwest Airlines	Yes	Yes	Yes
Qantas	Yes	No	Yes
<b>Regional Airlines</b>			
Era Aviation	Yes*	Yes	No
PenAir	Yes*	Yes	No
Big Sky Airlines	No	Yes	No

\* This airline does not have its own frequent flyer program. However, Alaska's Mileage Plan members can earn and redeem miles on this airline's route system.

\*\* Alaska has codeshare agreements with the Delta Connection carriers Skywest and ASA as part of its agreement with Delta Air Lines.

## COMPETITION

Competition in the airline industry is intense. We believe the principal competitive factors in the industry that are important to customers are:

safety record and reputation,

flight schedules,

fares,

customer service,

routes served,

frequent flyer programs,

on-time arrivals,

baggage handling,

on-board amenities,

type of aircraft, and

code-sharing relationships.

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Together, Alaska and Horizon carry approximately 3.2% of all U.S. domestic passenger traffic. We compete with one or more domestic or foreign airlines on most of our routes, including Southwest Airlines, United Airlines, Northwest Airlines, Continental Airlines, American Airlines, Delta Air Lines, US Airways, and regional affiliates associated with some of these carriers. Most of these airlines are larger and have greater financial resources and name recognition or lower operating costs than our companies. In addition, competitors that have successfully reorganized out of bankruptcy have lower operating costs derived from renegotiated labor, supply and financing agreements. Some of these competitors have chosen to add service, reduce their fares, or both in our markets. Continuing growth of LCCs, including Southwest Airlines, AirTran Airways, Frontier Airlines, jetBlue Airways, and Virgin America, places significant competitive pressures on us and other network carriers because the LCCs have the ability to charge a lower fare for travel between similar cities. As such, we may be unable to compete effectively against other airlines that introduce service or discounted fares in the markets that we serve. Due to its short-haul markets, Horizon also competes with ground transportation in many markets, including train, bus and automobile transportation.

**TICKET DISTRIBUTION**

Airline tickets are distributed through three primary channels:

*Airline websites such as alaskaair.com or horizonair.com.* It is less expensive for us to sell through these direct channels and, as a result, we continue to take steps to drive more business to our websites. In addition, we believe this channel is preferable from a branding and customer-relationship standpoint in that we can establish ongoing communication with the customer and tailor offers accordingly. In October 2007, we passed a significant milestone by processing over 50% of our monthly sales through our website a sign of progress toward our goal of transitioning more of our customers to this direct sales channel.

*Traditional and online travel agents.* Consumer reliance on traditional travel agencies is shrinking, giving way to online travel agencies. Both traditional and online travel agencies typically use Global Distribution Systems (GDS), such as Sabre, to obtain their fare and inventory data from airlines. Bookings made through these agencies result in a fee that is charged to the airline. Many of our large corporate customers require that we use these agencies. Some of our competitors do not use this distribution channel and, as a result, have lower ticket distribution costs.

*Reservation call centers.* These call centers are located in Phoenix, Arizona; Kent, Washington; and Boise, Idaho. We generally charge a \$10 fee for booking reservations through these call centers.

Our sales by channel are presented below:

	2007	2006
Alaskaair.com/horizonair.com	43%	39%
Traditional and online travel agencies	43%	47%
Reservations call center	12%	12%
All other channels	2%	2%
<b>Total</b>	<b>100%</b>	<b>100%</b>

**EMPLOYEES**

Labor costs have historically made up 30% to 40% of an airline's total operating costs. Most major airlines, including ours, have employee groups that are covered by collective bargaining agreements. Often, airlines with unionized work forces have higher labor costs than carriers without unionized work forces, and they may not have the ability to adjust labor costs downward quickly enough to respond to new competition. New entrants into the U.S. airline industry generally do not have unionized work forces, which can be a competitive advantage for those airlines. Alaska has been able to reduce wages and benefits costs from 2004 levels through a number of initiatives, but we have experienced recent increases in wage and benefit costs because of normal scale and step increases,

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market wage increases, and higher healthcare costs. Horizon faces similar pressures on wages and benefits. We expect to see continued upward pressure on wages and benefits in the future. We recognize the need to continue to improve employee productivity in order to mitigate this cost pressure and to reduce our wages and benefits on an available-seat-mile basis. We have initiatives underway to increase productivity and efficiency.

W