

ALASKA AIR GROUP INC  
Form 10-Q  
August 08, 2008  
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**UNITED STATES**  
**SECURITIES AND EXCHANGE COMMISSION**  
**WASHINGTON, DC 20549**  
**FORM 10-Q**

(Mark One)

**QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934**  
For the quarterly period ended June 30, 2008.

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.**

(Exact name of registrant as specified in its charter)

**Delaware**  
(State or other jurisdiction of  
incorporation or organization)

**91-1292054**  
(I.R.S. Employer

Identification No.)

**19300 International Boulevard, Seattle, Washington 98188**

(Address of principal executive offices)

**Registrant's telephone number, including area code: (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  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 the definitions of large accelerated filer, accelerated filer, and smaller reporting company in Rule 12b-2 of the Exchange Act.

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(Check one):

Large accelerated filer

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

APPLICABLE ONLY TO CORPORATE ISSUERS:

Indicate the number of shares outstanding of each of the issuer's classes of common stock, as of the latest practicable date.

The registrant has 36,019,026 common shares, par value \$1.00, outstanding at July 31, 2008.

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**ALASKA AIR GROUP, INC.**

**Quarterly Report on Form 10-Q for the three months ended June 30, 2008**

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As used in this Form 10-Q, 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.

### **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, 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 timing of disposal and amounts of potential lease termination payments with lessors for our remaining MD-80, CRJ-700 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;

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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, see **Item 1A: Risk Factors** of the Company's annual report on Form 10-K for the year ended December 31, 2007. Please consider our forward-looking statements in light of those risks as you read this report.

**Table of Contents****PART I. FINANCIAL INFORMATION****Item 1: Condensed Consolidated Financial Statements  
CONDENSED CONSOLIDATED BALANCE SHEETS (unaudited)**

Alaska Air Group, Inc.

**ASSETS**

| (in millions)                                  | June 30,<br>2008  | December 31,<br>2007 |
|--|-------------------|----------------------|
| <b>Current Assets</b>                          |                   |                      |
| Cash and cash equivalents                      | \$ 179.1          | \$ 204.3             |
| Marketable securities                          | 826.9             | 618.5                |
| Total cash and marketable securities           | 1,006.0           | 822.8                |
| Securities lending collateral                  | 111.3             | 111.9                |
| Receivables - net                              | 165.0             | 138.0                |
| Inventories and supplies - net                 | 59.7              | 46.6                 |
| Deferred income taxes                          | 63.4              | 84.9                 |
| Fuel hedge contracts                           | 233.3             | 100.7                |
| Prepaid expenses and other current assets      | 95.3              | 85.4                 |
| <b>Total Current Assets</b>                    | <b>1,734.0</b>    | <b>1,390.3</b>       |
| <b>Property and Equipment</b>                  |                   |                      |
| Aircraft and other flight equipment            | 3,219.2           | 2,981.2              |
| Other property and equipment                   | 590.9             | 574.5                |
| Deposits for future flight equipment           | 438.4             | 430.0                |
|  | 4,248.5           | 3,985.7              |
| Less accumulated depreciation and amortization | 1,106.7           | 1,023.4              |
| <b>Total Property and Equipment - Net</b>      | <b>3,141.8</b>    | <b>2,962.3</b>       |
| <b>Fuel Hedge Contracts</b>                    | <b>71.9</b>       | <b>11.8</b>          |
| <b>Other Assets</b>                            | <b>147.8</b>      | <b>126.5</b>         |
| <b>Total Assets</b>                            | <b>\$ 5,095.5</b> | <b>\$ 4,490.9</b>    |

See accompanying notes to condensed consolidated financial statements.

**Table of Contents****CONDENSED CONSOLIDATED BALANCE SHEETS (unaudited)**

Alaska Air Group, Inc.

**LIABILITIES AND SHAREHOLDERS EQUITY**

| (in millions except share amounts)   | June 30,<br>2008  | December 31,<br>2007 |
|--|-------------------|----------------------|
| <b>Current Liabilities</b>   |                   |                      |
| Accounts payable   | \$ 84.2           | \$ 101.5             |
| Accrued aircraft rent  | 56.8              | 59.1                 |
| Accrued wages, vacation and payroll taxes  | 104.7             | 112.3                |
| Other accrued liabilities  | 498.4             | 448.5                |
| Air traffic liability  | 532.2             | 364.5                |
| Securities lending obligation  | 111.3             | 111.9                |
| Current portion of long-term debt  | 262.2             | 175.9                |
| <b>Total Current Liabilities</b>   | <b>1,649.8</b>    | <b>1,373.7</b>       |
| <b>Long-Term Debt, Net of Current Portion</b>  | <b>1,444.9</b>    | <b>1,124.6</b>       |
| <b>Other Liabilities and Credits</b>   |                   |                      |
| Deferred income taxes  | 128.1             | 132.6                |
| Deferred revenue   | 442.5             | 413.6                |
| Other liabilities  | 420.0             | 422.4                |
|  | <b>990.6</b>      | <b>968.6</b>         |
| <b>Commitments and Contingencies</b>   |                   |                      |
| <b>Shareholders Equity</b>   |                   |                      |
| Preferred stock, \$1 par value Authorized: 5,000,000 shares, none issued or outstanding                              |                   |                      |
| Common stock, \$1 par value Authorized: 100,000,000 shares Issued: 2008 - 42,915,668 shares 2007 - 42,821,986 shares | 42.9              | 42.8                 |
| Capital in excess of par value   | 902.4             | 895.1                |
| Treasury stock (common), at cost: 2008 - 6,896,506 shares 2007 - 4,771,306 shares                                    | (161.4)           | (112.5)              |
| Accumulated other comprehensive loss   | (132.8)           | (133.3)              |
| Retained earnings  | 359.1             | 331.9                |
|  | <b>1,010.2</b>    | <b>1,024.0</b>       |
| <b>Total Liabilities and Shareholders Equity</b>   | <b>\$ 5,095.5</b> | <b>\$ 4,490.9</b>    |

See accompanying notes to condensed consolidated financial statements.

**Table of Contents****CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS (unaudited)**

Alaska Air Group, Inc.

| (in millions except per-share amounts)            | Three Months Ended<br>June 30 |                | Six Months Ended<br>June 30 |                |
|---|-------------------------------|----------------|-----------------------------|----------------|
|   | 2008                          | 2007           | 2008                        | 2007           |
| <b>Operating Revenues</b>                         |                               |                |                             |                |
| Passenger   | \$ 863.5                      | \$ 836.2       | \$ 1,639.2                  | \$ 1,532.0     |
| Freight and mail                                  | 27.7                          | 27.4           | 49.9                        | 48.6           |
| Other - net                                       | 39.6                          | 40.8           | 81.2                        | 83.2           |
| <b>Total Operating Revenues</b>                   | <b>930.8</b>                  | <b>904.4</b>   | <b>1,770.3</b>              | <b>1,663.8</b> |
| <b>Operating Expenses</b>                         |                               |                |                             |                |
| Wages and benefits                                | 234.4                         | 236.6          | 476.8                       | 473.6          |
| Variable incentive pay                            | 5.1                           | 3.8            | 8.7                         | 14.3           |
| Aircraft fuel, including hedging gains and losses | 182.0                         | 227.8          | 464.0                       | 412.7          |
| Aircraft maintenance                              | 54.2                          | 59.0           | 112.2                       | 117.5          |
| Aircraft rent                                     | 42.3                          | 44.7           | 85.9                        | 88.0           |
| Landing fees and other rentals                    | 56.9                          | 56.5           | 112.9                       | 111.2          |
| Contracted services                               | 43.6                          | 39.8           | 88.1                        | 78.4           |
| Selling expenses                                  | 44.1                          | 41.1           | 78.6                        | 80.1           |
| Depreciation and amortization                     | 51.5                          | 43.8           | 100.8                       | 85.7           |
| Food and beverage service                         | 13.4                          | 12.8           | 25.7                        | 24.0           |
| Other   | 61.5                          | 57.1           | 118.7                       | 112.0          |
| Fleet transition costs - MD-80                    | 26.0                          |                | 26.0                        |                |
| Fleet transition costs - CRJ-700                  | 6.1                           |                | 6.1                         |                |
| Fleet transition costs - Q200                     | 3.2                           | 3.7            | 9.0                         | 6.7            |
| <b>Total Operating Expenses</b>                   | <b>824.3</b>                  | <b>826.7</b>   | <b>1,713.5</b>              | <b>1,604.2</b> |
| <b>Operating Income</b>                           | <b>106.5</b>                  | <b>77.7</b>    | <b>56.8</b>                 | <b>59.6</b>    |
| <b>Nonoperating Income (Expense)</b>              |                               |                |                             |                |
| Interest income                                   | 10.5                          | 13.8           | 20.8                        | 28.2           |
| Interest expense                                  | (25.0)                        | (22.5)         | (48.4)                      | (43.5)         |
| Interest capitalized                              | 6.1                           | 6.7            | 12.6                        | 13.8           |
| Other - net                                       | 0.1                           | (0.7)          | 0.3                         | (0.9)          |
|   | (8.3)                         | (2.7)          | (14.7)                      | (2.4)          |
| Income before income tax                          | 98.2                          | 75.0           | 42.1                        | 57.2           |
| Income tax expense                                | 35.1                          | 28.9           | 14.9                        | 21.4           |
| <b>Net Income</b>                                 | <b>\$ 63.1</b>                | <b>\$ 46.1</b> | <b>\$ 27.2</b>              | <b>\$ 35.8</b> |
| <b>Basic Earnings Per Share:</b>                  | <b>\$ 1.75</b>                | <b>\$ 1.14</b> | <b>\$ 0.75</b>              | <b>\$ 0.89</b> |
| <b>Diluted Earnings Per Share:</b>                | <b>\$ 1.74</b>                | <b>\$ 1.13</b> | <b>\$ 0.74</b>              | <b>\$ 0.88</b> |
| Shares used for computation:                      |                               |                |                             |                |
| Basic   | 36.059                        | 40.450         | 36.542                      | 40.408         |
| Diluted   | 36.255                        | 40.782         | 36.876                      | 40.915         |

See accompanying notes to condensed consolidated financial statements.





**Table of Contents****CONDENSED CONSOLIDATED STATEMENTS OF SHAREHOLDERS EQUITY (unaudited)**

Alaska Air Group, Inc.

| (in millions)                                     | <i>Common<br/>Shares<br/>Outstanding</i> | <b>Common<br/>Stock</b> | <b>Capital in<br/>Excess of<br/>Par Value</b> | <b>Treasury<br/>Stock,<br/>at Cost</b> | <b>Accumulated<br/>Other<br/>Comprehensive<br/>Loss</b> | <b>Retained<br/>Earnings</b> | <b>Total</b> |
|---|--|-------------------------|---|--|---|------------------------------|--------------|
| Balances at December 31, 2007                     | 38.051                                   | \$ 42.8                 | \$ 895.1                                      | \$ (112.5)                             | \$ (133.3)  | \$ 331.9                     | \$ 1,024.0   |
| Net income for the six months ended June 30, 2008 |  |                         |   |  |   | 27.2                         | 27.2         |
| Other comprehensive income (loss):                |  |                         |   |  |   |                              |              |
| Related to marketable securities:                 |  |                         |   |  |   |                              |              |
| Change in fair value                              |  |                         |   |  | (6.1)   |                              |              |
| Reclassification to earnings                      |  |                         |   |  | 1.6   |                              |              |
| Income tax effect                                 |  |                         |   |  | 1.6   |                              |              |
|   |  |                         |   |  | (2.9)   |                              | (2.9)        |
| Adjustments related to employee benefit plans:    |  |                         |   |  | 5.4   |                              |              |
| Income tax effect                                 |  |                         |   |  | (2.0)   |                              |              |
|   |  |                         |   |  | 3.4   |                              | 3.4          |
| Total comprehensive income                        |  |                         |   |  |   |                              | 27.7         |
| Purchase of treasury stock                        | (2.126)                                  |                         |   | (48.9)                                 |   |                              | (48.9)       |
| Stock-based compensation                          |  |                         | 5.7   |  |   |                              | 5.7          |
| Common stock issued under stock plans             | 0.006                                    |                         | 0.1   |  |   |                              | 0.1          |
| Treasury stock issued under stock plans           | 0.001                                    |                         |   |  |   |                              |              |
| Stock issued for employee stock purchase plan     | 0.087                                    | 0.1                     | 1.5   |  |   |                              | 1.6          |
| Balances at June 30, 2008                         | 36.019                                   | \$ 42.9                 | \$ 902.4                                      | \$ (161.4)                             | \$ (132.8)  | \$ 359.1                     | \$ 1,010.2   |

See accompanying notes to condensed consolidated financial statements.

**Table of Contents****CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS (unaudited)**

Alaska Air Group, Inc.

Six Months Ended June 30

| (in millions)   | 2008            | 2007            |
|---|-----------------|-----------------|
| <b>Cash flows from operating activities:</b>                                      |                 |                 |
| Net income  | \$ 27.2         | \$ 35.8         |
| Adjustments to reconcile net income to net cash provided by operating activities: |                 |                 |
| Fleet transition costs, including impairment charge                               | 41.1            | 6.7             |
| Depreciation and amortization   | 100.8           | 85.7            |
| Stock-based compensation  | 5.7             | 5.4             |
| Changes in fair values of open fuel hedge contracts                               | (192.7)         | (4.8)           |
| Gain on sale of assets  | (2.8)           | (1.4)           |
| Changes in deferred income taxes  | 14.8            | 24.2            |
| Increase in receivables - net   | (27.0)          | (54.9)          |
| Increase in prepaid expenses and other current assets                             | (27.1)          | (16.7)          |
| Increase in air traffic liability   | 167.7           | 181.9           |
| Increase in other current liabilities   | 5.9             | 1.4             |
| Increase (decrease) in deferred revenue and other-net                             | (9.5)           | 3.9             |
| <b>Net cash provided by operating activities</b>                                  | <b>104.1</b>    | <b>267.2</b>    |
| <b>Cash flows from investing activities:</b>                                      |                 |                 |
| Property and equipment additions:   |                 |                 |
| Aircraft and aircraft purchase deposits   | (242.4)         | (411.6)         |
| Other flight equipment  | (20.5)          | (40.6)          |
| Other property and equipment  | (21.2)          | (21.0)          |
| <b>Total property and equipment additions</b>                                     | <b>(284.1)</b>  | <b>(473.2)</b>  |
| Proceeds from disposition of assets   | 5.4             | 54.1            |
| Purchases of marketable securities  | (474.1)         | (679.9)         |
| Sales and maturities of marketable securities                                     | 262.6           | 630.0           |
| Restricted deposits and other   | 1.5             | (9.0)           |
| <b>Net cash used in investing activities</b>                                      | <b>(488.7)</b>  | <b>(478.0)</b>  |
| <b>Cash flows from financing activities:</b>                                      |                 |                 |
| Proceeds from issuance of long-term debt  | 530.5           | 196.1           |
| Long-term debt payments   | (123.9)         | (62.6)          |
| Purchase of treasury stock  | (48.9)          |                 |
| Proceeds and tax benefit from issuance of common stock                            | 1.7             | 4.8             |
| <b>Net cash provided by financing activities</b>                                  | <b>359.4</b>    | <b>138.3</b>    |
| <b>Net change in cash and cash equivalents</b>                                    | <b>(25.2)</b>   | <b>(72.5)</b>   |
| Cash and cash equivalents at beginning of year                                    | 204.3           | 230.7           |
| <b>Cash and cash equivalents at end of period</b>                                 | <b>\$ 179.1</b> | <b>\$ 158.2</b> |
| Supplemental disclosure of cash paid (received) during the period for:            |                 |                 |
| Interest (net of amount capitalized)  | \$ 31.1         | \$ 27.1         |

Income taxes

See accompanying notes to condensed consolidated financial statements.

**3.9**

(4.1)

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**NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (unaudited)**

Alaska Air Group, Inc.

**Note 1. Basis of Presentation and Significant Accounting Policies**

*Organization and Basis of Presentation*

The accompanying unaudited condensed consolidated financial statements of Alaska Air Group, Inc. (Air Group or the Company) include the accounts of the parent company, Alaska Air Group, Inc., and its principal subsidiaries, Alaska Airlines, Inc. (Alaska) and Horizon Air Industries, Inc. (Horizon), through which the Company conducts substantially all of its operations. These interim condensed consolidated financial statements are unaudited and should be read in conjunction with the consolidated financial statements in the Company's Annual Report on Form 10-K for the year ended December 31, 2007. 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, 2008, as well as the results of operations for the three and six months ended June 30, 2008 and 2007. The adjustments made were of a normal recurring nature.

The Company's condensed consolidated financial statements have been prepared in conformity with accounting principles generally accepted in the United States of America (GAAP). In preparing these condensed consolidated financial 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. Significant estimates made include assumptions used to record liabilities; expenses and revenues associated with the Company's Mileage Plan; amounts paid to lessors upon aircraft lease terminations; the fair market value of surplus or impaired aircraft, engines and parts; assumptions used in the calculations of pension expense in the Company's defined-benefit plans; and the amounts of certain accrued liabilities. Actual results may differ from the Company's estimates.

*Reclassifications*

The Company has made certain reclassifications to conform the prior year's data to the current format.

*Securities Lending*

The Company lends certain marketable securities to third parties for a time period of less than one year. During the time period in which these securities are loaned to the third parties, the Company requires cash collateral for 102% of the daily market value of the loaned securities. As of June 30, 2008, the Company had \$109.2 million of securities on loan under the program. These affected securities are included as marketable securities under current assets on the consolidated balance sheets.

*New Accounting Pronouncements*

In March 2008, the Financial Accounting Standards Board issued Statement of Financial Standards (SFAS) No. 161, *Disclosures about Derivative Instruments and Hedging Activities – an amendment of FASB Statement No. 133*. SFAS 161 requires entities that use derivative instruments to provide certain qualitative disclosures about their objectives and strategies for using such instruments, amounts and location of the derivatives in the financial statements, among other disclosures. SFAS 161 is effective for fiscal years and interim periods beginning after November 15, 2008, with early application encouraged. Because of the importance and prominence of the Company's fuel-hedging program, management believes that the current disclosures included in quarterly and annual filings include many of the disclosures required under SFAS 161. Therefore, the Company currently does not anticipate that the adoption of SFAS 161 will have a material impact on the disclosures already provided.

In February 2007, the FASB issued SFAS No. 159, *The Fair Value Option for Financial Assets and Financial Liabilities*, which allows entities the option to measure eligible financial instruments at fair value as of specified dates. Such election, which may be applied on an instrument-by-instrument basis, is typically irrevocable once elected. This statement was effective beginning January 1, 2008. The Company did not elect the fair value option upon adoption.

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In September 2006, the FASB issued SFAS No. 157, *Fair Value Measurements*, which defines fair value, establishes a framework for measuring fair value and expands disclosure about fair-value measurements required under other accounting pronouncements. SFAS 157 does not change existing guidance as to whether or not an instrument is carried at fair value. The Company partially adopted this standard for financial assets and liabilities as of January 1, 2008. In accordance with FASB Staff Position No. 157-2, the Company has deferred adoption of SFAS 157 as it relates to nonfinancial assets and liabilities until January 1, 2009.

SFAS 157 defines fair value as the exchange price that would be received for an asset or paid to transfer a liability (an exit price) in the principal or most advantageous market for the asset or liability in an orderly transaction between market participants on the measurement date. SFAS 157 also establishes a fair value hierarchy, which requires an entity to maximize the use of observable inputs and minimize the use of unobservable inputs when measuring fair value. The standard describes three levels of inputs that may be used to measure fair value:

*Level 1* - Quoted prices in active markets for identical assets or liabilities.

*Level 2* - Observable inputs other than Level 1 prices such as quoted prices for similar assets or liabilities; quoted prices in markets that are not active; or other inputs that are observable or can be corroborated by observable market data for substantially the full term of the assets or liabilities.

*Level 3* - Unobservable inputs that are supported by little or no market activity and that are significant to the fair value of the assets or liabilities.

*Cash, Cash Equivalents and Marketable Securities*

The Company uses the market approach in determining the fair value of its cash, cash equivalents and marketable securities. The securities held by the Company are valued based on observable prices in active markets and considered to be liquid and easily tradable. Amounts measured at fair value as of June 30, 2008 are as follows:

|                           | Level 1  | Level 2  | Level 3 | Total      |
|---------------------------|----------|----------|---------|------------|
| Cash and cash equivalents | \$ 137.1 | \$ 42.0  | \$      | \$ 179.1   |
| Marketable securities     | 129.0    | 697.9    |         | 826.9      |
| Total                     | \$ 266.1 | \$ 739.9 | \$      | \$ 1,006.0 |

**Note 2. Fleet Transition***Alaska Transition to All-Boeing 737 Fleet*

In March 2006, the Company's Board of Directors approved a plan to accelerate the retirement of its MD-80 fleet (15 owned and 11 leased aircraft at the time) and remove those aircraft from service by the end of 2008. At June 30, 2008, seven MD-80s were in the operating fleet, all but two of which are under short-term operating lease arrangements that expire in 2008. All of the MD-80 aircraft will be removed from service by the end of August 2008.

Alaska has four MD-80 aircraft under long-term lease arrangements, all of which have been or will be retired prior to the end of their lease terms. Two of the aircraft were retired during the second quarter and placed in temporary storage at an aircraft storage facility. As a result, the Company recorded a \$26.0 million charge in the second quarter reflecting the remaining discounted future lease payments and other contract-related costs. The Company expects to record a similar charge in its statement of operations in the third quarter when the remaining two aircraft are retired.

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*Horizon Transition to All-Q400 Fleet*

Horizon has an arrangement with another carrier to sublease 16 of its Bombardier Q200 aircraft. As of June 30, 2008, all of the 16 aircraft were delivered to the other carrier with sublease terms that approximate Horizon's lease terms. Each of these subleases resulted in a loss for Horizon approximating the difference between the cumulative future lease payments and the expected sublease receipts that was recorded when the specific aircraft was removed from Horizon's fleet. During the three months ended June 30, 2008, two of the Q200s were delivered to the other carrier, resulting in a sublease loss of \$2.9 million. During the six months ended June 30, 2008, five of the aircraft were delivered, resulting in an \$8.7 million loss.

On April 23, 2007, Horizon announced an order for 15 additional Q400 aircraft, with options to purchase 20 more. These aircraft will be delivered in 2008 and 2009. With this order, Horizon plans to phase out its remaining leased Q200 aircraft by October 2008 and is in the process of negotiating transactions that would allow it to dispose of these aircraft. One of these Q200 aircraft was removed from service during the second quarter and the associated lease was terminated resulting in a net \$0.3 million charge to Horizon. The Company may have losses on the phase-out of the remaining Q200s, depending on market conditions at the time and the structure of the disposal transaction used. However, the nature, timing or amount of any potential loss or gain cannot be reasonably estimated at this time.

On April 23, 2008, the Company's Board of Directors approved a plan to transition Horizon to an all-Q400 fleet and remove its CRJ-700 fleet from operations within two years, along with the Q200 transition described above. As a result of the decision, the Company determined that its two owned CRJ-700s were impaired and recorded an impairment charge on the aircraft and their related spare parts of \$5.5 million in the second quarter of 2008 to reduce the carrying value of these assets to their estimated fair value. Salvage values and estimated useful lives were also revised to correspond to the shorter period of expected use.

The Company also recorded a \$0.6 million severance charge related to this fleet transition. The Company expects a charge in the third quarter as well related to severance programs offered to other impacted employees, primarily Horizon pilots. The amount of the charge has not yet been quantified, but it is not expected to be material.

As noted above, Horizon plans to remove all 18 leased CRJ-700 aircraft from operations by the end of 2009, which is well before the end of the contractual lease terms. The Company is currently evaluating various alternatives to dispose of these leased aircraft in the most economically feasible way. The nature, timing or amount of any potential gain or loss associated with these transactions cannot be reasonably estimated at this time.

**Table of Contents****Note 3. Fuel Hedge Contracts**

The Company's operations are inherently dependent upon the price and availability of aircraft fuel. To manage economic risk associated with fluctuations in aircraft fuel prices, the Company periodically enters into call options, collar structures and swap agreements for crude oil, among other initiatives.

The Company records derivative instruments, all of which are currently fuel hedge contracts, on the balance sheet at their fair value. Changes in the fair value of these fuel hedge contracts are recorded each period in aircraft fuel expense.

The following table summarizes the components of aircraft fuel expense for the three and six months ended June 30, 2008 and 2007 (in millions):

|   | Three Months Ended<br>June 30 |                 | Six Months Ended June 30 |                 |
|---|-------------------------------|-----------------|--------------------------|-----------------|
|   | 2008                          | 2007            | 2008                     | 2007            |
| Raw or into-plane fuel cost                             | \$ 393.3                      | \$ 231.9        | \$ 705.2                 | \$ 427.4        |
| Changes in value and settlement of fuel hedge contracts | (211.3)                       | (4.1)           | (241.2)                  | (14.7)          |
| <b>Aircraft fuel expense</b>                            | <b>\$ 182.0</b>               | <b>\$ 227.8</b> | <b>\$ 464.0</b>          | <b>\$ 412.7</b> |

The Company realized gains of \$56.0 million and \$5.9 million during the three months ended June 30, 2008 and 2007, respectively, on fuel hedge contracts that settled during the period. Gains on the settled hedges were \$85.2 million and \$7.7 million during the six months ended June 30, 2008 and 2007, respectively.

The Company uses the market approach in determining the fair value of its hedge portfolio. The Company's fuel hedging contracts consist of over-the-counter contracts, which are not traded on an exchange. The fair value of these contracts is determined based on observable inputs that are readily available in active markets or can be derived from information available in active, quoted markets. Therefore, the Company has categorized these contracts as Level 2 in the fair value hierarchy described in SFAS 157.

Outstanding future fuel hedge positions are as follows:

|                          | Approximate % of<br>Expected Fuel<br>Requirements | Gallons<br>Hedged<br>(in millions) | Approximate<br>Crude Oil<br>Price per Barrel |
|--------------------------|---|------------------------------------|--|
| Third Quarter 2008       | 50%   | 56.5                               | \$ 78  |
| Fourth Quarter 2008      | 50%   | 51.5                               | \$ 77  |
| <b>Remainder of 2008</b> | <b>50%</b>  | <b>108.0</b>                       | <b>\$ 78</b>                                 |
| First Quarter 2009       | 46%   | 38.9                               | \$ 106                                       |
| Second Quarter 2009      | 39%   | 35.0                               | \$ 105                                       |
| Third Quarter 2009       | 30%   | 28.9                               | \$ 107                                       |
| Fourth Quarter 2009      | 24%   | 21.1                               | \$ 105                                       |
| <b>Full Year 2009</b>    | <b>35%</b>  | <b>123.9</b>                       | <b>\$ 106</b>                                |
| First Quarter 2010       | 12%   | 10.2                               | \$ 121                                       |
| Second Quarter 2010      | 10%   | 8.6                                | \$ 120                                       |
| Third Quarter 2010       | 5%  | 5.7                                | \$ 120                                       |
| Fourth Quarter 2010      | 5%  | 5.1                                | \$ 120                                       |
| <b>Full Year 2010</b>    | <b>8%</b>   | <b>29.6</b>                        | <b>\$ 120</b>                                |





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As of June 30, 2008 and December 31, 2007, the fair values of the Company's fuel hedge positions were \$305.2 million and \$112.5 million, respectively, including capitalized premiums of \$67.7 million and \$30.9 million, respectively, and are presented as both current and non-current assets in the condensed consolidated balance sheets.

**Note 4. Long-term Debt**

Long-term debt obligations were as follows (in millions):

|  | June 30,<br>2008  | December 31,<br>2007 |
|--|-------------------|----------------------|
| Fixed-rate notes payable due through 2022      | \$ 1,282.1        | \$ 783.9             |
| Variable-rate notes payable due through 2019   | 277.7             | 430.8                |
| Pre-delivery payment facility expiring in 2009 | 147.3             | 85.8                 |
| Long-term debt                                 | 1,707.1           | 1,300.5              |
| Less current portion                           | (262.2)           | (175.9)              |
|  | <b>\$ 1,444.9</b> | <b>\$ 1,124.6</b>    |

During the first six months of 2008, Alaska borrowed \$196.0 million using fixed-rate debt secured by flight equipment and another \$140.9 million from its pre-delivery payment facility. Alaska made payments of \$121.4 million, including \$79.4 million on its pre-delivery payment facility. Additionally, Horizon financed 13 of its recently delivered Q400 aircraft using a fixed-rate debt arrangement with proceeds totaling \$193.6 million and made normal debt payments of \$2.5 million.

**Note 5. Common Stock Repurchase**

In September 2007, the Board of Directors authorized the Company to repurchase up to \$100 million of its common stock. The Company completed the \$100 million common stock repurchase program on February 29, 2008. Under that program, the Company repurchased 4,113,782 shares, or 10 percent of the outstanding stock at the start of the program, at an average price of \$24.31 per share. During the three months ended March 31, 2008, the Company repurchased 1,520,500 shares for approximately \$37.2 million.

In March 2008, the Company announced a new \$50 million common stock repurchase program. Through June 30, 2008, the Company had repurchased 605,700 shares of its common stock for approximately \$11.7 million under this new program. In April 2008, the Company temporarily ceased further repurchases under this program given the uncertainty in the economic environment. However, if the circumstances warrant, the Company may from time to time consider repurchasing shares of its common stock under the existing share repurchase program.

**Note 6. Employee Benefit Plans**

*Pension Plans - Qualified Defined Benefit*

Net pension expense for the three and six months ended June 30, 2008 and 2007 included the following components (in millions):

|               | Three Months Ended |                 | Six Months Ended June 30 |                 |
|---------------|--------------------|-----------------|--------------------------|-----------------|
|               | 2008               | June 30<br>2007 | 2008                     | June 30<br>2007 |
| Service cost  | \$ 11.1            | \$ 13.3         | \$ 23.3                  | \$ 26.6         |
| Interest cost | 15.6               | 15.0            | 31.3                     | 30.0            |

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|                                    |                |         |                |         |
|------------------------------------|----------------|---------|----------------|---------|
| Expected return on assets          | <b>(18.0)</b>  | (16.3)  | <b>(35.9)</b>  | (32.6)  |
| Amortization of prior service cost | <b>1.1</b>     | 1.0     | <b>2.2</b>     | 2.0     |
| Actuarial loss                     | <b>1.4</b>     | 3.0     | <b>2.8</b>     | 6.0     |
| Net pension expense                | <b>\$ 11.2</b> | \$ 16.0 | <b>\$ 23.7</b> | \$ 32.0 |

The Company contributed \$17.2 million and \$34.4 million to its qualified defined-benefit plans during the three and six months ended June 30, 2008, respectively, and expects to contribute an additional \$17.3 million to these plans during the remainder of 2008. The Company made \$17.5 million and \$35.0 million in contributions to its qualified defined-benefit pension plans during the three and six months ended June 30, 2007, respectively.

**Table of Contents***Pension Plans - Nonqualified Defined Benefit*

Net pension expense for the unfunded, noncontributory defined-benefit plans was \$0.9 million for the three months ended June 30, 2008 and 2007 and \$1.8 million for the six months ended June 30, 2008 and 2007.

*Postretirement Medical Benefits*

Net periodic benefit cost for the post-retirement medical plans for the three months ended June 30, 2008 and 2007 was \$2.8 million and \$2.9 million, respectively. The net periodic benefit cost for the six months ended June 30, 2008 and 2007 was \$5.6 million and \$5.8 million, respectively.

**Note 7. Other Assets**

Other assets consisted of the following (in millions):

|  | June 30,<br>2008 | December 31,<br>2007 |
|--|------------------|----------------------|
| Restricted deposits (primarily restricted investments) | \$ 85.4          | \$ 90.4              |
| Deferred costs and other*                              | 62.4             | 36.1                 |
|  | <b>\$ 147.8</b>  | <b>\$ 126.5</b>      |

\* Deferred costs and other includes deferred financing costs, long-term prepaid rent, lease deposits and other items.

**Note 8. Mileage Plan**

Alaska's Mileage Plan deferrals and liabilities are included under the following balance sheet captions (in millions):

|   | June 30,<br>2008 | December 31,<br>2007 |
|---|------------------|----------------------|
| <b>Current Liabilities:</b>                         |                  |                      |
| Other accrued liabilities                           | \$ 266.5         | \$ 239.7             |
| <b>Other Liabilities and Credits (non-current):</b> |                  |                      |
| Deferred revenue                                    | 416.0            | 387.8                |
| Other liabilities                                   | 19.4             | 21.0                 |
|   | <b>\$ 701.9</b>  | <b>\$ 648.5</b>      |

Alaska's Mileage Plan revenue is included under the following statement of operations captions for the three and six months ended June 30 (in millions):

|                    | Three Months Ended<br>June 30 |         | Six Months Ended June 30 |         |
|--------------------|-------------------------------|---------|--------------------------|---------|
|                    | 2008                          | 2007    | 2008                     | 2007    |
| Passenger revenues | \$ 35.5                       | \$ 32.3 | \$ 60.9                  | \$ 60.6 |

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|                      |                |         |                 |          |
|----------------------|----------------|---------|-----------------|----------|
| Other - net revenues | 24.4           | 25.6    | 51.1            | 53.5     |
|                      | <b>\$ 59.9</b> | \$ 57.9 | <b>\$ 112.0</b> | \$ 114.1 |

**Note 9. Stock-Based Compensation Plans**

The Company accounts for stock-based awards using SFAS No. 123R, *Share-Based Payment: An Amendment of SFAS Nos. 123 and 95*. All stock-based compensation expense is recorded in wages and benefits in the condensed consolidated statements of operations.

*Stock Options*

The Company has stock option awards outstanding under a number of long-term incentive equity plans, one of which continues to provide for the grant of stock options to purchase the Company's common stock at market prices on the date of grant to directors, officers and employees of the Company and its subsidiaries.

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During the six months ended June 30, 2008, the Company granted 388,111 options with a weighted-average fair value of \$11.13 per share. During the same period in the prior year, the Company granted 187,107 options with a weighted-average fair value of \$19.71 per share.

The Company recorded stock-based compensation expense related to stock options of \$1.0 million (\$0.6 million after tax) and \$1.1 million (\$0.8 million after tax) for the three months ended June 30, 2008 and 2007, respectively. The Company recorded compensation expense of \$2.0 million (\$1.2 million after tax) and \$2.0 million (\$1.4 million after tax) for the six months ended June 30, 2008 and 2007, respectively. As of June 30, 2008, \$9.6 million of compensation cost associated with unvested stock option awards attributable to future service had not yet been recognized. This amount will be recognized as expense over a weighted-average period of 2.7 years.

As of June 30, 2008, options to purchase 2,684,427 shares of common stock were outstanding with a weighted-average exercise price of \$30.77. Of that total, 1,835,830 were exercisable at a weighted-average exercise price of \$30.39.

*Restricted Stock Awards*

During the six months ended June 30, 2008, the Company awarded 306,645 restricted stock units (RSUs) to certain employees, with a weighted-average grant date fair value of \$22.66. This amount reflects the value of the RSU awards at the grant date based on the closing price of the Company's common stock. The Company recorded stock-based compensation expense related to RSUs of \$1.5 million (\$0.9 million after tax) and \$1.4 million (\$0.9 million after tax) for the three months ended June 30, 2008 and 2007, respectively, and \$2.8 million (\$1.8 million after tax) and \$2.7 million (\$1.7 million after tax) for the six months ended June 30, 2008 and 2007, respectively.

As of June 30, 2008, \$10.0 million of compensation cost associated with unvested restricted stock awards attributable to future service had not yet been recognized. This amount will be recognized as expense over a weighted-average period of 2.2 years.

*Performance Stock Awards*

During the first quarters of 2008 and 2007, the Company awarded Performance Share Unit awards (PSUs) to certain executives. These award types are similar to restricted stock units (RSUs), but vesting is based on a performance condition tied to the Company achieving a specified pretax margin over a three-year period. During the second quarter of 2008, the Company has adjusted its assumptions as to the number of shares that will ultimately vest. As a result, all previously recorded compensation expense related to PSUs has been reversed. The amount credited to compensation expense was \$0.7 million (\$0.4 million after tax) and \$0.5 million (\$0.3 million after tax) during the three and six months ended June 30, 2008, respectively. The Company recorded compensation expense associated with the PSUs of \$0.2 million (\$0.1 million after tax) and \$0.3 million (\$0.2 million after tax) during the three and six months ended June 30, 2007, respectively.

*Deferred Stock Awards*

In the second quarter of 2008, the Company awarded 13,976 Deferred Stock Unit awards (DSUs) to members of its Board of Directors as a portion of their retainers. The underlying common shares are issued upon retirement from the Board, but require no future service period. As a result, the entire intrinsic value of the awards on the date of grant was expensed in the second quarter of 2008. The total amount of compensation expense recorded was \$0.3 million (\$0.2 million after tax).

*Employee Stock Purchase Plan*

Compensation expense recognized under the Employee Stock Purchase Plan was \$0.4 million and \$0.2 million for the three months ended June 30, 2008 and 2007, respectively, and \$1.1 million and \$0.4 million for the six months ended June 30, 2008 and 2007, respectively.

**Table of Contents***Summary of Stock-Based Compensation*

The table below summarizes the components of total stock-based compensation for the three and six months ended June 30 (in millions):

|                              | Three Months Ended<br>June 30 |        | Six Months Ended June 30 |        |
|------------------------------|-------------------------------|--------|--------------------------|--------|
|                              | 2008                          | 2007   | 2008                     | 2007   |
| Stock options                | \$ 1.0                        | \$ 1.1 | \$ 2.0                   | \$ 2.0 |
| Restricted stock units       | 1.5                           | 1.4    | 2.8                      | 2.7    |
| Performance share units      | (0.7)                         | 0.2    | (0.5)                    | 0.3    |
| Deferred stock units         | 0.3                           |        | 0.3                      |        |
| Employee stock purchase plan | 0.4                           | 0.2    | 1.1                      | 0.4    |
|                              | \$ 2.5                        | \$ 2.9 | \$ 5.7                   | \$ 5.4 |

**Note 10. Operating Segment Information**

Operating segment information for Alaska and Horizon for the three- and six-month periods ended June 30 was as follows (in millions):

|                                      | Three Months Ended<br>June 30 |          | Six Months Ended June 30 |            |
|--------------------------------------|-------------------------------|----------|--------------------------|------------|
|                                      | 2008                          | 2007     | 2008                     | 2007       |
| Operating revenues:                  |                               |          |                          |            |
| Alaska mainline (1)                  | \$ 742.6                      | \$ 724.1 | \$ 1,405.6               | \$ 1,326.6 |
| Alaska purchased capacity (1)        | 77.8                          | 71.0     | 148.2                    | 128.3      |
| Total Alaska                         | 820.4                         | 795.1    | 1,553.8                  | 1,454.9    |
| Horizon                              | 188.9                         | 178.0    | 366.1                    | 339.6      |
| Other (2)                            | 0.2                           | 0.2      | 0.5                      | 0.5        |
| Elimination of intercompany revenues | (78.7)                        | (68.9)   | (150.1)                  | (131.2)    |
| Consolidated                         | \$ 930.8                      | \$ 904.4 | \$ 1,770.3               | \$ 1,663.8 |
| Income (loss) before income tax:     |                               |          |                          |            |
| Alaska mainline                      | \$ 94.0                       | \$ 84.0  | \$ 62.4                  | \$ 86.6    |
| Alaska purchased capacity            | (6.7)                         | (3.1)    | (13.0)                   | (13.2)     |
| Total Alaska                         | 87.3                          | 80.9     | 49.4                     | 73.4       |
| Horizon                              | 12.6                          | (4.9)    | (4.6)                    | (14.1)     |
| Other (2)                            | (1.7)                         | (1.0)    | (2.7)                    | (2.1)      |
| Consolidated                         | \$ 98.2                       | \$ 75.0  | \$ 42.1                  | \$ 57.2    |

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|                                      | June 30,<br>2008 | December 31,<br>2007 |
|--------------------------------------|------------------|----------------------|
| Total assets at end of period:       |                  |                      |
| Alaska                               | \$ 4,678.4       | \$ 4,221.0           |
| Horizon                              | 726.9            | 629.0                |
| Other (2)                            | 1,160.5          | 1,130.3              |
| Elimination of intercompany accounts | (1,470.3)        | (1,489.5)            |
| Consolidated                         | \$ 5,095.5       | \$ 4,490.9           |

- (1) Alaska mainline revenue represents revenue from passengers aboard Alaska jets, freight and mail revenue, and all other revenue. Purchased capacity revenue represents that revenue earned by Alaska on capacity provided by Horizon and a small third party under a capacity purchase arrangement.
- (2) Includes the parent company, Alaska Air Group, Inc., including its investments in Alaska and Horizon, which are eliminated in consolidation.

**Note 11. Contingencies***Grievance with International Association of Machinists*

In June 2005, the International Association of Machinists (IAM) filed a grievance under its Collective Bargaining Agreement (CBA) with Alaska alleging that Alaska violated the CBA by, among other things, subcontracting the ramp service operation in Seattle. The dispute was referred to an arbitrator and hearings on the grievance commenced in January 2007, with a final hearing date in August 2007. In August 2008, the arbitrator issued a ruling in the matter. In that ruling, the arbitrator found that Alaska had violated the CBA and instructed Alaska and the IAM to negotiate a remedy. Management is evaluating the decision, but currently does not believe that any final remedy will materially impact our financial position or results of operations.

*Other items*

The Company is a party to routine litigation matters incidental to its business and with respect to which no material liability is expected.

Management believes the ultimate disposition of the matters discussed above is not likely to materially affect the Company's financial position or results of operations. This 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.



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**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 operations and our present business environment. MD&A is provided as a supplement to and should be read in conjunction with our condensed 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 the Company's filings with the Securities and Exchange Commission, including those listed in Part I, Item 1A. Risk Factors in our Annual Report on Form 10-K for the year ended December 31, 2007. This overview summarizes MD&A, which includes the following sections:

*Second Quarter in Review* highlights from the second quarter of 2008 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 the results of operations of Alaska and Horizon for the three and six months ended June 30, 2008. We believe this analysis will help the reader better understand our condensed consolidated statements of operations. This section also includes forward-looking statements regarding our view of the remainder of 2008.

*Liquidity and Capital Resources* an analysis of cash flows, sources and uses of cash, contractual obligations, commitments and off-balance sheet arrangements, an overview of financial position and the impact of inflation and changing prices.

Air Group's filings with the Securities and Exchange Commission, including its annual report on Form 10-K, quarterly reports on Form 10-Q, current reports on Form 8-K and amendments to those reports are accessible free of charge at [www.alaskaair.com](http://www.alaskaair.com). The information contained on our website is not a part of this quarterly report on Form 10-Q.

**SECOND QUARTER IN REVIEW**

Our consolidated pretax income increased to \$98.2 million during the second quarter of 2008 from \$75.0 million in the second quarter of 2007. We recorded unprecedented mark-to-market gains on the value of our portfolio of fuel hedges that will settle in future periods. These mark-to-market gains masked the \$161.4 million, or nearly 70%, increase in our raw fuel cost over the second quarter of 2007. Even with the benefit of \$56 million of cash savings from our fuel hedge program, our economic fuel cost (as defined below) increased \$111.3 million, or 49%, over the prior-year period. These record-high fuel prices are having a severely negative impact on our operating results along with the rest of the industry. The increase in our economic fuel costs far exceeded the \$26.4 million increase in total operating revenues, resulting in a significant decline in our operating cash flows. Other significant developments during the second quarter of 2008 are described below.

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### *Alaska Fleet Transition*

Our fleet transition at Alaska continues to progress as planned. We now expect to remove all MD-80s from service by the end of August 2008.

We have four MD-80 aircraft under long-term lease arrangements that have been or will be retired prior to the end of their lease terms. Two of those aircraft were removed from service during the second quarter and placed in temporary storage at an aircraft storage facility. As a result, we recorded a \$26.0 million charge during the second quarter associated with these aircraft representing the remaining obligation under the existing lease contracts. We expect to retire the other two in August, which will result in a similar charge of \$25 million to \$28 million during the third quarter of 2008.

### *Horizon Fleet Transition*

In 2006, Horizon entered into an agreement to sublease up to 16 of its Bombardier Q200 aircraft to a third party. During the second quarter of 2008, the final two aircraft were transferred to the other carrier, resulting in a loss on the sublease arrangement of \$2.9 million that is reflected as Fleet transition costs - Q200s in the condensed consolidated statements of operations. The loss generally represents the difference between Horizon's remaining lease payments and expected sublease receipts.

On April 23, 2007, we announced an order for 15 additional Q400 aircraft, with options for 20 more. The 15 aircraft will be delivered in 2008 and 2009. With this order, we plan to phase out the remaining leased Q200 aircraft by October 2008, and we are in the process of negotiating transactions that would allow for their exit from the fleet. One of these Q200 aircraft was removed from service during the second quarter and the associated lease was terminated resulting in a net \$0.3 million charge to Horizon. We may record losses as we phase out the remaining Q200s, depending on market conditions at the time and the structure of the disposal transactions used. The nature, timing or amount of any potential loss or gain cannot be reasonably estimated at this time. However, we do expect to record any impact from these transactions in the third and fourth quarters of 2008 as Q200s are removed from the fleet.

On April 23, 2008, our Board of Directors approved a plan to transition Horizon to an all-Q400 fleet and remove its CRJ-700 fleet from operations within two years, along with the Q200 transition described above. As a result of the decision, we determined that our two owned CRJ-700s were impaired and recorded an impairment charge on the aircraft and their related spare parts of \$5.5 million in the second quarter of 2008 to reduce the carrying value of these assets to their estimated fair value. Salvage values and estimated useful lives were also revised to correspond to the shorter period of expected use.

We also recorded a \$0.6 million severance charge related to this fleet transition. We expect a charge in the third quarter as well related to severance programs offered to other impacted employees, primarily Horizon pilots. The amount of the charge has not yet been quantified but is not expected to be material.

As noted above, Horizon plans to remove all 18 leased CRJ-700 aircraft from operations by the end of 2009, which is well before the end of the contractual lease terms. We are currently evaluating various alternatives to dispose of these leased aircraft in the most economically feasible way. The nature, timing or amount of any potential gain or loss associated with these transactions cannot be reasonably estimated at this time.

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### *Common Stock Repurchase*

In September 2007, our Board of Directors authorized the Company to repurchase up to \$100 million of our common stock over a twelve-month period. We completed the repurchase in February 2008. On March 13, 2008, we announced a new \$50 million common stock repurchase program. Through June 30, 2008, we had repurchased 605,700 shares of our common stock for approximately \$11.7 million under this new program. The repurchased shares have been recorded as treasury shares in our condensed consolidated balance sheets.

We have temporarily stopped further repurchases under this program given the uncertainty in the economic environment. However, if the circumstances warrant, we may from time to time consider repurchasing shares of our common stock under our existing share repurchase program.

### *Fees and Mileage Plan Changes*

Like many of our competitors, we have raised some of our existing fees or implemented new fees in an effort to increase our revenues. Examples include:

increasing the charge for booking through reservations and airport sales agents from \$10 to \$15,

raising the fee for overweight baggage from \$25 to \$50,

increasing the charge for transporting pets in the cabin from \$75 to \$100 one-way, and

raising the unaccompanied minor fee from \$30 to \$75 for one-way nonstop flights and from \$60 to \$75 for connecting flights.

The increases above were effective May 21, 2008. We also began charging \$25 for a second checked bag effective July 1, 2008. First class and top-tier Mileage Plan members and customers on flights within the state of Alaska are exempt from the new fee.

On July 24, 2008 we also announced a \$25 fee for booking Mileage Plan award travel on partner airlines. We also announced that our domestic round-trip Coach Saver award will increase to 25,000 miles from 20,000 miles and we have expanded our 15,000-mile Intra-Alaska award levels in coach to an Intra-State award. This award offers travel wholly within one individual state for 15,000 award miles. Other changes include an increase in the award miles needed for Peak awards and the introduction of a three-tier award level structure. All of these changes are effective for awards redeemed on or after November 1, 2008.

### *Operational Performance*

Our core promise to our customers is to get them and their bags where we promise, safely and on time. Operational performance is one of our top initiatives in 2008. Although we have more improvements to make, we are pleased with our progress thus far in 2008. In each month of the six-month period ended June 30, 2008, Alaska exceeded its prior-year performance in on-time arrivals and did the same in schedule completion rates for five of the six months. Similarly, Horizon has exceeded its prior-year performance in both on-time performance and schedule completion rates on a year-to-date basis for the first six months of 2008 compared to 2007.

### *New Markets*

In the second quarter, we announced that Alaska would begin service to its fourth Hawaiian destination, Kona, on November 17, 2008. This service will include year-round daily flights from Seattle. Alaska also announced new service to Minneapolis twice daily beginning October 26, 2008. Horizon announced seasonal daily nonstop service between Los Angeles International Airport and Mammoth Lakes, CA beginning December 18, 2008.



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### *Labor Negotiations*

Alaska is currently in negotiations with its pilots and has been since early 2007. The contract with Alaska's pilots became amendable May 1, 2007. The Air Line Pilots Association (ALPA) at Alaska has requested mediation from the National Mediation Board (NMB) in order to assist with contract negotiations. We welcome the assistance from the NMB and hope to reach a negotiated contract that recognizes the important contributions that our pilots make while not harming our competitive position. Factoring in pay rates, productivity measures, pension, and post-retirement medical benefits, we believe our pilot unit costs are among the highest in the industry for the size of aircraft operated.

We do not know what the final outcome of these negotiations will be or when agreements will be reached. However, uncertainty around open contracts could be a distraction to some employees, reduce employee engagement in our business, and prevent us from achieving the operational goals (such as on-time and completion-rate targets) that we have set.

### *Outlook*

Because of soaring jet fuel prices and a softening economy, the airline industry is facing a financial crisis that some industry watchers believe is worse than the period immediately following the September 11 attacks. We face those same challenges, plus the reality of new competition in many of our most important markets on the West Coast. At the current price of oil, ticket prices must increase dramatically in order for this industry to return to profitability.

In response to the current economic environment, we are taking action to cut capacity and adjust several other areas of our business. Our plan includes:

preserving and enhancing our cash and marketable securities position;

cutting capacity and redeploying aircraft to more profitable routes;

boosting revenues through fare increases, improved load factors, and ancillary fees such as those described above;

conserving fuel; and

controlling our non-fuel costs.

We currently expect Alaska mainline capacity to be relatively flat and Horizon total system capacity to decline by 9% for the full year of 2008 compared to 2007. Although capacity is expected to be flat at Alaska, total departures at Alaska are expected to decline by just over 6% compared to 2007. We also anticipate 5% to 10% capacity reductions at Alaska in 2009 compared with the full year of 2008.

Along with the capacity reductions, Alaska announced that it plans to reduce its management work force by 5% or more effective September 1, 2008, which will result in an expected charge of \$3 million to \$5 million in the third quarter. We do expect reductions in our operational staff as well, either through furlough, voluntary leaves, or other means. As we work through the schedule changes needed to achieve our capacity reduction goals, we will be able to more specifically quantify the full effect on these other work groups and plan to announce further information in early September.

Horizon reduced its management work force by 13% earlier this year and expects to further reduce operational and management positions in connection with the capacity cuts. When these actions are taken, there will likely be a charge to the statement of operations.

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**RESULTS OF OPERATIONS**

**COMPARISON OF THREE MONTHS ENDED JUNE 30, 2008 TO THREE MONTHS ENDED JUNE 30, 2007**

Our consolidated net income for the second quarter of 2008 was \$63.1 million, or \$1.74 per diluted share, compared to net income of \$46.1 million, or \$1.13 per diluted share, in the second quarter of 2007. Both periods include adjustments to reflect the timing of gain or loss recognition resulting from mark-to-market accounting related to our fuel hedge position. In 2008 we recognized net mark-to-market gains of \$155.3 million (\$97.3 million after tax, or \$2.69 per share) compared to losses of \$1.8 million (\$1.1 million after tax, or \$0.03 per share) in the second quarter of 2007. The second quarter of 2008 also included fleet transition charges of \$32.1 million (\$20.1 million after tax, or \$0.56 per share) related to the ongoing transitions out of the MD-80 and CRJ-700 fleets.

We believe disclosure of the impact of these individual charges is useful information to investors and other readers because:

it is useful to monitor performance without these items as it improves a reader's ability to compare our results to the results of other airlines;

our results excluding these adjustments related to fuel hedge accounting is 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 condensed consolidated statements of operations;

our results excluding these items are most often used in internal management and board reporting and decision-making; and

we believe it is the basis by which we are evaluated by industry analysts.

Our consolidated results are primarily driven by the results of our two operating carriers. Alaska reported pretax income of \$87.3 million in the second quarter of 2008, while Horizon reported pretax income of \$12.6 million. Without the significant mark-to-market gains recorded on our portfolio of fuel hedge contracts that will settle in future periods, both carriers would have reported pretax losses during the second quarter. Financial and statistical data for Alaska and Horizon are shown on pages 23 and 24, respectively. An in-depth discussion of the results of Alaska and Horizon begins on page 25.

**Table of Contents****Alaska Airlines Financial and Statistical Data (unaudited)**

| <b>Financial Data (in millions):</b>              | <b>Three Months Ended June 30</b> |             |                 | <b>Six Months Ended June 30</b> |             |                 |
|---|-----------------------------------|-------------|-----------------|---------------------------------|-------------|-----------------|
|   | <b>2008</b>                       | <b>2007</b> | <b>% Change</b> | <b>2008</b>                     | <b>2007</b> | <b>% Change</b> |
| <b>Operating Revenues:</b>                        |                                   |             |                 |                                 |             |                 |
| Passenger   | \$ 682.7                          | \$ 663.3    | 2.9             | \$ 1,290.0                      | \$ 1,209.2  | 6.7             |
| Freight and mail                                  | 26.6                              | 26.3        | 1.1             | 47.9                            | 47.0        | 1.9             |
| Other - net                                       | 33.3                              | 34.5        | (3.5)           | 67.7                            | 70.4        | (3.8)           |
| <i>Total mainline operating revenues</i>          | <b>742.6</b>                      | 724.1       | 2.6             | <b>1,405.6</b>                  | 1,326.6     | 6.0             |
| Passenger - purchased capacity                    | 77.8                              | 71.0        | 9.6             | 148.2                           | 128.3       | 15.5            |
| <b>Total Operating Revenues</b>                   | <b>820.4</b>                      | 795.1       | 3.2             | <b>1,553.8</b>                  | 1,454.9     | 6.8             |
| <b>Operating Expenses:</b>                        |                                   |             |                 |                                 |             |                 |
| Wages and benefits                                | 184.3                             | 185.6       | (0.7)           | 374.5                           | 372.9       | 0.4             |
| Variable incentive pay                            | 3.3                               | 2.1         | 57.1            | 5.9                             | 9.8         | (39.8)          |
| Aircraft fuel, including hedging gains and losses | 151.2                             | 193.4       | (21.8)          | 384.9                           | 351.0       | 9.7             |
| Aircraft maintenance                              | 37.4                              | 34.5        | 8.4             | 79.5                            | 68.8        | 15.6            |
| Aircraft rent                                     | 27.9                              | 27.9        |                 | 56.1                            | 54.2        | 3.5             |
| Landing fees and other rentals                    | 42.7                              | 42.2        | 1.2             | 84.6                            | 84.0        | 0.7             |
| Contracted services                               | 33.9                              | 30.2        | 12.3            | 68.6                            | 59.6        | 15.1            |
| Selling expenses                                  | 36.0                              | 33.4        | 7.8             | 62.5                            | 65.0        | (3.8)           |
| Depreciation and amortization                     | 41.6                              | 35.6        | 16.9            | 80.4                            | 71.0        | 13.2            |
| Food and beverage service                         | 12.6                              | 12.0        | 5.0             | 24.3                            | 22.6        | 7.5             |
| Other   | 47.4                              | 43.2        | 9.7             | 89.2                            | 83.0        | 7.5             |
| Fleet transition costs - MD-80                    | 26.0                              |             | NM              | 26.0                            | 0.0         | NM              |
| <i>Total mainline operating expenses</i>          | <b>644.3</b>                      | 640.1       | 0.7             | <b>1,336.5</b>                  | 1,241.9     | 7.6             |
| Purchased capacity costs                          | 84.5                              | 74.1        | 14.0            | 161.2                           | 141.5       | 13.9            |
| <b>Total Operating Expenses</b>                   | <b>728.8</b>                      | 714.2       | 2.0             | <b>1,497.7</b>                  | 1,383.4     | 8.3             |
| <b>Operating Income</b>                           | <b>91.6</b>                       | 80.9        |                 | <b>56.1</b>                     | 71.5        |                 |
| Interest income                                   | 12.3                              | 16.6        |                 | 25.4                            | 32.5        |                 |
| Interest expense                                  | (22.2)                            | (22.1)      |                 | (44.0)                          | (42.5)      |                 |
| Interest capitalized                              | 5.4                               | 6.0         |                 | 11.3                            | 12.3        |                 |
| Other - net                                       | 0.2                               | (0.5)       |                 | 0.6                             | (0.4)       |                 |
|   | (4.3)                             |             |                 | (6.7)                           | 1.9         |                 |
| <b>Income Before Income Tax</b>                   | <b>\$ 87.3</b>                    | \$ 80.9     |                 | <b>\$ 49.4</b>                  | \$ 73.4     |                 |
| <b>Mainline Operating Statistics:</b>             |                                   |             |                 |                                 |             |                 |
| Revenue passengers (000)                          | 4,425                             | 4,627       | (4.4)           | 8,505                           | 8,489       | 0.2             |
| RPMs (000,000) traffic                            | 4,872                             | 4,820       | 1.1             | 9,398                           | 8,886       | 5.8             |
| ASMs (000,000) capacity                           | 6,238                             | 6,140       | 1.6             | 12,322                          | 11,834      | 4.1             |
| Passenger load factor                             | 78.1%                             | 78.5%       | (0.4)pts        | 76.3%                           | 75.1%       | 1.2pts          |
| Yield per passenger mile                          | 14.01¢                            | 13.76¢      | 1.8             | 13.73¢                          | 13.61¢      | 0.9             |
| Operating revenue per ASM (RASM)                  | 11.90¢                            | 11.79¢      | 0.9             | 11.41¢                          | 11.21¢      | 1.8             |
| Passenger revenue per ASM                         | 10.94¢                            | 10.80¢      | 1.3             | 10.47¢                          | 10.22¢      | 2.5             |
| Operating expenses per ASM                        | 10.33¢                            | 10.43¢      | (0.9)           | 10.85¢                          | 10.49¢      | 3.4             |

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|  |         |         |          |         |         |        |
|--|---------|---------|----------|---------|---------|--------|
| Aircraft fuel cost per ASM                       | 2.42¢   | 3.15¢   | (23.2)   | 3.13¢   | 2.96¢   | 5.6    |
| Fleet transition charges per ASM                 | 0.42¢   | 0.00¢   | NM       | 0.21¢   | 0.00¢   | NM     |
| Aircraft fuel cost per gallon                    | \$ 1.75 | \$ 2.16 | (19.0)   | \$ 2.23 | \$ 2.02 | 10.4   |
| Economic fuel cost per gallon                    | \$ 3.24 | \$ 2.14 | 51.4     | \$ 2.98 | \$ 2.05 | 45.4   |
| Fuel gallons (000,000)                           | 86.4    | 89.8    | (3.8)    | 172.3   | 173.9   | (0.9)  |
| Average number of full-time equivalent employees | 9,880   | 9,748   | 1.4      | 9,881   | 9,645   | 2.4    |
| Aircraft utilization (blk hrs/day)               | 10.9    | 11.0    | (0.9)    | 10.8    | 10.9    | (0.9)  |
| Average aircraft stage length (miles)            | 974     | 917     | 6.2      | 971     | 917     | 5.9    |
| Operating fleet at period-end                    | 115     | 114     | 1a/c     | 115     | 114     | 1a/c   |
| <b>Regional Operating Statistics:</b>            |         |         |          |         |         |        |
| RPMs (000,000)                                   | 302     | 273     | 10.6     | 569     | 493     | 15.4   |
| ASMs (000,000)                                   | 399     | 352     | 13.4     | 762     | 668     | 14.1   |
| Passenger load factor                            | 75.7%   | 77.6%   | (1.9)pts | 74.7%   | 73.8%   | 0.9pts |
| Yield per passenger mile                         | 25.76¢  | 26.01¢  | (0.9)    | 26.05¢  | 26.02¢  | 0.1    |
| Operating revenue per ASM                        | 19.50¢  | 20.17¢  | (3.3)    | 19.45¢  | 19.21¢  | 1.3    |
| Operating expenses per ASM                       | 21.18¢  | 21.05¢  | 0.6      | 21.15¢  | 21.18¢  | (0.1)  |

NM = Not Meaningful



**Table of Contents****Horizon Air Financial and Statistical Data (unaudited)**

| <b>Financial Data (in millions):</b>              | <b>Three Months Ended June 30</b> |             |                 | <b>Six Months Ended June 30</b> |             |                 |
|---|-----------------------------------|-------------|-----------------|---------------------------------|-------------|-----------------|
|   | <b>2008</b>                       | <b>2007</b> | <b>% Change</b> | <b>2008</b>                     | <b>2007</b> | <b>% Change</b> |
| <b>Operating Revenues:</b>                        |                                   |             |                 |                                 |             |                 |
| Passenger - brand flying                          | \$ 107.7                          | \$ 96.8     | 11.3            | \$ 210.4                        | \$ 183.7    | 14.5            |
| Passenger - capacity purchase arrangements (a)    | 78.7                              | 78.9        | (0.3)           | 150.1                           | 151.4       | (0.9)           |
| <i>Total passenger revenue</i>                    | <b>186.4</b>                      | 175.7       | 6.1             | <b>360.5</b>                    | 335.1       | 7.6             |
| Freight and mail                                  | 0.7                               | 0.6         | 16.7            | 1.3                             | 1.1         | 18.2            |
| Other - net                                       | 1.8                               | 1.7         | 5.9             | 4.3                             | 3.4         | 26.5            |
| <b>Total Operating Revenues</b>                   | <b>188.9</b>                      | 178.0       | 6.1             | <b>366.1</b>                    | 339.6       | 7.8             |
| <b>Operating Expenses:</b>                        |                                   |             |                 |                                 |             |                 |
| Wages and benefits                                | 48.6                              | 50.2        | (3.2)           | 98.9                            | 99.1        | (0.2)           |
| Variable incentive pay                            | 1.8                               | 1.7         | 5.9             | 2.8                             | 4.5         | (37.8)          |
| Aircraft fuel, including hedging gains and losses | 30.8                              | 34.4        | (10.5)          | 79.1                            | 61.7        | 28.2            |
| Aircraft maintenance                              | 16.8                              | 24.5        | (31.4)          | 32.7                            | 48.7        | (32.9)          |
| Aircraft rent                                     | 14.4                              | 16.8        | (14.3)          | 29.8                            | 33.8        | (11.8)          |
| Landing fees and other rentals                    | 14.5                              | 14.5        |                 | 28.9                            | 27.7        | 4.3             |
| Contracted services                               | 6.9                               | 6.7         | 3.0             | 14.9                            | 12.8        | 16.4            |
| Selling expenses                                  | 8.1                               | 7.7         | 5.2             | 16.1                            | 15.1        | 6.6             |
| Depreciation and amortization                     | 9.6                               | 7.9         | 21.5            | 19.8                            | 14.1        | 40.4            |
| Food and beverage service                         | 0.8                               | 0.8         |                 | 1.4                             | 1.4         |                 |
| Other   | 11.2                              | 11.7        | (4.3)           | 24.0                            | 24.5        | (2.0)           |
| Fleet transition costs - CRJ-700                  | 6.1                               |             | NM              | 6.1                             |             | NM              |
| Fleet transition costs - Q200                     | 3.2                               | 3.7         | NM              | 9.0                             | 6.7         | NM              |
| <b>Total Operating Expenses</b>                   | <b>172.8</b>                      | 180.6       | (4.3)           | <b>363.5</b>                    | 350.1       | 3.8             |
| <b>Operating Income (Loss)</b>                    | <b>16.1</b>                       | (2.6)       |                 | <b>2.6</b>                      | (10.5)      |                 |
| Interest income                                   | 1.3                               | 1.3         |                 | 2.7                             | 2.3         |                 |
| Interest expense                                  | (5.7)                             | (4.3)       |                 | (11.4)                          | (7.3)       |                 |
| Interest capitalized                              | 0.7                               | 0.7         |                 | 1.3                             | 1.5         |                 |
| Other - net                                       | 0.2                               |             |                 | 0.2                             | (0.1)       |                 |
|   | (3.5)                             | (2.3)       |                 | (7.2)                           | (3.6)       |                 |
| <b>Income (Loss) Before Income Tax</b>            | <b>\$ 12.6</b>                    | \$ (4.9)    |                 | <b>\$ (4.6)</b>                 | \$ (14.1)   |                 |
| <b>Combined Operating Statistics: (a)</b>         |                                   |             |                 |                                 |             |                 |
| Revenue passengers (000)                          | 1,913                             | 1,909       | 0.2             | 3,765                           | 3,518       | 7.0             |
| RPMs (000,000) traffic                            | 695                               | 731         | (4.9)           | 1,353                           | 1,358       | (0.4)           |
| ASMs (000,000) capacity                           | 944                               | 973         | (3.0)           | 1,886                           | 1,898       | (0.6)           |
| Passenger load factor                             | 73.6%                             | 75.1%       | (1.5)pts        | 71.7%                           | 71.5%       | 0.2pts          |
| Yield per passenger mile                          | 26.82¢                            | 24.04¢      | 11.6            | 26.64¢                          | 24.68¢      | 8.0             |
| Operating revenue per ASM (RASM)                  | 20.01¢                            | 18.29¢      | 9.4             | 19.41¢                          | 17.89¢      | 8.5             |
| Passenger revenue per ASM                         | 19.75¢                            | 18.06¢      | 9.3             | 19.11¢                          | 17.66¢      | 8.3             |
| Operating expenses per ASM                        | 18.31¢                            | 18.56¢      | (1.4)           | 19.27¢                          | 18.45¢      | 4.5             |
| Aircraft fuel per ASM                             | 3.26¢                             | 3.53¢       | (7.5)           | 4.19¢                           | 3.26¢       | 28.6            |
| CRJ-700 fleet transition costs per ASM            | 0.65¢                             | 0.00¢       | NM              | 0.32¢                           | 0.00¢       | NM              |
| Q200 fleet transition costs per ASM               | 0.34¢                             | 0.38¢       | NM              | 0.48¢                           | 0.35¢       | NM              |

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|  |         |         |        |         |         |        |
|--|---------|---------|--------|---------|---------|--------|
| Aircraft fuel cost per gallon                    | \$ 1.79 | \$ 2.23 | (19.7) | \$ 2.27 | \$ 2.06 | 10.2   |
| Economic fuel cost per gallon                    | \$ 3.33 | \$ 2.21 | 50.7   | \$ 3.05 | \$ 2.11 | 44.5   |
| Fuel gallons (000,000)                           | 17.2    | 15.4    | 11.7   | 34.9    | 30.0    | 16.3   |
| Average number of full-time equivalent employees | 3,792   | 3,869   | (2.0)  | 3,822   | 3,841   | (0.5)  |
| Aircraft utilization (blk hrs/day)               | 8.5     | 8.5     |        | 8.4     | 8.6     | (2.3)  |
| Operating fleet at period-end                    | 65      | 74      | (9a/c) | 65      | 74      | (9a/c) |

NM = Not Meaningful

- (a) Represents combined information for Horizon flights operated under Capacity Purchase Agreements (CPAs) with Alaska and as Frontier Jet Express (through November 2007). See pages 31 and 39 for additional line of business information.

**Table of Contents****ALASKA AIRLINES**

Alaska reported income before income taxes of \$87.3 million during the second quarter of 2008 compared to \$80.9 million in the second quarter of 2007. The \$6.4 million difference between the periods is primarily due to the significant mark-to-market fuel hedging gains during the current quarter stemming from the rise in world oil prices during the quarter and, to a lesser extent, increases in revenue. These were largely offset by higher raw fuel costs, purchased capacity costs, maintenance costs, and MD-80 fleet transition charges.

**ALASKA REVENUES**

Total operating revenues increased \$25.3 million, or 3.2%, during the second quarter of 2008 as compared to the same period in 2007. The changes are summarized in the following table:

| (in millions)                          | Three Months Ended June 30 |          |          |
|--|----------------------------|----------|----------|
|  | 2008                       | 2007     | % Change |
| Passenger revenue - mainline           | \$ 682.7                   | \$ 663.3 | 2.9      |
| Freight and mail                       | 26.6                       | 26.3     | 1.1      |
| Other - net                            | 33.3                       | 34.5     | (3.5)    |
| Total mainline revenues                | \$ 742.6                   | \$ 724.1 | 2.6      |
| Passenger revenue - purchased capacity | 77.8                       | 71.0     | 9.6      |
| Total operating revenues               | \$ 820.4                   | \$ 795.1 | 3.2      |

**Passenger Revenue Mainline**

Mainline passenger revenue increased 2.9% on a 1.6% increase in available seat miles combined with a 1.3% increase in passenger unit revenues. Load factor was relatively flat and yields were 1.8% higher compared to the prior-year period. Our average trip length has increased with the Hawaii service and other longer flights, putting downward pressure on yields and unit revenues. We estimate that the longer stage lengths impacted our quarter-over-quarter unit revenue change by about three points. Our load factor in July 2008 was 79.7%, compared to 83.4% in July 2007. Our advance bookings currently suggest that load factors will be down about one point in August and up three points in September compared to the prior year.

**Passenger Revenue Purchased Capacity**

Passenger revenue purchased capacity increased by \$6.8 million to \$77.8 million because of a 10.6% increase in passenger traffic offset by a 3.3% decline in unit revenues compared to the prior year. Unit revenues decreased due to a 1.9-point decrease in load factor combined with a 0.9% decrease in ticket yields. The Capacity Purchase Arrangement (CPA) with Horizon is the primary driver of the increase in traffic as more markets that were historically flown by Alaska aircraft are shifted to the CPA.

During the second quarter, capacity purchase flying costs exceeded capacity purchase passenger revenues by \$6.7 million, compared to \$3.1 million in the second quarter of 2007. Revenues in these CPA markets are highly seasonal in nature. For example, purchased capacity operating margins by quarter were as follows in 2007:

| (in millions)             | Q1 2007   | Q2 2007  | Q3 2007 | Q4 2007  |
|---------------------------|-----------|----------|---------|----------|
| Purchased capacity margin | \$ (10.1) | \$ (3.1) | \$ 0.6  | \$ (8.8) |

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However, the reported results of purchased capacity flying do not reflect the total contribution of these flights to our mainline operation as many of the flights feed traffic from smaller cities.

***ALASKA EXPENSES***

For the quarter, total operating expenses increased \$14.6 million compared to the same period in 2007. 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:

| Operating Expenses (in millions) | Three Months Ended June 30 |          |          |
|----------------------------------|----------------------------|----------|----------|
|                                  | 2008                       | 2007     | % Change |
| Mainline                         | \$ 644.3                   | \$ 640.1 | 0.7      |
| Purchased capacity costs         | 84.5                       | 74.1     | 14.0     |
| Total operating expenses         | \$ 728.8                   | \$ 714.2 | 2.0      |

***Mainline Operating Expenses***

Total mainline operating costs for the second quarter of 2008 increased by \$4.2 million or 0.7% to \$644.3 million compared to \$640.1 million in the same period of 2007. The increase was primarily due to the \$26.0 million charge associated with the early retirement of two MD-80 aircraft and increases in other operating expenses, offset by a \$42.2 million decline in our reported fuel expense. However, the large increase in the value of hedge portfolio that will benefit future periods masked the massive increase in our economic fuel costs during the quarter. Significant variances from the second quarter of 2008 are described more fully below.

***Variable Incentive Pay***

Variable incentive pay increased \$1.2 million, or 57.1%, to \$3.3 million despite the decline in our operating results as defined by the various incentive plans. The increase is due to higher expenses associated with our Operational Performance Rewards plan, which rewards employees for meeting monthly on-time performance and customer-satisfaction goals, offset by lower net costs associated with our other incentive plans which are largely tied to operating results.

***Aircraft Fuel***

Aircraft fuel expense includes both raw fuel expense (as defined below) plus the effect of mark-to-market adjustments to our portfolio of hedges that will benefit future periods, included in our income statement 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 when the underlying instrument increases or decreases in value as crude oil prices 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.

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Aircraft fuel expense decreased \$42.2 million, or 21.8%, compared to the second quarter of 2007. The elements of the change are illustrated in the following table:

| (in millions, except per-gallon amounts)  | Three Months Ended June 30 |                 |               |
|---|----------------------------|-----------------|---------------|
|   | 2008                       | 2007            | % Change      |
| Fuel gallons consumed   | 86.4                       | 89.8            | (3.8)         |
| Raw price per gallon  | \$ 3.78                    | \$ 2.20         | 71.8          |
| <b>Total raw fuel expense</b>   | <b>\$ 326.6</b>            | <b>\$ 196.9</b> | <b>65.9</b>   |
| Net impact on fuel expense from changes in value of the fuel hedge portfolio (gain) | (175.4)                    | (3.5)           | NM            |
| <b>Aircraft fuel expense, as reported</b>   | <b>\$ 151.2</b>            | <b>\$ 193.4</b> | <b>(21.8)</b> |

Fuel gallons consumed decreased by 3.8% on a 1.6% increase in capacity because of the improved fuel efficiency of our fleet as we continue to transition out of the less-efficient MD-80 aircraft to newer, more-efficient B737-800 aircraft.

The raw fuel price per gallon increased by 71.8% as a result of higher West Coast jet fuel prices driven by significantly higher crude oil costs and a dramatic increase in the refinery margin.

We also evaluate *economic fuel expense*, which we define as *raw fuel expense* less the cash we receive from hedge counterparties for hedges that settle during the period, offset by the premium expense that we recognize. 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 only when they are realized through a cash receipt from our hedge contract counterparties. 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 operation. Accordingly, many industry analysts evaluate our results using this measure, and it is the basis for most internal management reporting and incentive pay plans.

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Our *economic fuel expense* is calculated as follows:

| (in millions, except per-gallon amounts) | Three Months Ended June 30 |                 |             |
|--|----------------------------|-----------------|-------------|
|  | 2008                       | 2007            | % Change    |
| Raw fuel expense                         | \$ 326.6                   | \$ 196.9        | 65.9        |
| Less: cash received from settled hedges  | (46.5)                     | (5.0)           | NM          |
| <b>Economic fuel expense</b>             | <b>\$ 280.1</b>            | <b>\$ 191.9</b> | <b>46.0</b> |
| Fuel gallons consumed                    | <b>86.4</b>                | 89.8            | (3.8)       |
| <b>Economic fuel cost per gallon</b>     | <b>\$ 3.24</b>             | \$ 2.14         | 51.4        |

NM = Not meaningful

The total cash benefit from hedges that settled during the period increased to \$46.5 million in 2008 up from \$5.0 million in 2007. The increase is primarily due to the dramatic increase in the value of the settled contracts as crude oil prices have increased.

We currently expect *economic fuel expense* to be significantly higher for the remainder of 2008 than in 2007 because of higher crude oil prices and refinery margins for jet fuel. We are unable to predict our raw or economic fuel costs because of the significant volatility in the price of crude oil.

*Aircraft Maintenance*

Aircraft maintenance increased by \$2.9 million, or 8.4%, compared to the prior-year quarter primarily because of an increase in the cost of component repair and higher materials costs. Our current expectation is that aircraft maintenance costs will be lower for the balance of 2008 compared to 2007 because of the timing of certain required maintenance events, although the full year is expected to be higher than 2007.

*Contracted Services*

Contracted services increased by \$3.7 million, or 12.3%, compared to the second quarter of 2007 primarily as a result of higher vendor costs in order to help improve our operational performance.

*Selling Expenses*

Selling expenses increased by \$2.6 million, or 7.8%, compared to the second quarter of 2007 as a result of higher advertising costs associated with promoting our West Most schedule, higher Mileage Plan selling costs and higher credit card commissions, offset by lower ticket distribution fees.

*Depreciation and Amortization*

Depreciation and amortization increased \$6.0 million, or 16.9%, compared to the second quarter of 2007. This is primarily due to the additional B737-800 aircraft delivered in 2007 and in the first six months of 2008, partially offset by lower depreciation and amortization expense associated with our MD-80 fleet. We expect depreciation and amortization in 2008 to exceed the 2007 amount by \$24 million to \$28 million because of new aircraft deliveries.

**Table of Contents***Fleet Transition Charges*

In the second quarter of 2008, we retired two MD-80 aircraft and placed them in temporary storage at an aircraft storage facility. These aircraft, along with two other MD-80s, are under long-term lease arrangements. The \$26.0 million charge in the second quarter represents the remaining discounted future lease payments and our estimate of future maintenance costs to meet return requirements under the terms of the lease contracts. We expect a similar charge in the third quarter of 2008 as we retire the remaining two MD-80 aircraft under long-term leases.

*Mainline Unit Costs per Available Seat Mile*

Operating costs per ASM (CASM) is an important metric in the industry and we use it to gauge the effectiveness of our cost-reduction efforts. Our effort to reduce unit cost focuses not only on controlling the actual dollars we spend, but also on the ability to increase our capacity without adding a commensurate amount of cost.

Our mainline operating costs per ASM are summarized below:

|  | <b>Three Months Ended June 30</b> |             |                 |
|--|-----------------------------------|-------------|-----------------|
|  | <b>2008</b>                       | <b>2007</b> | <b>% Change</b> |
| Total mainline operating expenses per ASM (CASM) | <b>10.33¢</b>                     | 10.43¢      | (0.9)           |
| CASM includes the following components:          |                                   |             |                 |
| Aircraft fuel cost per ASM                       | <b>2.42¢</b>                      | 3.15¢       | (23.2)          |
| Fleet transition charges per ASM                 | <b>0.42¢</b>                      |             | NM              |
| NM = Not Meaningful                              |                                   |             |                 |

We have separately listed in the above table our fuel costs and fleet transition charges per ASM. These amounts are included in CASM, but for internal purposes we consistently use unit cost metrics that exclude fuel and certain special items to measure our cost-reduction progress. We believe that such analysis may be important to investors and other readers of these financial statements for the following reasons:

Mainline cost per ASM excluding fuel and certain special items is one of the most important measures used by managements of both Alaska and Horizon and by the Air Group Board of Directors in assessing quarterly and annual cost performance. For Alaska Airlines, these decision-makers evaluate operating results of the mainline operation, which includes the operation of the B737 and MD-80 aircraft fleets branded in Alaska Airlines livery. The revenues and expenses associated with purchased capacity are evaluated separately.

Mainline cost per ASM excluding fuel and fleet transition charges (and other items as specified in our governing documents) is an important metric for the employee incentive plan that covers company management and executives.

By eliminating fuel expense and other special items from our unit cost metrics, we believe that we have better visibility into the results of our non-fuel cost-reduction initiatives. 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.

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Mainline cost per ASM excluding fuel and other special items is a measure commonly used by industry analysts, and we believe it is the basis by which they compare our airlines to others in the industry. The measure is also the subject of frequent questions from investors.

Disclosure of the individual impact of certain noted items provides investors the ability to measure and monitor performance both with and without these special items. We believe that disclosing the impact of certain items such as fleet transition costs and restructuring charges, is important because it provides information on significant items that are not necessarily indicative of future performance. Industry analysts and investors consistently measure the Company's performance without these items for better comparability between periods and among other airlines.

Although we disclose our mainline passenger unit revenues for Alaska, we do not (nor are we able to) evaluate mainline unit revenues excluding the impact that rising fuel costs have had on ticket prices. Economic fuel cost represents approximately 35% of our total mainline operating expenses, excluding fleet transition costs and with fuel stated on an economic basis. Fluctuations in our fuel prices often drive changes in unit revenues in the mid-to-long term. Although we believe it is useful to evaluate non-fuel unit costs for the reasons noted above, we would caution readers of these financial statements not to place undue reliance on unit costs excluding fuel as a measure or predictor of future profitability because of the significant impact of fuel costs on our business.

We currently forecast our mainline costs per ASM excluding fuel for the third quarter and full year of 2008 to be up 3% to 4% and flat, respectively, compared to 2007, although with the recently announced capacity reductions, there will be upward pressure on the full-year unit-cost measure.

### ***Purchased Capacity Costs***

Purchased capacity costs increased \$10.4 million, or 14.0%, from the second quarter of 2007 to \$84.5 million in the second quarter of 2008. Of the total, \$78.7 million was paid to Horizon under the CPA for 374 million ASMs. This expense is eliminated in consolidation. The balance includes amounts paid to a third party for the Dutch Harbor flying (which approximates the amount paid in 2007) and certain administrative and information technology costs borne by Alaska allocated to the purchased capacity flying with Horizon. The increase was primarily due to the 12.3% capacity increase under the Horizon CPA and the increasing cost of fuel.

### **HORIZON AIR**

Horizon reported income before income taxes of \$12.6 million during the second quarter of 2008 compared to a loss of \$4.9 million in 2007. The \$17.5 million increase is primarily due to significant mark-to-market fuel hedging gains during the quarter stemming from the significant rise in world oil prices during the quarter and declines in maintenance and aircraft rent, partially offset by significantly higher raw fuel costs and fleet transition charges associated with the decision to exit the CRJ-700 and Q200 fleets.



**Table of Contents****HORIZON REVENUES**

For the second quarter of 2008, operating revenues increased \$10.9 million, or 6.1%, compared to 2007. Horizon's passenger revenues are summarized in the table below:

| Revenues (in millions) and % of ASMs        | Three Months Ended June 30<br>2008 |           | Three Months Ended June 30<br>2007 |           |
|---|------------------------------------|-----------|------------------------------------|-----------|
|   | Revenues                           | %<br>ASMs | Revenues                           | %<br>ASMs |
| Passenger revenue from Horizon brand flying | \$ 107.7                           | 60        | \$ 96.8                            | 51        |
| Revenue from CPA with Alaska                | 78.7                               | 40        | 68.9                               | 34        |
| Revenue from Frontier JetExpress            |                                    |           | 10.0                               | 15        |
| Total passenger revenue and % of ASMs       | \$ 186.4                           | 100       | \$ 175.7                           | 100       |

Line-of-business information is presented in the table below. In the CPA arrangements, Horizon is insulated from market revenue factors and is guaranteed contractual revenue amounts based on operational capacity. As a result, yield and load factor information for the CPA arrangements are not presented.

|              | Three Months Ended June 30, 2008 |             |                    |                               |        |                               |        |             |        |             |
|--------------|----------------------------------|-------------|--------------------|-------------------------------|--------|-------------------------------|--------|-------------|--------|-------------|
|              | Capacity and Mix                 |             |                    | Load Factor                   |        | Yield                         |        | RASM        |        |             |
|              | Actual<br>(000,000)              | %<br>Change | Current<br>% Total | Point<br>Change<br>Yr-over-Yr | Actual | Point<br>Change<br>Yr-over-Yr | Actual | %<br>Change | Actual | %<br>Change |
| Brand Flying | 570                              | 15.9        | 60%                | 10 pts                        | 71.3%  | (3.3) pts                     | 26.52¢ | 0.3         | 19.34¢ | (4.0)       |
| Alaska CPA   | 374                              | 12.3        | 40%                | 6 pts                         | NM     | NM                            | NM     | NM          | 21.02¢ | 1.6         |
| System Total | 944                              | (3.0)       | 100%               |                               | 73.6%  | (1.5) pts                     | 26.82¢ | 11.6        | 20.01¢ | 9.4         |

System-wide, Horizon's unit revenues increased 9.4%. However, the increase was largely due to the shift in capacity out of Frontier JetExpress flying (which produces relatively low RASM because of the nature of the contract and the longer-haul nature of the flying) to higher RASM brand and Alaska CPA flying.

Horizon brand flying includes those routes in the Horizon system not covered by the Alaska CPA. Horizon controls all scheduling, routes and pricing for the flights, and has the inventory and revenue risk in those markets. Passenger revenue from Horizon brand flying increased \$10.9 million or 11.3% on a 15.9% increase in brand capacity offset by a 4.0% decline in unit revenues. The decline in unit revenues was due to a 3.3-point decline in load factor on relatively flat yield in those markets.

Revenue from the CPA with Alaska totaled \$78.7 million during the second quarter of 2008 compared to \$68.9 million in the second quarter of 2007. The increase is primarily due to a 12.3% increase in capacity provided under this arrangement. Under the CPA, the fee paid by Alaska is based on Horizon's actual operating costs plus a specified margin. This revenue is eliminated in consolidation.

**Table of Contents*****HORIZON EXPENSES***

Total operating expenses decreased \$7.8 million, or 4.3%, as compared to the same period in 2007. Most of this decrease can be attributed to the \$7.7 million decline in maintenance costs and an increase in mark-to-market gains in our fuel hedge portfolio during the second quarter. These declines in expense were offset by rising raw fuel costs and the assimilation of the capacity from the Frontier JetExpress flying into Horizon markets. This resulted in increased fuel costs, station costs, landing fees, and other associated operational costs. Other significant period-over-period changes in the components of operating expenses are as follows:

***Wages and Benefits***

Wages and benefits decreased \$1.6 million, or 3.2%, as a result of a decrease in full-time equivalent employees as we begin to scale back our capacity. We expect to see further year-over-year reductions throughout the remainder of the year.

***Aircraft Fuel***

Aircraft fuel decreased \$3.6 million, or 10.5%, compared to the second quarter of 2007. The elements of the change are illustrated in the following table:

| <b>(in millions, except per-gallon amounts)</b>                                     | <b>Three Months Ended June 30</b> |             |                 |
|---|-----------------------------------|-------------|-----------------|
|   | <b>2008</b>                       | <b>2007</b> | <b>% Change</b> |
| Fuel gallons consumed   | <b>17.2</b>                       | 15.4        | 11.7            |
| Raw price per gallon  | <b>\$ 3.88</b>                    | \$ 2.27     | 70.9            |
| <b>Total raw fuel expense</b>   | <b>\$ 66.7</b>                    | \$ 35.0     | 90.6            |
| Net impact on fuel expense from changes in value of the fuel hedge portfolio (gain) | <b>(35.9)</b>                     | (0.6)       | NM              |
| <b>Aircraft fuel expense</b>  | <b>\$ 30.8</b>                    | \$ 34.4     | (10.5)          |

The 11.7% increase in gallons consumed is primarily a function of the elimination of Frontier JetExpress flying. As those aircraft were redeployed into the Horizon fleet, Horizon now purchases the fuel, whereas under the JetExpress arrangement, fuel was purchased by Frontier. We expect to see similar year-over-year increases in the number of gallons consumed for the same reason. Offsetting these increases in fuel consumption is the improved fuel efficiency of our fleet resulting from new Q400 aircraft deliveries. These more fuel-efficient aircraft have helped to improve the overall fuel-burn rate per ASM by approximately 10% from the second quarter of 2007.

The raw fuel price per gallon increased by 70.9 % as a result of higher West Coast jet fuel prices driven by higher crude oil costs.

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Our *economic fuel expense* is calculated as follows:

| (in millions, except per-gallon amounts) | Three Months Ended June 30 |                |             |
|--|----------------------------|----------------|-------------|
|  | 2008                       | 2007           | % Change    |
| Raw fuel expense                         | \$ 66.7                    | \$ 35.0        | 90.6        |
| Less: cash received from settled hedges  | (9.5)                      | (0.9)          | NM          |
| <b>Economic fuel expense</b>             | <b>\$ 57.2</b>             | <b>\$ 34.1</b> | <b>67.7</b> |
| Fuel gallons consumed                    | 17.2                       | 15.4           | 11.7        |
| <b>Economic fuel cost per gallon</b>     | <b>\$ 3.33</b>             | <b>\$ 2.21</b> | <b>50.7</b> |

NM = Not meaningful

The total cash benefit from hedges that settled during the period increased to \$9.5 million in 2008 from \$0.9 million in 2007.

We currently expect *economic fuel expense* to be higher for the full year of 2008 than in 2007 because of higher crude oil prices and refinery margins for jet fuel.

*Aircraft Maintenance*

Aircraft maintenance expense decreased \$7.7 million, or 31.4%, primarily as a result of fewer scheduled maintenance events. The second quarter of 2007 had a higher number of CRJ-700 and Q400 engine events than average. Additionally, we have seen savings from increased efficiencies in our processes, particularly in line maintenance and shops. We expect maintenance expense will be approximately \$20 million to \$25 million lower for all of 2008 compared to 2007.

*Aircraft Rent*

Aircraft rent decreased \$2.4 million, or 14.3%, as a result of the transition of 16 leased Q200 aircraft to a third party over the past 18 months.

*Depreciation and Amortization*

Depreciation and amortization increased \$1.7 million, or 21.5%, as a result of the new Q400s purchased in 2007 and 2008. Additionally, we recorded higher depreciation expense on our CRJ-700 spare parts since we now intend to phase out those aircraft earlier than originally expected.

*Fleet Transition Costs*

Fleet transition costs associated with the sublease of Q200 aircraft were \$2.9 million during the second quarter of 2008 compared to \$3.7 million in the same period of 2007. As of the end of second quarter, all 16 of the Q200 aircraft under the existing sublease arrangement have been delivered by us to the third-party carrier. We also recorded a \$0.3 million charge associated with one additional Q200 that was removed from operating service in June 2008.

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Additionally, during the second quarter, as a result of the Board's decision to retire the CRJ-700 fleet earlier than expected, we recorded a \$5.5 million impairment charge associated with the two owned CRJ-700 aircraft and related spare parts and a \$0.6 million severance charge related to a reduction in work force. We anticipate having further charges in the future as we retire the remaining 18 leased CRJ-700 aircraft.

*Operating Costs per Available Seat Mile (CASM)*

As discussed above, CASM is an important metric in the industry and we use it to gauge the effectiveness of our cost-reduction efforts. As at Alaska, Horizon's efforts to reduce unit cost focuses not only on controlling the actual dollars spent, but also on increasing available seat miles without adding a commensurate amount of cost. We intend to increase capacity primarily through larger-gauge aircraft as we replace aging Q200 aircraft with larger Q400 aircraft. However, we do expect a reduction of capacity in 2008 as noted previously, which puts upward pressure on our unit costs.

Our operating costs per ASM are summarized below:

|   | <b>Three Months Ended June 30</b> |             |                 |
|---|-----------------------------------|-------------|-----------------|
|   | <b>2008</b>                       | <b>2007</b> | <b>% Change</b> |
| Total operating expenses per ASM (CASM) | <b>18.31¢</b>                     | 18.56¢      | (1.4)           |
| CASM includes the following components: |                                   |             |                 |
| Aircraft fuel cost per ASM              | <b>3.26¢</b>                      | 3.53¢       | (7.5)           |
| Fleet transition costs per ASM          | <b>0.99¢</b>                      | 0.38¢       | 160.5           |

We currently forecast our costs per ASM excluding fuel and fleet transition costs for the third quarter and full year of 2008 to be up about 10% to 11% and 1% to 2%, respectively, compared to 2007.

**Consolidated Nonoperating Income (Expense)**

Net nonoperating expense was \$8.3 million in the second quarter of 2008 compared to \$2.7 million for the same period of 2007. Interest income decreased \$3.3 million compared to the second quarter of 2007 primarily as a result of lower average portfolio returns. Interest expense increased \$2.5 million primarily resulting from new debt arrangements in the second half of 2007 and the first half of 2008, partially offset by lower interest rates on our variable-rate debt. Capitalized interest decreased \$0.6 million from \$6.7 million in the second quarter of 2007 to \$6.1 million in the second quarter of 2008. This decrease is due to the decline in pre-delivery deposits made in connection with aircraft orders.

**Consolidated Income Tax Expense (Benefit)**

See discussion below under Comparison of Six Months Ended June 30, 2008 to Six Months Ended June 30, 2007.

**COMPARISON OF SIX MONTHS ENDED JUNE 30, 2008 TO SIX MONTHS ENDED JUNE 30, 2007**

Our consolidated net income for the six months ended June 30, 2008 was \$27.2 million, or \$0.74 per diluted share, compared to net income in 2007 of \$35.8 million, or \$0.88 per diluted share. Both periods include adjustments to reflect timing of gain and loss recognition resulting from mark-to-market fuel hedge accounting.

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For the first six months of 2008, we recognized net mark-to-market gains of \$156.0 million (\$97.7 million after tax, or \$2.65 per share), compared to net gains of \$7.0 million (\$4.4 million after tax, or \$0.11 per share) in the same period of 2007. The first six months of 2008 also include fleet transition costs of \$32.1 million (\$20.1 million after tax, or \$0.54 per share) related to the ongoing transitions out of the MD-80 and CRJ-700 fleets.

**ALASKA AIRLINES**

Alaska reported income before income taxes of \$49.4 million during the first six months of 2008 compared to \$73.4 million in the first six months of 2007. Similar to the quarter discussion, the \$24.0 million difference between the periods is due primarily to the significant mark-to-market fuel hedging gains during the quarter stemming from the rise in world oil prices during the year and, to a lesser extent, increases in revenue. These were largely offset by higher raw fuel costs, purchased capacity costs, maintenance costs, and MD-80 fleet transition charges.

**ALASKA REVENUES**

Total operating revenues increased \$98.9 million, or 6.8%, during the first six months of 2008 as compared to the same period in 2007. The changes are summarized in the following table:

| (in millions)                          | Six Months Ended June 30 |            |          |
|--|--------------------------|------------|----------|
|  | 2008                     | 2007       | % Change |
| Passenger revenue - mainline           | \$ 1,290.0               | \$ 1,209.2 | 6.7      |
| Freight and mail                       | 47.9                     | 47.0       | 1.9      |
| Other - net                            | 67.7                     | 70.4       | (3.8)    |
| Total mainline revenues                | \$ 1,405.6               | \$ 1,326.6 | 6.0      |
| Passenger revenue - purchased capacity | 148.2                    | 128.3      | 15.5     |
| Total operating revenues               | \$ 1,553.8               | \$ 1,454.9 | 6.8      |

**Operating Revenues - Mainline**

Mainline passenger revenue for the first six months increased 6.7% on a 4.1% increase in available seat miles. There was a 2.5% increase in passenger revenues per available seat mile (PRASM), with a load factor increase of 1.2 pts over the first six months of 2007. The year-over-year yield was nearly flat for the six-month period.

Other net revenue declined by \$2.7 million, or 3.8%, from the first six months of 2007 resulting from higher costs associated with redemptions of Mileage Plan tickets on other airlines. Offsetting the decline was an increase in Mileage Plan commission revenues as there was an increase in the sale of mileage credits to our bank partner.

**Passenger Revenue - Purchased Capacity**

Passenger revenue - purchased capacity flying increased by \$19.9 million over the same period last year because of a 15.4% increase in passenger traffic combined with a 1.3% increase in unit revenues compared to the prior year. Unit revenues increased due to a 0.9-point increase in load factor on relatively flat ticket yields. The Capacity Purchase Arrangement (CPA) with Horizon is the primary driver of the increase as more markets that were historically flown by Alaska aircraft are shifted to the CPA.

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During the six months ended June 30, 2008, purchased capacity flying costs exceeded purchased capacity passenger revenues by \$13.0 million. However, the reported results of purchased capacity flying do not reflect the total contribution of these flights to our mainline operation as many of the flights feed traffic from smaller cities.

**ALASKA EXPENSES**

For the six months ended June 30, 2008, total operating expenses increased \$114.3 million or 8.3% compared to the same period in 2007 as a result of a higher mainline operating costs, most notably aircraft fuel and fleet transition charges. 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:

| Operating Expenses (in millions) | Six Months Ended June 30 |            |          |
|----------------------------------|--------------------------|------------|----------|
|                                  | 2008                     | 2007       | % Change |
| Mainline                         | \$ 1,336.5               | \$ 1,241.9 | 7.6      |
| Purchased capacity costs         | 161.2                    | 141.5      | NM       |
| Total operating expenses         | \$ 1,497.7               | \$ 1,383.4 | 8.3      |

NM = Not Meaningful

**Mainline Operating Expenses**

Total mainline operating expenses increased \$94.6 million or 7.6% during the first six months of 2008 compared to the same period last year. The increases were primarily due to the \$33.9 million increase in aircraft fuel (which includes substantial mark-to-market gains that masked a much larger increase in the net cash, or economic cost of fuel), increases in maintenance costs, contracted services, depreciation and the \$26.0 million of fleet transition costs. Significant operating expense increases are more fully described below.

**Variable Incentive Pay**

Variable incentive pay for the first six months of 2008 declined \$3.9 million or 39.8%, compared to same period in 2007. The decrease results from lower expected annual payouts under the various Air Group profit-based incentive plans which are largely tied to operating results, offset by higher expenses associated with our Operational Performance Rewards plan.

**Aircraft Fuel**

Aircraft fuel expense increased \$33.9 million, or 9.7%, compared to the first six months of 2007. The elements of the change are illustrated in the following table:

| (in millions, except per-gallon amounts)  | Six Months Ended June 30 |          |          |
|---|--------------------------|----------|----------|
|   | 2008                     | 2007     | % Change |
| Fuel gallons consumed   | 172.3                    | 173.9    | (0.9)    |
| Raw price per gallon  | \$ 3.39                  | \$ 2.09  | 62.2     |
| Total raw fuel expense  | \$ 584.3                 | \$ 362.8 | 61.1     |
| Net impact on fuel expense from changes in value of the fuel hedge portfolio (gain) | (199.4)                  | (11.8)   | NM       |
| Aircraft fuel expense   | \$ 384.9                 | \$ 351.0 | 9.7      |

NM = Not Meaningful



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Fuel gallons were relatively flat in comparison to the same time period in 2007 on a 4.1% increase in capacity because of the improved fuel efficiency of our fleet of newer more fuel-efficient B737-800 aircraft.

The raw fuel price per gallon increased by 62.2% as a result of higher West Coast jet fuel prices driven by higher crude oil costs and refinery margins.

Our *economic fuel expense* is calculated as follows:

| (in millions, except per-gallon amounts) | Six Months Ended June 30 |                 |             |
|--|--------------------------|-----------------|-------------|
|  | 2008                     | 2007            | % Change    |
| Raw fuel expense                         | \$ 584.3                 | \$ 362.8        | 61.1        |
| Less: cash received from settled hedges  | (70.7)                   | (6.5)           | NM          |
| <b>Economic fuel expense</b>             | <b>\$ 513.6</b>          | <b>\$ 356.3</b> | <b>44.1</b> |
| Fuel gallons consumed                    | 172.3                    | 173.9           | (0.9)       |
| <b>Economic fuel cost per gallon</b>     | <b>\$ 2.98</b>           | <b>\$ 2.05</b>  | <b>45.4</b> |

NM = Not meaningful

The total cash benefit from hedges that settled during the period increased to \$70.7 million in 2008 up from \$6.5 million in 2007. The increase is primarily due to the dramatic increase in the value of the settled contracts as crude oil prices have increased.

*Aircraft Maintenance*

Aircraft maintenance increased by \$10.7 million, or 15.6%, during the first six months of 2008, compared to the same period in the prior year due to an increase in the number of engine and airframe events and higher component repair and materials costs.

*Depreciation and Amortization*

Depreciation and amortization increased \$9.4 million, or 13.2%, compared to the first six months of 2007. This is primarily the result of 14 new B737-800 aircraft delivered in 2007 and six new B737-800 aircraft delivered in the first six months of 2008.

*Fleet Transition Charges*

In the second quarter of 2008, we retired two MD-80 aircraft and placed them in temporary storage at an aircraft storage facility. These aircraft, along with two other MD-80s, are under long-term lease arrangements. The \$26.0 million charge in the second quarter represents the remaining lease payments under the lease contract and our estimate of maintenance costs that will be incurred in the future to meet the minimum return conditions under the lease requirements. We expect a similar charge in the third quarter of 2008 as we retire the remaining two MD-80 aircraft under long-term leases.

*Other Expenses*

Other expenses increased \$6.2 million, or 7.5% compared to the first six months of 2007. The increase is primarily attributable to higher personnel and crew costs, property taxes, and supplies.



**Table of Contents***Mainline Unit Costs per Available Seat Mile*

Our mainline operating costs per ASM are summarized below:

|  | Six Months Ended June 30 |        |          |
|--|--------------------------|--------|----------|
|  | 2008                     | 2007   | % Change |
| Total mainline operating expenses per ASM (CASM) | 10.85¢                   | 10.49¢ | 3.4      |
| CASM includes the following components:          |                          |        |          |
| Aircraft fuel cost per ASM                       | 3.13¢                    | 2.96¢  | 5.6      |
| Fleet transition charges per ASM                 | 0.21¢                    |        | NM       |
| NM = Not Meaningful                              |                          |        |          |

*Purchased Capacity Costs*

Purchased capacity costs increased \$19.7 million, from \$141.5 million for the first six months of 2007 to \$161.2 million for the six months ended June 30, 2008. Of the total, \$150.1 million was paid to Horizon under the CPA for 718 million ASMs. This expense is eliminated in consolidation. The balance includes amounts paid to a third party for the Dutch Harbor flying and certain administrative and information technology costs borne by Alaska allocated to the purchased capacity flying with Horizon.

**HORIZON AIR**

Horizon reported a loss before income taxes of \$4.6 million during the first six months of 2008 compared to a loss of \$14.1 million in 2007. The \$9.5 million improvement is primarily due to significant mark-to-market fuel hedging gains during the quarter stemming from the significant rise in world oil prices during the quarter and declines in maintenance and aircraft rent, partially offset by significantly higher raw fuel costs and fleet transition charges associated with the decision to exit the CRJ-700 and Q200 fleets.

**Horizon Air Revenues**

During the six months ended June 30, 2008, operating revenues increased \$26.5 million, or 7.8%, compared to 2007. Horizon's passenger revenues are summarized in the table below:

| Revenues (in millions) and % of ASMs        | Six Months Ended June 30 |        |          |        |
|---|--------------------------|--------|----------|--------|
|   | 2008                     |        | 2007     |        |
|   | Revenues                 | % ASMs | Revenues | % ASMs |
| Passenger revenue from Horizon brand flying | \$ 210.4                 | 62     | \$ 183.7 | 50     |
| Revenue from CPA with Alaska                | 150.1                    | 38     | 131.2    | 33     |
| Revenue from Frontier JetExpress            |                          |        | 20.2     | 17     |
| Total Passenger revenue and % of ASMs       | \$ 360.5                 | 100    | \$ 335.1 | 100    |

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Line-of-business information is presented in the table below. In the CPA arrangement, Horizon is insulated from market revenue factors and is guaranteed contractual revenue amounts based on operational capacity. As a result, yield and load factor information is not presented.

|              | Six Months Ended June 30, 2008 |             |                    |                            |              |                 |            |               |             |               |             |
|--------------|--------------------------------|-------------|--------------------|----------------------------|--------------|-----------------|------------|---------------|-------------|---------------|-------------|
|              | Capacity and Mix               |             |                    |                            | Load Factor  |                 |            | Yield         |             | RASM          |             |
|              | Actual<br>(000,000)            | %<br>Change | Current<br>% Total | Point Change<br>Yr-over-Yr | Actual       | Point<br>Change | Yr-over-Yr | Actual        | %<br>Change | Actual        | %<br>Change |
| Brand Flying | <b>1,168</b>                   | 22.3        | <b>62%</b>         | 12 pts                     | <b>69.2%</b> |                 | (1.7) pts  | <b>26.04¢</b> | (3.9)       | <b>18.50¢</b> | (6.1)       |
| Alaska CPA   | <b>718</b>                     | 14.0        | <b>38%</b>         | 5 pts                      | <b>NM</b>    |                 | NM         | <b>NM</b>     | NM          | <b>20.89¢</b> | 0.4         |
| System Total | <b>1,886</b>                   | (0.6)       | <b>100%</b>        |                            | <b>71.7%</b> |                 | 0.2 pts    | <b>26.64¢</b> | 8.0         | <b>19.41¢</b> | 8.5         |

NM = Not Meaningful

System-wide, Horizon's unit revenues increased 8.5%. However, the increase was largely due to the shift in capacity out of Frontier JetExpress flying (which produces relatively low RASM because of the nature of the contract and the longer-haul nature of the flying) to higher RASM brand and Alaska CPA flying.

Horizon brand flying includes those routes in the Horizon system not covered by the Alaska CPA. Horizon has the inventory and revenue risk in those markets. Passenger revenue from Horizon brand flying increased \$26.7 million, or 14.5%, on a 22.3% increase in brand capacity, offset by a decline of 6.1% in unit revenues. The decline in unit revenues was due to a 1.7-point reduction in load factor, from 70.9% in the first six months of 2007 to 69.2% in the first six months of 2008, along with a 3.9% decline in yield in those markets.

Revenue from the CPA with Alaska totaled \$150.1 million during the first six months of 2008 compared to \$131.2 during the same period in 2007. The increase is primarily due to a 14% increase in capacity provided under this arrangement. Under the CPA, the fee paid by Alaska is based on Horizon's actual operating costs plus a specified margin. This revenue is eliminated in consolidation.

**HORIZON EXPENSES**

Total operating expenses increased \$13.4 million, or 3.8%, as compared to the same period in 2007. Significant period-over-period changes in the components of operating expenses are as follows.

**Table of Contents***Aircraft Fuel*

Aircraft fuel increased \$17.4 million, or 28.2%, compared to the same period in 2007. The elements of the change are illustrated in the following table:

| (in millions, except per-gallon amounts)  | Six Months Ended June 30 |         |          |
|---|--------------------------|---------|----------|
|   | 2008                     | 2007    | % Change |
| Fuel gallons consumed   | <b>34.9</b>              | 30.0    | 16.3     |
| Raw price per gallon  | <b>\$ 3.46</b>           | \$ 2.15 | 60.9     |
| <b>Total raw fuel expense</b>   | <b>\$ 120.9</b>          | \$ 64.6 | 87.2     |
| Impact on fuel expense from changes in value of the fuel hedge portfolio (gain) | <b>(41.8)</b>            | (2.9)   | NM       |
| <b>Aircraft fuel expense</b>  | <b>\$ 79.1</b>           | \$ 61.7 | 28.2     |

NM = Not Meaningful

The 16.3% increase in gallons consumed is primarily a function of the elimination of Frontier JetExpress flying. As those aircraft were redeployed into the Horizon fleet, Horizon began purchasing the fuel, whereas under the JetExpress arrangement, fuel was purchased by Frontier. Offsetting these increases in fuel consumption is the improved fuel efficiency of our fleet resulting from new Q400 aircraft deliveries. These more fuel-efficient aircraft have helped to improve the overall fuel-burn rate per ASM by approximately 11% from the first six months of 2007.

The raw fuel price per gallon increased by 60.9% as a result of higher West Coast jet fuel prices driven by higher crude oil costs.

Our *economic fuel expense* is calculated as follows:

| (in millions, except per-gallon amounts) | Six Months Ended June30 |         |          |
|--|-------------------------|---------|----------|
|  | 2008                    | 2007    | % Change |
| Raw fuel expense                         | <b>\$ 120.9</b>         | \$ 64.6 | 87.2     |
| Less: cash received from settled hedges  | <b>(14.5)</b>           | (1.2)   | NM       |
| <b>Economic fuel expense</b>             | <b>\$ 106.4</b>         | \$ 63.4 | 67.8     |
| Fuel gallons consumed                    | <b>34.9</b>             | 30.0    | 16.3     |
| <b>Economic fuel cost per gallon</b>     | <b>\$ 3.05</b>          | \$ 2.11 | 44.5     |

NM = Not meaningful

The total cash benefit from hedges that settled during the period increased to \$14.5 million in 2008 from \$1.2 million in 2007.

**Table of Contents***Aircraft Maintenance*

Aircraft maintenance expense decreased \$16.0 million, or 32.9%, primarily as a result of fewer scheduled maintenance events.

*Aircraft Rent*

Aircraft rent expense decreased \$4.0 million or 11.8% due to the sublease of the Q200 aircraft.

*Depreciation and Amortization*

Depreciation and amortization increased as a result of the new Q400 aircraft delivered in 2007 and 2008 and the acceleration of depreciation on CRJ-700 and Q200 parts as we expect to cease flying those aircraft by the end of 2009 and October 2008, respectively.

*Fleet Transition Charges*

Fleet transition costs associated with the sublease of Q200 aircraft were \$8.7 million during the first six months of 2008 compared to \$6.7 million in the same period of 2007. As of the end of second quarter, all 16 of the Q200 aircraft under the existing sublease arrangement have been delivered. We also recorded a \$0.3 million charge associated with one additional Q200 that was removed from operating service in June.

Additionally, during the first six months of 2008, as a result of the Board's decision to retire the CRJ-700 fleet earlier than expected, we recorded a \$5.5 million impairment charge associated with the two owned CRJ-700 aircraft and related spare parts and a \$0.6 million severance charge related to a reduction in work force. We anticipate having further charges in the future as we retire the remaining 18 leased CRJ-700 aircraft.

*Operating Costs per Available Seat Mile (CASM)*

Our operating costs per ASM are summarized below:

|   | Six Months Ended June 30 |        |          |
|---|--------------------------|--------|----------|
|   | 2008                     | 2007   | % Change |
| Total operating expenses per ASM (CASM) | 19.27¢                   | 18.45¢ | 4.5      |
| CASM includes the following components: |                          |        |          |
| Aircraft fuel cost per ASM              | 4.19¢                    | 3.26¢  | 28.6     |
| Fleet transition costs per ASM          | 0.80¢                    | 0.35¢  | NM       |
| NM = Not Meaningful                     |                          |        |          |

**Consolidated Nonoperating Income (Expense)**

Net nonoperating expense was \$14.7 million in the first six months of 2008 compared to \$2.4 million in the same period of 2007. The reasons for the changes to the components of nonoperating expense are consistent with those in the three-month discussion.

**Consolidated Income Tax Expense (Benefit)**

We provide for income taxes each quarter based on either our estimate of the effective tax rate for the full year or the actual year-to-date effective tax rate if it is our best estimate of our annual rate. For the first six months of 2008, we used the estimated income tax rate based on our current full-year estimate of pre-tax earnings.

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Our effective income tax rate on the pre-tax income for the first six months of 2008 was 35.4%, compared to 37.4% for the first six months of 2007. In arriving at this rate, we considered a variety of factors, including our full-year forecasted pre-tax results, the U.S. federal rate of 35%, estimated full-year nondeductible expenses and estimated state income taxes. The effective rate for the first six months of 2007 was positively impacted by a \$1.7 million credit that resulted from a favorable impact of a state income tax matter. Excluding this benefit, our effective tax rate would have been approximately 40% for the 2007 period.

We evaluate our tax rate each quarter and make adjustments when necessary. Our final effective tax rate for the full year is highly dependent on the level of pre-tax income or loss and the magnitude of any nondeductible expenses in relation to that pre-tax amount.

**CRITICAL ACCOUNTING ESTIMATES**

For information on our critical accounting estimates, see Item 7 of our Annual Report on Form 10-K for the year ended December 31, 2007.

**LIQUIDITY AND CAPITAL RESOURCES**

Because of the current economic environment and the state of the airline industry, we have a significant focus on preserving our liquidity position and maintaining, or even increasing, our cash and marketable securities position. In addition to the bank line-of-credit and pre-delivery payment facilities described below, other sources of liquidity may include financing other assets such as the 11 unencumbered aircraft in our fleet, aircraft parts, or receivables or a forward sale of mileage credits to our bank partner. We believe that our current cash and marketable securities combined with future cash flows from operations and other sources of liquidity will fund our operations for the foreseeable future.

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

|   | June 30, 2008   | December 31, 2007 | Change   |
|---|---|-------------------|----------|
|   | (In millions, except per share and debt-to-capital amounts) |                   |          |
| Cash and marketable securities  | \$ 1,006.0  | \$ 822.8          | \$ 183.2 |
| Long-term debt, net of current portion  | 1,444.9   | 1,124.6           | 320.3    |
| Shareholders' equity  | 1,010.2   | 1,024.0           | (13.8)   |
| Long-term debt-to-capital assuming aircraft operating leases are capitalized at seven times annualized rent | 72%:28%   | 70%:30%           | NA       |

During the six months ended June 30, 2008 our cash and marketable securities increased \$183.2 million to \$1.0 billion. The following discussion summarizes the primary drivers of the increase and our expectation of future cash requirements.

**Table of Contents***Cash Provided by Operating Activities*

During the first six months of 2008, net cash provided by operating activities was \$104.1 million, compared to \$267.2 million generated during the same period of 2007. The \$163.1 million reduction in our operating cash flow was driven by significantly higher economic fuel costs, which approximates the actual cash spent on fuel. Air Group's total economic fuel expense increased 48%, or \$200 million, to \$620 million in the first six months of 2008 compared to 2007. We expect similar year-over-year declines in our cash flow provided by operating activities throughout the remainder of the year, although the amount of the decline is substantially dependent on the cost of jet fuel and our ability to increase revenues.

*Cash Used in Investing Activities*

Cash used in investing activities was \$488.7 million during the first six months of 2008, compared to \$478.0 million during the same period of 2007. Our capital expenditures were lower as we purchased six B737-800s and one Q400 during the first six months of 2008 compared to seven B737-800s and 11 Q400s in the first six months of 2007. Additionally, we had net purchases of marketable securities of \$211.5 million during the 2008 period.

We currently expect capital expenditures for 2008 to be as follows (in millions):

|                        | Aircraft-<br>related | Non-aircraft | Total         |
|------------------------|----------------------|--------------|---------------|
| Alaska                 | \$ 390               | \$ 75        | \$ 465        |
| Horizon                | 100                  | 5            | 105           |
| <b>Total Air Group</b> | <b>\$ 490</b>        | <b>\$ 80</b> | <b>\$ 570</b> |

*Cash Provided by Financing Activities*

Net cash provided by financing activities was \$359.4 million during the first six months of 2008 compared to \$138.3 million during the same period of 2007. We obtained debt financing for six B737-800s and 13 Q400s during the period. We also borrowed \$140.9 million on our pre-delivery payment facility during the year. Offsetting the borrowings were \$123.9 million of debt payments and the repurchase of \$48.9 million of our common stock as part of our stock repurchase program.

We plan to meet our significant capital and operating commitments through internally generated funds from operations and cash and marketable securities on hand, along with additional debt financing and proceeds from our pre-delivery payment facility.

*Bank Line-of-Credit Facility*

Alaska has a \$185 million variable-rate credit facility that expires in March 2010. As of June 30, 2008, there are no outstanding borrowings on this credit facility and the Company has no immediate plans to borrow using this facility. This credit facility contains contractual restrictions and requires maintenance of certain financial ratios, including a fixed-charge coverage ratio. Based on our current forecast, we estimate that as of the end of the third quarter, we will not meet the required minimum fixed-charge coverage ratio. We are currently evaluating remedies to this potential covenant breach and believe that it is likely that we will be able to obtain a waiver of, or modification to, this covenant.

*Pre-delivery Payment Facility*

Alaska's \$172 million variable-rate revolving loan facility is available to provide a portion of the pre-delivery funding requirements of Alaska's purchase of new Boeing 737-800 aircraft under the current aircraft purchase agreement. The maximum available amount is reduced to \$152 million beginning in August 2009.

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The facility expires on August 31, 2011. The interest rate is based on one-month LIBOR plus a specified margin. Any borrowings will be secured by Alaska's rights under the Boeing purchase agreement. The principal amounts outstanding on the facility relate to specified aircraft and will be repaid at the time that Alaska takes delivery of the aircraft, if not sooner. As of June 30, 2008, \$147.3 million was outstanding under this facility.

**Contractual Obligations, Commitments and Off-Balance Sheet Arrangements***Aircraft Purchase Commitments*

At June 30, 2008, we had firm orders for 39 aircraft requiring aggregate payments of approximately \$818 million, as set forth below. In addition, Alaska has options to acquire 45 additional B737-800s and Horizon has options to acquire 20 Q400s. Alaska and Horizon expect to finance the firm orders and, to the extent exercised, the option aircraft through operating lease arrangements, long-term debt or internally generated cash.

During the first six months of 2008, Alaska took delivery of six owned B737-800 aircraft, all of which were paid for with cash on hand; then two of these six aircraft were financed with a fixed-rate debt arrangement subsequent to the delivery. Two more of these aircraft were financed subsequent to June 30, 2008. Alaska also financed four of the 2007 deliveries during the first six months of 2008 with fixed-rate debt arrangements. Additionally, Alaska took delivery of one B737-800 aircraft under an operating lease arrangement.

The following table summarizes aircraft purchase commitments as of June 30, 2008 and payments by year:

Delivery Period Firm Orders

| Aircraft            | July 1 December 31, |           |          |          |  | Total     |
|---------------------|---------------------|-----------|----------|----------|--|-----------|
|                     | 2008                | 2009      | 2010     | 2011     |  |           |
| Boeing 737-800      | 10                  | 6         | 6        | 3        |  | 25        |
| Bombardier Q400     | 3                   | 11        |          |          |  | 14        |
| <b>Total</b>        | <b>13</b>           | <b>17</b> | <b>6</b> | <b>3</b> |  | <b>39</b> |
| Payments (Millions) | \$ 261.2            | \$ 354.0  | \$ 157.9 | \$ 44.9  |  | \$ 818.0  |

The 2008 deliveries of B737-800 aircraft are more heavily weighted toward the last six months of the year. The Q400 deliveries are expected in the fourth quarter of 2008. Financing for six more B737-800 aircraft is expected to close in 2008. We expect to arrange debt financing for the majority of our future aircraft deliveries. Our agreements with Boeing and Bombardier provide us with flexibility to adjust aircraft deliveries in the future should we wish to revise our fleet plans.

**Table of Contents***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, 2008. This table excludes contributions to our various pension plans, which we could be approximately \$50 million to \$75 million per year through 2012 based on our current funding policy.

| (in millions)   | July 1    | December 31, |                 | 2010            | 2011            | 2012            | Beyond            | Total             |
|---|-----------|--------------|-----------------|-----------------|-----------------|-----------------|-------------------|-------------------|
|   | 2008      | 2008         | 2009            |                 |                 |                 | 2013              |                   |
| Current and long-term debt obligations                              | \$        | 56.6         | \$ 117.9        | \$ 124.6        | \$ 158.8        | \$ 202.3        | \$ 899.6          | \$ 1,559.8        |
| Current and long-term portions of the pre-delivery payment facility |           | 147.3        |                 |                 |                 |                 |                   | 147.3             |
| Operating lease commitments (1)                                     |           | 84.6         | 233.9           | 219.3           | 180.8           | 181.4           | 524.6             | 1,424.6           |
| Aircraft purchase commitments                                       |           | 261.2        | 354.0           | 157.9           | 44.9            |                 |                   | 818.0             |
| Interest obligations (2)  |           | 47.9         | 89.0            | 81.5            | 73.6            | 63.2            | 199.9             | 555.1             |
| Other purchase obligations (3) (4)                                  |           | 13.7         | 30.0            | 30.3            | 30.6            | 30.9            | 62.7              | 198.2             |
| <b>Total</b>  | <b>\$</b> | <b>611.3</b> | <b>\$ 824.8</b> | <b>\$ 613.6</b> | <b>\$ 488.7</b> | <b>\$ 477.8</b> | <b>\$ 1,686.8</b> | <b>\$ 4,703.0</b> |

- (1) Operating lease commitments generally include aircraft operating leases, airport property and hangar leases, office space, and other equipment leases. The aircraft operating leases include lease obligations for four leased MD-80 aircraft, two of which we retired in the second quarter and the other two of which will retire in the third quarter. We remain obligated under the existing lease contracts on these aircraft.
- (2) For variable-rate debt, future obligations are shown above using interest rates in effect as of June 30, 2008.
- (3) Includes minimum obligations under our long-term power-by-the-hour maintenance agreement for engines on our B737-400 aircraft, but not the power-by-the-hour maintenance agreement for engines on our B737-700 and -900 aircraft signed on July 23, 2008.
- (4) Excludes \$27.1 million of unrecognized tax benefits for which we cannot make a reasonably reliable estimate of the amount and period of payment.

**Effect of Inflation** - Inflation and price changes other than for aircraft fuel and passenger fares do not have a significant effect on our operating revenues, operating expenses and operating income.



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### **ITEM 3. QUANTITATIVE AND QUALITATIVE DISCLOSURES 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 2007 10-K except as follows:

#### *Market Risk Aircraft Fuel*

Currently, our fuel-hedging portfolio consists almost exclusively of crude oil call options. We utilize the contracts in our portfolio as hedges to decrease our exposure to the volatility of jet fuel prices. Call options are designed to effectively cap our cost of the crude oil component of fuel prices, allowing us to limit our exposure to increasing fuel prices. 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 that we pay to enter into the contracts. Although to a lesser extent, we also use collar structures for fuel hedging purposes. We believe there is risk in not hedging against the possibility of fuel price increases. We estimate that a 10% increase or decrease in crude oil prices as of June 30, 2008 would increase or decrease the fair value of our hedge portfolio by approximately \$66.0 million and \$63.6 million, respectively.

We have fuel purchase contracts that fix the refining margin we pay for approximately 50% of our fuel consumption in the third quarter of 2008.

Our portfolio of fuel hedge contracts was worth \$305.2 million at June 30, 2008, including \$67.7 million of capitalized premiums paid to counterparties, compared to a portfolio value of \$112.5 million at December 31, 2007. With the increase in the price and volatility of crude oil, the cost of the premiums we pay to obtain these contracts has increased substantially.

Please refer to Note 3 in the notes to the condensed consolidated financial statements, for company-specific data on the results of our fuel-hedging program, as well as a summary of hedge positions as of June 30, 2008.

### **ITEM 4. CONTROLS AND PROCEDURES**

#### *Evaluation of Disclosure Controls and Procedures*

As of June 30, 2008 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 defined as controls and procedures 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, 2008.

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

We made no changes in our internal control over financial reporting during the quarter ended June 30, 2008 that have materially affected, or are reasonably likely to materially affect, our internal control over financial reporting

## **PART II. OTHER INFORMATION**

### **ITEM 1. LEGAL PROCEEDINGS**

In June 2005, the International Association of Machinists (IAM) filed a grievance under its Collective Bargaining Agreement (CBA) with Alaska alleging that Alaska violated the CBA by, among other things, subcontracting the ramp service operation in Seattle. The dispute was referred to an arbitrator and hearings on

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the grievance commenced in January 2007, with a final hearing date in August 2007. In August 2008, the arbitrator issued a ruling in the matter. In that ruling, the arbitrator found that Alaska had violated the CBA and instructed Alaska and the IAM to negotiate a remedy. We are evaluating the decision, but currently do not believe that any final remedy will materially impact our financial position or results of operations.

*Other*

The Company is a party to routine litigation matters incidental to its business and with respect to which no material liability is expected.

Management believes the ultimate disposition of the matters discussed above is not likely to materially affect the Company's 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**

In addition to the other information set forth in this report, you should carefully consider the factors discussed in Part I, Item 1A. Risk Factors in our Annual Report on Form 10-K for the year ended December 31, 2007, as filed with the SEC on February 20, 2008, which could materially affect our business, financial condition or future results. There have been no material changes to the risk factors described in that report. The risks described in our Annual Report on Form 10-K are not the only risks facing the Company. 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****Issuer Purchases of Equity Securities**

|               |                    | Total number of<br>shares purchased | Average price paid<br>per share | Maximum approximate<br>remaining dollar<br>value<br>of shares that can be<br>repurchased under<br>the<br>plan (1) |
|---------------|--------------------|-------------------------------------|---------------------------------|---|
| April 1, 2008 | April 30, 2008 (1) | 430,700                             | \$ 19.40                        |   |
| Total         |                    | 430,700                             | \$ 19.40                        | \$ 38,322,441   |

- (1) Purchased pursuant to a \$50 million repurchase plan authorized by the Board of Directors in March 2008. The plan expires after twelve months. The remaining dollar value of shares that can be purchased is solely under this \$50 million plan. The Company has temporarily ceased further purchases under this program given the uncertainty in the economic environment. However, if the circumstances warrant, we may from time to time consider repurchasing shares of our common stock under our existing share repurchase program.

**ITEM 3. DEFAULTS UPON SENIOR SECURITIES**

None.

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**ITEM 4. SUBMISSION OF MATTERS TO A VOTE OF SECURITY HOLDERS**

(a) The Company's Annual Meeting of Stockholders was held on May 20, 2008.

(b) At the Annual Meeting, William S. Ayer, Phyllis J. Campbell, Mark R. Hamilton, R. Marc Langland, Dennis F. Madsen and Byron I. Mallott were elected directors for one-year terms expiring on the date of the Annual Meeting in 2009.

The terms of the following directors continued after the Annual Meeting:

Patricia M. Bedient  
 Jessie J. Knight, Jr.  
 J. Kenneth Thompson

(c) The results of voting in the election of directors were as follows:

| <b>Board Nominees</b> | <b>For</b> | <b>Withheld</b> |
|-----------------------|------------|-----------------|
| William S. Ayer       | 28,880,610 | 559,459         |
| Phyllis J. Campbell   | 28,877,439 | 562,630         |
| Mark R. Hamilton      | 28,820,321 | 619,748         |
| R. Marc Langland      | 28,920,945 | 519,124         |
| Dennis F. Madsen      | 28,797,285 | 642,784         |
| Byron I. Mallott      | 28,830,662 | 609,407         |

| <b>Shareholder Nominees</b> | <b>For</b> | <b>Withheld</b> |
|-----------------------------|------------|-----------------|
| Richard D. Foley            | 78,861     | 28,261          |
| Stephen Nieman              | 81,179     | 25,943          |
| Terry K. Dayton             | 80,032     | 27,090          |
| Carl L. Olson               | 78,459     | 28,663          |
| William B. Davidge          | 77,809     | 29,313          |
| Aaron C. Kreps              | 77,809     | 29,313          |

(d) The results of voting on Proposals 2 through 5 were as follows:

2. A board proposal to approve the Alaska Air Group, Inc. 2008 Performance Incentive Plan:

|                  | <b>Number of<br/>Votes</b> | <b>% of Shares<br/>Outstanding</b> |
|------------------|----------------------------|------------------------------------|
| For              | 23,615,516                 | 64.56%                             |
| Against          | 1,471,389                  | 4.02%                              |
| Abstain          | 62,075                     | .17%                               |
| Broker Non-votes | 4,291,090                  | 11.17%                             |

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3. A stockholder-sponsored proposal to amend the Company's governance documents to require a shareholder vote on the poison pill.

|                  | Number of<br>Votes | % of Shares<br>Outstanding |
|------------------|--------------------|----------------------------|
| For              | 7,564,828          | 20.68%                     |
| Against          | 17,431,669         | 47.66%                     |
| Abstain          | 152,482            | .42%                       |
| Broker Non-votes | 4,291,090          | 11.17%                     |

4. A stockholder-sponsored proposal requesting that the Board of Directors amend the Company's governance documents to adopt cumulative voting.

|                  | Number of<br>Votes | % of Shares<br>Outstanding |
|------------------|--------------------|----------------------------|
| For              | 12,876,358         | 35.20%                     |
| Against          | 12,159,075         | 33.24%                     |
| Abstain          | 113,546            | .31%                       |
| Broker Non-votes | 4,291,090          | 11.17%                     |

5. A stockholder-sponsored proposal requesting that the Board of Directors adopt a policy to allow stockholders to cast an advisory vote on the compensation of certain executive officers.

|                  | Number of<br>Votes | % of Shares<br>Outstanding |
|------------------|--------------------|----------------------------|
| For              | 13,478,067         | 36.85%                     |
| Against          | 11,034,216         | 30.17%                     |
| Abstain          | 636,697            | 1.74%                      |
| Broker Non-votes | 4,291,090          | 11.17%                     |

**ITEM 5. OTHER INFORMATION**

None.

**ITEM 6. EXHIBITS**

See Exhibit Index on page 51.

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**Signatures**

Pursuant to the requirements 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.

Registrant

Date: August 8, 2008

By: /s/ Brandon S. Pedersen

Brandon S. Pedersen

Vice President/Finance and Controller (Principal Accounting Officer)

By: /s/ Bradley D. Tilden

Bradley D. Tilden

Executive Vice President/Finance and Planning and Chief Financial Officer (Principal Financial Officer)

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**EXHIBIT INDEX**

Pursuant to Item 601(a)(2) of Regulation S-K, this Exhibit Index immediately precedes the exhibits.

The following exhibits are numbered in accordance with Item 601 of Regulation S-K.

| <b>Exhibit No.</b> | <b>Description</b>   |
|--------------------|--|
| 10.1               | Alaska Air Group, Inc. 2008 Performance Incentive Plan (Filed as Exhibit 10.1 to Registrant's Current Report on Form 8-K, filed on May 22, 2008 and incorporated herein by reference.) |
| 10.2               | Form of Nonqualified Stock Option Agreement (Filed as Exhibit 10.2 to Registrant's Current Report on Form 8-K, filed on May 22, 2008 and incorporated herein by reference.)            |
| 10.3               | Form of Stock Unit Award Agreement (Filed as Exhibit 10.3 to Registrant's Current Report on Form 8-K, filed on May 22, 2008 and incorporated herein by reference.)                     |
| 10.4               | Form of Director Deferred Stock Unit Award Agreement (Filed as Exhibit 10.4 to Registrant's Current Report on Form 8-K, filed on May 22, 2008 and incorporated herein by reference.)   |
| 31.1(1)            | Section 302 Certification of Chief Executive Officer Pursuant to 18 U.S.C. Section 1350  |
| 31.2(1)            | Section 302 Certification of Chief Financial Officer Pursuant to 18 U.S.C. Section 1350  |
| 32.1(1)            | Section 906 Certification of Chief Executive Officer Pursuant to 18 U.S.C. Section 1350  |
| 32.2(1)            | Section 906 Certification of Chief Financial Officer Pursuant to 18 U.S.C. Section 1350  |

(1) Filed herewith