ALASKA AIR GROUP INC
Form 10-Q
May 08, 2007
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UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

WASHINGTON, DC 20549

FORM 10-Q

(Mark One)

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

For the quarterly period ended March 31, 2007.

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	**91-1292054**
(State or other jurisdiction of incorporation or organization)	**(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 **x** No ¨

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

Large accelerated filer **x** Accelerated filer ¨ Non-accelerated filer ¨

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

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 40,438,715 common shares, par value $1.00, outstanding at March 31, 2007.

ALASKA AIR GROUP, INC.

Quarterly Report on Form 10-Q for the three months ended March 31, 2007

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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 contex indicates otherwise.

Cautionary Note Regarding Forward-Looking Statements

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

- the competitive environment and other trends 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 the MD-80 fleet disposal and the amounts of potential lease termination payments to lessors and sublease payments from sublessees;
- our significant indebtedness;
- compliance with our financial covenants;
- potential downgrades of our credit ratings and the availability of financing;
- the implementation of our growth strategy;
- our ability to meet our cost reduction goals;
- operational disruptions;
- general economic conditions, as well as economic conditions in the geographic regions we serve;
- the concentration of our revenue from a few key markets;

- actual or threatened terrorist attacks, global instability and potential U.S. military actions or activities;
- insurance costs;
- changes in laws and regulations;
- increases in government fees and taxes;
- 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
- our reliance on third-party vendors and partners.

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, 2006. Please consider our forward-looking statements in light of those risks as you read this report.

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PART I. FINANCIAL INFORMATION

ITEM 1. Condensed Consolidated Financial Statements
CONSOLIDATED BALANCE SHEETS (unaudited)

Alaska Air Group, Inc.

ASSETS

(In Millions)	March 31, 2007	December 31, 2006
Current Assets		
Cash and cash equivalents	**$161.0**	$230.7
Marketable securities	**809.1**	783.2
Total cash and marketable securities	**970.1**	1,013.9
Securities lending collateral	**109.6**	111.3
Receivables - net	**158.3**	134.2
Inventories and supplies - net	**47.8**	44.7
Deferred income taxes	**139.7**	134.2
Fuel hedge contracts	**58.0**	45.9
Prepaid expenses and other current assets	**110.6**	88.1
Total Current Assets	**1,594.1**	1,572.3
Property and Equipment		
Aircraft and other flight equipment	**2,594.0**	2,296.6
Other property and equipment	**541.6**	530.7
Deposits for future flight equipment	**367.4**	437.8
	3,503.0	3,265.1
Less accumulated depreciation and amortization	**932.5**	906.1
Total Property and Equipment - Net	**2,570.5**	2,359.0
Fuel Hedge Contracts	**24.0**	22.7
Other Assets	**154.5**	123.1
Total Assets	**$4,343.1**	$4,077.1

See accompanying notes to condensed consolidated financial statements.

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CONSOLIDATED BALANCE SHEETS (unaudited)

Alaska Air Group, Inc.

LIABILITIES AND SHAREHOLDERS EQUITY

(In Millions Except Share Amounts)	March 31, 2007	December 31, 2006
Current Liabilities		
Accounts payable	**$75.8**	$90.0
Accrued aircraft rent	**56.1**	56.8
Accrued wages, vacation and payroll taxes	**108.8**	144.0
Other accrued liabilities	**460.7**	404.3
Air traffic liability	**451.3**	311.2
Securities lending obligation	**109.6**	111.3
Current portion of long-term debt	**118.0**	119.1
Total Current Liabilities	**1,380.3**	1,236.7
Long-Term Debt, Net of Current Portion	**1,171.3**	1,031.7
Other Liabilities and Credits		
Deferred income taxes	**91.6**	114.6
Deferred revenue	**335.6**	333.0
Other liabilities	**478.0**	475.6
	905.2	923.2
Commitments and Contingencies		
Shareholders Equity		
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: 2007 - 42,616,739 shares 2006 - 42,501,163 shares	**42.6**	42.5
Capital in excess of par value	**884.7**	877.9
Treasury stock (common), at cost: 2007 - 2,178,024 shares 2006 - 2,207,474 shares	**(49.7)**	(50.4)
Accumulated other comprehensive loss	**(187.9)**	(191.4)
Retained earnings	**196.6**	206.9
	886.3	885.5
Total Liabilities and Shareholders Equity	**$4,343.1**	$4,077.1

See accompanying notes to condensed consolidated financial statements.

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CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS (unaudited)

Alaska Air Group, Inc.

Three Months Ended March 31

(In Millions Except Per Share Amounts)	**2007**	**2006**
Operating Revenues		
Passenger	**$695.8**	$679.5
Freight and mail	**21.2**	21.4
Other - net	**42.4**	34.5
Total Operating Revenues	**759.4**	735.4
Operating Expenses		
Wages and benefits	**237.0**	223.2
Variable incentive pay	**10.5**	8.5
Contracted services	**38.6**	36.7
Aircraft fuel, including hedging gains and losses	**184.9**	163.1
Aircraft maintenance	**58.5**	61.2
Aircraft rent	**43.3**	46.6
Food and beverage service	**11.2**	11.5
Selling expenses	**39.0**	41.6
Depreciation and amortization	**41.9**	36.9
Landing fees and other rentals	**54.7**	47.4
Other	**54.9**	52.8
Fleet transition costs, including impairment charge	**3.0**	131.1
Total Operating Expenses	**777.5**	860.6
Operating Loss	**(18.1)**	(125.2)
Nonoperating Income (Expense)		
Interest income	**14.4**	11.1
Interest expense	**(21.0)**	(19.1)
Interest capitalized	**7.1**	4.7
Other - net	**(0.2)**	(0.9)
	0.3	(4.2)
Loss before income tax	**(17.8)**	(129.4)
Income tax benefit	**(7.5)**	(50.3)
Net Loss	**$(10.3)**	$(79.1)
Basic and Diluted Loss Per Share:	**$(0.26)**	$(2.36)
Shares used for computation:		
Basic and Diluted	**40.365**	33.464

See accompanying notes to condensed consolidated financial statements.

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CONDENSED CONSOLIDATED STATEMENTS OF SHAREHOLDERS EQUITY (unaudited)

Alaska Air Group, Inc.

(In Millions)	*Common Shares Outstanding*	Common Stock	Capital in Excess of Par Value	Treasury Stock, at Cost	Accumulated Other Comprehensive Loss	Retained Earnings	Total
Balances at December 31, 2006	40.294	$42.5	$877.9	$(50.4)	$(191.4)	$206.9	$885.5
Net loss for the three months ended March 31, 2007						(10.3)	(10.3)
Other comprehensive income (loss):							
Related to marketable securities:							
Change in fair value					1.6		
Reclassification to earnings					(0.5)		
Income tax effect					(0.4)		
					0.7		0.7
Adjustments related to employee benefit plans:					4.4		
Income tax effect					(1.6)		
					2.8		2.8
Total comprehensive loss							(6.8)
Stock-based compensation			2.5				2.5
Stock issued for employee stock purchase plan	0.024		0.7				0.7
Stock issued under stock plans, including $0.5 million tax benefit	0.121	0.1	3.6	0.7			4.4
Balances at March 31, 2007	40.439	$42.6	$884.7	$(49.7)	$(187.9)	$196.6	$886.3

See accompanying notes to condensed consolidated financial statements.

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CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS (unaudited)

Alaska Air Group, Inc.

Three Months Ended March 31 (In Millions)	2007	2006
Cash flows from operating activities:		
Net loss	**$(10.3)**	$(79.1)
Adjustments to reconcile net loss to net cash provided by operating activities:		
Fleet transition costs, including impairment charge	**3.0**	131.1
Depreciation and amortization	**41.9**	36.9
Stock-based compensation	**2.5**	1.9
Changes in fair values of open fuel hedge contracts	**(13.3)**	3.7
Changes in deferred income taxes	**(4.8)**	(47.0)
Tax benefit from stock option exercises	**(0.5)**	
Increase in receivables - net	**(24.1)**	(15.3)
Increase in prepaid expenses and other current assets	**(26.7)**	(20.4)
Increase in air traffic liability	**140.1**	103.9
Increase in other current liabilities	**3.1**	9.7
Decrease in deferred revenue and other-net	**(46.8)**	(40.2)
Net cash provided by operating activities	**64.1**	85.2
Cash flows from investing activities:		
Proceeds from disposition of assets	**1.9**	0.2
Purchases of marketable securities	**(474.7)**	(108.3)
Sales and maturities of marketable securities	**450.7**	146.4
Securities lending collateral	**1.7**	3.3
Securities lending obligation	**(1.7)**	(3.3)
Property and equipment additions:		
Aircraft and aircraft purchase deposits	**(230.1)**	(161.0)
Other flight equipment	**(16.3)**	(4.4)
Other property and equipment	**(7.6)**	(7.6)
Restricted deposits and other	**(0.4)**	1.9
Net cash used in investing activities	**(276.5)**	(132.8)
Cash flows from financing activities:		
Proceeds from issuance of long-term debt, net	**163.4**	122.4
Long-term debt payments	**(24.9)**	(9.3)
Proceeds from issuance of common stock	**3.7**	1.4
Tax benefit from stock option exercises	**0.5**	
Net cash provided by financing activities	**142.7**	114.5
Net change in cash and cash equivalents	**(69.7)**	66.9
Cash and cash equivalents at beginning of year	**230.7**	73.6
Cash and cash equivalents at end of period	**$161.0**	$140.5
Supplemental disclosure of cash paid (received) during the period for:		
Interest (net of amount capitalized)	**$9.9**	$11.3
Income taxes	**$(4.1)**	

See accompanying notes to condensed consolidated financial statements.

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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, 2006. In the opinion of management, all adjustments have been made which are necessary to present fairly the Company s financial position as of March 31, 2007, as well as the results of operations for the three months ended March 31, 2007 and 2006. 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 March 31, 2007, the Company had $107.3 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 July 2006, the Financial Accounting Standards Board (FASB) issued FASB Interpretation No. 48, Accounting for Uncertainty in Income Taxes an interpretation of FASB Statement No. 109 (FIN 48), which clarifies the accounting and disclosure for uncertainty in tax positions, as defined in that statement. The purpose of FIN 48 is to clarify certain aspects of the recognition and measurement related to accounting for income tax uncertainties. This interpretation was effective for the Company as of January 1, 2007. See Note 10 for a discussion of the impact of the adoption of this interpretation.

Note 2. Fleet Transition

Transition to All-Boeing 737 Fleet

In March 2006, the Company s Board 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, which is earlier than the original retirement schedule. As a result of this decision, the Company evaluated impairment as required by SFAS No. 144 *Accounting for the Impairment or Disposal of Long-Lived Assets*, and concluded that the carrying value of the owned MD-80 fleet was no longer recoverable when compared to the estimated remaining future cash flows. Accordingly, during the first quarter of 2006, the Company recorded an impairment charge totaling $131.1 million (pretax) to write down the fleet to its estimated fair market value.

In the third quarter of 2006, the Company also purchased five MD-80 aircraft from lessors and, in conjunction with the purchases, terminated the leases for those five aircraft. Two additional leased MD-80 aircraft were returned to the lessor upon expiration of the lease arrangements.

The Company has reached an agreement with a buyer for its 20 owned MD-80s. As of May 7, 2007, the Company has closed on sale transactions for eight of these aircraft and expects to complete the remaining sales during the second quarter. The majority of these aircraft will be leased from the buyer under short-term lease arrangements.

As of March 31, 2007, the Company leases four MD-80 aircraft, whose current expiration dates range from January 2011 to October 2012. The Company expects to cease operation of these aircraft prior to the lease expiration date through lease buy-outs, lease agreement restructuring, subleasing of the aircraft, or storing the aircraft at a long-term storage facility. At such time as one of these actions is taken on the aircraft, the Company expects to have an operating charge that will be recorded in the consolidated statements of operations. Aggregate minimum lease payments for these aircraft through the end of the lease are approximately $82 million.

Sublease of Q200 Aircraft

During the third quarter of 2006, Horizon signed a letter of intent with another carrier to sublease 16 of its Bombardier Q200 aircraft. Under the terms of the letter of intent, up to eleven aircraft will leave Horizon s operating fleet in 2007, and an additional five aircraft will leave in the first half of 2008. Each sublease will result in a loss for Horizon approximating the difference between the lease payments and the sublease receipts. The loss on each aircraft will be recorded when the specific aircraft leave Horizon s fleet and the sublease arrangement begins. As of March 31, 2007, two of the aircraft have been delivered to the other carrier, resulting in a sublease loss of approximately $3.0 million in the first quarter. The Company expects the loss to average $1.5 million per aircraft.

On April 23, 2007, Horizon announced an order for 15 additional Q400 aircraft, with options for 20 more. These aircraft will be delivered in 2008 and 2009. With this order, Horizon also plans to phase out the remaining Q200 aircraft by the end of 2009. Since all of Horizon s Q200 aircraft are leased, the Company expects to realize a loss on the transition out of the remaining Q200s since the current market lease rates for these aircraft are below our contractual lease rates. However, the nature, timing, or amount of the loss cannot be reasonably estimated at this point for the aircraft that are not part of the sublease agreement described above.

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Note 3. Restructuring Charges

In July 2006, Alaska reached new four-year agreements with the approximately 3,700 clerical, office and passenger service employees and the ramp service and stores agents, all represented by the International Association of Machinists. Among other items, the agreements included a severance package offered to employees in the top four wage-scale steps that includes cash payments based on years of service, one year of medical coverage after the severance date, and continued travel privileges for a period of time. The total amount of the charge was $28.6 million and was recorded as restructuring charges in the statement of operations during the third quarter of 2006.

The following table displays the activity and balance of the severance and related costs components of the Company s restructuring accrual as of and for the three months ended March 31, 2007 and 2006. Substantially all of the accrual at December 31, 2006 and March 31, 2007 relates to the severance package described above.

Accrual for Severance and Related Costs ($ in millions)	**2007**	**2006**
Balance at December 31, 2006 and 2005, respectively	**$19.9**	$3.1
Cash payments	**(9.6)**	(1.6)
Balance at March 31	**$10.3**	$1.5

The Company will make the majority of the remaining cash payments in the second quarter of 2007. The accrual for severance and related costs is included in accrued wages, vacation and payroll taxes in the consolidated balance sheets.

Note 4. Fuel Hedge Contracts

The Company s operations are inherently dependent upon the price and availability of aircraft fuel. To manage economic risks associated with fluctuations in aircraft fuel prices, the Company periodically enters into call options, 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 consolidated 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 months ended March 31, 2007 and 2006 (in millions):

	2007	**2006**
Raw fuel cost	**$195.5**	$193.0
Changes in value and settlements of fuel hedge contracts	**(10.6)**	(29.9)
Aircraft fuel expense	**$184.9**	$163.1

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The Company realized gains of $1.8 million and $29.9 million in the three months ended March 31, 2007 and 2006, respectively, on fuel hedge contracts that settled during the period.

Outstanding fuel hedge positions as of March 31, 2007 are as follows:

Quarter	Approximate % of Expected Fuel Requirements	Gallons Hedged (in millions)	Approximate Crude Oil Price per Barrel
Second Quarter 2007	53%	55.1	$57.31
Third Quarter 2007	49%	53.7	$56.98
Fourth Quarter 2007	41%	43.4	$59.67
First Quarter 2008	36%	36.6	$61.92
Second Quarter 2008	29%	31.2	$63.53
Third Quarter 2008	21%	24.2	$63.94
Fourth Quarter 2008	23%	23.6	$64.20
First Quarter 2009	5%	5.6	$67.68
Second Quarter 2009	5%	5.8	$67.50
Third Quarter 2009	6%	6.3	$68.25

As of March 31, 2007 and December 31, 2006, the fair values of the Company s fuel hedge positions were $82.0 million and $68.6 million, respectively, including capitalized premiums of $43.9 million and $39.3 million, respectively, and are presented as both current and non-current assets in the consolidated balance sheets.

Note 5. Other Assets

Other assets consisted of the following (in millions):

	March 31, 2007	December 31, 2006
Restricted deposits (primarily restricted investments)	**$91.7**	$91.2
Deferred costs and other	**62.9**	31.9
	$154.6	$123.1

Note 6. Mileage Plan

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

	March 31, 2007	December 31, 2006
Current Liabilities:		
Other accrued liabilities	**$212.9**	$196.6
Other Liabilities and Credits (non-current):		
Deferred revenue	**331.0**	328.3
Other liabilities	**20.4**	20.7
	$564.3	$545.6

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Alaska s Mileage Plan revenue is included under the following statement of operations captions for the three months ended March 31, 2007 and 2006 (in millions):

	2007	2006
Passenger revenues	**$28.3**	$25.7
Other-net revenues	**27.9**	20.5
	$56.2	$46.2

Note 7. Long-term Debt

At March 31, 2007 and December 31, 2006, long-term debt obligations were as follows (in millions):

	March 31, 2007	December 31, 2006
Fixed-rate notes payable due through 2022	**$806.6**	$721.0
Variable-rate notes payable due through 2022	**453.4**	390.6
Pre-delivery payment facility expiring in 2009	**29.3**	39.2
Long-term debt	**1,289.3**	1,150.8
Less current portion	**(118.0)**	(119.1)
	$1,171.3	$1,031.7

During the first three months of 2007, Alaska borrowed $163.4 million using fixed-rate and variable-rate debt secured by flight equipment and made payments of $24.9 million, including $9.9 million on its pre-delivery payment facility.

Note 8. Employee Benefit Plans

Pension Plans-Qualified Defined Benefit

Net pension expense for the three months ended March 31 included the following components (in millions):

	March 31, 2007	March 31, 2006
Service cost	**$13.3**	$12.3
Interest cost	**15.0**	12.7
Expected return on assets	**(16.3)**	(12.5)
Amortization of prior service cost	**1.0**	1.2
Actuarial loss	**3.0**	3.9
Net pension expense	**$16.0**	$17.6

The Company contributed $17.5 million to its qualified defined-benefit plans during the three months ended March 31, 2007, and expects to contribute an additional $35 million to these plans during the remainder of 2007. The Company made $16.8 million in contributions to its defined benefit-pension plans during the three months ended March 31, 2006.

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Pension Plans-Nonqualified Defined Benefit

Net pension expense for the unfunded, noncontributory defined benefit plans was $0.9 million and $1.0 million for the three months ended March 31, 2007 and 2006 respectively.

Postretirement Medical Benefits

Net periodic benefit cost for the postretirement medical plans for the three months ended March 31, 2007 and 2006 included the following components:

	March 31, 2007	March 31, 2006
Service cost	**$1.2**	$1.3
Interest cost	**1.4**	1.0
Amortization of prior service cost	**(0.1)**	(0.2)
Actuarial loss	**0.4**	0.4
Net periodic benefit cost	**$2.9**	$2.5

Note 9. Stock-Based Compensation Plans

The Company accounts for stock-based awards using Statement of Financial Accounting Standards SFAS No. 123R, Share-Based Payment: An Amendment of SFAS Nos. 123 and 95. This standard requires companies to recognize as expense the fair value of stock options and other equity-based compensation issued to employees as of the grant date. The standard applies to both stock options and restricted stock units that the Company grants to employees and to the Company s Employee Stock Purchase Plan (ESPP), which features a look-back provision and allows employees to purchase stock at a 15% discount. All stock-based compensation expense is recorded in wages and benefits in the condensed consolidated statements of operations.

Stock Options

For stock options granted prior to January 1, 2006 (the date of adoption of SFAS 123R), for which the vesting period is not complete, the modified prospective method for transition permitted by SFAS 123R was used. Under this method, the Company accounts for the unvested portion of these awards on a prospective basis, with expense recognized in the condensed consolidated statements of operations beginning January 1, 2006 using the grant-date fair values previously calculated for pro forma disclosures. The Company selected this method due to the relatively limited use of stock-based awards and the immaterial impact on the comparability between periods. The Company also elected to use the method available under FASB Staff Position FSP No. 123(R)-3 *Transition Election Related to Accounting for the Tax Effects of Share-Based Payment Awards*, which provides an alternative method for calculating historical excess tax benefits (the APIC pool) from the method described in FAS 123(R) for stock-based compensation awards. The standard also requires that tax benefits realized from stock award exercise gains in excess of stock-based compensation expense recognized for financial statement purposes be reported as cash flows from financing activities rather than as operating cash flows.

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A portion of the Company s granted options qualify as incentive stock options (ISO) for income tax purposes. As such, a tax benefit is not recorded at the time the compensation cost related to the options is recorded for book purposes due to the fact that an ISO does not ordinarily result in a tax benefit unless there is a disqualifying disposition. Stock option grants of non-qualified options result in the creation of a deferred tax asset, which is a temporary difference, until the time the option is exercised. Due to the treatment of incentive stock options for tax purposes, the Company s effective tax rate is subject to variability.

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. Under the various plans, options for 7,476,565 shares have been granted and, at March 31, 2007, 664,245 shares were available for future grant. Under all plans, the stock options granted have terms of up to ten years. The Company s options are typically granted with graded vesting provisions, and compensation cost is amortized over the service period using the straight-line method. The fair value of each stock option grant is estimated on the date of grant using the Black-Scholes option-pricing model, which requires the Company to make several assumptions. The risk-free interest rate is based on the U.S. Treasury yield curve in effect for the term nearest the expected term of the option at the time of grant. The dividend yield is zero as the Company currently does not pay dividends. The expected volatility of the common stock is based on the historical volatility over a period commensurate with the expected term of the awards. The expected life of the options and the expected forfeiture rates are based on our historical experience for various homogenous employee groups.

The tables below summarize stock option activity for the three months ended March 31, 2007:

	Shares	Weighted-Average Exercise Price Per Share	Weighted-Average Contractual Life (Years)	Aggregate Intrinsic Value (in millions)
Outstanding, December 31, 2006	2,539,268	$32.08		
Granted	154,515	42.80		
Exercised	(100,230)	29.23		
Canceled	(5,960)	32.49		
Outstanding, March 31, 2007	2,587,593	$32.83	5.1	$16.5

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	Shares	Weighted-Average Exercise Price Per Share	Weighted-Average Contractual Life (Years)	Aggregate Intrinsic Value (in millions)
Exercisable at March 31, 2007	1,889,360	$31.70	3.8	$14.2

The fair value of each option grant was estimated on the date of grant using the Black-Scholes option-pricing model with the following weighted-average assumptions used for grants during the three months ended March 31, 2007 and 2006:

	2007	2006
Expected volatility	**43.5%**	41.6%
Expected term	**6 years**	6 years
Risk-free interest rate	**4.7%**	4.5%
Expected dividend yield		
Weighted-average fair value of options granted	**$20.98**	$14.17

The Company recorded stock-based compensation expense related to stock options of $0.9 million for the three months ended March 31, 2007 and 2006, with corresponding tax benefits of $0.3 million. The total intrinsic value of options exercised during the three months ended March 31, 2007 was $1.4 million. Cash received from option exercises during the three months ended March 31, 2007 totaled $3.0 million. A total of 160,480 options vested during the first quarter of 2007 with an aggregate fair value of $2.6 million. As of March 31, 2007, $9.3 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 1.7 years.

The following table summarizes stock options outstanding and exercisable at March 31, 2007 with their weighted-average exercise prices and remaining contractual lives:

Range of Exercise prices	Remaining Life (years)	Shares	Price Per Share
Outstanding:			
$10 to $20	5.4	202,680	$18.69
$21 to $28	5.5	563,635	26.14
$29 to $34	5.1	868,683	31.64
$35 to $45	5.7	783,695	39.39
$46 to $58	1.1	168,900	47.75
$10 to $58	5.1	2,587,593	$32.83

Range of Exercise prices	Shares	Price Per Share
Exercisable:		
$10 to $20	200,430	$18.71
$21 to $28	485,742	26.22
$29 to $34	638,863	31.27
$35 to $45	395,425	38.86
$46 to $58	168,900	47.75
$10 to $58	1,889,360	$31.70

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Restricted Stock Awards

During the three months ended March 31, 2007, the Company awarded 62,820 restricted stock units (RSUs) to certain employees, with grant date fair values of $2.7 million. These amounts reflect the value of the total RSU awards at the grant date based on the closing price of the Company s common stock. Compensation cost for RSUs is recognized over three years from the date of grant as the awards cliff vest after three years. As of March 31, 2007, 508,670 RSUs were outstanding, with an aggregate intrinsic value of $19.4 million. The Company recorded stock-based compensation expense related to RSUs of $1.3 million ($0.8 million after tax) and $0.9 million ($0.6 million after tax) for the three months ended March 31, 2007 and 2006, respectively. These amounts are included in wages and benefits in the condensed consolidated statements of operations.

As of March 31, 2007, $9.9 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 1.1 years.

Performance Stock Awards

During the first quarter of 2007, the Company awarded Performance Share Unit awards (PSUs) to certain executives. These awards 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. The PSU Plan allows a portion of the PSUs to vest even if the specified pretax margin falls below the target, and additional shares to be granted if the margin target is exceeded, subject to a maximum. The Company intends to regularly review its assumptions about meeting the performance goal and expected vesting, and to adjust the related compensation expense accordingly. The Company recorded compensation expense related to PSUs of $0.1 million during the first quarter of 2007.

Employee Stock Purchase Plan

The Company has an Employee Stock Purchase Plan. Compensation expense recognized under the plan was $0.2 million and $0.1 million for the three months ended March 31, 2007 and 2006, respectively.

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Note 10. Income Taxes

In July 2006, the FASB issued FIN 48. The purpose of FIN 48 is to clarify certain aspects of the recognition and measurement related to accounting for income tax uncertainties. Under FIN 48, the impact of an uncertain income tax position must be recognized at the largest amount that is more likely than not of being sustained upon audit by the relevant taxing authority. An uncertain income tax position will not be recognized if it has less than a 50% likelihood of being sustained.

The Company was subject to the provisions of FIN 48 as of January 1, 2007. Upon adoption, no cumulative effect of accounting change was necessary or recorded in the condensed consolidated financial statements. The total amount of unrecognized tax benefits as of the date of adoption was $26.2 million. This number includes a $24.5 million increase in the liability and a corresponding increase in deferred tax assets for unrecognized tax benefits as a result of the implementation of FIN 48 and $1.7 million of tax benefits that, if recognized, would impact the effective tax rate.

Accrued interest on tax positions is recorded as a component of interest expense. Total accrued interest on tax positions included in the FIN 48 liability was zero at January 1, 2007 and $0.3 million at March 31, 2007. No penalties were accrued at January 1, 2007 or at March 31, 2007.

The periods subject to examination for the Company s federal income tax return are the 2003 through 2006 tax years. The periods subject to examination for the Company s major state income tax returns other than California are also the years 2003 through 2006. In California, the income tax years 2002 through 2006 remain open to examination.

The Company anticipates that total unrecognized tax benefits will decrease by $4.0 million due to the expiration of the statute of limitations for certain tax years prior to December 31, 2007.

The Company does not believe that it is reasonably possible that the total unrecognized tax benefit would significantly increase or decrease in the next 12 months. The FIN 48 liability for its unrecognized tax benefit is classified in other long-term liabilities on the consolidated balance sheet.

During the first quarter of 2007, the Company received a favorable decision in a matter with the State of California. As a result of the decision, the company reduced its FIN 48 liability by $0.7 million, recorded a previously unrecognized tax benefit of $1 million, and accrued interest income of $1.5 million.

Note 11. Earnings Per Share

In April 2006, the Company s senior convertible notes were converted into 5.769 million shares of common stock and are included in the calculation of the basic weighted-average shares outstanding for the three months ended March 31, 2007. For the three months ended March 31, 2007 and 2006, all outstanding options to purchase common shares were excluded in the calculation for diluted earnings per share as the Company had a net loss in each of those periods.

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Note 12. Operating Segment Information

Operating segment information for Alaska and Horizon for the three-month period ended March 31 was as follows (in millions):

	Three Months Ended March 31,	
	2007	**2006**
Operating revenues:		
Alaska	**$659.8**	$590.0
Horizon	**161.6**	146.2
Other*	**0.3**	0.3
Elimination of intercompany revenues	**(62.3)**	(1.1)
Consolidated	**$759.4**	$735.4
Loss before income tax:		
Alaska	**$(7.5)**	$(124.7)
Horizon	**(9.2)**	(0.4)
Other*	**(1.1)**	(4.3)
Consolidated	**$(17.8)**	$(129.4)

March 31, 2007