CALLWAVE INC
Form 10-K
September 12, 2007
Table of Contents

Index to Financial Statements

UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

FORM 10-K

(Mark One)

x ANNUAL REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934
For the Fiscal Year Ended June 30, 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: 000-50958

CALLWAVE, INC.

(Exact name of registrant as specified in its charter)

Delaware	**77-0490995**
(State or other jurisdiction of incorporation or organization)	**(I.R.S. Employer Identification Number)**
136 West Canon Perdido Street, Suite C	
Santa Barbara, California	**93101**

(Address of principal executive offices) **(Zip code)**

(805) 690-4100

(Registrant s telephone number, including area code)

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

Title of each class	Name of each exchange on which registered
Common Stock, no par value	The NASDAQ Stock Market, LLC

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

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

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

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

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

Large Accelerated Filer ¨ Accelerated Filer ¨ Non-Accelerated Filer x

[In determining who are affiliates of the Company for purposes of this computation, it is assumed that directors, officers, and any persons who held on December 29, 2006, more than 5% of the issued and outstanding common stock of the Company are affiliates of the Company. The characterization of such directors, officers, and other persons as affiliates is for purposes of this computation only and should not be construed as a determination or admission for any other purpose that any of such persons are, in fact, affiliates of the Company.]

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

The aggregate market value of common stock held by non-affiliates computed by reference to the price at which the common stock was last sold as of December 29, 2006 was $22,619,414.

At August 6, 2007, the number of shares outstanding of the registrant s common stock, no par value, was 20,880,064.

Portions of the Proxy Statement to be filed with the Securities and Exchange Commission and to be used in connection with the Annual Meeting of Stockholders are incorporated by reference into Part III of this annual report on Form 10-K to the extent stated therein.

Table of Contents

Index to Financial Statements

Table of Contents

Table of Contents

Index to Financial Statements

PART I

Item 1. Business

BUSINESS

Industry Background

A decade ago, the primary means of communication was the landline telephone. The emergence of the wireless mobile market and the internet is increasingly supplementing and/or replacing the use of the traditional landline telephone. Mobile telephones and the Internet, which penetrated the early adopter markets in the 1990s have now reached mass market acceptance with over 182 million wireless subscribers in the United States alone, according to the Cellular Telecommunications and Internet Association (CTIA). However, mainstream users of mobile telephones still retain their existing landlines for a variety of reasons, including the desire to retain their published telephone number, the familiar experience of a traditional telephone, the varying quality of mobile reception in some areas, and access to the Internet.

Fueled by the business imperative to create new revenue sources, deliver IP applications and protect their large voice calling communities from emerging competitors, telecommunications service providers are beginning to offer services that combine the benefits of landline telephones with the flexibility of mobile phones. This trend is called fixed-mobile convergence. As service providers begin to develop strategies to offer these new services, they are evaluating traditional solutions, such as installing new telecommunications infrastructure or shipping new mobile handsets, as well as non-traditional solutions including software-based private label on-demand solutions. Traditional solutions typically require large capital investments and longer deployment cycles. The private label on-demand model typically requires less capital and operating allocation, greater flexibility, and faster time-to-market because services are provided by a host . This hosted solution platform eliminates the need for the customer to make capital investments in infrastructure in order to utilize the service.

Company Overview

CallWave is leading a new category of convergence services focused on Phone Companion Services. Our business strategy encompasses both our traditional direct to consumer web channel and an indirect carrier channel designed to market our services under the brands of telecommunications service providers and web portals.

We provide services on a free trial or subscription basis that add features and functionality to the telecommunications services used by mainstream consumers and small and home offices. Our Phone Companion Software (PCS)-based services are delivered on our proprietary Enhanced Services Platform, which allows subscribers to manage calls across their existing landline, mobile and Internet networks. Our services enable subscribers to receive, respond, and manage calls on most communications devices without requiring them to purchase or install additional hardware, purchase additional telecommunications services, change their phone number, or switch their service provider. Calls can be accessed on a subscriber s handset, in email, or on the Internet.

Our Enhanced Services Platform intercepts inbound phone and fax calls to our subscribers and is able to redirect these calls to the devices or access points selected by the subscribers using their existing telecommunications lines. In addition, the Enhanced Services Platform enables us to provide virtual phone and fax numbers to our subscribers who then can publish multiple phone or fax numbers for use with a single phone line. As of June 30, 2007, we had approximately 631,000 paying subscribers for our services.

Historically, our subscriber base consisted primarily of dial-up subscribers who, before subscribing to our service, had been missing calls while on the Internet via their dial up connection. The CallWave Enhanced Service Platform allowed customers to screen, transfer or intercept incoming calls while their dial-up service

Table of Contents

Index to Financial Statements

connection was in use. As customers have migrated away from traditional dial up Internet connections towards faster and more reliable broadband offerings, we have enhanced our service platform in the web and carrier channels. These enhancements include Web 2.0 widgets, voice to text recognition applications, wireless mobile voicemail, and desktop texting applications.

Our services and offerings improve the utilization of existing telecommunications services by our subscribers. We believe our services and offerings complement the efforts of telecommunications service providers to improve average revenue per user (ARPU), reduce churn, create new revenue sources, and protect their calling communities from emerging competitors. We do this by providing IP-enabled applications that are interoperable with current generation landline, mobile and IP networks and devices that can seamlessly migrate to an IMS-enabled environment. This has allowed us to establish cooperative relationships with service providers and web portals that market our private label services under their brand.

The CallWave Solution

We provide Phone Companion Services that facilitate the convergence of fixed and mobile telephone services on a free trial or subscription basis to mainstream consumers and small and home offices. Our solution is delivered over the Internet and through our Phone Companion Software (PCS), which is simple to adopt and use, running on a user s desktop that is a companion to the user s communication device. Our proprietary Enhanced Services Platform allows subscribers to bridge calls across existing landline, mobile and Internet networks. This software-based call-bridging service enables subscribers to receive calls on any communications device that is available to them at the time without requiring them to purchase or install additional hardware, get a new telephone number, or change service providers. Additionally, we add value to traditional telecommunications devices by offering information services that provide call management and are easy to use features.

For example, our platform allows subscribers who cannot answer a call on their home telephone or mobile phone (because either the subscriber is unavailable or the line is busy), to screen and accept the call on another device, such as a landline, mobile phone or a personal computer connected to the Internet using voice-over-IP technology. Unlike traditional call-forwarding services, our software allows our subscribers to screen a voicemail in real-time before deciding whether to take the call on their existing landline, mobile or Internet networks, enabling our mass-market subscribers to more effectively manage their personal communications. By screening incoming calls across existing landline, mobile and Internet networks, our subscribers realize greater value from their existing telecommunications services. Our platform also allows mobile phone subscribers to get their voicemail in their email or on the Internet. Unlike traditional mobile voicemail where there is limited opportunity to easily manage the message experience, our software allows our subscribers to get a copy of their mobile voicemail in their email or on the Internet to more easily see and prioritize who has called and then listen, respond, and manage the message accordingly.

Customers have the flexibility to pay us for their subscriptions using credit cards, mail-in checks or through their telephone bills. Subscribers register for our service either on our website or on our partners websites and download our client software onto their personal computers to utilize our applications. Our Web 2.0 widgets and wireless mobile voicemail applications do not require a download of our client software.

Our private label carrier business delivers IP-enabled applications to service providers marketed under their brand that are interoperable with current network infrastructures. These applications enable service providers to deliver converged voice services ahead of converged networks that are rapidly deployed at a minimal cost.

Certain key aspects of our solutions are common, including:

Affordable application services. Our application-based services are customized to meet the requirements of cost-conscious mainstream subscribers, without requiring them to purchase additional hardware or telephone lines or change service providers. We offer flexible service levels, enabling our subscribers to pay for only those applications they need to manage their existing telecommunications services.

Table of Contents

Index to Financial Statements

Ease of installation and use. We designed our application-based services to be easy to install on a personal computer and easy to use with minimal behavioral changes. During registration and installation, our software is automatically configured, based on subscribers existing communications services. The registration and installation process typically takes only a few minutes. In most cases, we automatically provision our services without subscribers having to call their existing network service providers. Our call-bridging services are delivered over subscribers existing communication networks and require no additional hardware and no new telephone number. Our wireless mobile voicemail services do not require a software download.

Optimized use of existing telecommunications networks and devices. Our software-based service enables real-time connectivity among subscribers existing telecommunications services and devices by allowing them to choose where a call is delivered. Our application-based services also provide users with detailed caller identification information, giving subscribers the choice to take the call or direct it to their preferred and most convenient answering device. Our wireless mobile voicemail service offer many of the same benefits without having to download software.

Scalable, reliable and flexible software platform. Our software platform has been designed to scale to support millions of users, to deliver carrier-class reliability and to be sufficiently flexible to address the changing market needs. Our software-based infrastructure and open architecture enable us to efficiently and economically identify and develop new information services for our subscribers as they adopt new technologies and desire enhanced functionality from their communication services as well as support IMS and next generation network requirements of service providers.

Complementary to telecommunications service providers. Our software platform integrates with and enhances the existing offerings of the providers of telecommunications services and is interoperable with current generation landline, mobile and IP networks and devices that can seamlessly migrate and scale to an IMS enabled environment.

Products and Services

CallWave Internet Answering Machine

Our CallWave Internet Answering Machine services have historically generated most of our revenues. These services extend the functionality of our subscribers existing telecommunications services by adding easy-to-use enhancements such as real-time voicemail, which allows subscribers to screen a message being left on their landline number from their mobile phone or their Internet-connected personal computer. Our landline services also include virtual telephone numbers that enable our subscribers to receive the benefits of a personalized or dedicated phone number routed to their existing telephone lines, without requiring additional physical phone lines to be installed. As a result, multiple virtual numbers can be set up to deliver calls to the same physical landline telephone that might otherwise be shared by multiple people in a household or small business. These services extend the functionality of networks and devices that our subscribers already use by connecting their landline phones to their mobile phones and Internet networks without requiring new equipment at their premises. During the year, CallWave upgraded this service to support an auto-populating address book with integration to the customer s mobile phone and giving some customers the ability to use our enhanced features to initiate text or voice communications to persons in their address book.

We offer three principal levels of CallWave service:

CallWave Alert ($1.50 per month or $17.95 per year). CallWave Alert is our lowest-priced subscription level. Our CallWave Alert service delivers notifications of calls placed to any of our subscribers telephone numbers, even when those lines are not answered or are in use by sending a message to a device of our subscribers choosing.

CallWave Messenger ($5.95 per month). CallWave Messenger is our mid-level subscription, providing all of the features of CallWave Alert, as well as caller identification and delivery of voice messages, even when subscribers lines are in use or are not answered.

Table of Contents

Index to Financial Statements

CallWave Connect ($7.95 per month). CallWave Connect is our most feature-rich and high-end service level currently offered. CallWave Connect service enables customers to screen, transfer or receive calls in real-time, and if they choose, interrupt the message to take the call. In addition, subscribers to CallWave Connect receive the benefits of a system that automatically creates a contact book based on the calls received and allows them to use our enhanced features to reply or call back to persons listed in their contact book and to initiate text or voice communications to other persons as well.

CallWave Fax

CallWave Fax utilizes the same Enhanced Services Platform to offer customers personalized fax numbers that deliver faxes to the user s e-mail account. This provides greater flexibility to customers by allowing them to receive and print faxes from any location where they are connected to a personal computer and allows customers to keep a digital history of all faxes. It also provides financial stability for customers by charging a flat fee of $7.95 for unlimited faxes every month.

CallWave Mobile

CallWave Mobile is the company s first visual voicemail product. This service sends a copy of the mobile phone s voicemail to the user s email, enabling the user to sort, prioritize, listen and respond (via text reply or call back) to messages all from their email in-box. The service does not require the user to download software, switch service providers, purchase a new handset or change their mobile phone number. When users are not at their PC s, they are notified of mobile voicemail messages via an SMS text message sent to the handset. Users can also access messages the traditional way by dialing into their mobile phone s voicemail system. This service is currently free during the beta testing period.

CallWave Web 2.0 Widgets

Widgets are mini web applications that are very simple to download and highly cost-effective channels for delivering software and services to consumers whom we may not reach through other marketing channels. During the year, CallWave introduced SMS text messaging widgets in addition to the wireless industry s first visual voicemail widget. The visual voicemail widget enables users to view their list of wireless mobile voice messages on their desktop and then prioritize and listen to these messages. The SMS text widget allows desktop sending of text messages throughout the world. All widgets have access to a PhonePage described below. We distribute our widgets on popular galleries including Google, Apple, Yahoo!, Microsoft, and social networks. The widgets are currently free during the beta testing period. At June 30, 2007, we had approximately one million widget subscribers.

CallWave Vtxt and PhonePage

Our Vtxt service transforms mobile voicemail into readable, searchable and storable content. Incorporating our proprietary speech recognition and Web 2.0 visual voicemail technology, the Vtxt service allows subscribers to read the GIST of their voicemail on their handset. Users will also be able to manage and reply to voice and text messages from a personal web page and search for a permanent archive of voice and text messages. The Phone Page also gives the user the ability to reply to callers via text or voice right from the Web and automatically creates a contact book based on the calls received. The Vtxt service is built upon state of the art voicemail-optimized speech recognition technology and a managed services architecture that will offer unlimited storage. This enables the Vtxt service to function without requiring live operator transcription and expands the market to include privacy conscious consumers and public corporation users who are subject to non-disclosure laws. The Vtxt service is currently free during the beta testing period.

Our Strategy

Our objective is to establish ourselves as the leader in the convergence service category of Phone Companion Services. This includes services that require our Phone Companion Software (PCS) on the desktop, which is simple to adopt and use, and is a voice portal running on the user s PC. Unlike traditional VoIP services, CallWave s PCS serves as a companion to the user s existing mobile or landline phone, providing a more seamless integrated communications experience. Through CallWave s Enhanced Services Platform, the PCS desktop is fully synchronized and interoperable with the end user s existing phone number, service provider, contacts, call log and voice messages. The CallWave Enhanced Services Platform is fully scalable to manage other next generation rich media sources. Our strategy also includes Web 2.0 and wireless mobile voicemail applications that do not require a software download and enable users to manage their communications on the handset, in email, and over the Internet. We plan to achieve this objective through a combination of offering services direct to consumers in our web channel and through private label of these services to indirect carrier partners.

Invest personnel and marketing resources in the wireless mobile services market. We believe that the market for mobile telephony services will continue to grow at a faster rate than the market for landline telephony services. We intend to focus our marketing efforts on acquiring new wireless mobile subscribers and retaining existing landline customers.

Extend our reach through indirect carrier and web portal partnerships. Today, most of our sales come from direct acquisition of customers through our web channel. We also have commercial relationships with Internet and telecommunications service providers through which we provide various call-bridging services to their subscribers. In addition, we also maintain online distribution relationships with a number of smaller companies. We intend to develop similar relationships with other carriers to help us reach a wider range of subscribers, particularly as broadband and voice-over-IP technology are adopted by the mainstream.

Maintain our focus on the needs of the mainstream and wireless mobile market. We endeavor to provide services that the mainstream and wireless mobile market highly values and that we can provide to users at an affordable price. We believe that the market opportunity for addressing the communications needs of these cost-conscious and mobile users is large and growing. We intend to remain focused on these markets and provide a range of enhanced communications services that meet the needs of this market.

Continue to follow a subscriber-driven approach to development of new products and offerings. We believe that our large subscriber base helps us gain a comprehensive and accurate understanding of the needs, desires and priorities of our subscribers, which is critical to the ongoing success of our business. We also conduct subscriber studies and focus groups to further increase our understanding of our subscribers needs, desires and priorities. The information captured through this ongoing research and analysis enables us to better identify subscriber requirements and behavioral patterns and continue to develop new and enhanced communications services that current and potential subscribers in the mainstream market value. This information is also helpful in our efforts to attract new strategic partners. We intend to continue to follow a subscriber-driven approach to product development and marketing.

Provide enhanced communications services for mainstream and wireless mobile users. Our software-based platform bridges calls effectively across all mainstream forms of Internet access and across all landline, mobile and Internet service providers. This enables us to provide affordable, value-added communications services to mainstream users without the additional cost of changing service providers or purchasing new hardware or the inconvenience of changing phone numbers. We intend to continue to serve the cost-conscious and mobile market across all telecommunications services and devices.

Extend and enhance component applications and service levels. Our centralized software platform gives us the flexibility to design, deploy, test and enhance features and applications quickly and easily. We are able to bundle these component applications rapidly into new service levels. We intend to offer additional applications and service levels to meet the diverse and evolving needs of our existing and targeted subscribers and we intend to enhance existing applications and service levels to remain competitive.

Table of Contents

Index to Financial Statements

Technology

Our core technology is delivered by our desktop based Phone Companion Software (PCS) through our proprietary Enhanced Services Platform. We have designed our call-bridging software to be highly configurable and flexible, enabling us to deliver customized services to each of our subscribers through a common software platform, and to quickly add or enhance applications and features to meet the evolving needs of the mainstream market.

We designed our Enhanced Services Platform to be:

Network independent. Our call-bridging platform is independent from the telecommunications networks through which consumers and businesses communicate. Our platform interfaces with existing landline, mobile and Internet networks through industry-standard protocols. By remaining independent from this network transport layer, we are able to enhance existing telecommunications services across distinct networks and devices.

Scalable and reliable. Our platform currently processes over 17 million calls per month, and is designed to handle significantly higher call volume under the current architecture. Our software platform has been designed to be fully redundant, with no single points of failure in our software switching facility. We use fully-redundant fault-tolerant components, redundant network connections and redundant copies of data. We also maintain spare parts on site for critical components.

Flexible. Since our platform is centralized and software-based, we are able to add or enhance applications and features easily and quickly. This flexibility enables us to efficiently design, deploy, test and enhance our applications and features. We expect that any new applications we develop could easily be incorporated into our proprietary billing system.

Configurable. During registration and installation, our software is automatically configured based on subscribers existing landline, mobile and Internet services. Our configurable software platform enables subscribers to choose the specific applications and features they desire either during the registration process or during ongoing use.

Secure. Our call-bridging infrastructure and customer data are housed within secure data centers to prevent intrusions and to ensure the privacy of customer data.

Our Enhanced Services Platform intercepts inbound calls from traditional landline, wireless and IP-based networks, manages and filters calls and delivers calls to our subscribers on landline telephones, mobile phones and personal computers. Our platform contains a number of component applications, or communications applets, which we bundle into customized services to address the unique needs of our different target markets. For example, our software allows subscribers who are using their landline telephones for Internet access to screen and accept telephone calls on other devices such as a mobile phone or other landline telephone.

Intercept calls. Our software switch intercepts inbound phone and fax calls to our subscribers and is able to redirect these calls to the devices selected by the subscribers. This software switch is a carrier-class switch that resides within the communications network. In most cases, our subscribers use traditional call-forwarding services provided by their telecommunications service providers to redirect inbound calls to our software switch for delivery to the subscriber. To simplify the initial configuration process, we can automatically provision these call-forwarding services for most of our subscribers without time-consuming manual intervention.

Filter and manage calls. Our subscribers are able to screen calls in real-time before deciding whether or not to take the call. The real-time screening experience is similar to listening to a voice message as it is being left on an answering machine. While screening a call, a subscriber is able to accept the call on a mobile or landline phone by pressing a specified button on the phone or by clicking the take the call button on our client software that appears on the subscriber s personal computer. We also provide our subscribers with detailed caller identification information and enable them to block telemarketer calls. Our client software has a user interface that allows our subscribers simply to type in the phone numbers of the devices to which calls can be delivered.

Table of Contents

Index to Financial Statements

Deliver calls. Calls intercepted by our software platform can be delivered to any available telecommunications device. Once users decide to accept a call, either after reviewing the caller identification information or while screening a message, we deliver the call to the appropriate telecommunications service provider through our software switch. In order to deliver the call, our software switch initiates a new call to the subscriber and then connects, or bridges, the initial call and the new call together, rather than simply re-routing the initial call. This feature enables subscribers to receive calls in real-time after first screening the call.

Customer Support

Support is provided to customers at all stages of their experience with us through our client software, email and telephone. Email inquiries and help requests are generally responded to within 24 hours, while telephone inquiries are handled through a toll-free number during normal business hours. Our customer support representatives have direct access to customers account information and can change service configurations for customers in real time.

Our customer care staff services the customer email and telephone support load. The customer care workforce is augmented with additional agents from third-party call center operations trained for, and dedicated to, our support.

Sales and Marketing

We sell our services directly to consumers through our web channel and private label our services through our carrier channel. The majority of our sales to date have been through our web channel.

Historically, we have offered potential subscribers a free 30-day trial to our CallWave Connect service, the highest level of service we currently offer. At the end of the trial period, the user may choose to subscribe to our lower-priced CallWave Messenger or CallWave Alert services, remain on our CallWave Connect service or cancel the service entirely. In the past, we offered a free service to consumers and small and home offices and attempted to convert them to paying subscribers over time. Services that are in beta are typically offered free during the beta testing period.

We reach our customers through a variety of sales and marketing channels. We continuously analyze and re-evaluate our sales and marketing strategies to ensure we are effectively reaching out to our target markets. Our primary sales and marketing channels include:

Internet advertising. We use a number of different Internet advertising relationships and channels to reach our potential and existing subscribers. We typically pay fees to our Internet advertising vendors, based principally on the number of website visitors.

Channel relationships. We have a commercial relationship with Hawaiian Tel, Century Tel, and EarthLink under which they resell our services to their customers on a co-branded basis. We also maintain channel relationships with several smaller service providers.

Unpaid channels. We acquire a portion of our subscribers through unpaid channels such as widget galleries and word-of-mouth referrals. For example, many of our subscribers sign up for our service after calling another subscriber, interacting with our platform and learning about the benefits of our service.

Customers and Channel Relationships

Customers

From April 2001, when we first introduced our paid services, through June 30, 2005, our subscriber base increased dramatically. Over the last two years we have experienced the expected churn in our traditional business as subscribers move away from dial-up services as an access medium for the internet to faster more

9

Table of Contents

Index to Financial Statements

reliable broadband services. For the year ended June 30, 2006 we had 706,000 paying subscribers. During fiscal year 2007, as expected, our paid subscriber base decreased 11% to 631,000. Our paying subscribers primarily elect one of our three current service offerings: CallWave Alert, CallWave Messenger and CallWave Connect. As of June 30, 2007, approximately 30% of paying subscribers use our CallWave Messenger service, with CallWave Alert and CallWave Connect comprising approximately 44% and 22% of the paying subscriber base, respectively. CallWave Connect is our newest service and was introduced in April 2003. The remaining approximately 4% of our subscribers are on our legacy CallWave Pro service, which is no longer actively marketed to subscribers.

Infrastructure and Operations

Infrastructure

We have developed a sophisticated subscription billing system that supports free trials, monthly and prepaid annual plans, installment payments and configurable packages and price points. We bill our subscribers directly, in which case they pay either by check or credit card, or indirectly through regional and national service providers.

All subscriber data is stored in SQL Server databases. We store and analyze aggregate subscriber data to understand trends and subscriber behavior. This data is not currently shared with any other party, except for the express purposes of service provisioning, billing and legal compliance, and is not sold to any other party.

Operations

Our operations group manages our system and service deployments and upgrades, facility build-outs, network architecture, physical and network security, data redundancy and availability, system health monitoring, data logging, capacity planning, disaster planning, interaction with telecommunications technical staff and general troubleshooting.

Our wholly-owned subsidiary, Liberty Telecom, operates telecommunications switching equipment and other facilities in Reno, Nevada. Our Reno, Nevada facility is built using a highly-redundant architecture to enhance the reliability and availability of our services. We completed building a backup site in a Las Vegas, Nevada co-location facility to achieve geographic redundancy. At this time all services are redundantly hosted in the new facility. The architecture of our services simplifies our ability to build this redundant facility in a way where the use of backup services is, in most cases, automatic and unnoticed by the customer.

We monitor the performance of our service and our infrastructure. We utilize monitoring tools that we have developed in-house or licensed from third parties, as well as open source monitoring tools. System status is reported to centralized consoles. System status reports are open for viewing by any employee and alarms are delivered proactively to operations personnel and engineering experts. We make extensive use of data logging and graphing for monitoring subscriber trends and capacity issues, and for detecting and notifying our operations staff of uncharacteristic changes in traffic. This data collection is used extensively throughout the organization for various decision support and troubleshooting purposes. The monitoring infrastructure is continually updated to improve our ability to detect problems before they are noticed by subscribers.

Liberty Telecom

Liberty Telecom, LLC, a Delaware limited liability company, is our wholly-owned subsidiary. Liberty Telecom is a local exchange carrier and is subject to the jurisdiction of both the Nevada State Public Utilities Commission, or Nevada PUC, and the FCC. Liberty Telecom has received approval from the Nevada PUC to operate as a Local Exchange Carrier, or LEC. This LEC approval enables Liberty to provide local exchange and intrastate exchange access telecommunication services to end user customers and long distance carriers and other

Table of Contents

Index to Financial Statements

consumers of exchange access service. Under federal law, Liberty Telecom provides interstate exchange access services under blanket authority granted by the FCC in its rules. As a local exchange carrier, Liberty Telecom maintains a tariff for interstate access charges on file at the FCC, has obligations to make periodic payments to the federal and state universal service funds, file periodic reports on its utilization of numbers, and is subject to the general laws and regulations of both Nevada and the United States applicable to telecommunications carriers, including the obligation to provide services that are just, reasonable, and non-discriminatory.

Our service is designed to allow customers, when they are connected to the Internet on a dial-up connection, to receive a notice that someone is calling them, as well as to give them the opportunity to take that call. In order to provide this capability, we need to have local circuits terminating at our center in Reno, Nevada that carry the calls, which have been redirected and forwarded to our center over toll-free lines. Liberty Telecom provides us with those local connections for receiving the call-forwarded traffic. In addition, if, after screening a call, a subscriber wishes to take the call, we need a carrier to carry the local portion of the traffic to the device on which the customer will receive the call. Liberty provides us with the telecommunications services that support that need.

In addition to using its own facilities to provide telecommunications services, Liberty Telecom also has Interconnection Agreements with SBC/Nevada Bell and Sprint in Nevada under which Liberty Telecom can exchange traffic with these carriers, obtain services, lease facilities, and collocate its own facilities, as necessary, in order to provide its own telecommunications services.

Our ownership of Liberty Telecom provides us with several benefits, including the following:

- Liberty Telecom saves us money because it is able to connect calls directly with other telecommunications carriers as a peer, often at little or no charge from the other carriers. Because the wholesale rate given to a peer carrier is lower than the lowest rate given to a non-peer customer for certain types of purchased telecommunication services, our ownership of Liberty Telecom allows us to reduce substantially the access facilities charges we otherwise would pay.

- Liberty Telecom provides us a reliable source of telephone numbers, which we need in order to provide services to our subscribers. Unrelated telecommunications service providers would not be as reliable a source of telephone numbers, as they have a limited supply of telephone numbers and may allocate their available numbers to other companies rather than to us.

- Liberty Telecom increases the reliability of our services to our customers by providing us with interconnections to the carriers that host the inbound and outbound telecommunications services used by our subscribers. This allows us to identify and resolve service problems far more quickly and effectively than we would be able to achieve if we were to obtain these interconnections from unrelated service providers, and reduces the number and extent of service disruptions that our customers encounter.

Research and Development

We believe it is essential to have a strong research and development team in order to respond rapidly to market needs with a high degree of quality, reliability and scalability. Our research and development team follows a formal development process that has been refined to meet our objectives and minimize post-deployment maintenance. We operate a single version of our centralized software-based platform and are able to automatically upgrade our client software, allowing us to minimize the cost of maintaining and supporting legacy versions of technology.

Our research and development expenditures were $7,178,000, $6,805,000 and $6,868,000 for the fiscal years ended June 30, 2007, 2006 and 2005, respectively.

Competition

The market for our products and services is increasingly competitive, evolving rapidly and is subject to shifting customer needs and introductions of new products and services. Our current and potential competitors approach the market from different areas of expertise and vary in size and scope with respect to the products and services that they offer or may offer in the future.

Table of Contents

Index to Financial Statements

We face competition from providers of enhanced services and products, such as answering machines, voicemail, Internet call waiting, and virtual telephone numbers for fax or voice communications. The companies that compete in these areas include Avaya, AOL, Protus IP Solutions, Ring Central, and j2 Global Communications, or j2. For example, Avaya enables telecommunications service providers to offer voice messaging enhanced services to their customers. j2 offers fax services that provide users local fax and voicemail numbers, and the ability to send faxes from the user s computer desktop as well as to receive faxes as email attachments, optical character recognition of incoming faxes, and the ability to listen to voicemail. Those services compete with our enhanced services and fax service offerings. Protus IP Solutions enables online fax by email, using existing email accounts and the Internet to send and receive faxes without a fax machine. Some of those services compete with our fax service offerings.

We face competition from Internet service providers such as AOL, Google, MSN, AT&T WorldNet, and United Online, which are increasingly integrating enhanced functionalities with their basic services. AOL offers an enhanced communication application that includes such services as caller ID, caller name and location, incoming call management technology, telemarketer blocking, ability to listen to messages while online, call log of missed calls while online, ability to answer calls while user is online and voicemail for unanswered incoming phone calls. AOL markets its service offerings primarily to customers that already subscribe to AOL s Internet access services, though its service offerings also are available to non-AOL users.

We face competition from telephone service providers such as the regional Bell operating companies and cable access providers. These competitors are increasingly integrating enhanced functionalities with their basic services. For example, BellSouth offers an Internet call waiting service that competes with our service offerings. The product includes caller ID, caller name, incoming call management technology and voicemail for unanswered incoming phone calls. BellSouth markets its product primarily to its residential telephone user base, though its service is not presently available in all BellSouth service areas.

We face competition from providers of voice-to text products. The companies that compete in these areas include Simulscribe, Spinvox and Vonage. Simulscribe and Spinvox use speech recognition technology and live operators to fully transcribe the voicemail message to text. Simulscribe private labels its services to Vonage. Because CallWave s service does not rely on live operator assistance, messages remain private and secure, while the overall service becomes highly scalable.

Further, we face competition from primary line displacement vendors which are competing with telephone service providers. These competitors include Vonage, AT&T CallVantage, 8X8, and Net2Phone, and are offering enhanced services with their basic telephone services. For example, Vonage offers local and long-distance telephone services for consumers and small businesses. Each of these plans includes features such as voice mail, caller ID, caller name, call waiting, call forwarding, and three-way calling. Vonage also offers other options at an additional cost, including a dedicated fax line and additional phone numbers. These services are marketed to users with high-speed Internet access and compete directly with our service offerings to those same users.

We compete with all of the above companies for a share of the monthly telecommunications and information services spending of our target market. We differentiate ourselves by offering services that are independent of the underlying network infrastructure and, hence, enabling subscribers access to enhanced communication services without changing their service providers, phone number, or purchasing new equipment.

The principal factors upon which we compete in our markets include the following:

- service features targeted at the needs of the mainstream market;
- reasonable and affordable pricing;
- low capital expenditure cost structure;
- commercial relationships with existing network service providers;

network and device independence;

Table of Contents

Index to Financial Statements

- reliability and availability of service;
- ease of installation and use; and
- vendor reputation and brand.

We believe that we compete favorably based on these factors. Many of our current and potential competitors, however, have greater name recognition, longer operating histories, larger subscriber bases and significantly greater financial resources than we have. In particular, many of our competitors are large, established network service providers such as AOL, Google, AT&T, Comcast, Verizon and SBC that are able to market and distribute enhanced communications services within their already large base of subscribers. They may be able to devote greater resources to product development and marketing and sales than we can. As a result, they may be able to respond more quickly to new technologies and changes in customer requirements than we can. Furthermore, these competitors may be able to adopt more aggressive pricing policies and offer customers more attractive terms, including potentially providing a competing solution at little or no cost as part of a bundled product offering. We cannot assure you that our current and future competitors will not offer or develop products or services that are superior to ours or achieve greater market acceptance than ours or that we will be able to compete effectively against them.

Intellectual Property

Our success is dependent in part upon our ability to develop and preserve our technology and to operate our business without infringing on the proprietary rights of others. We rely on a combination of patents, trademarks, domain name registrations, trade secret laws and contractual restrictions to enforce our rights in our intellectual property. We seek to limit disclosure of our intellectual property by requiring employees and consultants with access to our proprietary information to execute confidentiality agreements. While the protection of our intellectual property is important to our business, because of the rapid pace of innovation within the telecommunications and information services industries, we believe that factors such as the technological and creative skills of our personnel, our focus upon our subscribers needs and timely and effective customer support are more important to the success of our business.

We are the owner of United States Patent Number 6,477,246, which was issued in November 2002, and expires in March 2020, which relates to the method and systems for providing Internet call waiting services. We are the owner of United States Patent Number 6,738,461 which was issued in May 2004, and expires in February 2022, which relates to the method and systems for returning a call to a private number over a telephone system. We are the owner of United States Patent Number 6,879,677 which was issued in April 2005, and expires in January 2023, which relates to method and systems for notifying a wireless caller when a called party s line is available to take a call. We are the owner of United States Patent Number 6,898,275 which was issued in May 2005, and expires in September 19, 2020, which relates to method and systems for providing Internet call waiting services. We are the owner of United States Patent Number 6,968,174 which was issued on November 22, 2005, and expires July 3, 2023, which relates to methods and systems for providing consumers with a reliable, secure, and convenient method of utilizing a telecommunications network to pay for goods or services on a one-time or recurring basis. Lastly, we are the owner of United States Patent Number 7,103,167 which was issued on September 5, 2006, and expires November 9, 2023, which relates to methods and systems for screening telephone calls. In addition, we have a collection of patent applications pending in the United States relating to fixed and mobile telephony, fax processing and billing. We cannot assure you that patents will be issued from pending or future applications or that, if patents are issued, they will not be challenged, invalidated or circumvented, or that any rights granted thereunder will provide meaningful protection or other commercial advantage to us. Moreover, we cannot assure you that any patent rights will be upheld in the future or that we will be able to preserve any of our other intellectual property rights.

We hold several registered trademarks in the United States, including a registered mark on the phrase Internet Answering Machine , the name CallWave, and on a stylized service mark for CW.

Table of Contents

Index to Financial Statements

We license intellectual property from third parties and incorporate such intellectual property into our services. These relationships are generally non-exclusive and have a limited duration. Moreover, we have certain obligations with respect to non-use and non-disclosure of such intellectual property. We cannot assure you that the steps we have taken to prevent infringement or misappropriation of our intellectual property or the intellectual property of third parties will be successful.

See the sections titled Risk Factors We may not be able to protect and enforce our intellectual property rights, which could impair our ability to compete and reduce the value of our services, and Other persons may assert claims that our business operations or technology infringe or misappropriate their intellectual property rights, which could increase our costs of operation and distract management and could result in expensive settlement costs.

Employees

As of June 30, 2007, we had 113 full-time employees: 47 are in research and development, 32 are in operations and customer care, 20 are in sales and marketing and 14 are in general and administrative functions. None of our employees are covered by collective bargaining agreements. We believe that our relations with our employees are good.

Item 1A. Risk Factors

Our ability to successfully generate increased revenues and profits will be dependent upon our success in entering into and successfully managing indirect carrier distribution relationships.

We grew our business by directly marketing our services to consumers and small businesses through Internet advertising. We intend to attempt to grow our business by promoting our services to users through indirect carrier distribution arrangements in which we enter into distribution agreements with telecommunications service providers, which agree to distribute our services to their subscribers under their brand. We do not have significant experience in developing and managing those indirect relationships. There typically is a long lead time required to conclude agreements for such arrangements, additional time is thereafter required to implement each agreed-upon arrangement, and the actual pace of implementation is dependent upon cooperation and support from the companies with which we enter into those arrangements. In addition, even if we are able to put such indirect distribution relationships in place, the extent to which the service provider s customers subscribe for our services will be dependent in substantial part upon the pace and manner in which the service provider implements and promotes our services, which are outside of our control. If we are unable to successfully implement those indirect distribution relationships we may not realize substantial growth in our subscribers for our services, we will not realize substantial growth in revenues or profitability, and our results of operations and financial condition will be adversely affected.

We may suffer losses from operations and reduce our accumulated cash reserves as we shift resources from our profitable direct distribution business and focus our business and investments on indirect carrier distribution of our services.

We have elected to reduce the amount of resources that we are devoting to our traditional business in which we had marketed and distributed our services directly to users, and instead to expand the resources that we are investing in the development and marketing of our services through indirect carrier distribution arrangements. As a result, we expect to realize lower revenues from our traditional business. However, we do not expect to begin generating substantial revenues from indirect distribution arrangements for at least several quarters. That delay in generating substantial revenues is attributable to a number of factors, including the time period required to develop indirect distribution relationships with telecommunications carriers, the time required to implement technological changes to our services in order to make them compatible with the communications infrastructure of carriers with which we enter into indirect distribution relationships, and the time required to successfully market our services to those carriers customers and persuade those customers to subscribe for our services. As

Table of Contents

Index to Financial Statements

we undergo this transition from a business based upon our traditional landline services sold directly to the consumer, to one based primarily upon the delivery of services through indirect distribution relationships, we are likely to realize losses from operations and reduce our accumulated cash reserves.

Our ability to successfully implement indirect carrier distribution arrangements is dependent upon our ability to integrate our technology with that of the companies that distribute our services.

In order for our indirect carrier distribution arrangements to be successful, the companies with whom we enter into indirect distribution arrangements must be able to integrate our services with their own service offerings. That integration process requires that our technology operate effectively with the service platforms from which those companies deliver telecommunications services to their customers and meet the technical specifications and operating parameters imposed by companies with which we are seeking indirect distribution relationships. The integration of our services with the service platform of those other companies is a complex process that requires not only that our respective technology platforms operate together, but also that our engineering departments work effectively together at a technical level in integrating our respective services. Those tasks require time, and we may encounter technical difficulties that occasion delay. We also may encounter some technical difficulties that adversely affect the customer s ability to fully utilize our services or even our ability to integrate our services at all. If we are unable to overcome those challenges, then our indirect distribution strategy may be adversely affected, and we may not be able to achieve the revenue and profitability gains that we are seeking to achieve.

The use of indirect carrier distribution arrangements may cause us to realize lower revenues and profitability than we traditionally have realized from direct web distribution of our services.

We expect that the principal growth in subscribers will come primarily from the implementation of indirect distribution arrangements. While these arrangements typically deliver subscribers to us at a lower subscriber acquisition cost than our traditional sources of subscribers, they also tend to generate a lower average revenue per user, or ARPU, than the traditional direct web channel sources of subscribers. In order to achieve substantial future revenue growth from these indirect carrier distribution arrangements, we will need to implement indirect distribution arrangements that afford us broad exposure to significant numbers of potential subscribers, and we will need the other parties to those arrangements to cooperate with us in distributing our services to their customers. If we are unable to accomplish those objectives, then we may not achieve future revenue growth, and our results of operations will be adversely affected.

Our ability to successfully implement indirect carrier distribution arrangements and custom integrate our technology with that of the service providers that distribute our services may cause us to reduce our ability to innovate in our direct web channel.

In order for our indirect distribution arrangements to be successful, the companies with whom we enter into indirect distribution arrangements require custom features, unique network integrations and branding. That integration process requires development from our engineering team. Given limited engineering resources, our ability to rapidly innovate and deliver competitive new services in the direct web channel may be reduced.

If telecommunications carriers modernize their voice mail and call management services at a rate that is slower than what we predict, then we may experience delays in realizing growth in revenues and profitability from our services.

Our services allow carriers to upgrade their existing telephone-based voicemail systems to a visual voice mail system where users can receive their voicemail in their email or web page or in a client application running on the user s personal computer. We believe that there is an opportunity for the marketing and distribution of our visual voicemail and call management services because these services are more convenient to use and have lower underlying costs to the carrier. We therefore have decided to devote substantial resources to indirect marketing

Table of Contents

Index to Financial Statements

and distribution of our services. If the pace of that convergence of landline and other telecommunications services unfolds more slowly than we currently foresee it occurring, then the proportion of mass market consumers who are ready to subscribe to our services may be much smaller than is necessary to support substantial growth in our revenues and profitability. If the proportion of consumers who subscribe for our services is correspondingly lower, then our results of operations and financial condition will be adversely affected.

Because we are unable to predict with precision the rate at which we will acquire paying subscribers for our services through the indirect distribution relationships that we will be emphasizing, our results of operations may be correspondingly less predictable, our stock price therefore may be more volatile, and our stockholders may suffer losses.

From our traditional business, which involved the direct marketing and distribution of our services to customers in the web channel, we have assembled a substantial amount of data that allowed us to predict our subscriber counts, revenues, and profits in that legacy business with some reliability. As our business increasingly emphasizes the delivery of our services through indirect distribution relationships, however, we will be operating without historical data that would allow us to predict with any precision the rate at which our services will be accepted by consumers or the prices at which consumers may be willing to subscribe for those services. Consequently, we may experience significantly greater swings in our revenues and profitability than in the past, our stock price may become increasingly volatile, and our stockholders may realize losses in the value of their shares.

If service providers elect to bundle services similar to ours that they obtain from other providers or to develop such services themselves as part of their product offering, we could lose many of our paid subscribers.

The market for communications and information services is competitive, and many service providers attempt to attract and retain subscribers by offering a variety of services. While service providers that provide Internet call waiting and call management services generally impose a separate charge, those service providers may in the future bundle such services with their other service offerings, thereby effectively offering these services for no incremental fee. If we lose subscribers to those network service providers that bundle services that are competitive with ours and we are unable to find replacement subscribers willing to pay for our services, our business, revenues and profitability would be adversely affected.

Increased marketing costs for Internet advertising may cause further erosion in our traditional landline business.

Our subscriber acquisition costs for our traditional land-line customers are dependent largely upon our ability to purchase multiple types of advertising at a reasonable cost. Our advertising costs vary over time, depending upon a number of factors, some of which are beyond our control, such as seasonality, the particular mix of advertising we use and the rate at which we convert potential subscribers into paid subscribers, and consolidation among companies that control advertising channels. We have experienced an increase in subscriber acquisition costs in the recent periods. Given our belief that our revenues from our traditional landline business will decline over time, we have decided not to increase the amount of money that we spend on Internet advertising for our landline services. As a result, we are realizing both reduced marketing expenditures and a higher unit cost for the advertising services that we purchase. We expect that those two factors will occasion an acceleration in the decline of our landline business over time.

New Internet-based distribution channels are emerging for the types of services we offer direct to the consumer which may cause an increase in our marketing costs.

Widgets and Gadgets have introduced a new, low cost distribution channel for direct-to-consumer web services such as voicemail and other call management services. If we fail to establish a position in this new channel it may impact our ability to acquire customers for our services unless we increase our marketing costs.

Table of Contents

Index to Financial Statements

We are dependent upon billing arrangements with regional telephone companies for collecting fees from many of our subscribers.

We currently collect the majority of our revenues through billing arrangements in which our subscribers local telephone companies bill and collect our service fees from our subscribers on our behalf and forward those fees to us. We collect the remainder of our revenues through our subscribers credit cards and checks. If the telephone companies terminated those billing arrangements, or if the cost of those arrangements increased significantly, we may be unable to continue to collect a significant portion of our revenues in this manner, and instead would have to collect those revenues through use of subscribers credit cards, by having subscribers mail checks to us, or by other means. Because many subscribers prefer to pay for our services through their telephone bills, any need to rely upon alternative means to collect a significant portion of our revenues may lead to a loss of a substantial portion of the subscribers who currently pay for our services as part of their monthly bill from their telephone company, a decline in the rate at which we increase the number of our paid subscribers, or significant delinquencies in payments by our subscribers. If we are not able to successfully manage and maintain these billing relationships, our bad debt reserves may increase and we may lose subscribers that prefer paying for our services on their local telephone bill.

Customer billing is a highly complex process, and our billing system must efficiently interface with third party systems. Our ability to accurately and efficiently bill our subscribers is dependent on the successful operation of the third party systems upon which we rely and our ability to provide these third parties the information required to process transactions. Any failures or error in our current billing systems or procedures or resulting from any upgrades to our billing systems or procedures could materially and adversely affect our business and financial results.

If we fail to maintain effective internal financial and managerial systems and procedures, our results of operations may be adversely affected.

As we expand our operations and offer new services, there is a risk that our systems and procedures may not be adequate to support our operations or ensure proper identification of and proper accounting treatment for our activities. Our failure to maintain and implement such adequate systems and procedures could adversely affect the information on which we base our decisions, thereby causing us to make inappropriate business decisions. Those incorrect decisions in turn, could adversely affect our business, financial condition, and results of operation.

We face competition from well-capitalized hardware vendors, software vendors and service providers against whom we may not be able to successfully compete.

Competition in the communications and information services industries is intense. We face competition for our offerings from Internet service providers, such as AOL, landline and wireless telephone companies, such as AT&T, cable companies and other communications hardware, software and services vendors. These companies are better capitalized, have greater name recognition and significantly larger existing subscriber bases than we do. We may also face competition in the future from communications hardware and software companies that are currently focused on other markets. If these or other companies provide services similar to ours, we may not be able to compete effectively, which would harm our results of operations and financial condition.

There are limited barriers to entry for other companies to provide services that compete with ours.

Telecommunications services were historically provided by companies that made substantial capital investments in their networks. The size of those investments and the time required to deploy those networks served as significant barriers to entry into such markets. In contrast, we provide software-based enhanced services that do not require substantial capital expenditures to deploy and maintain. As a result, other companies with strong technical staffs and knowledge of the communications and information services industries could compete with us without facing significant capital expenditures or other barriers to entry. As a result, we may

Table of Contents

Index to Financial Statements

face increasing competition from companies with significantly greater resources than we have, which may force us to reduce our prices and increase our operating expenses to remain competitive. If we are not able to compete successfully with these companies, we may lose customers or fail to grow our business as we anticipate, either of which could harm our financial condition, results of operations and future growth prospects.

We rely upon the networks of numerous long-distance and local carriers to provide services to our subscribers. If the cost of these services were to increase, we may not be able to profitably provide our services to our subscribers.

In providing services to our subscribers, we incur a number of underlying telecommunications costs which are beyond our control. Our services rely in part upon the toll-free long-distance and local services that we purchase from network service providers. In order to deliver our services to our subscribers, our customers also must subscribe to certain ancillary services from their telecommunications providers that re-route certain telephone calls from our subscribers telephone lines to toll-free numbers that we have leased at our software-based switching facility, which facilitates the receipt of the call by the number that the subscribers designate. The cost of services, which we integrate into our service offerings, or which subscribers assume directly, in order to receive our services is beyond our control and may increase for a number of reasons, including:

- a general increase in wholesale long-distance rates or charges for call forwarding services;
- an election by service providers to implement a new pricing structure on the services that we currently purchase;
- an election by third-party service providers to impose charges for services which are currently toll-free; and
- an increase in subscriber usage patterns that increases the cost of the services that we purchase.

Our ability to offer services to our subscribers at competitive rates is partially dependent upon our ability to use that toll-free telephone network and our subsidiary s ability to procure telephone network access and services on a reliable basis and at reasonable prices. If we are unable to effectively manage the cost of our underlying network services, then our pricing structure with a significant number of our subscribers would increase, which could make it difficult to conduct business at attractive margins. Similarly, if the costs of the ancillary services which our subscribers must purchase from their telecommunications providers in order to receive our services were to increase, then our services may become less attractive to our existing and prospective customers, and we may lose subscribers which would adversely affect our revenues, our prospects for growth, our operating results, and our financial condition.

There are a limited number of long-distance and interconnection service providers that are able to provide the services on which we rely.

We currently have contracts with four service providers for long-distance services, and our wholly-owned subsidiary, Liberty Telecom, LLC also has interconnection agreements with other telecommunications companies, which together provide us with services that we integrate into our enhanced offerings. Each of those contracts may be terminated without cause by the service provider upon advance written notice. The required notice period, in each instance, is less than the amount of time that we would likely need to negotiate a contract with a successor provider and modify our system to re-route our subscribers inbound calls to that successor s network. In addition, there are only a limited number of service providers with which we can contract to provide these services. As a result, if one or more of the service providers from which we currently procure long-distance or interconnection services were to terminate our existing contractual relationships, we may not be able to locate a substitute provider on a timely basis and upon reasonable terms, if at all, in order to avoid a disruption or loss of service to our subscribers. If we are not able to purchase access to sufficient long-distance and interconnection services at reasonable prices, we may not be able to profitably provide our services to our subscribers and our operating results and financial condition would be harmed.

[Table of Contents](#)

[Index to Financial Statements](#)

We rely upon the Internet and other networks controlled by third parties to provide our services and if we are not able to maintain access to these networks at reasonable rates, we may not be able to profitably provide our services.

We provide our services by integrating and enhancing underlying services on other companies networks that rely on the public switched telephone network, across the private networks constructed and owned by other companies such as those in the cable industry, and across the Internet. If the owners of any one or more of those networks were either to refuse to transport calls to our subscribers, or were to impose significantly higher charges for those calls, or if applicable regulations were to impose significantly higher charges for those calls, we would likely face increased operating costs, our profitability could suffer and our business could be harmed.

Because a significant portion of our subscribers are price sensitive, we may not be able to increase the charges for our services without adversely affecting our ability to attract and retain paid subscribers.

Our subscribers are generally price sensitive. In response to that sensitivity, we have attempted to control our costs in order to be able to charge low subscription rates for our landline services, which generally range from $1.50 to $7.95 per month, and are as high as $9.95 per month in limited circumstances. We expect that recruiting new subscribers may become more expensive on average if we increase our marketing efforts. If we experience significant cost increases or otherwise want to increase our margins, we may be unable to increase our monthly charges by an amount sufficient to allow us to maintain margins or our profitability, and our business and operating results could be adversely affected.

We are dependent upon the availability of reasonably priced call-forwarding services to provide our services to the majority of our subscribers in a cost-effective manner.

Customers who subscribe to certain of our services typically subscribe to call-forwarding services from their local telephone service provider. Generally, these call-forwarding services are available to our subscribers at a reasonable price. If the service providers do not provide these services at a reasonable price, the overall price of obtaining our services may exceed the amount that our current and potential subscribers are willing to pay. If the prices for these services increase, a significant number of our subscribers may terminate their subscriptions for our services, which would have an adverse effect on our revenues, operating results, financial condition, and prospects for growth.

Customers who subscribe to certain of our services typically configure call-forwarding services from their wireless provider. Generally, these call-forwarding services are available to our subscribers at no additional charge. If the wireless service providers do not provide these services at a reasonable price, at all, or exclusively to another enhanced service provider, our ability to provide some of our services may not be practical. If the prices for these services increase or are no longer available, a significant number of our subscribers may terminate their subscription for our services, which would have an adverse effect on our growth potential.

We are dependent upon the availability of reasonably priced text messaging services to provide some of our services.

Customers who subscribe to certain of our services rely on our ability to send text messages on their behalf to other cell phone users or from us directly to our subscribers. Generally, these text messaging capabilities are available to us and are available at a reasonable price. If the wireless service providers terminate our ability to send text messages, a significant number of our subscribers may terminate their subscriptions for our services, which would have an adverse effect on our growth potential. Service providers might choose to terminate our ability to send text messages if they view our services as a competitive threat to their own or if our infrastructure is hacked and mass spam messages are sent to cell phone users.

Table of Contents

Index to Financial Statements

A catastrophic event at Liberty Telecom s telephone switching facilities would cause the disruption of our services to subscribers.

Our enhanced services currently depend on telecommunications services from our subsidiary, Liberty Telecom, which are provided using call-switching facilities in Las Vegas and Reno, Nevada. A catastrophic event, such as an earthquake or a fire, that destroys part or all of the facilities would disrupt our business and prevent us from providing services to our subscribers for an extended period of time. Because our subscribers expect our services to match the high reliability that characterizes services in the communications and information services industries generally, any failure in our ability to service our subscribers could cause us to lose significant numbers of subscribers, and make it more difficult to obtain new paid subscribers.

A system failure or a breach of our network security could delay or interrupt service to our subscribers or lead to a misappropriation of our confidential information.

Our operations are dependent upon our ability to protect our computer network from interruption, unauthorized entry, computer viruses and other similar events. Our existing and planned precautions may not be adequate to prevent a significant interruption in the operation of our network. Despite the implementation of security measures, our infrastructure also may be vulnerable to computer viruses, hackers or similar disruptive problems caused by our subscribers, employees or other Internet users who attempt to invade public and private data networks. A system failure or a breach of our security measures may lead to a disruption in service, or the misappropriation of confidential information, which may result in significant liability to us and also may deter current and potential subscribers from using our services. Any system failure or security breach that causes interruptions or data loss in our operations or in the computer systems of our subscribers could cause us to lose paid subscribers and harm our business, prospects, financial condition and results of operations.

Our security measures may not prevent security breaches that could harm our business. Currently, a significant number of our users authorize us to bill their credit card accounts directly for all transaction fees charged by us. We rely on encryption and authentication technology licensed from third parties to provide the security and authentication technology to effect secure transmission of confidential information, including customer credit card numbers. Advances in computer capabilities, new discoveries in the field of cryptography or other developments may result in a compromise or breach of the technology used by us to protect transaction data. Any compromise of our security could harm our reputation and, therefore, our business, and also subject us to significant liability. In addition, a party who is able to circumvent our security measures could misappropriate proprietary information, or cause interruptions in our operations, damage our computers or those of our users, or otherwise damage our reputation and business.

If we experience excessive fraudulent credit card charges, we could lose the right to accept credit cards for payment and our subscriber base could decrease significantly.

A significant number of our paid subscribers authorize us to bill their credit card accounts directly for all service fees charged by us. We incur losses from claims that the customer did not authorize the credit card transaction to purchase our service. If the numbers of unauthorized credit card transactions becomes excessive, we could be assessed substantial fines for excess charge backs, or we could lose the right to accept credit cards for payment. If we were unable to accept credit cards, our paid subscriber base could significantly decrease, which could have a material adverse effect on our business, prospects, financial condition, operating results and cash flows.

If we do not successfully anticipate the service demands of our subscribers, we may be unable to successfully attract and retain subscribers.

We must accurately forecast the features and functionality required by our current and potential subscribers. In addition, we must design and implement service enhancements that meet subscriber requirements in a timely and efficient manner. We may not successfully determine subscriber requirements and, therefore, may not be

[Table of Contents](#)

[Index to Financial Statements](#)

able to satisfy subscriber demands. Furthermore, as our current subscribers needs change, we may not be able to identify, design and implement in a timely and efficient manner services incorporating the type and level of features desired by our subscribers. If we fail to accurately determine or effectively market subscriber feature requirements or service enhancements, we may lose current subscribers or fail to attract new subscribers, and may be unable to grow our revenues.

Other persons may assert claims that our business operations or technology infringe or misappropriate their intellectual property rights, which could increase our costs of operation and distract management and could result in expensive settlement costs.

Other companies or individuals, including our competitors, may claim that we infringe or misappropriate their intellectual property rights. From time to time, third parties have contacted us, asserting that we may infringe their intellectual property rights. For example, in December 2003 and April 2004, a major communications infrastructure company delivered two letters to one of our distributors, in which we were not named, offering to negotiate with our distributor a nonexclusive license to certain patents that the infrastructure company believed to be relevant to our service and implying that our service may infringe those patents. As part of this process, we have received a legal opinion from our intellectual property counsel that our services do not infringe the patents of this infrastructure company, although there is no assurance that a court would agree with that opinion.

A determination that we have infringed the intellectual property rights of a third party could expose us to substantial damages, restrict our operations or require us to procure costly licenses to the intellectual property that is the subject of the infringement claims. Such a license may not be available to us on acceptable terms or at all. Any effort to defend ourselves from assertions of infringement or misappropriation of a third party s intellectual property rights, whether or not we are successful, would be expensive and time-consuming and would divert management resources. Any adverse determination that we have infringed the intellectual property rights of a third party, or the costs we incur to defend ourselves against such claims, whether or not we are successful, would have a material adverse impact on our business and results of operations.

Our customers or other companies with whom we have a commercial relationship could also become the target of litigation relating to the patent and other intellectual property rights of others. This could trigger support and indemnification obligations, which could result in substantial expenses, including the payment by us of costs and damages relating to patent infringement. In addition to the time and expense required for us to meet our support and indemnification obligations, any such litigation could hurt our relations with our customers and other companies. Thus, the sale of our services could decrease. Claims for indemnification may be made by third parties with whom we do business and such claims may harm our business, prospects, financial condition and results of operations.

As most recently reported in the Quarterly Report on Form 10-Q for the quarter ended March 31, 2007, as filed on May 14, 2007, we were involved in litigation with Catch Curve, Inc., a Delaware corporation, and j2 Global Communications, a Delaware corporation (collectively j2 Global). The litigation concerned allegations that our operations infringed certain patents of j2 Global, and involved two actions pending in the United States District Court for the Central District of California (Action Nos. 04-7068 and 05-4819).

Effective March 13, 2007, CallWave and j2 Global entered into a Patent License and Settlement Agreement (the Agreement). In the Agreement, we and j2 Global agreed to resolve all of j2 Global s outstanding patent infringement claims. Under the terms of the Agreement, we paid $4 million to j2 Global for a fully paid-up, nonexclusive license to use the Licensed Patents (as that term is defined in the Agreement) for non-fax services. In addition, we agreed to pay a running royalty of at least 10% for a non-exclusive license to use the Licensed Patents for fax services. We and j2 Global have agreed to dismiss all pending litigation.

[Table of Contents](#)

[Index to Financial Statements](#)

We may be engaged in legal proceedings that could cause us to incur unforeseen expenses and could occupy a significant amount of our management s time and attention.

From time to time, we may be subject to litigation, such as class action lawsuits, that could negatively affect our business operations and financial position. Such disputes could cause us to incur unforeseen expenses, could occupy a significant amount of our management s time and attention, and could negatively affect our business operations and financial condition.

We may not be able to protect and enforce our intellectual property rights, which could impair our ability to compete and reduce the value of our services.

We rely primarily upon a combination of trademark, trade secret, copyright and patent law protections, and contractual restrictions to protect our proprietary technology. Those measures may not provide meaningful protection. For example, any rights granted under any of our existing or future patents may not provide meaningful protection or any commercial advantage to us. Such patents could be challenged or circumvented by our competitors or declared invalid or unenforceable in judicial or administrative proceedings. The failure of any patents to adequately protect our technology would make it easier for our competitors to offer similar services. With respect to our proprietary rights, it may be possible for third parties to copy or otherwise obtain and use our proprietary technology or marks without authorization or to develop similar technology independently. Monitoring unauthorized use of our proprietary technology or marks is difficult and costly. We may not be able to detect unauthorized use of, or to take appropriate steps to enforce, our intellectual property rights, particularly in foreign countries where the laws may not protect our proprietary rights as fully as in the United States. If we commence an action to terminate a third party s authorized use of our intellectual property rights, we may face challenges to the validity and enforceability of our proprietary rights and may not prevail in any litigation regarding those rights. Any efforts to enforce or determine the scope of our intellectual property rights, whether initiated by us or a third party, would be expensive and time-consuming, would divert management resources and could adversely affect our business, whether or not such litigation results in a determination favorable to us.

If we are unable to obtain additional telephone numbers, we may not be able to grow our subscriber base.

Our future success will depend in part upon our ability to procure and maintain sufficient quantities of telephone numbers in area codes where our subscribers are located at costs we can afford. The ability of telecommunications carriers to provide us with telephone numbers to be used in conjunction with our services depends on applicable regulations, the practices of telecommunications carriers that provide telephone numbers, and the level of demand for new telephone numbers. In addition, the Federal Communications Commission, or FCC, has regulations concerning numbering resource utilization. If CallWave does not sufficiently utilize the numbers assigned to it, it may have to relinquish control of those unused numbers. Furthermore, the FCC and state public utility commissions periodically review numbering utilization, and may in the future propose additional changes to regulations or interpret existing regulations that affect number assignment and the availability of numbers for, or the applicability of number portability requirements to, our services. Failure to have access to sufficient telephone numbers in a timely and cost-effective manner, or the loss of use of numbers we have previously accessed or may access, could prevent us from entering some markets or slow our growth in the markets in which we currently sell our services.

Our Enhanced Services Platform is a complex hardware and software system that could fail and cause service interruptions to our subscribers.

Our hardware and software systems are complex and are critical to our business. If our systems fail, our subscribers or our indirect distribution partners subscribers might experience reduced levels of service or service interruptions. Software-based services, such as ours, may contain undetected errors or failures when introduced or when new versions are released. Errors may be found in our software before or after commercial release, and, as a result, we may experience development delays or a disruption of our services. Failures in our system or interruptions to our service could cause us or our indirect distribution partners to lose paid subscribers and harm our business, prospects, financial condition and results of operations.

Table of Contents

Index to Financial Statements

If we are unable to maintain access to national IP-protocol based networks, then our business and results of operations may be adversely affected.

Historically, to obtain our services, our subscribers had their calls routed on long-distance circuits through the public switched telephone network to our software switching facilities in Nevada. That structure requires that we often pay for long-distance telephone service. We expect to increasingly rely upon the public Internet or third-party managed Internet protocol networks, which would not change how we provision services to our subscribers, but would allow us to reduce our cost of sales by using more of the less expensive Internet and local telephone network minutes and fewer of the more expensive long-distance telephone network minutes. We recently entered into a contract with a provider of these Internet and managed Internet protocol network services, which is a privately managed Internet where access is controlled to ensure quality of service. If we are unable to establish and effectively manage such relationships on a cost-effective basis, or if the costs associated with Internet and local telephone network minutes increase, then our ability to manage our costs may be adversely affected and our results of operations may suffer.

Our success depends in large part upon our retention of our executive officers and our ability to hire and retain additional key personnel.

Our future performance depends in large part upon the continued services of our executive officers and other key technical, operations and management personnel. Our future success also depends on our continuing ability to attract and retain highly qualified technical, operations and managerial personnel. Competition for such personnel is intense, and we may not be able to retain our key employees or attract or retain other highly qualified technical, operations and management personnel in the future. The loss of the services of one or more of our executive officers or other key employees or our inability to attract and retain additional qualified personnel could harm our business and prospects.

We may need to raise additional capital to support the growth of our operations, but such additional funds may not be available.

Our future capital needs are difficult to predict. We may require additional capital in order to take advantage of opportunities, including strategic alliances and potential acquisitions, or to respond to changing business conditions and unanticipated competitive pressures. Additionally, funds generated from our operations may be less than anticipated. As of June 30, 2007, we had total working capital of $51.9 million, $20.3 million of cash and cash equivalents and $32.4 million of marketable securities. While we believe that our current capital resources will be sufficient to fund our operations through the end of June 30, 2008, we may need to raise additional funds either by borrowing money or issuing additional equity in order to handle unforeseen contingencies or take advantage of new opportunities. We may not be able to raise such funds on favorable terms, if at all. If we are unable to obtain additional funds, then we may be unable to take advantage of new opportunities or take other actions that otherwise might be important to our business or prospects.

If we acquire other businesses or license technologies, they could prove difficult to integrate, disrupt our business, dilute stockholder value and adversely affect our operating results.

Our business strategy in the future may include the acquisition of other businesses or licensing of technologies. We may not be able to identify, negotiate, integrate or finance any such future acquisition or license successfully. We have not acquired any companies to date and have no arrangements or agreements with respect to any potential acquisition and, therefore, have no experience with integrating other business operations or technologies with ours. If we engage in any such strategic transaction, then we may encounter unforeseen operating challenges and expenses that may require a significant amount of management time that otherwise would be devoted to running our operations. If we undertake acquisitions or other strategic transactions, then we may issue shares of stock that dilute the interests of existing stockholders; and we may incur debt, assume contingent liabilities, or create additional expenses related to amortizing intangible assets, any one or more of which may harm our business and results of operations.

Table of Contents

Index to Financial Statements

We are exposed to risks and increased expense from recent legislation requiring companies to evaluate internal controls.

Section 404 of the Sarbanes-Oxley Act of 2002 (the Act) requires our management to report on the effectiveness of our internal controls over financial reporting beginning with the fiscal year ended June 30, 2008. In addition, the Act requires our independent registered public accounting firm to attest to the effectiveness of our internal controls over financial reporting. In fiscal year 2008 we expect to incur significant expense and to devote significant management resources to comply with Section 404. In the event that we or our independent registered public accounting firm determine that our internal controls over financial reporting are not effective as defined under Section 404 for fiscal year 2008 or any subsequent period, or we are unable to remediate any potential material weaknesses is our internal controls, investor perceptions of our company may be adversely affected and could cause a decline in the market price of our stock, and we could experience further increases in expenses and redirection of management resources in order to remedy any such weakness in internal controls.

Risks Related To Our Industry

We may not be able to respond to the rapid technological change of the communications and information services industries and, as a result, our business may be adversely affected.

The communications and information services industries are undergoing rapid and significant technological change. We cannot predict the effect of technological changes on our business. We expect that new services and technologies will emerge in the markets in which we compete. Those new services and technologies may be superior to the services and technologies that we provide or those new services may render our services and technologies obsolete. In addition, those services and technologies may not be compatible with ours. If we are not able to effectively respond to technological changes, the services we provide may no longer be attractive to our current and potential subscribers and our business, prospects, financial condition and results of operations may be harmed.

We are exposed to risks that our subscribers could attempt to use some of our features to reach emergency services by dialing 911, which could result in liability since we do not provide access to emergency services to subscribers who dial 911.

Some features of our services allow our subscribers to initiate calls to other end users served by the public switched network, mobile service providers, or interconnected VoIP providers. These features do not support 911 services, and thus our subscribers cannot access emergency services by dialing 911. Although we provide subscribers with numerous warnings that they cannot use our service features to dial 911 and include conspicuous limitations on liability clauses within our service agreements, there remains the risk that a subscriber will attempt to use the features we provide to place a call to an emergency services provider, which could result in the loss of or damage to property or injury or death to one or more persons. If a court or other body with competent jurisdiction concludes that we are at least partially liable for such loss, damage, or injury, we could incur the obligation to pay substantial monetary damages that adversely affect our operating results and cause us financial harm.

We may be required to incur significant costs to modify our systems in order to meet the requirements of the Communications Assistance to Law Enforcement Act.

The Communications Assistance to Law Enforcement Act, or CALEA, requires telecommunications carriers to have the capability to perform wiretaps and to record other call identifying information. We currently believe that the circuit-switching facilities of our subsidiary, Liberty Telecom, are in compliance with CALEA-related requirements. There is substantial uncertainty within the industry as to how to implement these requirements with respect to packet-switched networks, such as that operated by Liberty Telecom and upon which we rely to provide our enhanced services. As Liberty Telecom expands its service offerings, further modifications to its

Table of Contents

Index to Financial Statements

local switching equipment may be necessary to comply with applicable laws and regulations. In 2005, the FCC released an order concluding that CALEA applies to facilities-based broadband Internet access providers and providers of interconnected VoIP service. On May 12, 2006, the FCC issued an order that addressed, among other things, the assistance capabilities required for facilities-based broadband Internet access providers and providers of interconnected VoIP. The FCC has requested comment on, among other things, whether CALEA should apply to other types of IP-enabled services. That proceeding or other proceedings examining CALEA-related requirements as they apply to circuit-switched or packet-switched networks could result in additional regulatory burdens for us and for Liberty Telecom. Complying with CALEA and rules implementing CALEA may require us to incur substantial costs, which could negatively impact our results of operations.

The underlying telecommunications and telecommunications services upon which we rely to provide our services may become subject to burdensome regulations that could increase our costs or hamper our ability to provide our service offerings.

We provide our services through data transmissions over public telephone lines and other facilities provided by telecommunications companies. The underlying transmissions are typically subject to regulation by the FCC, state public utility commissions and, in the future, could become subject to regulation by foreign governmental authorities to the extent subscribers use our services outside the territories of the United States. These regulations affect the prices that we pay for transmission services, the competition we face from communications service providers that may choose to offer enhanced services similar to ours and other aspects of our market. Changes in the federal and state regulatory rules governing the offerings of our underlying suppliers, or developments in the interpretation of existing regulations, could decrease our revenue, increase our costs or restrict our service offerings. The impact of federal or state legislative, regulatory, or adjudicatory actions or requirements may apply not only prospectively but conceivably retroactively and could result in an increase in our costs, adversely affect how we conduct our business, our financial condition and results of operations.

Our wholly-owned subsidiary, Liberty Telecom, is a telecommunications carrier subject to state and federal regulation as a Competitive Local Exchange Carrier and is required to have a certificate of public convenience and necessity in order to operate in the state of Nevada as a Competitive Local Exchange Carrier. If Liberty Telecom were to lose its certificate, we may not be able to obtain access to telecommunications services at rates or on other terms and conditions that are as favorable as those that we currently have.

On September 23, 2005, the FCC released an order reclassifying wireline broadband Internet access services as information services, thereby placing wireline broadband Internet access services within the same general regulatory framework as cable modem services. Similarly, on November 7, 2006, and March 23, 2007, the FCC released orders declaring Broadband over Power Line (BPL)-enabled Internet access service and wireless broadband Internet access service, respectively, to be information services. As information services, wireline, wireless, and BPL-enabled broadband Internet access, like cable modem service, no longer are subject to regulation under Title II of the Communications Act of 1934, as amended, or the FCC s Computer Inquiry rules, but are subject to specific obligations imposed under Title I of the Act. The Commission also permitted, in March 2006, a petition of Verizon for forbearance of federal Title II and Computer Inquiry regulation of its broadband services to be deemed granted by operation of law, an action which is now subject to appeal. Further, petitions for forbearance seeking relief similar to that deemed granted to Verizon were filed by AT&T, Sprint, Embarq, and other ILECs in 2006, and the Commission must act on these various petitions in the second half of 2007. These FCC actions, and the grant of the pending petitions for forbearance, could potentially enable ILECs to (1) raise barriers for subscribers to their broadband transmission services to use our enhanced services, (2) charge higher rates for underlying broadband transmission service to subscribers to our enhanced services, or (3) bundle enhanced services that are similar to our enhanced services with their broadband transmission services at such a rate that it becomes economically infeasible for us to compete with the ILEC. If one or more ILECs take any of those actions with explicit or tacit permission from the FCC, then it could have a material adverse impact upon our profitability and the results of our operations.

Table of Contents

Index to Financial Statements

Our business and users may be subject to sales tax and other taxes.

The application of indirect taxes, such as sales and use tax, to e-commerce businesses such as CallWave and our users is a complex and evolving issue. Many of the fundamental statutes and regulations that impose these taxes were established before the growth of the Internet and e-commerce. In many cases, it is not clear how existing statutes apply to the Internet or e-commerce. In addition, some jurisdictions have implemented laws specifically addressing the Internet or some aspect of e-commerce and several other proposals have been made at the U.S. federal, state and local level that would impose additional taxes on the sale of goods and services through the Internet. These proposals, if adopted, could substantially impair the growth of e-commerce, hamper our ability to retain and attract new customers and diminish our ability to derive financial benefit from our activities. In December 2004, the U.S. federal government enacted legislation extending the moratorium on states and other local authorities imposing access or discriminatory taxes on the Internet through November 2007. This moratorium does not prohibit federal, state, or local authorities from collecting taxes on our income or from collecting taxes that are due under existing tax rules. The application of existing, new, or future laws could have adverse effects on our business, prospects, and operating results. There have been, and will continue to be, substantial ongoing costs associated with complying with the various indirect tax requirements in the numerous markets in which we conduct or will conduct business.

Future legislation, regulation, or legal decisions affecting the Internet, Internet telephony or IP-enabled services could restrict our business, prevent us from offering our services or increase our cost of doing business.

We believe that, as a matter of regulatory classification, our offerings are unregulated enhanced services or information services rather than regulated telecommunications services as those terms are defined by the Communications Act of 1934, as amended, (the Act) and the FCC. We also believe that our offerings do not meet the FCC s definition of interconnected VoIP services, which are subject to certain common carrier-type regulations under the FCC s rules. As such, we believe that we are not currently subject to direct regulation by the FCC either as a common carrier or as a provider of interconnected VoIP services. Nor do we believe that we are subject to regulation under state statutes or rules that govern telecommunications utilities, telephone companies, local exchange carriers, telephone toll services, or other similar regulatory categories. However, there is a risk that (1) federal or state regulators could rule that some features of our services are subject to existing common carrier or common carrier-type regulations, (2) the FCC could expand the definition of interconnected VoIP services to cover some or all of the features of our services, in which case the features would be subject to the common carrier-type regulations the FCC has imposed on providers of interconnected VoIP services, or (3) state or federal regulators could otherwise increase the scope of services subject to their regulations to include one or more of our services or specific features of our services.

To date, the FCC has not adopted a comprehensive regulatory framework for IP-enabled services or even attempted to classify IP-enabled services generally under the Act. In 2004, the FCC released a notice of proposed rulemaking in Docket 04-36 that sought public comment regarding the regulatory classification of IP-based services and the regulatory framework for those services, including the rights and obligations of providers of IP-enabled services. However, the FCC has yet to address the majority of the issues raised in this proceeding. Instead, the FCC has issued several *ad hoc* decisions classifying particular offerings as telecommunications, telecommunications services, or information services, and clarifying the regulatory consequences of those classifications under the Act and the FCC s rules. With respect to a subset of IP-enabled voice services called interconnected VoIP services, the FCC also has begun imposing various common carrier-type regulatory obligations, including the obligation to contribute to the federal Universal Service Fund, to offer enhanced 911 service, to comply with the same CALEA requirements that apply to providers of telecommunications services, to comply with regulations regarding the use and protection of Customer Proprietary Network Information, to comply with the disability access requirements that currently apply to telecommunications service providers (including the obligation to contribute to the Interstate Telecommunications Relay Services fund), and to pay federal regulatory fees. Under the FCC s current definition, interconnected VoIP services include any service that: (i) enables real-time, two-way voice communications; (ii) requires a broadband connection from the user s

Table of Contents

Index to Financial Statements

location; (iii) requires IP-compatible customer premises equipment; and (iv) permits users generally to receive calls that originate on the Public Switched Telephone Network (PSTN) and to terminate calls to the PSTN.

Interconnected VoIP services generally are offered to the public as substitutes for, or as substantially equivalent to, existing telecommunications services. By contrast, our customers could not use our services unless they are also separately receiving telecommunications services from their own service providers. Moreover, our services do not require, although they are compatible with, a broadband connection from the user s location or IP-compatible customer premises equipment, and thus they do not meet the FCC s definition of interconnected VoIP services. Nonetheless, in light of the FCC s decisions imposing regulatory obligations upon interconnected VoIP services, certain states have indicated that they may be interested in regulating services that they perceive to be the functional equivalent of telecommunications services. We may be faced with substantially increased regulatory burdens and costs if (1) state regulators attempt to regulate the information services that we provide or rule that any of our services or features are subject to their current regulatory provisions (even if the FCC does not also regulate such services or features), or (2) if the FCC expands the definition of interconnected VoIP services to include, or otherwise determines that the scope of the services subject to its regulations does include, the types of services we provide.

Apart from the specific regulatory obligations that the FCC has imposed upon providers of interconnected VoIP services, there are few laws, regulations or rulings that specifically address access to, or commerce on, the Internet, including the provision of IP-based telephony and other IP-enabled services. However, the growth in the market for IP-based telephony and other IP-enabled communications, and the popularity of these services, along with other regulatory objectives, such as ensuring adequate funding levels for the federal Universal Service Fund create the risk that governments and agencies increasingly will seek to regulate services such as our current offerings, including the potential for rulings that such regulations have applied all along. Many legislative and regulatory actions are underway or are being contemplated by federal and state authorities and certain past decisions suggest that the FCC or state regulatory authorities could eventually rule that certain IP-enabled services are telecommunications services that are subject to common carrier regulations. For example, on April 21, 2004, the FCC released a narrow declaratory ruling finding that certain Internet protocol telephony services are telecommunications services upon which interstate access charges may be assessed. Prior to this decision, the FCC had never ruled that a specific service relying on Internet-protocol technology was a telecommunications service. More recently, on June 27, 2006, the FCC issued a decision finding that providers of interconnected VoIP services offer telecommunications as defined by the Communications Act and must therefore contribute to the federal Universal Service Fund. Similarly, on June 30, 2006, the FCC released an order holding that menu-driven prepaid calling cards, and prepaid calling cards that use IP transport to deliver all or a portion of the call embody telecommunications services, and these prepaid calling card providers qualify as telecommunications carriers that are subject to, among other things, Universal Service Fund contributions based on their interstate revenues as well as intrastate and interstate access charges. These rulings illustrate that certain Internet-protocol based services may become subject to costs and regulations that, previously, were not thought to be applicable. We are unable to predict the impact, if any, that future legislation, regulations, or administrative and judicial decisions may have on our business.

In any event, as communications services increasingly are delivered over the Internet and as we expand the services and features that we offer, our business may become increasingly regulated at the federal, state, and/or foreign government levels, which may increase our operating costs and could also subject us to new regulatory fees or financial obligations. As we introduce new offerings, it is possible that some of them may fall within existing telecommunications or interconnected VoIP regulations, increasing our costs and reducing our operating margins.

Regulatory proceedings, legislative efforts and adjudications, including but not limited to some of those described above, have created a certain level of uncertainty regarding the regulatory classification of some of our services and features. Future regulatory actions may lead to the imposition of additional regulatory obligations and requirements on us in the provision of our services and features, including but not limited to certification

Table of Contents

Index to Financial Statements

requirements, interstate or intrastate access charges, regulatory fees, payments to support state and federal universal service-funds, taxes related to Internet or IP-enabled communications, requirements to provide free access to certain users, regulations based on encryption concerns, consumer protection requirements and certain minimum service levels. We could conceivably become subject to requirements and obligations not only at the federal level, but also in any of the states in which we have customers or from which third persons initiate communications to call our customers, as well as in any of those jurisdictions in which facilities exist or activities occur which support our offerings. Further, as we expand into additional lines of business or make new service offerings, we could become subject to existing or future regulation or other legal requirements, including but not limited to those which apply to telecommunications services and the providers of such services. The impact of federal or state legislative, regulatory, or adjudicatory actions or requirements may apply not only prospectively but conceivably retroactively and could result in an increase in our costs, possible penalties and forfeitures in the event determinations are made that certain features of our services have been subject to regulatory or legal obligations all along, adversely affect how we conduct our business, adversely affect our financial condition and results of operations, and restrict our growth potential.

Risks Related To Our Common Stock

Our executive officers, directors and 5% stockholders own a significant percentage of our stock and will be able to exercise significant influence over stockholder votes.

Our executive officers, directors and 5% stockholders together beneficially own approximately 69% of our common stock, including shares subject to options and warrants that confer beneficial ownership of the underlying shares. Accordingly, these stockholders, for the foreseeable future will continue to have significant influence over our affairs including the election of directors and significant corporate transactions, such as a merger or other sale of our company or its assets. This concentrated control will limit the ability of shareholders to influence corporate matters and, as a result, we may take actions that our stockholders do not view as beneficial. For example, this concentration of ownership could have the effect of delaying or preventing a change in control or otherwise discouraging a potential acquirer from attempting to obtain control of us, which in turn could cause the market price of our common stock to decline or prevent our stockholders from realizing a premium over the market price for their shares of our common stock.

Provisions in Delaware law and our charter documents may make it difficult for a third party to acquire us and could depress the price of our common stock.

Provisions of Delaware law, our certificate of incorporation and our bylaws could make it more difficult for a third party to acquire control of us. For example:

- we are subject to Section 203 of the Delaware General Corporation Law, which would make it difficult for another party to acquire us without the approval of our board of directors;
- our certificate of incorporation authorizes our board of directors to issue preferred stock without requiring stockholder approval, and preferred stock could be issued as a defensive measure in response to a takeover proposal; and
- our certificate of incorporation or bylaws:
  - prohibits cumulative voting in the election of directors;
  - limits the persons who may call special meetings of our stockholders; and

imposes advance notice requirements for nominations for election to our board of directors and for proposing matters to be acted upon by our stockholders.

These and other provisions of Delaware law, our certificate of incorporation and our bylaws may make it more difficult for a third party to acquire us even if an acquisition might be in the best interests of our stockholders, and the price at which shares of our common stock are purchased and sold therefore may be depressed.

Table of Contents

Index to Financial Statements

We are incurring increased costs as a result of being a public company.

As a public company, we are incurring significant additional legal, accounting and other expenses. The Sarbanes-Oxley Act of 2002, as well as new rules subsequently implemented by the Securities and Exchange Commission and the NASDAQ National Market, require changes in corporate governance practices of public companies. These new rules and regulations have resulted in increased legal and financial compliance costs and management efforts and we expect those costs and efforts to continue to increase. It has become more expensive for us to obtain director and officer liability insurance, and it may become more difficult to obtain such insurance in the future, which may cause us to accept reduced policy limits and reduced coverage or to incur substantially higher costs to obtain the same or similar coverage. As a result, it may be more difficult for us to attract and retain qualified persons to serve on our board of directors or as executive officers. We cannot predict or estimate the amount of additional costs we may incur, but these additional costs and demands on management time and attention may harm our business and results of operations.

We do not intend to pay cash dividends.

We have never declared or paid cash dividends on our capital stock. We currently intend to retain all available funds and any future earnings for use in the operation and expansion of our business and do not anticipate paying any cash dividends in the foreseeable future. As a result, capital appreciation, if any, of our common stock will be the sole source of potential gain for our stockholders for the foreseeable future.

Item 2. Properties

Our corporate headquarters are located at 136 West Canon Perdido Street, Santa Barbara, California, where we lease approximately 16,000 square feet. The lease expires on July 31, 2010. We conduct our research and development and sales and marketing activities at these facilities. We have an option to extend the term of this lease for an additional five years.

We lease approximately 7,900 square feet at 5464 Carpinteria Avenue, Carpinteria, California under a lease that terminates on June 30, 2008. We conduct our customer care and general operations at this facility.

Liberty Telecom leases approximately 1,658 square feet of office space in Reno, Nevada to house and operate its telecommunications switching equipment. The lease expires in December 2012. Liberty Telecom has three options to extend the term of the lease for an additional 60 months each.

Liberty Telecom also has a co-location agreement to house and operate certain telecom switching equipment in approximately 150 square feet in Las Vegas, Nevada. The co-location agreement expires in August 2007. Liberty Telecom has four options to renew the term of the Agreement for an additional 24 months each.

Our facilities are fully used for current operations. We believe our properties are suitable and adequate for our present needs, and we periodically evaluate whether additional facilities are necessary.

Item 3. Legal Proceedings

As most recently reported in the Quarterly Report on Form 10-Q for the quarter ended March 31, 2007, as filed on May 14, 2007, we were involved in litigation with Catch Curve, Inc., a Delaware corporation, and j2 Global Communications, a Delaware corporation (collectively j2 Global). The litigation concerned allegations that our operations infringed certain patents of j2 Global, and involved two actions pending in the United States District Court for the Central District of California (Action Nos. 04-7068 and 05-4819).

Effective March 13, 2007, CallWave and j2 Global entered into a Patent License and Settlement Agreement (the Agreement). In the Agreement, we and j2 Global agreed to resolve all of j2 Global s outstanding patent infringement claims. Under the terms of the Agreement, we paid $4 million to j2 Global for a fully paid-up,

Table of Contents

Index to Financial Statements

nonexclusive license to use the Licensed Patents (as that term is defined in the Agreement) for non-fax services. In addition, we agreed to pay a running royalty of at least 10% for a non-exclusive license to use the Licensed Patents for fax services. We and j2 Global have agreed to dismiss all pending litigation.

Item 4. Submission of Matters to a Vote of Security Holders

No matters were submitted to a vote of security holders during the fourth quarter of the Company s 2007 fiscal year.

Table of Contents

Index to Financial Statements

PART II

Item 5. Market for Registrant s Common Equity, Related Stockholder Matters and Issuer Purchases of Equity Securities

Market Information and Holders

Our common stock is listed on the NASDAQ Stock Market, LLC, under the symbol CALL . Trading of our common stock commenced September 30, 2004 following completion of our initial public offering.

The following table sets forth, for the periods indicated, the high and low sales prices for our common stock as reported by the NASDAQ Stock Market, LLC:

Fiscal 2007	High	Low
First Quarter	$ 3.77	$ 2.56
Second Quarter	2.92	2.51
Third Quarter	3.35	2.50
Fourth Quarter	3.96	2.84

Fiscal 2006	High	Low
First Quarter	$ 5.18	$ 3.96
Second Quarter	5.25	3.69
Third Quarter	5.14	3.80
Fourth Quarter	4.51	3.43

There were approximately 63 stockholders of record of our common stock as of July 31, 2007, although there is a significantly larger number of beneficial owners of our common stock.

Dividends

We have not paid any cash dividends on our capital stock and do not anticipate paying any cash dividends in the foreseeable future.

Securities Authorized for Issuance under Equity Compensation Plans

Equity Compensation Plan Information

As of June 30, 2007

Plan Category	Number of Securities to be Issued upon Exercise of Outstanding	Weighted-Average Exercise Price of Outstanding Options Warrants	Remaining Available for Future Issuance Under Equity Compensation

	Options, Warrants and Rights (a)	and Rights (b)	Plans (Excluding Securities Reflected in Column (a)) (c)
Equity compensation plans approved by security holders	3,580,345	$ 3.49	1,335,663

Recent Sales of Unregistered Securities

None

Table of Contents

Index to Financial Statements

Item 6. Selected Financial Data

SELECTED CONSOLIDATED FINANCIAL DATA

(in thousands, except per share data)

The following selected consolidated financial data should be read in conjunction with, and are qualified by reference to, our consolidated financial statements and related notes and the section titled Management s Discussion and Analysis of Financial Condition and Results of Operations appearing elsewhere in this annual report. We have prepared this information using our audited consolidated financial statements for the years ended June 30, 2007, 2006, 2005, 2004 and 2003.

Fiscal Year Ended June 30,			
2007	**2006**	**2005**	**200**
$ 25,201	$ 36,594	$ 45,518	$ 38,
8,746	13,088	13,026	11,
16,455	23,506	32,492	27,
7,652	6,293	9,533	5,
7,178	6,805	6,868	5,
12,021	11,508	7,622	4,
114	23	4	
	253		
26,965	24,882	24,027	16,
(10,510)	(1,376)	8,465	10,
3,044	2,479	1,032	
(7,466)	1,103	9,497	11,
6	3,086	(2,105)	(

$ (7,472)	$ (1,983)		$ 11,602	$ 11,
$ (0.36)	$ (0.10)		$ 0.72	$ 1
$ (0.36)	$ (0.10)		$ 0.57	$ (
20,827	20,615		16,171	5,
20,827	20,615		20,295	15,
		As of June 30,		
2007	**2006**		**2005**	**200**
$ 20,299	$ 24,040		$ 16,828	$ 6,
32,411	36,907		39,996	7,
			335	
51,918	62,049			

The accompanying notes are an integral part of these Condensed Consolidated Financial Statements.

4

DELTA AIR LINES, INC.
Notes to the Condensed Consolidated Financial Statements
September 30, 2012
(Unaudited)

NOTE 1. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

Basis of Presentation

The accompanying unaudited Condensed Consolidated Financial Statements include the accounts of Delta Air Lines, Inc. and our wholly-owned subsidiaries. These financial statements have been prepared in accordance with accounting principles generally accepted in the United States (“GAAP”) for interim financial information. Consistent with these requirements, this Form 10-Q does not include all the information required by GAAP for complete financial statements. As a result, this Form 10-Q should be read in conjunction with the Consolidated Financial Statements and accompanying Notes in our Form 10-K.

Management believes the accompanying unaudited Condensed Consolidated Financial Statements reflect all adjustments, including normal recurring items and restructuring and other items, considered necessary for a fair statement of results for the interim periods presented.

Due to seasonal variations in the demand for air travel, the volatility of aircraft fuel prices, changes in global economic conditions and other factors, operating results for the three and nine months ended September 30, 2012 are not necessarily indicative of operating results for the entire year.

Recent Accounting Standards

Presentation of Comprehensive Income

In June 2011, the Financial Accounting Standards Board ("FASB") issued "Presentation of Comprehensive Income." The standard revises the presentation and prominence of the items reported in other comprehensive income and is effective retrospectively for fiscal years beginning after December 15, 2011. We adopted this standard in the March 2012 quarter and have presented comprehensive income on our Condensed Consolidated Statements of Operations and Comprehensive Income.

Testing Indefinite-Lived Intangible Assets for Impairment

In July 2012, the FASB issued "Testing Indefinite-Lived Intangible Assets for Impairment." The standard gives companies the option to perform a qualitative assessment to determine whether it is more likely than not that an indefinite-lived intangible asset is impaired rather than calculating the fair value of the indefinite-lived intangible asset. It is effective prospectively for annual and interim impairment tests performed for fiscal years beginning after September 15, 2012, with early adoption permitted. We adopted this standard and will apply the provisions to our annual indefinite-lived intangible asset impairment tests in the December 2012 quarter. The adoption of this standard will not have a material impact on our Consolidated Financial Statements.

NOTE 2. OIL REFINERY

Jet fuel costs have continued to increase in recent years, making fuel expense our single largest expense. Because global demand for jet fuel and related products is increasing at the same time that jet fuel refining capacity is decreasing in the U.S. (particularly in the Northeast), the refining margin reflected in the prices we pay for jet fuel has increased. We purchased an oil refinery in June 2012 as part of our strategy to mitigate the increasing cost of the refining margin we are paying.

Acquisition

On June 22, 2012 (the "Closing Date"), our wholly-owned subsidiary, Monroe Energy, LLC (“Monroe”), acquired the Trainer refinery located near Philadelphia, Pennsylvania from Phillips 66. Monroe invested $180 million to acquire the refinery. Monroe received a $30 million grant from the Commonwealth of Pennsylvania. The acquisition includes pipelines and terminal assets that will allow the refinery to supply jet fuel to our airline operations throughout the Northeastern U.S., including our New York hubs at LaGuardia Airport and John F. Kennedy International Airport.

Prior to the transaction, Phillips 66 had shut down operations at the refinery. Monroe is making required capital improvements totaling approximately $100 million to restart the refinery and bring it to its desired operating state.

We accounted for the refinery acquisition as a business combination. The refinery, pipelines, and terminal assets acquired were recorded in property and equipment, net at $180 million based on their respective fair values on the Closing Date.

Refinery Operations and Strategic Agreements

The facility is capable of refining 185,000 barrels of crude oil per day. BP will supply crude oil used by the refinery under a three year agreement. The refinery will produce approximately 30% jet fuel after the capital improvements are completed. The refinery's remaining production will consist of gas, diesel and refined products ("non-jet fuel products"). Under a multi-year agreement, we will exchange a significant portion of the non-jet fuel products with Phillips 66 for jet fuel to be used in our airline operations. Substantially all of the remaining production of non-jet fuel products will be sold to BP under a long-term buy/ sale agreement effectively exchanging those non-jet fuel products for jet fuel. Our agreement with Phillips 66 requires us to deliver specified quantities of non-jet fuel products and they are required to deliver jet fuel to us. If we or Phillips 66 do not have the specified quantity and type of product available, the delivering party is required to procure any such shortage to fulfill its obligation under the agreement. Substantially all of the refinery's expected production of non-jet fuel products is included in these agreements.
Refinery Start-Up

Production at the refinery restarted in September 2012. It is expected to reach its full refining capacity during the fourth quarter, at which time we expect to begin to realize the benefits of ownership of the refinery. The results of the refinery's operations were not material in the September 2012 quarter. Our future financial statements will disclose two operating segments: our airline segment and our refinery segment.

NOTE 3. FAIR VALUE MEASUREMENTS

Assets (Liabilities) Measured at Fair Value on a Recurring Basis

(in millions)	September 30, 2012	Level 1	Level 2	Level 3
Cash equivalents	$ 1,996	$ 1,996	$—	$—
Short-term investments	959	959	—	—
Restricted cash equivalents and investments	400	400	—	—
Long-term investments	209	94	26	89
Hedge derivatives, net				
Fuel hedge contracts	252	50	202	—
Interest rate contracts	(70)	—	(70)	—
Foreign currency exchange contracts	(33)	—	(33)	—

(in millions)	December 31, 2011	Level 1	Level 2	Level 3
Cash equivalents	$ 2,357	$ 2,357	$—	$—
Short-term investments	958	958	—	—
Restricted cash equivalents and investments	341	341	—	—
Long-term investments	188	55	24	109
Hedge derivatives, net				
Fuel hedge contracts	70	—	70	—
Interest rate contracts	(91)	—	(91)	—

Foreign currency exchange contracts	(89	) —	(89	) —

6

Cash Equivalents, Short-term Investments and Restricted Cash Equivalents and Investments. Cash equivalents and short-term investments generally consist of money market funds and treasury bills. Restricted cash equivalents and investments are primarily held to meet certain projected self-insurance obligations and generally consist of money market funds and time deposits. These investments are recorded at cost, which approximates fair value. Fair value is based on a market approach using prices and other relevant information generated by market transactions involving identical or comparable assets.

Long-term Investments. Our long-term investments, primarily consisting of equity investments in GOL and Aeroméxico and auction rate securities, are classified in other noncurrent assets.

Hedge Derivatives. Our derivative contracts are generally negotiated with counterparties without going through a public exchange. Accordingly, our fair value assessments give consideration to the risk of counterparty default (as well as our own credit risk).

- Fuel Derivatives. Our fuel hedge portfolio consists of call options; put options; combinations of two or more call options and put options; swap contracts; and futures contracts. The products underlying the hedge contracts include heating oil, crude oil, jet fuel and diesel fuel, as these commodities are highly correlated with the price of jet fuel that we consume. Option contracts are valued under an income approach using option pricing models based on data either readily observable in public markets, derived from public markets or provided by counterparties who regularly trade in public markets. Volatilities used in these valuations ranged from 14% to 39% depending on the maturity dates, underlying commodities and strike prices of the option contracts. Swap contracts are valued under an income approach using a discounted cash flow model based on data either readily observable or derived from public markets. Discount rates used in these valuations vary with the maturity dates of the respective contracts and are based on LIBOR. Futures contracts and options on futures contracts are traded on a public exchange and valued based on quoted market prices.

- Interest Rate Derivatives. Our interest rate derivatives consist primarily of swap contracts and are valued primarily based on data readily observable in public markets.

- Foreign Currency Derivatives. Our foreign currency derivatives consist of Japanese yen and Canadian dollar forward contracts and are valued based on data readily observable in public markets.

7

NOTE 4. DERIVATIVES

Our results of operations are impacted by changes in aircraft fuel prices, interest rates and foreign currency exchange rates. In an effort to manage our exposure to these risks, we enter into derivative contracts and adjust our derivative portfolio as market conditions change.

Aircraft Fuel Price Risk

Our results of operations are materially impacted by changes in aircraft fuel prices. We actively manage our fuel price risk through a hedging program intended to reduce the financial impact on us from changes in the price of jet fuel. The objective of the fuel hedging program is to generate a positive cash position to defray the cost of jet fuel purchases. This fuel hedging program utilizes several different contract and commodity types. The economic effectiveness of this hedge portfolio is frequently tested against our financial targets. The hedge portfolio is rebalanced from time to time according to market conditions, which may result in locking in gains or losses on hedge contracts prior to their settlement dates.

Effective June 2011, we stopped designating substantially all of our new fuel derivative contracts as accounting hedges and discontinued hedge accounting for our then existing fuel derivative contracts that previously had been designated as accounting hedges. As a result, we record market adjustments for changes in fair value to earnings in aircraft fuel and related taxes. Prior to this change in accounting designation, gains or losses on these contracts were deferred in accumulated other comprehensive income ("AOCI") until contract settlement. We will reclassify to earnings all amounts relating to our fuel derivative contracts in AOCI on the original contract settlement dates.

The following table shows the impact of fuel hedge gains (losses) for both designated and undesignated contracts on aircraft fuel and related taxes:

	Three Months Ended September 30,		Nine Months Ended September 30,	
(in millions)	2012	2011	2012	2011
Market adjustments for changes in fair value	$414	$(179)	$(121)	$(99)
Effective portion reclassified from AOCI to earnings	—	68	15	202
Gain (loss) recorded in aircraft fuel and related taxes	$414	$(111)	$(106)	$103

During the September 2012 quarter, we recorded gains of $414 million due to changes in the fair value of our fuel hedges. The gains partially offset mark-to-market ("MTM") losses recorded during the June 2012 quarter on these fuel hedges. These MTM adjustments are based on market prices as of the end of the reporting period for contracts settling in future periods. The following tables reflect the estimated fair value asset (liability) positions, notional balances and maturity dates of our hedge contracts:

Hedge Position as of September 30, 2012

(in millions)	Notional Balance		Final Maturity Date	Prepaid Expenses and Other	Other Noncurrent Assets	Other Accrued Liabilities	Other Noncurrent Liabilities	Hedge Derivatives, Net
Designated as hedges								
Interest rate contracts (cash flow hedges)	$762	U.S. dollars	May 2019	$—	$—	$(23)	$(53)	$(76)
Interest rate contracts (fair value hedges)	$469	U.S. dollars	August 2022	6	—	—	—	6
Foreign currency exchange contracts	93,960 456	Japanese yen Canadian dollars	August 2015	1	2	(30)	(6)	(33)

Not designated as hedges								
Fuel hedge contracts	2,666	gallons - heating oil, crude oil, jet fuel and diesel	December 2013	549	86	(283)	(100)	252
Total derivative contracts				$556	$ 88	$(336)	$ (159)	$ 149

8

Hedge Position as of December 31, 2011

(in millions)	Notional	Balance	Final Maturity Date	Prepaid Expenses and Other	Other Noncurrent Assets	Other Accrued Liabilities	Other Noncurrent Liabilities	Hedge Derivatives, Net
Designated as hedges								
Interest rate contracts (cash flow hedges)	$989	U.S. dollars	May 2019	$—	$—	$(27)	$(57)	$(84)
Interest rate contracts (fair value hedges)	$500	U.S. dollars	August 2022	—	—	—	(7)	(7)
Foreign currency exchange contracts	126,993 313	Japanese yen Canadian dollars	April 2014	7	5	(58)	(43)	(89)
Not designated as hedges								
Fuel hedge contracts	1,225	gallons - heating oil, crude oil, jet fuel and diesel	December 2012	570	—	(500)	—	70
Total derivative contracts				$577	$5	$(585)	$(107)	$(110)

Hedge Gains (Losses)

Gains (losses) related to our designated hedge contracts, including those previously designated as accounting hedges, are as follows:

	Effective Portion Reclassified from AOCI to Earnings		Effective Portion Recognized in Other Comprehensive Income	
(in millions)	2012	2011	2012	2011
Three Months Ended September 30				
Fuel hedge contracts	$—	$68	$—	$(70)
Interest rate contracts	(5)	—	5	(51)
Foreign currency exchange contracts	(8)	(31)	(27)	(22)
Total designated	$(13)	$37	$(22)	$(143)
Nine Months Ended September 30				
Fuel hedge contracts	$15	$202	$(15)	$(136)
Interest rate contracts	(5)	—	8	(44)
Foreign currency exchange contracts	(21)	(53)	56	4
Total designated	$(11)	$149	$49	$(176)

Credit Risk

To manage credit risk associated with our aircraft fuel price, interest rate and foreign currency hedging programs, we select counterparties based on their credit ratings and limit our exposure to any one counterparty.

Our hedge contracts contain margin funding requirements. The margin funding requirements may cause us to post margin to counterparties or may cause counterparties to post margin to us as market prices in the underlying hedged items change. Due to the fair value position of our hedge contracts, we posted margin of $10 million and $30 million as of September 30, 2012 and December 31, 2011, respectively. These amounts are recorded in prepaid expenses and other.

9

NOTE 5. LONG-TERM DEBT

Fair Value of Debt

Market risk associated with our fixed and variable rate long-term debt relates to the potential reduction in fair value and negative impact to future earnings, respectively, from an increase in interest rates. In the table below, the aggregate fair value of debt is based primarily on reported market values, recently completed market transactions and estimates based on interest rates, maturities, credit risk and underlying collateral and is classified primarily as Level 2 within the fair value hierarchy.

(in millions)	September 30, 2012	December 31, 2011
Total debt at par value	$12,546	$13,797
Unamortized discount, net	(566)	(737)
Net carrying amount	$11,980	$13,060
Fair value	$12,800	$13,600

Certificates

In July 2012, we completed a $480 million offering of Pass Through Certificates, Series 2012-1 ("2012-1 EETC") through a pass through trust. During the September 2012 quarter, we used the proceeds to refinance aircraft securing the Delta 2002-1 EETC, a portion of which matured on July 2, 2012. We also used the proceeds to refinance aircraft securing the Northwest 2001-2 EETC, which was scheduled to mature in August 2013 but was prepaid in the September 2012 quarter. The details of the offering are shown in the table below:

(in millions)	Total Principal	Fixed Interest Rate	Offering Completion Date	Final Maturity Date	Collateral
2012-1A	$354	4.750%	July 2012	May 2020	31 aircraft
2012-1B	126	6.875%	July 2012	May 2019	31 aircraft[(1)]
	$480				

(1) The B tranche certificates are secured by the same aircraft that secure the A tranche certificates.

Covenants

We were in compliance with all covenants in our financing agreements at September 30, 2012.

10

NOTE 6. COMMITMENTS AND CONTINGENCIES

Aircraft Commitments

Future aircraft purchase commitments at September 30, 2012 total approximately $6.8 billion and include 100 B-737-900ER aircraft, 18 B-787-8 aircraft and seven previously owned MD-90 aircraft. We have obtained long-term financing commitments for a substantial portion of the purchase price of these aircraft.

In July 2012, we finalized agreements with Southwest Airlines and The Boeing Company to lease 88 B-717-200 aircraft with deliveries beginning in 2013 and continuing through 2015. Including the B-717-200 aircraft, we estimate that our total lease payments will be approximately $1.6 billion in 2013, $1.6 billion in 2014, $1.5 billion in 2015, $1.4 billion in 2016 and $8.8 billion after 2016.

Legal Contingencies

We are involved in various legal proceedings related to employment practices, environmental issues, antitrust matters and other matters concerning our business. We record liabilities for losses from legal proceedings when we determine that it is probable that the outcome in a legal proceeding will be unfavorable and the amount of loss can be reasonably estimated. We cannot reasonably estimate the potential loss for certain legal proceedings because, for example, the litigation is in its early stages or the plaintiff does not specify the damages being sought. Although the outcome of the legal proceedings in which we are involved cannot be predicted with certainty, management believes that the resolution of these matters will not have a material adverse effect on our Condensed Consolidated Financial Statements.

Other Contingencies

General Indemnifications

We are the lessee under many commercial real estate leases. It is common in these transactions for us, as the lessee, to agree to indemnify the lessor and the lessor's related parties for tort, environmental and other liabilities that arise out of or relate to our use or occupancy of the leased premises. This type of indemnity would typically make us responsible to indemnified parties for liabilities arising out of the conduct of, among others, contractors, licensees and invitees at, or in connection with, the use or occupancy of the leased premises. This indemnity often extends to related liabilities arising from the negligence of the indemnified parties, but usually excludes any liabilities caused by either their sole or gross negligence or their willful misconduct.

Our aircraft and other equipment lease and financing agreements typically contain provisions requiring us, as the lessee or obligor, to indemnify the other parties to those agreements, including certain of those parties' related persons, against virtually any liabilities that might arise from the use or operation of the aircraft or such other equipment.

We believe that our insurance would cover most of our exposure to liabilities and related indemnities associated with the commercial real estate leases and aircraft and other equipment lease and financing agreements described above. While our insurance does not typically cover environmental liabilities, we have certain insurance policies in place as required by applicable environmental laws.

Certain of our aircraft and other financing transactions include provisions that require us to make payments to preserve an expected economic return to the lenders if that economic return is diminished due to certain changes in law or regulations. In certain of these financing transactions, we also bear the risk of certain changes in tax laws that would subject payments to non-U.S. lenders to withholding taxes.

We cannot reasonably estimate our potential future payments under the indemnities and related provisions described above because we cannot predict (1) when and under what circumstances these provisions may be triggered and (2) the amount that would be payable if the provisions were triggered because the amounts would be based on facts and circumstances existing at such time.

Employees Under Collective Bargaining Agreements

At September 30, 2012, we had approximately 77,000 full-time equivalent employees. Approximately 14% of these employees were represented by unions.

During the June 2012 quarter, we reached an agreement with the Air Line Pilots Association, International ("ALPA") to modify the existing collective bargaining agreement, which covers approximately 10,700 Delta pilots. The agreement, which was ratified by the pilots in June 2012 and took effect on July 1, 2012, becomes amendable on December 31, 2015.

War-Risk Insurance Contingency

As a result of the terrorist attacks on September 11, 2001, aviation insurers significantly (1) reduced the maximum amount of insurance coverage available to commercial air carriers for liability to persons (other than employees or passengers) for claims from acts of terrorism, war or similar events and (2) increased the premiums for such coverage and for aviation insurance in general. Since September 24, 2001, the U.S. government has been providing U.S. airlines with war-risk insurance to cover losses, including those resulting from terrorism, to passengers, third parties (ground damage) and the aircraft hull. The U.S. Secretary of Transportation has extended coverage through September 30, 2013, and we expect the coverage to be further extended. The withdrawal of government support of airline war-risk insurance would require us to obtain war-risk insurance coverage commercially, if available. Such commercial insurance could have substantially less desirable coverage than currently provided by the U.S. government, may not be adequate to protect our risk of loss from future acts of terrorism, may result in a material increase to our operating expense or may not be obtainable at all, resulting in an interruption to our operations.

Other

We have certain contracts for goods and services that require us to pay a penalty, acquire inventory specific to us or purchase equipment specific to a contract, if we terminate this type of contract without cause prior to its expiration date. Because these obligations are contingent on our termination of a contract without cause prior to its expiration date, no obligation would exist unless such a termination occurs.

NOTE 7. RESTRUCTURING AND OTHER ITEMS

The following table shows amounts recorded in restructuring and other items on the Condensed Consolidated Statements of Operations and Comprehensive Income:

	Three Months Ended September 30,		Nine Months Ended September 30,	
(in millions)	2012	2011	2012	2011
Facilities, fleet and other	$122	$—	$171	$71
Severance and related costs	66	3	237	83
Gain on slot exchange	(39)	—	(78)	—
Total restructuring and other items	$149	$3	$330	$154

Facilities, Fleet and Other. We recently announced plans to reduce the total number of regional jets in our network while adding more mainline flying. This includes reducing the number of 50-seat regional jets in our fleet over the next few years. As a result of this reduction and changes to our business strategy, we announced our decision on July 27, 2012 to cease the operations of Comair, a wholly-owned regional airline subsidiary, as of September 29, 2012. We recorded a restructuring charge in the September 2012 quarter related to remaining lease payments for grounded aircraft, the acceleration of aircraft lease return costs and aircraft and related equipment and asset disposals.

Severance and Related Costs. We accrued $66 million in severance and related costs in the September 2012 quarter, related both to ceasing operations at Comair and providing severance benefits to Comair's 1,700 employees as well as a voluntary severance program. For the nine months ended September 30, 2012, we offered voluntary severance programs in which more than 2,000 employees elected to participate. These participants became eligible for retiree healthcare benefits. For all of these programs, we recognized a total charge of $237 million for the nine months ended September 30, 2012, which includes $110 million of special termination benefits (see Note 8).

12

Gain on Slot Exchange. During December 2011, we closed transactions with US Airways where we received takeoff and landing rights (each a "slot pair") at LaGuardia in exchange for slot pairs at Reagan National. In approving these transactions, the Department of Transportation restricted our use of the exchanged slots. We recorded a $78 million deferred gain in December 2011. We recognized $39 million of this deferred gain in the March 2012 quarter as half of the restrictions lapsed and recognized the remainder of the deferred gain in the September 2012 quarter as the remaining restrictions lapsed.

The following table shows the balances and activity for restructuring charges:

(in millions)	Severance and Related Costs	Lease Restructuring
Balance as of December 31, 2011	$46	$64
Additional costs and expenses	126	44
Payments	(40)	(11)
Balance as of September 30, 2012	$132	$97

NOTE 8. EMPLOYEE BENEFIT PLANS

The following table shows the components of net periodic cost:

	Pension Benefits		Other Postretirement and Postemployment Benefits	
(in millions)	2012	2011	2012	2011
Three Months Ended September 30				
Service cost	$—	$—	$14	$13
Interest cost	232	242	41	45
Expected return on plan assets	(176)	(181)	(19)	(22)
Amortization of prior service benefit	—	—	(7)	(1)
Recognized net actuarial loss (gain)	36	14	6	(3)
Special termination benefits	—	—	6	—
Net periodic cost	$92	$75	$41	$32
Nine Months Ended September 30				
Service cost	$—	$—	$43	$39
Interest cost	696	726	123	135
Expected return on plan assets	(528)	(543)	(57)	(67)
Amortization of prior service benefit	—	—	(16)	(2)
Recognized net actuarial loss (gain)	108	42	18	(9)
Special termination benefits	—	—	110	—
Net periodic cost	$276	$225	$221	$96

During the nine months ended September 30, 2012, we remeasured our postretirement healthcare obligation to account for changes to retiree medical benefits resulting from the final integration of wages and benefits following our merger with Northwest Airlines and the voluntary workforce reduction programs offered to eligible employees. As a result, we recorded $110 million of special termination benefits in restructuring and other items (see Note 7).

NOTE 9. INCOME TAXES

Valuation Allowance

We periodically assess whether it is more likely than not that we will generate sufficient taxable income to realize our deferred income tax assets. We establish valuation allowances if it is not likely we will realize our deferred income tax assets. In making this determination, we consider all available positive and negative evidence and make certain assumptions. We consider, among other things, our deferred tax liabilities, the overall business environment, our historical financial results, our industry's historically cyclical financial results and potential current and future tax planning strategies.

We recorded a full valuation allowance in 2004 due to our cumulative three year loss position at that time, compounded by the negative industry-wide business trends and outlook. At September 30, 2012, we had a $10.2 billion valuation allowance established against our deferred income tax assets, which represents a full valuation allowance against our net deferred income tax asset.

During the March 2012 quarter, we moved from a cumulative loss position over the previous three years to a cumulative income position for the first time since we established the full valuation allowance. We have concluded as of September 30, 2012 that the valuation allowance was still needed on our net deferred tax assets based upon the weight of the factors described above. We continue to evaluate our cumulative income position and income trend as well as our future projections of sustained profitability. We will evaluate whether this profitability trend constitutes sufficient positive evidence to support a reversal of our valuation allowance (in full or in part).

Income Tax Allocation

We consider all income sources, including other comprehensive income, in determining the amount of tax benefit allocated to continuing operations (the "Income Tax Allocation"). During 2009, as a result of the Income Tax Allocation, we recorded a non-cash deferred income tax expense of $321 million on other comprehensive income as a result of hedge gains on fuel derivatives and an offsetting non-cash income tax benefit of $321 million. This deferred income tax expense will remain in AOCI until all amounts in AOCI that relate to fuel derivatives which are designated as accounting hedges are recognized in the Consolidated Statement of Operations. We will reclassify to earnings all amounts relating to our fuel derivative contracts in AOCI on the original contract settlement dates. As a result, a non-cash income tax expense of $321 million will be recognized upon the settlement of the fuel derivative contracts designated as accounting hedges.

NOTE 10. EARNINGS PER SHARE

We calculate basic earnings per share by dividing net income by the weighted average number of common shares outstanding. Shares issuable upon the satisfaction of certain conditions are considered outstanding and included in the computation of basic earnings per share. The following table shows the computation of basic and diluted earnings per share:

	Three Months Ended September 30,		Nine Months Ended September 30,	
(in millions, except per share data)	2012	2011	2012	2011
Net income	$1,047	$549	$1,003	$429
Basic weighted average shares outstanding	846	838	845	838
Dilutive effect of share based awards	4	6	4	6
Diluted weighted average shares outstanding	850	844	849	844
Basic earnings per share	$1.24	$0.66	$1.19	$0.51
Diluted earnings per share	$1.23	$0.65	$1.18	$0.51
Antidilutive common stock equivalents excluded from diluted earnings per share	19	26	19	25

NOTE 11. SUBSEQUENT EVENTS

October 2012 Senior Secured Credit Facilities

In October 2012, we entered into senior secured credit facilities (the "Pacific Facilities") to borrow up to $2.0 billion. The Pacific Facilities consist of two first lien term loan facilities (the "Pacific Term Loans") and a $450 million revolving credit facility (the "Pacific Revolving Facility"). In connection with entering into the Pacific Facilities, we retired $1.2 billion principal amount of outstanding debt, including an existing term loan and senior secured and senior second lien notes, and terminated an existing undrawn $500 million revolving credit facility. These transactions are summarized in the table below:

	Final Maturity Date	Interest Rate(s) per Annum		October 2012 Proceeds Received	Principal Retired
Entered into in October 2012					
Pacific Term Loan B-1	October 2018	5.25%	variable[1][2]	$1,100	$—
Pacific Term Loan B-2	April 2016	4.25%	variable[1][2]	400	—
Pacific Revolving Facility ($450 million)	October 2017	undrawn	variable[3]	—	—
Retired/Terminated in October 2012					
Pacific Routes Term Facility	March 2016	4.25%	variable[1][4]	—	246
Pacific Routes Revolving Facility ($500 million)	March 2013	undrawn	variable[1]	—	—
Senior Secured Notes[5]	September 2014	9.5%	fixed	—	600
Senior Second Lien Notes[5]	March 2015	12.25%	fixed	—	306
Total				$1,500	$1,152

(1) Interest rate equal to LIBOR (subject to a floor) or another index rate, in each case plus a specified margin
(2) Represents the rate as of October 26, 2012
(3) Interest rate equal to LIBOR or another index rate, in each case plus a specified margin

(4) Represents the rate as of September 30, 2012
(5) Includes amounts that will be redeemed in November 2012 pursuant to an irrevocable notice of redemption

15

Borrowings under the Pacific Term Loans must be repaid annually in an amount equal to 1% per year of the original principal amount of the respective loans (to be paid in equal quarterly installments). The remaining unamortized principal amounts under the Pacific Term Loans are due on their final maturity dates. The Pacific Revolving Facility is currently undrawn.

Key Financial Covenants. Our obligations under the Pacific Facilities are guaranteed by substantially all of our domestic subsidiaries (the "Guarantors") and secured by a first lien on our Pacific route authorities and certain related assets. Like our other secured debt instruments, the Pacific Facilities include affirmative, negative and financial covenants that restrict our ability to, among other things, make investments, sell or otherwise dispose of collateral if we are not in compliance with the collateral coverage ratio test described below, pay dividends or repurchase stock. The financial covenants require us to maintain the minimum levels shown in the table below:

Minimum Fixed Charge Coverage Ratio(1)	1.20:1
Minimum Unrestricted Liquidity	
Unrestricted cash, permitted investments, and undrawn revolving credit facilities	$2.0 billion
Minimum Collateral Coverage Ratio(2)	1.60:1

(1) Defined as the ratio of (a) earnings before interest, taxes, depreciation, amortization and aircraft rent, and other adjustments to net income to (b) the sum of gross cash interest expense (including the cash interest portion of our capitalized lease obligations) and cash aircraft rent expense, for the 12-month period ending as of the last day of each fiscal quarter.

(2) Defined as the ratio of (a) the value of the collateral to (b) the sum of the aggregate outstanding obligations under the Pacific Facilities and certain other obligations.

Under the Pacific Facilities, if the Minimum Collateral Coverage Ratio is not maintained, we must either provide additional collateral to secure our obligations, or we must repay the loans under the facilities by an amount necessary to maintain compliance with the collateral coverage ratio. The value of the collateral that has been pledged may change over time, which may be reflected in appraisals of collateral required by the Pacific Facilities. These changes could result from factors that are not under our control. A decline in the value of collateral could result in a situation where we may not be able to maintain the collateral coverage ratio.

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

September 2012 Quarter Financial Highlights

Our net income for the September 2012 quarter was $1.0 billion, or $1.23 per diluted share. Total operating revenue increased $107 million, or 1%, over the September 2011 quarter, primarily due to higher passenger revenue due to yield improvement. Fuel expense decreased due to fuel hedge results and a 2% decline in consumption.

Passenger revenue increased $124 million due to a 3% year over year improvement in passenger mile yield on 1% lower traffic, while capacity declined 2%. Passenger revenue per available seat mile ("PRASM") increased 3% over the September 2011 quarter, reflecting higher revenue under corporate travel contracts and improvements in our products and services.

Total operating expense decreased $341 million over the September 2011 quarter, driven primarily by lower fuel expense. Our fuel expense decreased $672 million (including our contract carriers under capacity purchase agreements) compared to the September 2011 quarter due to fuel hedge gains and a 2% decrease in consumption. During the September 2012 quarter, we recorded gains of $414 million due to changes in the fair value of our fuel hedge portfolio. The majority of these gains relate to mark-to-market adjustments for fuel hedges settling in future periods. Excluding mark-to-market adjustments recorded in periods other than the settlement period ("MTM adjustments"), our average fuel price for the quarter was $3.14 per gallon, compared to $3.09 per gallon for the September 2011 quarter.

Our consolidated operating cost per available seat mile ("CASM") for the September 2012 quarter decreased 2.3% to 13.83 cents from 14.16 cents in the September 2011 quarter, primarily reflecting the market gain on fuel hedges. For the September 2012 quarter, CASM-Ex was 8.55 cents, or 5.6% higher than the September 2011 quarter. The non-GAAP financial measures used in this paragraph are defined in "Supplemental Information" below.

Strengthening the Balance Sheet

We will continue to focus on cash flow generation toward our goal of further strengthening our balance sheet. We finished the September 2012 quarter with $5.1 billion in unrestricted liquidity (consisting of cash, cash equivalents, short-term investments and undrawn revolving credit facility capacity). During the first nine months of 2012, we generated $1.9 billion in cash from operating activities, and we reduced debt by $1.1 billion and funded capital expenditures while maintaining a solid liquidity position.

Oil Refinery Acquisition

Jet fuel costs have continued to increase in recent years, making fuel expense our single largest expense. Because global demand for jet fuel and related products is increasing at the same time that jet fuel refining capacity is decreasing in the U.S. (particularly in the Northeast), the refining margin reflected in the prices we pay for jet fuel has increased. We purchased an oil refinery in June 2012 as part of our strategy to mitigate the increasing cost of the refining margin we are paying.

Acquisition

On June 22, 2012 (the "Closing Date"), our wholly-owned subsidiary, Monroe Energy, LLC (“Monroe”), acquired the Trainer refinery located near Philadelphia, Pennsylvania from Phillips 66. Monroe invested $180 million to acquire the refinery. Monroe received a $30 million grant from the Commonwealth of Pennsylvania. The acquisition includes pipelines and terminal assets that will allow the refinery to supply jet fuel to our airline operations throughout the Northeastern U.S., including our New York hubs at LaGuardia Airport and John F. Kennedy International Airport.

Prior to the transaction, Phillips 66 had shut down operations at the refinery. Monroe is making required capital improvements totaling approximately $100 million to restart the refinery and bring it to its desired operating state.

Refinery Operations and Strategic Agreements

The facility is capable of refining 185,000 barrels of crude oil per day. BP will supply crude oil used by the refinery under a three year agreement. The refinery will produce approximately 30% jet fuel after the capital improvements are completed. The refinery's remaining production will consist of gas, diesel and refined products ("non-jet fuel products"). Under a multi-year agreement, we will exchange a significant portion of the non-jet fuel products with Phillips 66 for jet fuel to be used in our airline operations. Substantially all of the remaining production of non-jet fuel products will be sold to BP under a long-term buy/ sale agreement effectively exchanging those non-jet fuel products for jet fuel. Our agreement with Phillips 66 requires us to deliver specified quantities of non-jet fuel products and they are required to deliver jet fuel to us. If we or Phillips 66 do not have the specified quantity and type of product available, the delivering party is required to procure any such shortage to fulfill its obligation under the agreement. Substantially all of the refinery's expected production of non-jet fuel products is included in these agreements.

Refinery Start-Up

Production at the refinery restarted in September 2012. It is expected to reach its full refining capacity during the fourth quarter, at which time we expect to begin to realize the benefits of ownership of the refinery. We expect these benefits to be $300 million on an annual basis. The results of the refinery's operations were not material in the September 2012 quarter.

Pilot Agreement

During the June 2012 quarter, we reached an agreement with the Air Line Pilots Association, International (“ALPA”) to modify the existing collective bargaining agreement covering Delta’s pilots. The agreement, which was ratified by the pilots in June 2012, provides career growth opportunities as well as pay and benefits improvements for our pilots including increases to base pay and changes to our profit sharing program. The agreement will also provide Delta with productivity gains and support our domestic fleet restructuring.

Domestic Fleet Restructuring

Our ongoing domestic fleet restructuring is focused on lowering unit costs while investing in our fleet to enhance the customer experience. As part of this effort, in July 2012, we finalized agreements with Southwest Airlines and The Boeing Company ("Boeing") to lease 88 B-717-200 aircraft. Delivery of the aircraft will begin next year, with 16 aircraft scheduled to enter our fleet in 2013. We will receive 36 aircraft deliveries in each of 2014 and 2015. The B-717-200 aircraft will primarily replace 50-seat regional jets on a capacity neutral basis. These B-717-200 are 110-seat aircraft and will feature new, fully upgraded interiors, with 12 First Class seats, 15 Economy Comfort seats and in-flight WiFi throughout the cabin. Including the B-717-200 aircraft, we estimate that our total lease payments will be approximately $1.6 billion in 2013, $1.6 billion in 2014, $1.5 billion in 2015, $1.4 billion in 2016 and $8.8 billion after 2016.

Our domestic fleet restructuring also includes replacing older, less efficient mainline aircraft. During 2011, we entered into an agreement with Boeing to purchase 100 new fuel efficient B-737-900ER aircraft. We will add these aircraft to our fleet between 2013 and 2018, primarily replacing older B-757 and B-767 aircraft. The state-of-the-art B-737-900ER will offer an industry leading customer experience, including expanded carry-on baggage space and a spacious cabin. Additionally, we continue to upgrade our fleet with the addition of previously owned MD-90 jets.

We continue to assess our fleet and expect to add the aircraft discussed above on a capacity neutral basis, as we retire older less efficient aircraft. We continue to evaluate older, retiring fleets and related equipment for changes in depreciable life and/or impairment.

18

New York Strategy

Strengthening our position in New York City continues to be an important part of our network strategy. As discussed below, key components of this strategy are operating a domestic hub at LaGuardia and creating a state-of-the-art facility at JFK. In May 2012, we announced new and expanded service to 10 popular leisure destinations (in addition to the service expansion discussed below) in the Caribbean, Bermuda, and Florida from LaGuardia and JFK. These flights are expected to begin operating in the December quarter of 2012.

LaGuardia. During December 2011, we closed transactions with US Airways where we received takeoff and landing rights (each a "slot pair") at LaGuardia in exchange for slot pairs at Reagan National. This exchange allows us to operate a new domestic hub at LaGuardia.

We have increased capacity at LaGuardia by 42%, adding 100 new flights and a total of 26 new destinations. The first phase of new flights began on March 25 and the second phase commenced on July 11. We currently operate about 260 daily flights between LaGuardia and 60 cities, which is more than any other airline.

We are also investing $160 million in a renovation and expansion project at LaGuardia to enhance the customer experience. In early 2012, we broke ground on the connector linking Terminals C and D and in September 2012 we opened a new SkyClub in Terminal C. Ongoing investments include expanded security lanes and baggage handling system in both terminals as well as an expanded SkyClub in Terminal D.

JFK. While our expanded LaGuardia schedule is focused on providing industry-leading domestic service, we are optimizing our international and trans-continental flight schedule at JFK during 2012 to facilitate convenient connections for our passengers and improve coordination with our SkyTeam alliance partners.

At JFK, we currently operate domestic flights primarily at Terminal 2 and international flights at Terminal 3 and, to a lesser extent, Terminal 4. Our five-year $1.2 billion renovation project at JFK, which began in 2010, is on schedule. The expansion and enhancement of Terminal 4, which includes the construction of nine new international gates, commenced in 2011 and is expected to be open in the spring of 2013. Upon completion of the Terminal 4 expansion, we will relocate our operations from Terminal 3 to Terminal 4, proceed with the demolition of Terminal 3, and thereafter conduct coordinated flight operations from Terminals 2 and 4. Once our project is complete, we expect that passengers will benefit from an enhanced customer experience and improved operational performance, including reduced taxi times and better on-time performance.

Results of Operations - Three Months Ended September 30, 2012 and 2011

Operating Revenue

(in millions)	Three Months Ended September 30, 2012	2011	Increase (Decrease)	% Increase (Decrease)
Passenger:				
Mainline	$7,017	$6,852	$165	2 %
Regional carriers	1,675	1,716	(41)	(2)%
Total passenger revenue	8,692	8,568	124	1 %
Cargo	243	257	(14)	(5)%
Other	988	991	(3)	— %
Total operating revenue	$9,923	$9,816	$107	1 %

		Increase (Decrease) vs. Three Months Ended September 30, 2011					
(in millions)	Three Months Ended September 30, 2012	Passenger Revenue	RPMs[1] (Traffic)	ASMs[2] (Capacity)	Passenger Mile Yield	PRASM[3]	Load Factor
Domestic	$3,690	4 %	1 %	1 %	4 %	3 %	(0.7) pts
Atlantic	1,751	(2)%	(4)%	(5)%	2 %	3 %	1.0 pts
Pacific	1,108	5 %	1 %	(1)%	3 %	6 %	2.0 pts
Latin America	468	3 %	6 %	3 %	(3)%	— %	2.4 pts
Total Mainline	7,017	2 %	— %	(1)%	3 %	3 %	0.3 pts
Regional carriers	1,675	(2)%	(8)%	(8)%	6 %	6 %	(0.5) pts
Total passenger revenue	$8,692	1 %	(1)%	(2)%	3 %	3 %	0.3 pts

(1) Revenue passenger miles (“RPMs”)
(2) Available seat miles (“ASMs”)
(3) Passenger revenue per ASM (“PRASM”)

Passenger Revenue. Passenger revenue increased $124 million, or 1%, due to an improvement in the passenger mile yield due to higher revenue under corporate travel contracts and improvements in our products and services. Capacity decreased 1% in the domestic region and 3% in international regions.

International mainline passenger revenue increased $19 million. Atlantic PRASM was up 3%, driven by a 2% increase in yield and a 5% reduction in capacity. Pacific passenger revenue increased 5% due to a 3% increase in yield.

Operating Expense

(in millions)	Three Months Ended September 30, 2012	2011	Increase (Decrease)	% Increase (Decrease)
Aircraft fuel and related taxes	$2,221	$2,881	$(660)	(23)%
Salaries and related costs	1,850	1,717	133	8%
Contract carrier arrangements	1,447	1,432	15	1%
Aircraft maintenance materials and outside repairs	493	428	65	15%
Passenger commissions and other selling expenses	440	480	(40)	(8)%
Contracted services	402	419	(17)	(4)%
Depreciation and amortization	392	384	8	2%
Landing fees and other rents	360	342	18	5%
Passenger service	201	207	(6)	(3)%
Profit sharing	174	167	7	4%
Aircraft rent	65	72	(7)	(10)%
Restructuring and other items	149	3	146	NM
Other	421	424	(3)	(1)%
Total operating expense	$8,615	$8,956	$(341)	(4)%

Fuel Expense. Including contract carriers under capacity purchase agreements, fuel expense decreased $672 million primarily due to fuel hedge gains and a 2% decline in consumption. The table below presents fuel expense, gallons consumed, and our average price per fuel gallon, including the impact of fuel hedge gains of $414 million in the September 2012 quarter:

(in millions, except per gallon data)	Three Months Ended September 30, 2012	2011	Increase (Decrease)	% Increase (Decrease)
Aircraft fuel and related taxes[1]	$2,221	$2,881	$(660)	
Aircraft fuel and related taxes included within contract carrier arrangements	540	552	(12)	
Total fuel expense	$2,761	$3,433	$(672)	(20)%
Total fuel consumption (gallons)	1,021	1,044	(23)	(2)%
Average price per fuel gallon	$2.71	$3.29	$(0.58)	(18)%

(1) Includes the impact of fuel hedge activity described further in the table below.

The table below shows the impact of hedging on fuel expense and average price per fuel gallon:

(in millions, except per gallon data)	Three Months Ended September 30, 2012	2011	Change	Average Price Per Gallon Three Months Ended September 30, 2012	2011	Change
Fuel purchase cost	$3,175	$3,322	$(147)	$3.11	$3.18	$(0.07)
Fuel hedge (gains) losses	(414)	111	(525)	(0.40)	0.11	(0.51)
Total fuel expense	$2,761	$3,433	$(672)	$2.71	$3.29	$(0.58)
MTM adjustments	440	(208)	648	0.43	(0.20)	0.63
Total fuel expense, adjusted	$3,201	$3,225	$(24)	$3.14	$3.09	$0.05

During the three months ended September 30, 2012, our fuel hedge gains of $414 million included $440 million in gains for MTM adjustments. These MTM adjustments are based on market prices as of the end of the reporting period for contracts settling in future periods. Such market prices are not necessarily indicative of the actual future value of the underlying hedge in the contract settlement period. Therefore, we adjust fuel expense for these items to arrive at a more meaningful measure of fuel cost. Our average price per fuel gallon, adjusted (a non-GAAP financial measure as defined in "Supplemental Information" below), was $3.14 for the September 2012 quarter.

21

Salaries and Related Costs. The increase in salaries and related costs is primarily due to employee pay increases, increases in pension expense and other benefits.

During the June 2012 quarter, we reached an agreement with ALPA that increases pay and benefits for our pilots. Our pilots and substantially all other employees received base pay increases on July 1, 2012 and will receive additional increases on January 1, 2013. These increases are designed both to recognize the upcoming change to the profit sharing program described below and to accelerate the planned 2013 pay increase for non-pilot employees.

Aircraft Maintenance Materials and Outside Repairs. Aircraft maintenance materials and outside repairs consists of costs associated with maintenance of aircraft used in our operations and maintenance sales to third parties by our MRO services business. The increase in maintenance costs is primarily due to our acceleration of certain maintenance events into the September 2012 quarter resulting in a lower total cost for those activities as well as initiatives to improve our operational reliability.

Passenger Commissions and Other Selling Expenses. The decrease in passenger commissions and other selling expenses is primarily due to lower booking fees and international commission rates.

Profit Sharing. Our broad based employee profit sharing program provides that, for each year in which we have an annual pre-tax profit, as defined by the terms of the program, we will pay a specified portion of that profit to employees. In determining the amount of profit sharing, the terms of the program specify the exclusion of special items, such as MTM adjustments and restructuring and other items, from pre-tax profit. During the June 2012 quarter, our profit sharing program was modified so that we will pay 10% of profits, on the first $2.5 billion of annual profits effective with the plan year beginning January 1, 2013 compared to paying 15% of annual profits for the 2012 plan year. Under the program, we will continue to pay 20% of annual profits above $2.5 billion.

Restructuring and Other Items. Due to the nature of amounts recorded within restructuring and other items, a year over year comparison is not meaningful. For a discussion of charges recorded in restructuring and other items, see Note 7 of the Notes to the Condensed Consolidated Financial Statements.

22

Results of Operations - Nine Months Ended September 30, 2012 and 2011

Operating Revenue

(in millions)	Nine Months Ended September 30, 2012	2011	Increase (Decrease)	% Increase (Decrease)
Passenger:				
Mainline	$19,323	$18,186	$1,137	6 %
Regional carriers	5,046	4,848	198	4 %
Total passenger revenue	24,369	23,034	1,335	6 %
Cargo	749	771	(22)	(3)%
Other	2,950	2,911	39	1 %
Total operating revenue	$28,068	$26,716	$1,352	5 %

(in millions)	Nine Months Ended September 30, 2012	Increase (Decrease) vs. Nine Months Ended September 30, 2011: Passenger Revenue	RPMs[1] (Traffic)	ASMs[2] (Capacity)	Passenger Mile Yield	PRASM[3]	Load Factor
Domestic	$10,611	7 %	1 %	(1)%	6 %	7 %	1.0 pts
Atlantic	4,423	1 %	(4)%	(7)%	5 %	9 %	2.8 pts
Pacific	2,825	12 %	5 %	3 %	7 %	9 %	1.9 pts
Latin America	1,464	8 %	4 %	1 %	4 %	7 %	2.4 pts
Total Mainline	19,323	6 %	— %	(2)%	6 %	8 %	1.7 pts
Regional carriers	5,046	4 %	(3)%	(4)%	8 %	9 %	0.9 pts
Total passenger revenue	$24,369	6 %	— %	(2)%	6 %	8 %	1.6 pts

(1) Revenue passenger miles (“RPMs”)
(2) Available seat miles (“ASMs”)
(3) Passenger revenue per ASM (“PRASM”)

Passenger Revenue. Passenger revenue increased $1.3 billion, or 6%, due to an improvement in the passenger mile yield of 6%, despite a 2% decline in capacity. Passenger mile yield and unit revenue increased due to fare increases, higher revenue under corporate travel contracts and improvements in our products and services.

International mainline passenger revenue increased $469 million. Atlantic PRASM was up 9%, driven by a 5% increase in yield on a 7% decrease in capacity. In early 2011, we faced industry overcapacity in the transatlantic market and in connection with our joint venture partners, AirFrance-KLM and Alitalia, we have reduced capacity in underperforming markets. Pacific passenger revenue increased 12% on a 3% and 5% increase in capacity and traffic, respectively. These results reflect higher yield and traffic, as demand returned to levels seen prior to the March 2011 earthquake and tsunami in Japan.

Operating Expense

(in millions)	Nine Months Ended September 30, 2012	2011	Increase (Decrease)	% Increase (Decrease)
Aircraft fuel and related taxes	$7,759	$7,710	$49	1 %
Salaries and related costs	5,438	5,183	255	5 %
Contract carrier arrangements	4,238	4,142	96	2 %
Aircraft maintenance materials and outside repairs	1,602	1,398	204	15 %
Passenger commissions and other selling expenses	1,213	1,289	(76)	(6)%
Contracted services	1,177	1,259	(82)	(7)%
Depreciation and amortization	1,166	1,141	25	2 %
Landing fees and other rents	1,012	975	37	4 %
Passenger service	559	552	7	1 %
Profit sharing	309	175	134	NM
Aircraft rent	208	224	(16)	(7)%
Restructuring and other items	330	154	176	NM
Other	1,233	1,265	(32)	(3)%
Total operating expense	$26,244	$25,467	$777	3 %

Fuel Expense. Including contract carriers under capacity purchase agreements, fuel expense increased $76 million because of an increase in our average price per fuel gallon, despite a 3% decrease in consumption. The table below presents fuel expense, gallons consumed, and our average price per fuel gallon, including the impact of fuel hedge losses of $106 million during the nine months ended September 30, 2012:

(in millions, except per gallon data)	Nine Months Ended September 30, 2012	2011	Increase (Decrease)	% Increase (Decrease)
Aircraft fuel and related taxes[1]	$7,759	$7,710	$49	
Aircraft fuel and related taxes included within contract carrier arrangements	1,587	1,560	27	
Total fuel expense	$9,346	$9,270	$76	1 %
Total fuel consumption (gallons)	2,875	2,955	(80)	(3)%
Average price per fuel gallon	$3.25	$3.14	$0.11	4 %

(1) Includes the impact of fuel hedge activity described further in the table below.

The table below shows the impact of hedging on fuel expense and average price per fuel gallon:

(in millions, except per gallon data)	Nine Months Ended September 30, 2012	2011	Change	Average Price Per Gallon Nine Months Ended September 30, 2012	2011	Change
Fuel purchase cost	$9,240	$9,373	$(133)	$3.21	$3.17	$0.04
Fuel hedge losses (gains)	106	(103)	209	0.04	(0.03)	0.07
Total fuel expense	$9,346	$9,270	$76	$3.25	$3.14	$0.11
MTM adjustments	30	(190)	220	0.01	(0.07)	0.08
Total fuel expense, adjusted	$9,376	$9,080	$296	$3.26	$3.07	$0.19

During the nine months ended September 30, 2012, our net fuel hedge losses of $106 million included $30 million in gains for MTM adjustments. These MTM adjustments are based on market prices as of the end of the reporting period for contracts settling in future periods. Such market prices are not necessarily indicative of the actual future value of the underlying hedge in the contract settlement period. Therefore, we adjust fuel expense for these items to arrive at a more meaningful measure of fuel cost. Our average price per fuel gallon, adjusted (a non-GAAP financial measure as defined in "Supplemental Information" below), was $3.26 for the nine months ended September 30, 2012.

Salaries and Related Costs. The increase in salaries and related costs is primarily due to employee pay increases, increases in pension expense and other benefits.

During the June 2012 quarter, we reached an agreement with ALPA that increases pay and benefits for our pilots. Our pilots and substantially all other employees received base pay increases on July 1, 2012 and will receive additional increases on January 1, 2013. These increases are designed both to recognize the upcoming change to the profit sharing program described below and to accelerate the planned 2013 pay increase for non-pilot employees.

Aircraft Maintenance Materials and Outside Repairs. Aircraft maintenance materials and outside repairs consists of costs associated with maintenance of aircraft used in our operations and maintenance sales to third parties by our MRO services business. The increase in maintenance costs is primarily due to the cyclical timing of maintenance events on our fleet, our acceleration of certain maintenance events into the September 2012 quarter resulting in a lower total cost for those activities as well as initiatives to improve our operational reliability.

Passenger Commissions and Other Selling Expenses. The decrease in passenger commissions and other selling expenses is primarily due to lower booking fees and international commission rates, partially offset by increases in sales.

Contracted Services. Contracted services expense improved year-over-year due primarily to the impact of severe winter storms on our operations in the March 2011 quarter.

Profit Sharing. Our broad based employee profit sharing program provides that, for each year in which we have an annual pre-tax profit, as defined by the terms of the program, we will pay a specified portion of that profit to employees. In determining the amount of profit sharing, the terms of the program specify the exclusion of special items, such as MTM adjustments and restructuring and other items, from pre-tax profit. During the June 2012 quarter, our profit sharing program was modified so that we will pay 10% of profits, on the first $2.5 billion of annual profits effective with the plan year beginning January 1, 2013 compared to paying 15% of annual profits for the 2012 plan year. Under the program, we will continue to pay 20% of annual profits above $2.5 billion.

Restructuring and Other Items. Due to the nature of amounts recorded within restructuring and other items, a year over year comparison is not meaningful. For a discussion of charges recorded in restructuring and other items, see Note 7 of the Notes to the Condensed Consolidated Financial Statements.

Non-Operating Results

The following table shows the components of other expense, net:

(in millions)	Three Months Ended September 30, 2012	Three Months Ended September 30, 2011	Favorable (Unfavorable)	Nine Months Ended September 30, 2012	Nine Months Ended September 30, 2011	Favorable (Unfavorable)
Interest expense, net	$(195)	$(229)	$ 34	$(623)	$(683)	$ 60
Amortization of debt discount, net	(48)	(48)	—	(148)	(141)	(7)
Loss on extinguishment of debt	(12)	(5)	(7)	(12)	(38)	26
Foreign currency exchange	5	(30)	35	(11)	(25)	14
Miscellaneous, net	(6)	(1)	(5)	(16)	(10)	(6)
Total other expense, net	$(256)	$(313)	$ 57	$(810)	$(897)	$ 87

25

Income Taxes

The following table shows the components of our income tax (provision) benefit:

(in millions)	Three Months Ended September 30, 2012	Three Months Ended September 30, 2011	Nine Months Ended September 30, 2012	Nine Months Ended September 30, 2011
International and state income tax provision	$(5)	$(4)	$(11)	$(6)
Alternative minimum tax refunds and other	—	6	—	83
Income tax (provision) benefit	$(5)	$2	$(11)	$77

We consider all income sources, including other comprehensive income, in determining the amount of tax benefit allocated to continuing operations. During the three and nine months ended September 30, 2012, we did not record an income tax provision for U.S. federal income tax purposes since our deferred tax assets are fully reserved by a valuation allowance. For a discussion of our valuation allowance, see Note 9 to the Notes of the Condensed Consolidated Financial Statements.

Operating Statistics

The following table sets forth our operating statistics:

Consolidated[1]	Three Months Ended September 30, 2012	Three Months Ended September 30, 2011	Nine Months Ended September 30, 2012	Nine Months Ended September 30, 2011
Revenue passenger miles (millions)	53,828	54,497	147,699	147,792
Available seat miles (millions)	62,283	63,262	176,073	179,622
Passenger mile yield	16.15 ¢	15.72 ¢	16.50 ¢	15.59 ¢
Passenger revenue per available seat mile	13.96 ¢	13.54 ¢	13.84 ¢	12.82 ¢
Operating cost per available seat mile (CASM)	13.83 ¢	14.16 ¢	14.91 ¢	14.18 ¢
CASM-Ex[2]	8.55 ¢	8.10 ¢	8.85 ¢	8.49 ¢
Passenger load factor	86.4 %	86.1 %	83.9 %	82.3 %
Fuel gallons consumed (millions)	1,021	1,044	2,875	2,955
Average price per fuel gallon[3]	$2.71	$3.29	$3.25	$3.14
Average price per fuel gallon, adjusted[2]	$3.14	$3.09	$3.26	$3.07
Full-time equivalent employees, end of period	76,626	79,709		

(1) Includes the operations of our contract carriers under capacity purchase agreements. Full-time equivalent employees exclude employees of contract carriers that we do not own.

(2) Non-GAAP financial measure as defined in "Supplemental Information" below.

(3) Includes the impact of fuel hedge activity.

Fleet Information

Our operating aircraft fleet, commitments, and options at September 30, 2012 are summarized in the following table:

	Current Fleet[1]					Commitments[2]		
Aircraft Type	Owned	Capital Lease	Operating Lease	Total	Average Age	Purchase	Lease	Options
B-717-200	—	—	—	—	—	—	88	—
B-737-700	10	—	—	10	3.7	—	—	—
B-737-800	73	—	—	73	11.7	—	—	—
B-737-900ER	—	—	—	—	—	100	—	30
B-747-400	4	9	3	16	18.9	—	—	—
B-757-200	86	36	33	155	19.2	—	—	—
B-757-300	16	—	—	16	9.6	—	—	—
B-767-300	10	2	3	15	21.5	—	—	—
B-767-300ER	50	5	3	58	16.5	—	—	4
B-767-400ER	21	—	—	21	11.6	—	—	6
B-777-200ER	8	—	—	8	12.7	—	—	—
B-777-200LR	10	—	—	10	3.5	—	—	11
B-787-8	—	—	—	—	—	18	—	—
A319-100	55	—	2	57	10.7	—	—	—
A320-200	41	—	28	69	17.6	—	—	—
A330-200	11	—	—	11	7.5	—	—	—
A330-300	21	—	—	21	7.1	—	—	—
MD-88	67	50	—	117	22.2	—	—	—
MD-90	41	8	—	49	15.5	7	—	—
DC9-50	19	—	—	19	34.4	—	—	—
Embraer 175	—	—	—	—	—	—	—	36
Total	543	110	72	725	16.6	125	88	87

(1) Excludes certain aircraft we own or lease which are operated by third party contract carriers on our behalf shown in the table below.

(2) Excludes our orders for five A319-100 aircraft and two A320-200 aircraft because we have the right to cancel these orders.

The following table summarizes the aircraft fleet operated by third party contract carriers on our behalf at September 30, 2012:

	Fleet Type						
Carrier	CRJ-200	CRJ-700	CRJ-900	ERJ-145	Embraer 170	Embraer 175	Total
Pinnacle Airlines, Inc.	140	—	57	—	—	—	197
ExpressJet Airlines, Inc.	92	40	16	—	—	—	148
SkyWest Airlines, Inc.	54	17	28	—	—	—	99
Compass Airlines, Inc.	—	—	—	—	6	36	42
Shuttle America Corporation	—	—	—	—	14	16	30
Chautauqua Airlines, Inc.	—	—	—	26	—	—	26
GoJet Airlines, LLC	—	22	—	—	—	—	22
Total	286	79	101	26	20	52	564

Pinnacle Airlines Corp. ("Pinnacle") along with Pinnacle Airlines Inc. and other of its subsidiaries, filed for bankruptcy in April 2012. We do not believe that Pinnacle's bankruptcy filing will have a material effect on our operations or financial statements.

27

Financial Condition and Liquidity

We expect to meet our cash needs for the next 12 months from cash flows from operations, cash and cash equivalents, short-term investments and financing arrangements. As of September 30, 2012, we had $5.1 billion in unrestricted liquidity, including $1.9 billion in availability under credit facilities.

Debt and Capital Leases. At September 30, 2012, total debt and capital leases, including current maturities, was $12.7 billion, a $1.1 billion reduction from December 31, 2011. Our ability to obtain additional financing, if needed, on acceptable terms could be adversely affected by the fact that a significant portion of our assets are subject to liens.

In July 2012, we completed a $480 million offering of Pass Through Certificates, Series 2012-1 ("2012-1 EETC") through a pass through trust. The 2012-1 EETC has a weighted average interest rate of 5.31% and matures in May 2020. We used the proceeds to refinance aircraft securing the Delta 2002-1 EETC, a portion of which matured on July 2, 2012. We also used the proceeds to refinance aircraft securing the Northwest 2001-2 EETC, which was scheduled to mature in August 2013 but was prepaid in the September 2012 quarter.

In October 2012, we entered into senior secured credit facilities (the "Pacific Facilities") to borrow up to $2.0 billion. The Pacific Facilities consist of two first lien term loan facilities (the "Pacific Term Loans") and a $450 million revolving credit facility (the "Pacific Revolving Facility"). In connection with entering into the Pacific Facilities, we retired $1.2 billion principal amount of outstanding debt, including a term loan facility, senior secured and senior second lien notes, and terminated an existing undrawn $500 million revolving credit facility.

Pension Obligations. We sponsor defined benefit pension plans for eligible employees and retirees. These plans are closed to new entrants and are frozen for future benefit accruals. During the nine months ended September 30, 2012, we contributed $678 million to our defined benefit pension plans. As a result of these contributions, we satisfied, on an accelerated basis, the minimum required contributions for our defined benefit pension plans for 2012.

Sources and Uses of Cash

Cash Flows from Operating Activities

Cash provided by operating activities totaled $1.9 billion and $1.7 billion for the nine months ended September 30, 2012 and 2011, respectively, primarily reflecting net income after adjusting for items such as depreciation and amortization and seasonal variations in the demand for air travel.

During the nine months ended September 30, 2012, cash provided by operating activities was reduced by $678 million in pension funding and $264 million in profit sharing payments for 2011. During the nine months ended September 30, 2011, cash provided by operating activities was reduced by $313 million in profit sharing payments for 2010 and decreases in accounts payable and other accrued liabilities.

Cash Flows from Investing Activities

The following table shows the components of net cash used in investing activities:

	Nine Months Ended September 30,	
(in millions)	2012	2011
Flight equipment	$(885)	$(676)
Technology and facilities	(287)	(210)
Oil refinery (see Note 2)	(258)	—

Short-term investments and other	1	(200)
Net cash used in investing activities	$(1,429)	$(1,086)

Flight equipment primarily includes (1) investments in full flat-bed seats in BusinessElite and other interior upgrades; (2) purchase and modifications of recently acquired MD-90s; and (3) other aircraft modifications and parts. Technology and facilities consists of improvements in delta.com and mobile apps and investments at our airports at LaGuardia and JFK. Net purchases of short-term investments and other in 2011 represents the net purchase of treasury bills, which are reflected as short-term investments on our Consolidated Balance Sheets.

Cash Flows from Financing Activities

Cash used in financing activities totaled $0.9 billion for the nine months ended September 30, 2012, reflecting the repayment of $1.4 billion in long-term debt and capital lease obligations, partially offset by a $73 million net increase in the fuel card obligation. We also completed the $480 million 2012-1 EETC offering.

Cash used in financing activities totaled $1.2 billion for the nine months ended September 30, 2011, reflecting the repayment of $2.0 billion in long-term debt and capital lease obligations, partially offset by $1.0 billion in proceeds from aircraft financing.

Critical Accounting Policies and Estimates

For information regarding our Critical Accounting Policies and Estimates, see the “Critical Accounting Policies and Estimates” section of “Item 7. Management's Discussion and Analysis of Financial Condition and Results of Operations” in our Form 10-K.

Recent Accounting Standards

Testing Indefinite-Lived Intangible Assets for Impairment

In July 2012, the FASB issued "Testing Indefinite-Lived Intangible Assets for Impairment." The standard gives companies the option to perform a qualitative assessment to determine whether it is more likely than not that an indefinite-lived intangible asset is impaired rather than calculating the fair value of the indefinite-lived intangible asset. It is effective prospectively for annual and interim impairment tests performed for fiscal years beginning after September 15, 2012, with early adoption permitted.We adopted this standard and will apply the provisions to our annual indefinite-lived intangible asset impairment tests in the December 2012 quarter. The adoption of this standard will not have a material impact on our Consolidated Financial Statements.

Supplemental Information

We sometimes use information ("non-GAAP financial measures") that is derived from the Consolidated Financial Statements, but that is not presented in accordance with accounting principles generally accepted in the U.S. (“GAAP”). Under the U.S. Securities and Exchange Commission rules, non-GAAP financial measures may be considered in addition to results prepared in accordance with GAAP, but should not be considered a substitute for or superior to GAAP results. The tables below show reconciliations of non-GAAP financial measures to the most directly comparable GAAP financial measures.

To determine our average price per fuel gallon, adjusted, we exclude mark-to-market adjustments on fuel hedges recorded in periods other than the settlement period ("MTM adjustments"). These MTM adjustments are based on market prices as of the end of the reporting period for contracts settling in future periods. Such market prices are not necessarily indicative of the actual future value of the underlying hedge in the contract settlement period. Therefore, we adjust fuel expense for these items to arrive at a more meaningful measure of fuel cost.

	Three Months Ended September 30,		Nine Months Ended September 30,	
Consolidated	2012	2011	2012	2011
Average price per fuel gallon[1]	$2.71	$3.29	$3.25	$3.14
MTM adjustments	0.43	(0.20)	0.01	(0.07)
Average price per fuel gallon, adjusted[2]	$3.14	$3.09	$3.26	$3.07

(1) Includes fuel expense incurred under contract carriers arrangements and the impact of fuel hedge activity.
(2) Includes the impact of fuel hedges settling during the period.

In addition to MTM adjustments, we exclude the following items from CASM to determine CASM-Ex:

- Aircraft fuel and related taxes. The volatility in fuel prices impacts the comparability of year-over-year financial performance. Management believes the exclusion of aircraft fuel and related taxes (including our contract carriers under capacity purchase arrangements) allows investors to better understand and analyze our non-fuel costs and our year-over-year financial performance.

- Ancillary businesses. Ancillary businesses are not related to the generation of a seat mile. These businesses include aircraft maintenance and staffing services we provide to third parties and our vacation wholesale operations.

- Profit sharing. Management believes the exclusion of this item provides a more meaningful comparison of our results to the airline industry and prior years' results.

- Restructuring and other items. Management believes the exclusion of this item is helpful to investors to evaluate our recurring core operational performance in the period shown.

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2012	2011	2012	2011
CASM	13.83 ¢	14.16 ¢	14.91 ¢	14.18 ¢
Items excluded:				
Aircraft fuel and related taxes	(5.13)	(5.09)	(5.32)	(5.05)
Ancillary businesses	(0.34)	(0.38)	(0.39)	(0.34)
Profit sharing	(0.28)	(0.26)	(0.18)	(0.10)
Restructuring and other items	(0.24)	—	(0.19)	(0.09)
MTM adjustments	0.71	(0.33)	0.02	(0.11)

CASM-Ex	8.55 ¢	8.10 ¢	8.85 ¢	8.49 ¢

30

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 Disclosures About Market Risk” in our Form 10-K, other than those discussed below.

The following sensitivity analysis does not consider the effects of a change in demand for air travel, the economy as a whole or actions we may take to seek to mitigate our exposure to a particular risk. For these and other reasons, the actual results of changes in these prices or rates may differ materially from the following hypothetical results.

Aircraft Fuel Price Risk

Our results of operations are materially impacted by changes in aircraft fuel prices. We actively manage our fuel price risk through a hedging program intended to reduce the financial impact on us from changes in the price of jet fuel. The objective of the fuel hedging program is to generate a positive cash position to defray the cost of jet fuel purchases. This fuel hedging program utilizes several different contract and commodity types. The economic effectiveness of this hedge portfolio is frequently tested against our financial targets. The hedge portfolio is rebalanced from time to time according to market conditions, which may result in locking in gains or losses on hedge contracts prior to their settlement dates.

Our fuel hedge portfolio consists of call options; put options; combinations of two or more call options and put options; swap contracts; and futures contracts. The products underlying the hedge contracts include heating oil, crude oil, jet fuel and diesel fuel, as these commodities are highly correlated with the price of jet fuel that we consume. Our fuel hedge contracts contain margin funding requirements. The margin funding requirements may cause us to post margin to counterparties or may cause counterparties to post margin to us as market prices in the underlying hedged items change. If fuel prices change significantly from the levels existing at the time we enter into fuel hedge contracts, we may be required to post a significant amount of margin. We may adjust our hedge portfolio from time to time in response to margin posting requirements.

For the nine months ended September 30, 2012, aircraft fuel and related taxes, including our contract carriers under capacity purchase agreements, accounted for $9.3 billion, or 36%, of our total operating expense. We recognized $106 million of net fuel hedge losses during the nine months ended September 30, 2012, including $30 million of mark-to-market gains primarily relating to hedge contracts settling in future periods.

The following table shows the projected cash impact to fuel cost assuming 10% and 20% increases or decreases in fuel prices. The hedge gain (loss) reflects the change in the projected cash settlement value of our open fuel hedge contracts at September 30, 2012 based on their contract settlement dates, assuming the same 10% and 20% changes.

(in millions)	Period From October 1, 2012 to December 31, 2013 (Increase) Decrease to Unhedged Fuel Cost[1]	Hedge (Loss) Gain[2]	Net Impact	Fuel Hedge Margin Received from (Posted to) Counterparties
+ 20%	$(2,800)	$(90)	$(2,890)	$80
+ 10%	(1,400)	120	(1,280)	20
- 10%	1,400	(70)	1,330	50
- 20%	2,800	(290)	2,510	(60)

(1) Projections based upon the (increase) decrease to unhedged fuel cost as compared to the jet fuel price per gallon of $3.14, excluding transportation costs and taxes, at September 30, 2012 and estimated fuel consumption of 4.6 billion gallons for the period from October 1, 2012 to December 31, 2013.

(2)

Projections based on average futures prices by contract settlement month compared to futures prices at September 30, 2012.

31

ITEM 4. CONTROLS AND PROCEDURES

Our management, including our Chief Executive Officer and Chief Financial Officer, performed an evaluation of our disclosure controls and procedures, which have been designed to permit us to effectively identify and timely disclose important information. Our management, including our Chief Executive Officer and Chief Financial Officer, concluded that the controls and procedures were effective as of September 30, 2012 to ensure that material information was accumulated and communicated to our management, including our Chief Executive Officer and Chief Financial Officer, as appropriate to allow timely decisions regarding required disclosure.

Except as set forth below, during the three months ended September 30, 2012, we did not make any changes in our internal control over financial reporting that have materially affected, or are reasonably likely to materially affect, our internal control over financial reporting.

On June 22, 2012, our wholly-owned subsidiary, Monroe Energy, LLC, acquired an oil refinery located near Philadelphia, Pennsylvania. The refinery became operational in the September 2012 quarter and management is currently evaluating policies, processes, technology and operations for the refinery. Management will continue to evaluate our internal control over financial reporting as we review the oil refinery activities.

REPORT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM

To the Board of Directors and Stockholders of
Delta Air Lines, Inc.

We have reviewed the consolidated balance sheet of Delta Air Lines, Inc. (the Company) as of September 30, 2012, and the related condensed consolidated statements of operations and comprehensive income for the three-month and nine-month periods ended September 30, 2012 and 2011, and the condensed consolidated statements of cash flows for the nine-month periods ended September 30, 2012 and 2011. These financial statements are the responsibility of the Company's management.

We conducted our review in accordance with the standards of the Public Company Accounting Oversight Board (United States). A review of interim financial information consists principally of applying analytical procedures and making inquiries of persons responsible for financial and accounting matters. It is substantially less in scope than an audit conducted in accordance with standards of the Public Company Accounting Oversight Board (United States), the objective of which is the expression of an opinion regarding the financial statements taken as a whole. Accordingly, we do not express such an opinion.

Based on our review, we are not aware of any material modifications that should be made to the accompanying condensed consolidated financial statements referred to above for them to be in conformity with U.S. generally accepted accounting principles.

We have previously audited, in accordance with the standards of the Public Company Accounting Oversight Board (United States), the consolidated balance sheet of Delta Air Lines, Inc. as of December 31, 2011 and the related consolidated statements of operations, stockholders' deficit, and cash flows for the year ended December 31, 2011 and in our report dated February 10, 2012, we expressed an unqualified opinion on those consolidated financial statements.

Atlanta, Georgia /s/ Ernst & Young LLP
October 26, 2012

PART II. OTHER INFORMATION

ITEM 1. LEGAL PROCEEDINGS

“Item 3. Legal Proceedings” of our Form 10-K includes a discussion of other legal proceedings. There have been no material changes from the legal proceedings described in our Form 10-K.

ITEM 1A. RISK FACTORS

“Item 1A. Risk Factors” of our Form 10-K includes a discussion of our risk factors. The information below updates, and should be read in conjunction with, the risk factors and information disclosed in our Form 10-K. Except as presented below, there have been no material changes from the risk factors described in our Form 10-K.

Our business and results of operations are dependent on the price and availability of aircraft fuel. High fuel costs or cost increases could have a materially adverse effect on our operating results. Likewise, significant disruptions in the supply of aircraft fuel would materially adversely affect our operations and operating results.

Our operating results are significantly impacted by changes in the price and availability of aircraft fuel. Fuel prices have increased substantially since the middle part of the last decade and have been extremely volatile during the last several years. In 2011, our average fuel price per gallon was $3.06, a 31% increase from an average fuel price of $2.33 in 2010. In 2010, our average fuel price per gallon was $2.33, an 8% increase from an average fuel price of $2.15 in 2009. In 2008, our average fuel price per gallon was $3.16, a 41% increase from an average price of $2.24 in 2007, which in turn was significantly higher than fuel prices just a few years earlier. Fuel costs represented 36%, 30% and 29% of our operating expense in 2011, 2010 and 2009, respectively. Volatility in fuel costs has had a significant negative effect on our results of operations and financial condition.

Our ability to pass along the increased costs of fuel to our customers may be affected by the competitive nature of the airline industry. We often have not been able to increase our fares to offset fully the effect of increased fuel costs in the past and we may not be able to do so in the future. In addition, our aircraft fuel purchase contracts do not provide material protection against price increases or assure the availability of our fuel supplies. We purchase most of our aircraft fuel under contracts that establish the price based on various market indices. We also purchase aircraft fuel on the spot market, from offshore sources and under contracts that permit the refiners to set the price.

We are currently able to obtain adequate supplies of aircraft fuel, but it is impossible to predict the future availability or price of aircraft fuel. In the future, we expect to acquire a significant amount of jet fuel from our wholly-owned subsidiary, Monroe, and through strategic agreements that Monroe has with BP and Phillips 66. Weather-related events, natural disasters, political disruptions or wars involving oil-producing countries, changes in governmental policy concerning aircraft fuel production, transportation or marketing, environmental concerns and other unpredictable events may result in crude oil and fuel supply shortages and crude oil and fuel price increases in the future. Additional increases in fuel costs or disruptions in fuel supplies could have additional negative effects on us.

The operation of an oil refinery by our wholly-owned subsidiary may pose risks to our consolidated financial results of operations that are different from the risks associated with our airline operations.

Our wholly-owned subsidiary, Monroe, recently acquired an oil refinery complex located near Philadelphia, Pennsylvania. Our ability to acquire jet fuel from Monroe and through strategic agreements with BP and Phillips 66 is expected to reduce our exposure to increases in fuel costs. Monroe's operation of the refinery, however, may pose risks to our consolidated financial results of operations that are different from the risks associated with our airline operations.

Operational. Disruptions or interruptions of production at the refinery could result from various sources including a major accident or mechanical failure, interruption of supply or delivery of crude oil, work stoppages relating to organized labor issues, or damage from severe weather or other natural or man-made disasters, including acts of terrorism. Because we plan to acquire a large amount of our jet fuel from Monroe, the disruption or interruption of production at the refinery could have an impact on our ability to acquire all of the jet fuel needed for our operations. If the refinery were to experience an interruption in operations, the financial benefits we expect to achieve from buying fuel from Monroe could be materially adversely affected (to the extent not recoverable through insurance) because of lost production and repair costs.

34

Under the strategic agreement that Monroe has with Phillips 66, it will exchange non-jet fuel products for jet fuel for use in our airline operations. Monroe is required to deliver specified quantities of non-jet fuel products to Phillips 66 and Phillips 66 is required to deliver specified quantities of jet fuel to us. If either party does not have the specified quantity or type of product available, that party is required to procure any such shortage to fulfill its obligation under the exchange agreements. If the refinery experiences a significant interruption in operations, Monroe may be required to expend substantial amounts to purchase the products it is required to deliver, which could have a material adverse effect on our consolidated financial results of operations.

In addition, the strategic agreements utilize market prices for the products being exchanged. If Monroe's cost of producing the non-jet fuel products that it is required to deliver under these agreements exceeds the value it receives for those products, the financial benefits we expect to achieve through the ownership of the refinery and our consolidated results of operations could be materially adversely affected.

Insurance. Monroe's refining operations are subject to various hazards unique to refinery operations, including explosions, fires, toxic emissions and natural catastrophes. Monroe's insurance coverage does not cover all potential losses, costs or liabilities and Monroe could suffer losses for uninsurable or uninsured risks or in amounts greater than its insurance coverage. In addition, Monroe's ability to obtain and maintain adequate insurance may be affected by conditions in the insurance market over which it has not control. If Monroe were to incur a significant liability for which it is not fully insured or for which insurance companies do not or are unable to provide coverage, this could have a material adverse effect on our consolidated financial results of operations.

Environmental. Monroe's operations are subject to numerous environmental laws and extensive regulations, including those relating to the discharge of materials into the environment, waste management, pollution prevention measures, and greenhouse gas emissions. If Monroe violates or fails to comply with these laws and regulations, Monroe could be fined or otherwise sanctioned, which if significant could have a material adverse effect on our financial results. In addition, the enactment of new environmental laws and regulations, including any laws or regulations relating to greenhouse gas emissions, could significantly increase the level of expenditures required for environmental matters for Monroe.

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

We withheld the following shares of common stock to satisfy tax withholding obligations during the September 2012 quarter from the distributions described below. These shares may be deemed to be “issuer purchases” of shares that are required to be disclosed pursuant to this Item.

Period	Total Number of Shares Purchased[(1)]	Average Price Paid Per Share	Total Number of Shares Purchased as Part of Publicly Announced Plans or Programs[(1)]	Maximum Number (or Approximate Dollar Value) of Shares That May Yet Be Purchased Under the Plan or Programs
July 2012	4,095	$10.62	4,095	[(1)]
August 2012	3,768	$9.16	3,768	[(1)]
September 2012	10,026	$8.73	10,026	[(1)]
Total	17,889		17,889	

(1) Shares were withheld from employees to satisfy certain tax obligations due in connection with grants of stock under the Delta Air Lines, Inc. 2007 Performance Compensation Plan (the "2007 Plan"). The 2007 Plan provides

for the withholding of shares to satisfy tax obligations. It does not specify a maximum number of shares that can be withheld for this purpose.

ITEM 6. EXHIBITS

(a) Exhibits

15	Letter from Ernst & Young LLP regarding unaudited interim financial information
31.1	Certification by Delta's Chief Executive Officer with respect to Delta's Quarterly Report on Form 10-Q for the quarterly period ended September 30, 2012
31.2	Certification by Delta's Senior Vice President and Chief Financial Officer with respect to Delta's Quarterly Report on Form 10-Q for the quarterly period ended September 30, 2012
32	Certification pursuant to Section 1350 of Chapter 63 of Title 18 of the United States Code by Delta's Chief Executive Officer and Senior Vice President and Chief Financial Officer with respect to Delta's Quarterly Report on Form 10-Q for the quarterly period ended September 30, 2012
101.INS	XBRL Instance Document
101.SCH	XBRL Taxonomy Extension Schema Document
101.CAL	XBRL Taxonomy Extension Calculation Linkbase Document
101.DEF	XBRL Taxonomy Extension Definition Linkbase Document
101.LAB	XBRL Taxonomy Extension Labels Linkbase Document
101.PRE	XBRL Taxonomy Extension Presentation Linkbase Document

36

SIGNATURE

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.

Delta Air Lines, Inc.
(Registrant)

/s/ Michael O. Randolfi
Michael O. Randolfi
Senior Vice President - Finance and Controller
(Principal Accounting Officer)

October 26, 2012

37