$511

$414

$548

$442

$600

$489 $500

$296 $313

$324

$241

$191

$400

$300

$200

$100

2001 2002 2003 2004 2005

9.2%

7.5%

10%

7.4%

7.2%

8%

6.4%

4.4%

3.5%

5.0% 4.8% 5.0%

6%

4%

2%

2001 2002 2003 2004 2005

|  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- |
| (in millions) | 2001 | 2002 | 2003 | 2004 | 2005 |
| Net Income, as reported | $511 | $241 | $442 | $313 | $548 |
| Impact of fuel contracts, net | 1 | (7) | (2) | 11 | (59) |
| Impact of government grant proceeds, net | (124) | (25) | (144) | - | - |
| Impact of passenger revenue adjustments, net | 16 | (18) | - | - | - |
| Impact of charges arising from terrorist attacks | 10 | - | - | - | - |
| Net income – non-GAAP | $414 | $191 | $296 | $324 | $489 |

Net Income (in millions) GAAP non-GAAP

Net Margin

GAAP

non-GAAP

Reconciliation of Reported Amounts to non-GAAP Items

See table for a reconciliation of non-GAAP to GAAP results.

See table for a reconciliation of non-GAAP to GAAP results.

(See note on page 15.) (unaudited)

CONSOLIDATED HIGHLIGHTS

(Dollars in millions, except per share amounts)

Operating expenses

Operating margin

Net margin

Net income per share – diluted

Return on average stockholders’ equity

Revenue passengers carried

Available seat miles {ASMs} (000s)

Passenger revenue yield per RPM

Operating expenses per ASM

Number of Employees at yearend

Operating revenues

Operating income

Net income

Net income per share – basic

Stockholders’ equity

Stockholders’ equity per common share outstanding

Revenue passenger miles {RPMs} (000s)

Passenger load factor

Operating revenue yield per ASM

Size of fleet at yearend

2005

2004

CHANGE

|  |  |  |
| --- | --- | --- |
| $7 , 584 | $6 , 530 | 16.1% |
| $ 6 , 764 | $ 5 , 976 | 13.2% |
| $ 8 2 0 | $ 5 5 4 | 48.0% |
| 1 0 . 8 % | 8 . 5 % | 2.3pts. |
| $ 5 4 8 | $ 3 1 3 | 75.1% |
| 7 . 2 % | 4 . 8 % | 2.4pts. |
| $. 70 | $. 40 | 75.0% |
| $. 67 | $. 38 | 76.3% |
| $ 6 , 6 7 5 | $ 5 , 5 2 4 | 20.8% |
| 9 . 0 % | 5 . 9 % | 3.1pts. |
| $8.32 | $6.99 | 19.0% |
| 7 7 , 6 9 3 , 8 7 5 | 7 0 , 9 0 2 , 7 7 3 | 9.6% |
| 6 0 , 2 2 3 , 1 0 0 | 5 3 , 4 1 8 , 3 5 3 | 12.7% |
| 8 5 , 1 7 2 , 7 9 5 | 7 6 , 8 6 1 , 2 9 6 | 10.8% |
| 70 . 7 % | 69 . 5 % | 1.2pts. |
| 12 . 09 ¢ | 11 . 76 ¢ | 2.8% |
| 8.9 0 ¢ | 8.5 0 ¢ | 4.7% |
| 7 . 94 ¢ | 7 . 77 ¢ | 2.2% |
| 445 | 417 | 6.7% |
| 3 1 , 7 2 9 | 3 1 , 0 11 | 2.3 % |

Southwest Airlines Co. is the nation’s low-fare, high Customer Satisfaction airline. We primarily serve shorthaul and mediumhaul city pairs, providing single-class air transportation, which targets business and leisure travelers. The Company, incorporated in Texas, commenced Customer Service on June 18, 1971 , with three Boeing 737 aircraft serving three Texas cities— Dallas, Houston, and San Antonio. At yearend 2005, Southwest operated 445 Boeing 737 aircraft and provided service to 61 airports in 31 states throughout the United States. Southwest has one of the lowest operating cost structures in the domestic airline industry and consistently offers the lowest and simplest fares. Southwest also has one of the best overall Customer Service records. LUV is our stock exchange symbol, selected to represent our home at Dallas Love Field, as well as the theme of our Employee, Shareholder, and Customer relationships.

“It’s not about one airline or one city. It is about helping our constituents. For a long time, I have thought the restrictions on Love Field have outlived their usefulness, and I think people ought to have the freedom to fly wherever they want and whenever they want.”

–*U.S. Rep. Sam Johnson,* The Dallas Morning News

S E T L O V E F R E E ! T h a t i s t h e b a t t l e c r y t h a t a c c o m p a n i e d 2 1 4 , 5 7 0 p e t i t i o n s a n d p l e a s f r o m e v e r y c i t y i n o u r S o u t h w e s t S y s t e m t o k e y U . S . S e n a t o r s i n Wa s h i n g t o n , D. C . T h e m e s s a g e w a s l o u d a n d c l e a r : I n d i v i d u a l c i t i z e n s , c h a m b e r s o f c o m m e r c e a c r o s s A m e r i c a , a n d n e w s p a p e r s f r o m c o a s t t o c o a s t p l e d g e d t h e i r s u p p o r t f o r r e p e a l i n g t h e W r i g h t A m e n d m e n t , a f e d e r a l l a w e n a c t e d i n 1 9 7 9 t o s e ve re l y re s t r i c t c o m m e rc i a l f l i g h t s o u t o f D a l l a s L ove F i e l d .

We b e l i e v e W r i g h t i s W r o n g . T h e A m e n d m e n t r e s t r i c t s c o m m e r c e , i s a n t i - c o m p e t i t i v e , a n d p e n a l i z e s

p a s s e n g e r s b y p r o t e c t i n g h i g h a i r f a r e s t o a n d f r o m N o r t h Te x a s . A p p a r e n t l y, t h e U . S . C o n g r e s s a n d t h e P r e s i d e n t a g r e e a n d

h a v e a u t h o r i z e d s e r v i c e f r o m D a l l a s L o v e F i e l d t o M i s s o u r i , w h i c h b e g a n o n D e c e m b e r 1 3 , 2 0 0 5 . O n e s m a l l s t e p f o r t h e U . S . C o n g r e s s , o n e g i a n t s t e p f o r g i v i n g e v e r y A m e r i c a n t h e F r e e d o m t o F l y.

To Our Shareholders:

In 2005, Southwest Airlines recorded its 33rd consecutive year of profitability, a record unmatched in commercial airline industry history.

Our 2005 profit was $548 million, or $.67 per diluted share, compared to $313 million, or $.38 per diluted share in 2004. These 2005 results represent increases over 2004 results of 75.1 percent and 76.3 percent, respectively.

Each year includes unrealized gains or losses recorded as required by Statement of Financial Accounting Standard 133, related to our successful fuel hedging activities. Excluding these unrealized items ($59 million in gains in 2005 and $11 million in losses in 2004) produces a year-over-year profit increase of 50.9 percent and per diluted share increase of 50.0 percent.

Driving these increases were strong revenue growth coupled with excellent cost controls. The improved results were achieved despite a 43.0 percent increase in (unhedged) jet fuel prices per gallon in 2005 versus 2004.

further improved the efficiency of Southwest Airlines and reduced our operating cost per available seat mile (excluding fuel) by 1.5 percent year-over-year. This was accomplished with pay increases, not furloughs, layoffs, or pay concessions. Despite many airline bankruptcies, which has allowed other airlines to restructure and reduce costs, Southwest remains among the lowest cost producers in the American airline industry.

Record, skyrocketing energy prices were a headline in 2005 and a dagger to the heart of the airline industry because of its energy dependency. Southwest Airlines was prepared for this crisis, however, as we were approximately 85 percent hedged for 2005 at approximately $26 per barrel of crude oil. Our hedging activities saved us almost $900 million in 2005, securing a solid profit improvement over the previous three years. Without our hedging program, it appears we would have had break-even results. Instead, hedging widened our cost advantage over our competitors and allowed us to continue to grow profitably, add new cities, expand our fleet, hire more Employees, and provide pay increases.



**2**

SOUTHWEST AIRLINES CO. ANNUAL REPORT 2005

*In 2005, we brought out the rally caps. For Southwest’s complete history at Dallas Love Field and the controversial Wright Amendment, log on*

*to* ***se****tlovefree.com.*

In 2005, we continued to add service to our new 2004 city, Philadelphia. In a little more than 18 months, it has grown from 14 daily departures to 53. Encouraged by our success there, we added Pittsburgh to our route map in May 2005. In six months’ time, our service expanded from ten to 19 daily departures. In October, we also expanded our Florida presence by the addition of Ft. Myers. Finally, in October, we announced the return of Southwest Airlines to Denver after a 20-year absence, much to the delight of our Customers. Denver, too, is off to a terrific start as of January 3, 2006. A happy New Year celebration, indeed.

We expanded our system in other ways last year. After a yearlong effort to repeal the anti-consumer, anti-competitive restriction on Dallas’ Love Field Airport, known as the Wright Amendment, the U.S. Congress passed and President Bush signed the “Bond Amendment,” which allows nonstop service from Love Field to points in Missouri. The law was passed November 30, 2005, and on December 13, we started four daily roundtrips from Dallas to both Kansas City and St. Louis. We also implemented our first-ever codeshare arrangement with ATA Airlines in January 2005, providing

single-ticket, connecting itineraries at Chicago Midway,

Operating revenues grew by 16.1 percent on capacity

growth of 10.8 percent (as measured by available seat miles). Better revenues were driven by stronger load factors (70.7 percent in 2005 versus 69.5 percent in 2004) and stronger yields per passenger, up 2.8 percent year-over- year. An improving economy, driving stronger travel

“Being invited to operate at DFW (by AA) is like the spider saying to the fly ‘Hey, why don’t you drop in for a bite to eat?’”

–*Chairman Herb Kelleher, announcing the results of the Campbell-Hill study*

demand, coupled with a decline in the glut of airline industry

seat capacity, all combined to support revenue growth. Our Marketing and Revenue Management Employees pulled off this feat utilizing only modest fare increases, while staying faithful to our cherished Low Fare Brand Leadership in America. And our People did an excellent job once again of providing outstanding Customer Service, placing Southwest first in Customer Satisfaction as measured by fewest Customer Complaints reported to the D.O.T. per passenger carried. Truly, we give America the Freedom to Fly.

Low fares are only feasible with low costs. Through hard work, innovation, and the wise use of automation, our People

Phoenix, and Las Vegas. Our first year with ATA was a resounding success, generating almost $50 million in revenues. We also enhanced our Chicago Midway presence by acquiring the rights to ten gates from ATA.

The year 2005 was not without challenges, however. In December 2005, a Southwest jet overran a runway at Chicago Midway, striking two automobiles. Joshua Woods, a passenger in one of the automobiles, was fatally injured. Our hearts and our prayers go out to Joshua and the Woods family. We are, of course, providing the National Transportation Safety Board our full support in the

investigation of this accident. We also continue to work closely with the Federal Aviation Administration to ensure a safe airline is as safe as it can humanly be.

Our compassion is extended to all those affected by last years’ natural disasters but particularly those in New Orleans. Rebuilding our service in New Orleans remains number one among competing priorities. We recently announced five more daily departures effective March 17 and coincident with the delivery of new Boeing 737 aircraft.

For 2006, we presently plan to add 33 new Boeing 737s to our fleet of 445 aircraft (as of December 31, 2005). That will produce an estimated increase in ASMs of eight percent. We are excited about the growth opportunities presently anticipated for 2006 and, especially, the strong revenue trends we are currently experiencing. Jet fuel prices, however, loom large over the 2006 outlook. Even with an industry-leading fuel hedge in place for 2006 (approximately

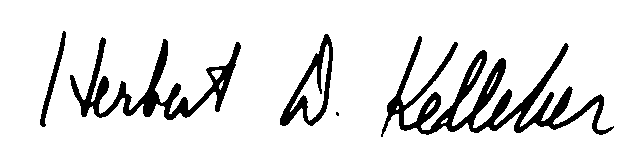
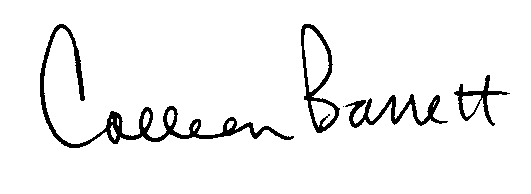
73 percent at approximately $36 per barrel), higher prices could cost us as much as $600 million in additional fuel expense based on current market prices. We will need strong revenue growth and energetic cost controls in other areas to overcome that hurdle.

The splendid results for 2005 were achieved, plainly and simply, through the efforts of our gifted and caring Employees. They are the reason that *FORTUNE* magazine, for the ninth year in a row, named Southwest Airlines one of America’s Most Admired Companies. And it is because of them and their Warrior Spirits, Servants’ Hearts, and Fun-LUVing Attitude that we are optimistic Southwest Airlines will rise up to meet these heady challenges.

To all the magnificent People of Southwest Airlines, we say, again, a hearty “Thank You!”

January 16, 2006 Most sincerely,

Gary C. Kelly



Chief Executive Officer

Colleen C. Barrett President

Herbert D. Kelleher Chairman of the Board

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With an estimated $10 billion in losses, 2005 was another difficult year for the U. S. airline industry. The glut of seat capacity and unprecedented energy prices forced many struggling airlines into survival mode, resulting in significant downsizing and numerous restructuring efforts. During 2005, additional airlines made the decision to file for bankruptcy protection, including Delta and Northwest. In total, the industry has lost more than

$ 40 billion over the last five-year period.

In contrast, Southwest reported its 33rd year of consecutive profitability— a record unmatched in aviation history. Although we were prepared for higher fuel costs with our protective fuel hedging program, it is the People of Southwest who deserve the credit for this remarkable record. Especially over the last five years, our industry has changed radically, and our Employees have had to overcome many challenges and adversities. There are now many airlines competing in the low-cost, low-fare niche, trying to emulate our success story. However, there is one thing they can never duplicate and that’s the Warrior Spirit of our Employees! At Southwest, our People are the difference. Our Employees are passionate about operating a safe airline while providing low fares and friendly service to our Customers, and they understand the importance of our Low-Cost Leadership.

Our Customers fly Southwest because we consistently deliver what they want— low fares, reliable service, frequent and convenient flights to great destinations, comfortable cabins, great inflight experience, top-rated frequent flyer program, hassle-free airports, and friendly Customer Service. As a result, Southwest earned the number-one ranking in Customer Satisfaction for 2005, based on complaints per passenger carried as reported to the D.O.T. Southwest is the largest carrier in the United States based on domestic enplaned passengers and scheduled domestic departures. In addition, Southwest tends to dominate the markets we serve, ranking first in market share in approximately 90 percent of our top 100 city pairs, and in the aggregate holds approximately 63 percent of the total market share in those markets.

7.94¢ 8.0¢

7.77¢

Operating Expenses Per Available Seat Mile (ASM)



7.8¢

7.54¢

7.60¢

7.6¢

7.41¢

7.4¢

7.2¢

2001 2002 2003 2004 2005

|  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- |
|  | 2001 | 2002 | 2003 | 2004 | 2005 |
| Passenger Revenues | $5,379 | $5,341 | $5,741 | $6,280 | $7,279 |
| Internet | 39% | 49% | 54% | 59% | 65% |
| Reservations Center | 24% | 20% | 19% | 18% | 15% |
| Travel Agency | 25% | 20% | 16% | 13% | 11% |
| Other | 12% | 11% | 11% | 10% | 9% |

|  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- |
| 6.36¢ | 6.30¢ | 6.44¢ | 6.47¢ | 6.37¢ | 6.5¢  6.4¢  6.3¢  6.2¢  6.1¢ |
| 2001 | 2002 | 2003 | 2004 | 2005 |  |

Operating Expenses Per ASM, Excluding Fuel

Passenger Revenues (in millions) and Distribution Method

Freedom to Fly

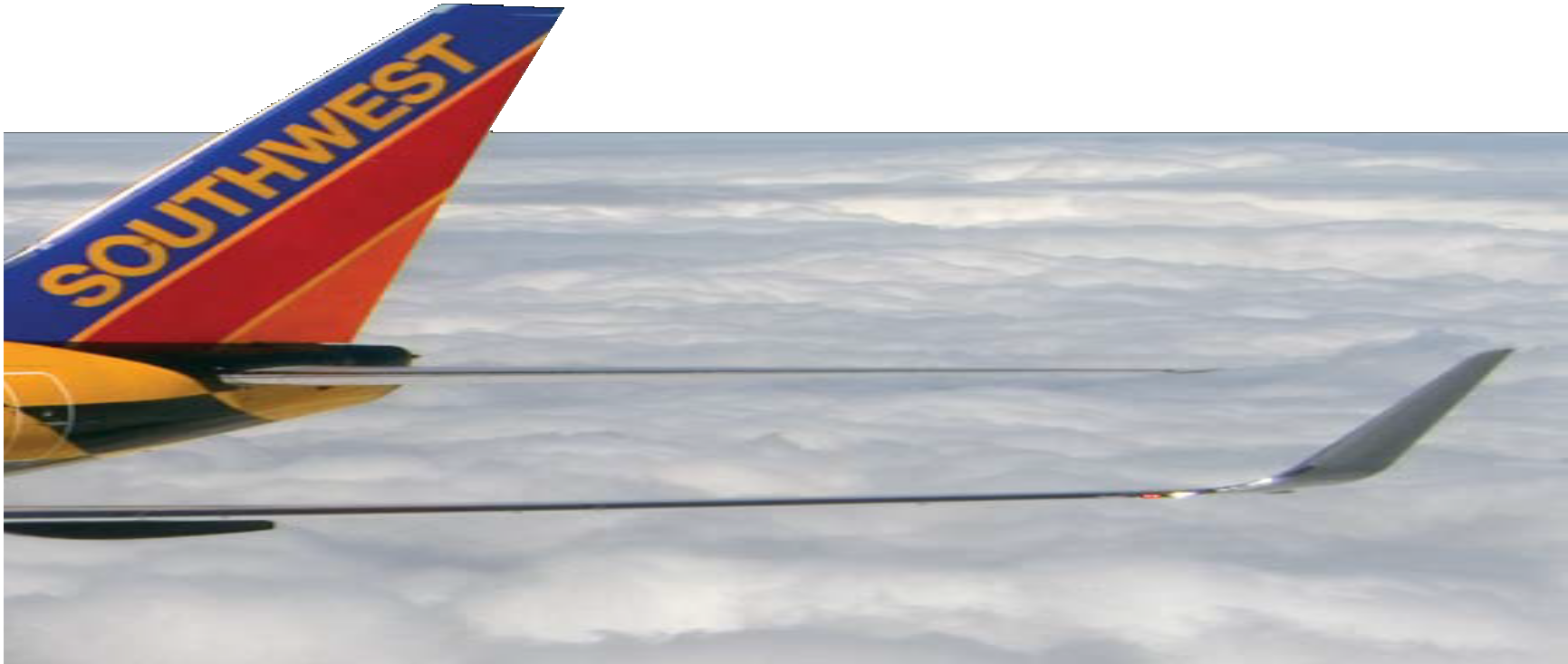
Our Employees take immense pride in knowing they give millions of Americans the Freedom to Fly. We are a low-fare airline by philosophy and have ALWAYS provided low fares to our Customers. When we enter a new market, our competition usually lowers their fares to match ours. The difference is that our fares stay low—whenever and wherever we fly. In addition to our low Customer-friendly fares, we offer lots of convenient flights to meet the demands of both our business

National Airport. Our frequent flights and expansive route system offer our Customers convenience and reliability with lots of options to get where they want to go, when they want to get there. Our frequent flights and simple, low-fare structure are easily accessible through our helpful Reservations Agents and through our web site, **southwest.com**. In today’s world of online shopping, consumers desire a buying experience

and leisure Customers. Unlike many of our competitors, we

do not charge a rebooking or exchange fee for Customers who change their itineraries, nor have we ever required a Saturday-night stay. We have an expanding network and, with the addition of Denver in January 2006, we now provide service to 62 airports with more than 3,000 daily flights. Through our codeshare with ATA Airlines, Inc., we also currently offer or have announced connecting service

through Chicago, Phoenix, Las Vegas, Houston, and Oakland to destinations such as Honolulu, Maui, New York’s La Guardia Airport, and Washington, D.C.’s Reagan



Maryland One, *unveiled June 14, 2005, is the sixth custom Boeing 737 in the Southwest Flagship fleet. Emblazoned with the historic crests of the Crossland and Calvert families, this high-flying 737-700 proudly waves as a tribute to the great state of Maryland, Southwest’s fourth busiest station in departures (BWI).*

“We are thrilled to honor Maryland with this beautiful aircraft; it is truly a testament to the great relationship we have developed with our Baltimore/Washington Customers and a tribute to our Employees....” –*President Colleen Barrett*

that is efficient and reliable. In addition to offering the online capability to book hotels, cars, and cruises, Customers can now print their boarding passes up to 24 hours in advance of their scheduled flight time, right from the convenience of their own computer. Furthermore, we’ve taken convenience a step further with the recent introduction of wireless checkin capability, allowing our Customers access to the travel information they need while on the road and away from their computer. With Internet and wireless checkin capabilities, in addition to the RAPID CHECK-IN self-service kiosks available in every airport across our system, more than 50 percent of our passengers choose to conveniently check in using our easy self-service tools.

Shopping for the best online deals can take a lot of unnecessary time. Southwest has always made it easy for travelers, with the Southwest Shortcut calendar for low fares, the weekly Click ’n’ Save e-mail specials, and full disclosure of all fares and availability. Almost 70 percent of our passenger revenues are now booked through **southwest.com**. And, with the introduction of our **DING!** Program in 2005, we now have the ability to deliver low fares directly to our Customers’ desktops. **DING!** alerts approximately two million **DING!** users to the hottest deals available at **southwest.com**. Booking online is convenient and simple for our Customers, and it is less expensive for Southwest.

For our business Customers, we offer a booking tool called SWABIZ that offers the conveniences of online booking and checkin for the Corporate Traveler. More importantly, SWABIZ provides travel reporting functionality

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for Corporate Travel Managers to better manage their business travel data. This service is provided free of charge to thousands of travel managers of small- to medium-sized businesses, as well as hundreds of the Fortune 500 companies who book their business travel on Southwest.

Southwest’s low fares have always made last-minute travel affordable. Customers can share that convenience with a friend or loved one with

“It doesn’t matter who they are. They all match our industry-leading low fares. They will fly airplanes. So far, they haven’t been able to match our great People. That’s our true strength and why I’m confident about the future of Southwest Airlines.”

–*CEO Gary Kelly,* The Wall Street Journal



**DING!** *That’s the unmistakable sound of Southwest’s innovative audio reminder that it’s time for our Customers to save even more on our legendary low fares at southwest.com. This downloadable desktop icon automatically alerts subscribers to shortterm Internet specials. As long as they are within earshot of their computers, our familiar* **DING!** *will chime loud and clear in their ears.*

a gift of the **southwest** giftcard, the gift of a destination! We’re always interested in giving our Customers a new way to enjoy our low fares. Through our everyday low fares, breadth of service across the country, easy-to-use web site, and now the **southwest** giftcard, travel on Southwest Airlines is the ideal gift.

Rapid Rewards

Not only do we offer our Customers convenient low fares, our Rapid Rewards Program is a generous and simple way for our frequent flyers to earn free travel. Members earn credits by flying or doing business with the program’s preferred partners. In the past, Southwest Members were required to fly eight roundtrips or earn 16 credits in a 12-month period to receive a roundtrip award. However, our Customers asked for more time to earn Award Travel, so we now allow Members 24 months to earn credits toward free travel. As part of this change, Southwest will remove systemwide blackout dates and implement seat restrictions for Award travel effective February 10, 2006. Once an Award is earned (by flying, buying, staying, driving, or surfing the Internet), Southwest automatically credits the Ticketless Award to our Customer’s online account— free travel fast with no hassle. Plus Southwest allows Members to transfer, but not sell, the Award to anyone. The Award is free but subject to the U. S. government September 1 1 th Security Fee of up to $10 roundtrip.

Southwest’s generous Companion Pass program remained just as bountiful a s before! When a M ember f l ies 50 roundtrips (or receives a tota l of 1 00 credits through flight or partner use) within a 12-month period, that member receives a Companion Pass, which allows the member to designate a Companion to fly with them for free for an entire year. The Companion’s travel is not subject to seat capacity restrictions or blackout dates.

Southwest Airlines’ Rapid Rewards program is widely recognized by users and industry watchers as the simplest and most lucrative frequent flyer program in the airline industry. For the seventh straight year, our program was honored with first place for Best Award Redemption at *InsideFlyer* magazine’s 17th annual Freddie Awards ceremony. Southwest also received first place awards for Best Customer Service and Best Bonus Promotion.

Low-Cost Leadership

Our Employees understand that it is only through low costs that we can profitably offer low fares. After 34 years, Southwest is still the Low-Cost Leader even though there are lots of airlines competing for the low-fare, low- cost niche. In 2005, we again had the lowest unit costs (adjusted for stage



*In 2005, Southwest announced a codeshare agreement with ATA, allowing Southwest passengers to book flights aboard ATA to such exciting destinations as Hawaii. Above, Southwest’s famous* Shamu One *nuzzles*

*up to a colorful Hawaii-bound ATA jet.*

Hurricane Katrina

*Southwest jets carried much-needed supplies and emergency personnel into New Orleans, then ferried thankful evacuees to Kelly AFB in San Antonio immediately after Hurricane Katrina struck the Louisiana coast in August 2005. Several Southwest 737s were pulled from regular service to help with the evacuation and relief efforts.*

*Katrina interrupted regular service to New Orleans for 23 days, beginning August 28, 2005. All of*

*our New Orleans Employees, along with many Employees from other parts of*

*the country, continued to help relief efforts and rebuild airport facilities so limited service could resume on September 20, 2005.*

*Southwest remains firmly committed to the rebuilding of New Orleans and the inevitable*

*rebirth of this great American city.*

length) of any domestic carrier. Our successful fuel hedging program protected us from record high fuel costs, reducing our fuel and oil expense by approximately $900 million in 2005. Even with this spectacular fuel hedge position, our jet fuel costs per gallon in 2005 were up 24 percent versus 2004. Despite these fuel price pressures, our unit costs increased only two percent. With growing low-cost competition and rising fuel costs, our Employees are working harder than ever to prepare for the future.

Our Employees understand that low costs are imperative to our success. And productivity is the key to maintaining our low-cost advantage over our competitors. Southwest continually achieves the highest productivity of any U. S. airline because of our high asset utilization and Employee proficiency. One reason for our productivity advantage is our dedication to the low-fare, point-to-point market strategy, which enables our People to be extremely efficient. Although we have always had an efficient operation, we have intensified our productivity efforts to prepare us for increasing low-cost competition. We’ve deployed technology and improved our Employee productivity throughout th e Compa ny. As a res ult, we currently employ 7 1 Employees per aircraft, our lowest ratio since 1972!

Our Employees are innovative and never give up,

which is the reason our year-over-year unit costs, excluding fuel, declined 1 . 5 percent in 2005.

To maximize efficiency, we schedule our aircraft on a point-to-point system, versus hub-and-spoke. We focus on local, not connecting, traffic. Consequently, approximately 80 percent of our Customers fly nonstop. Our point-to-point system

provides for more direct nonstop routings for our

Customers and, therefore, minimizes stops, connections, delays, and total trip time. Although our frequent flights and our codeshare agreement with ATA Airlines, Inc. allow for the convenient connection and transfer of Customers, we schedule our aircraft based on local traffic needs. This means our aircraft are going nonstop to the places our Customers want to go.

Aircraft are scheduled to minimize the amount of time at the gate, generally 25 minutes or less, reducing the number of aircraft and gate facilities that otherwise would be required. Our disciplined market focus also allows us to operate a single aircraft type, the fuel-efficient Boeing 737. Flying one aircraft type significantly simplifies scheduling, maintenance, flight operations, and training activities. To reduce fuel consumption, we equip our 737-700 aircraft with Blended Winglets. Our Pilots, Dispatchers,

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|  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- |
|  |  |  |  | $7,584 | $8,000 |
|  |  |  | $6,530 |  | $7,000 |
| $5,555 | $5,522 | $5,937 |  |  | $6,000 |
|  |  |  |  |  | $5,000 |
|  |  |  |  |  | $4,000 |
|  |  |  |  |  | $3,000 |
| 2001 | 2002 | 2003 | 2004 | 2005 |  |

|  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- |
|  |  |  |  | 8.90¢ | 9.0¢ |
| 8.51¢ | 8.02¢ | 8.27¢ | 8.50¢ |  | 8.5¢  8.0¢ |
|  |  |  |  |  | 7.5¢ |
|  |  |  |  |  | 7.0¢ |
|  |  |  |  |  | 6.5¢ |
| 2001 | 2002 | 2003 | 2004 | 2005 |  |

|  |  |  |  |  |  |  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- |
| .18 | .29 | .77 | .92 | .94 | .96 | 1.00 | 1.02 | 1.02 | 1.09 | 1.86 | 2.00  1.75  1.50  1.25  1.00  .75  .50  .25 |
| LUV | JBLU | ALK | CAL | NWAC | AWA | AAI | AMR | UAL | DAL | UAIR |  |

Operating Revenues (in millions)

Operating Revenues Per Available Seat Mile

Customer Service (Complaints per 100,000 Customers boarded)

For the year ending December 31, 2005



Ground Operations, and Fuel Management Employees work together to minimize fuel consumption, and we purchase fuel at the lowest possible cost.

We have a history of serving close-in, conveniently located airports such as Baltimore/Washington, Chicago Midway, Dallas Love Field, Ft. Lauderdale/Hollywood, Houston Hobby, Manchester, Providence, and Oakland. However, we also have successful operations at larger airports such as Phoenix, Los Angeles, St. Louis, Pittsburgh, and Philadelphia. In selecting airports, we look for well-managed, efficient airports with low landing fees and terminal rents. We also prefer airports that allow us to sustain high productivity and reliable ontime performance. All combined, the point-to-point route system; frequent flights; careful airport selection; single aircraft type; high asset utilization; fuel conservation and hedging programs; and high Employee productivity produce a very

safe, efficient, and cost-effective operation with exceptional ontime performance.

Passionate Culture

Even though many carriers have attempted to imitate many aspects of Southwest, they cannot duplicate our most important element of success— our People. Our People are our most valuable asset. It is their friendliness, Customer caring, and relentless resourcefulness that have helped make Southwest one of the world’s most successful airlines. Our People are passionate about everything they do, and they genuinely care about our

**SOUTHWEST AIRLINES CO. ANNUAL REPORT 2005 9**

SlamDunk One, *a soaring tribute to the historic partnership between the National Basketball Association (NBA) and its Official Airline (SWA). Unveiled on November 3, 2005, this*

*was the first custom paint scheme to feature a Southwest marketing partner since* Shamu One *in 1988. Inside, every NBA team logo is featured on the overhead bins.*

Customers, the communities we serve, and our Company. And it is that passion that has made

atmosphere of cooperation, trust, and Team S pirit. We encourage our Employees to be creative and

S outhwest Airlines one of the most respected

brands in America. For the ninth straight year, S outhwest was recognized in 2005 by *FORTUNE* magazine as one of America’s Most Admired Companies. In addition, S outhwest has been included, from 2000 to 2005 , in *Business Ethics* magazine’s l ist of 1 00 Best Corporate Citizens for service to seven stakeholder groups.



We devote a s ignificant amount of time and effort to hiring, training, and retaining our incredibly talented Employees. Although we are low- cost, we have provided excellent compensation packages to our Employees. We also nurture a rewarding work environment, which fosters an

“Simply put, Southwest is on top of the domestic aviation world. It’s flush with cash and low on debt. It’s shielded from record high jet fuel prices, and where it treads, other airlines quiver.” –*The Dallas Morning News*

have FUN on the job. Although we take our business and our safety record very seriously, our Employees have become well- known for using their trademark humor to ensure that our Customers have an enjoyable and memorable f l ight experience. Our Employees understand that

every interaction with our Customers is an opportunity to showcase our reliable product with warm, caring, compassionate Customer S ervice.

Although we fly planes, Southwest Airlines is really a Customer Service Company. And it is the way our Employees deliver Customer Service that differentiates Southwest Airlines from every other airline. At Southwest, we treat our Customers like guests, and our Employees are motivated to increase our productivity so that we can enhance our product without adding to our cost structure. As part of the airline industry’s restructuring and cost-cutting efforts, many airlines have chosen to cut free inflight amenities such as snacks, drinks, blankets, and pillows. Southwest Airlines, however, remains committed to providing our Customers a comfortable inflight experience. Southwest continues to give Customers free, name-brand snacks and nonalcoholic beverages on every flight. Our cabins are also comfortable and clean and feature attractive leather seats. Although we are low-cost, we invest in new planes and fly a young fleet with an average age of nine years.

Southwest Airlines has always been devoted to each and every community that we serve. Thousands of times each year, Southwest Airlines and its Employees reach out to individuals, families, and entire communities, providing help where it is needed. Since Hurricane Katrina, we have contributed millions of dollars in services and cash to New Orleans Relief Funds and have partnered with numerous organizations to provide travel, raise funds, and bring awareness to the needs of the New Orleans community. Southwest also generously supports the Ronald McDonald House, and our Adopt-A-Pilot program operates systemwide and features the volunteer efforts of more than 550 Southwest Airlines Pilots, who adopt and mentor a fifth-grade class with information on aviation, geography, and science.

It is nearly impossible to list the many ways our Employees give to their communities. Whether it’s rallying a group of Coworkers to help build a house or organizing a raffle to raise money for a community member in need, the support is immeasurable. Our People serve from their hearts, and they truly try to make an ongoing, positive difference in their “home towns.”

Strong Financial Position



Although the last five years have been financially devastating for the airline industry, our Employees have persevered and moved ahead. Over the past 34-plus years, we have wisely managed our growth. Our People are visionaries

and are always prudently planning for our future. As a result of our discipline and financial conservatism, we have strengthened our balance sheet during the most difficult period in aviation history. We have lots of liquidity and ample access to capital. We have improved our cash flow,

and Southwest is the only U. S. airline with an investment-grade credit rating. We ended 2005 with $ 2 . 5 billion in cash and shortterm investments, including

$ 950 million in fuel hedge collateral deposits. We also have a fully available

$ 600 million bank revolving credit facility. Our unmortgaged assets have a value of nearly $7 billion, and our debt to total capital is approximately 35 percent, including aircraft leases as debt. In addition, we have prepaid more than $600 million for future aircraft deliveries from Boeing.

*Southwest added yet another popular Customer convenience in November 2005 when we introduced the* **southwest**giftcard*, available online at southwest.com.*

Our profits substantially improved in 2005— our net income increased more than 50 percent from 2004! Considering the enormous operational challenges we

|  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- |
| 11:10 | 11:12 | 11:09 | 11:20 | 11:25 | 11:30  11:20  11:15  11:10  11:05 |
| 2001 | 2002 | 2003 | 2004 | 2005 |  |

|  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- |
| 355 | 375 | 388 | 417 | 445 | 500  400  300  200  100 |
| 2001 | 2002 | 2003 | 2004 | 2005 |  |

|  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- |
| Type | 2006 | 2007 | 2008 | 2009-  2012 | Total |
| Firm Orders | 33 | 29 | 6 | – | 68 |
| Options | – | 7 | 25 | – | 32 |
| Purchase Rights | – | 20 | 20 | 177 | 217 |
| Total | 33 | 56 | 51 | 177 | 317 |

faced due to the hurricanes this past summer and higher energy costs, we are very pleased with these results. Overall, our revenue growth was very healthy in 2005, particularly in the fourth quarter, and we are encouraged by our revenue trends so far in early 2006. Demand for low fares strengthened throughout 2005, and we achieved a Company-record load factor of 70.7 percent. Revenue yields also improved with only modest fare increases, reaffirming our Low Fare Leadership position. Our ATA codeshare

we initiated nonstop service from Dallas Love Field to St. Louis and Kansas City in December 2005.

We continued our efforts to expand Chicago Midway service during 2005, growing year-over-year capacity more than 40 percent. Chicago Midway is now tied with Phoenix Sky Harbor Airport as our second busiest airport at 200 daily flights. In December 2005, we completed a transaction with ATA Airlines, Inc. to acquire the leasehold rights to four additional gates at Chicago Midway, in exchange for a $20 million reduction

revenue was just under $50 million in 2005, which

exceeded our initial estimates. The combination of

stronger revenues, an excellent hedge position, and lower unit costs, excluding fuel, all contributed to our improved financial performance.



**SOUTHWEST AIRLINES CO. ANNUAL REPORT 2005**

**11**

Aircraft Utilization (hours and minutes per day)

Fleet Size (at yearend)

Boeing 737-700 Firm Orders and Options

In recognition of Southwest’s profitable growth, strong cash flows, and our strong balance sheet, ou r B oa rd of D i re ctors re ce n t ly a u th orize d a

$ 3 00 million stock repurchase program. This authorization reflects the Board’s confidence in our financial stability and our growth opportunities.

Route Expansion

We opened two new cities in 2005, Pittsburgh and Ft. Myers, and have been very pleased with their performance. In addition to these expansion efforts, we continue to grow our flourishing network. With 33 new 737-700 Boeing aircraft deliveries and the retirement of our last five Boeing 737-200s, we increased our year-over-year capacity in 2005 by nearly 1 1 percent.

Following the devastation of Hurricane Katrina, we have continued to rebuild our New Orleans service and will be back up to 18 daily flights in March 2006, with more to come. We achieved a major milestone as Las Vegas McCarren International Airport became our first airport with more than 200 daily departures. We also made progress in our efforts to repeal the Wright Amendment. As a result of the enactment of a 2005 federal transportation appropriations bill containing language that lifted the Wright Amendment restriction on the state of M iss ouri,

“No other major airline has brought more value to more budget-conscious business travelers than Southwest.

...[T]his airline juggernaut now ranks as the largest carrier in the nation in terms of passengers carried. Once the model that low-fare carriers aspired to, Southwest has become the model for the entire airline industry....”

–*Entrepreneur.com*

in our debtor-in-possession loan to ATA. We also enhanced our codeshare arrangement with ATA, subject to certain conditions, all of which must be fulfilled by February 28, 2006. In addition, we recently expanded our codeshare agreement to include ATA flights from DFW International Airport to Chicago Midway.

Looking forward into 2006, capacity growth is projected to be approximately eight percent, with a total of 33 planned Boeing 737-700 aircraft deliveries for the year. Our 62nd city, Denver, opened on January 3, 2006, and is off to a great start. Denver is a rich opportunity for growth and an exciting addition to the Southwest route system.

While 2006 will undoubtedly be full of challenges, we are financially well-positioned to aggressively take advantage of growth opportunities. Our People are adaptable and willing to change, and we are confident they will continue to do whatever it takes to keep Southwest on top.

ROSA PARKS, A TRUE FREEDOM FIGHTER

*As a Company that cherishes Freedom, Southwest Airlines was proud to participate in final honors for one of our country’s great Freedom Fighters, Rosa Parks.*

*Left to right: Captain Richard Turner; Supervisors Yolanda Gabriel, Rita Tubilleja, and Renee Gordon; Chief Pilot Lou Freeman, the first African- American chief pilot for any major carrier; and First Officer Trevor Hinton. Captain Turner and First Officer Hinton served as pilots and pall bearers for Ms. Parks.*

**Southwest 63%**

|  |  |  |  |  |  |  |  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- |
|  |  | | | | | |  | **168** | **200** | **200** | **214** | **225**  **200**  **175**  **150**  **125**  **100**  **75** |
| **Southwest’s Top Ten Airports — Daily Departures** (at yearend) | | | | | |
| **88** | | **89** | **120** | **120** | **133** | **135** | |
| **San Diego** | | **Orlando** | **Los Angeles** | **Dallas Love** | **Oakland** | **Houston Hobby** | | **Baltimore/ Washington** | **Chicago Midway** | **Phoenix** | **Las Vegas** |  |

**Other Carriers 37%**

**California 18%**

**Remaining West 25%**

**East 31%**

**Midwest 16%**

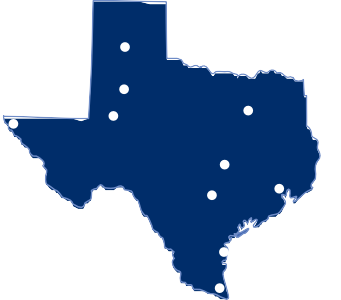
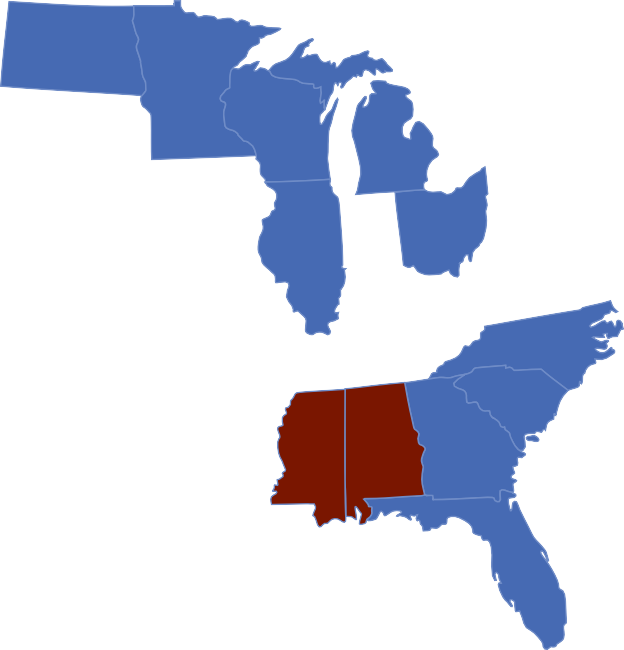
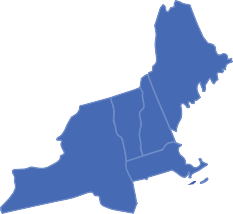
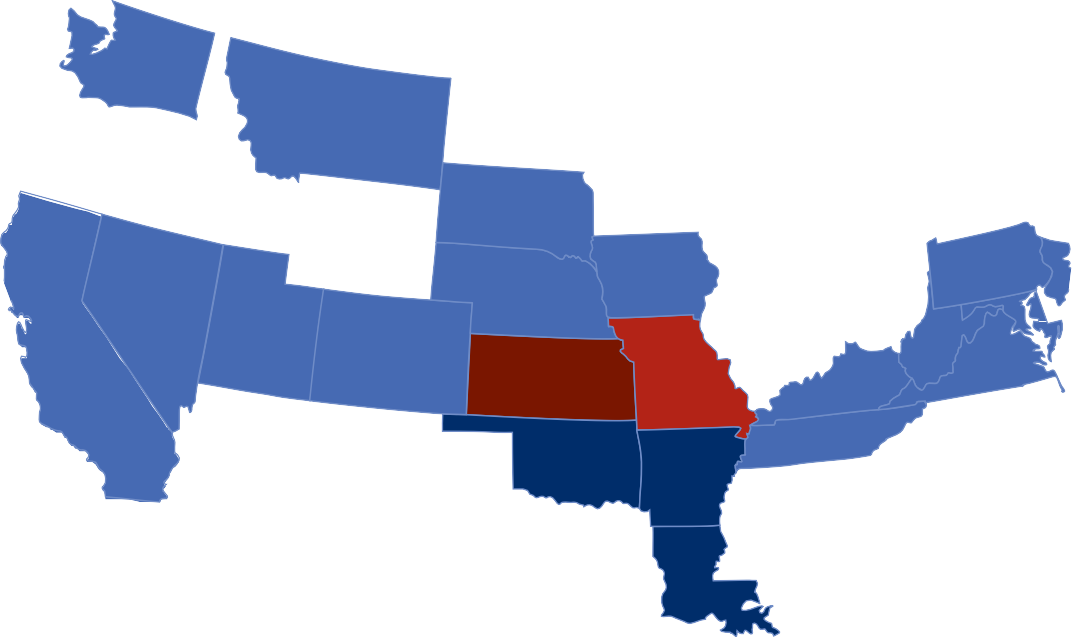
**Heartland 10%**

**Southwest’s Market Share** (as of third quarter 2005)

(Southwest’s top 100 city-pair markets based on passengers carried)

**Tacoma**

**Southwest’s Capacity By Region** (at yearend)



**Southwest System Map** (at yearend) Service to Denver begins January 3, 2006 Service to Ft. Myers began October 2, 2005 Service to Pittsburgh began May 4, 2005

**Buffalo/ Niagara Falls**

**Albany**

**Manchester**

**(Boston Area)**

**Boise**

**Detroit**

**Sacramento**

**Reno/Tahoe**

**Salt Lake City**

**Omaha**

**Chicago**

**(Midway)**

**Cleveland Pittsburgh**

**(Boston Area)**

**Hartford/Springfield**

**Long Island/Islip Philadelphia**

**Providence**

**Columbus**

**Indianapolis**

**Las Vegas**

**Burbank**

**St. Louis**

**Baltimore/ Washington(BWI)**

**(D.C. Area)**

**Norfolk**

**(Southern Virginia)**

**Louisville**

**Raleigh-Durham**

**Los Angeles (LAX) Orange County**

**San Diego**

**Ontario**

**Albuquerque**

**(Santa Fe Area)**

**(Palm Springs Area)**

**Phoenix**

**Tucson**

**Amarillo**

**Tulsa**

**Oklahoma City**

**Little Rock**

**Nashville**

**Lubbock**

**El Paso**

**Midland/**

**Odessa**

**Dallas**

**(Love Field)**

**Birmingham**

**Jackson**

**Austin**

**Jacksonville**

**San Antonio New Orleans**

**Houston**

**Corpus (Hobby) Tampa Bay Christi**

**Ft. Myers/Naples**

**Orlando**

**West Palm Beach Ft. Lauderdale**

**Harlingen/South Padre Island**

Flights from Love Field restricted to these states by the Wright Amendment (1979) Flights from Love Field expanded to these states by the Shelby Amendment (1997) Flights from Love Field expanded to Missouri by amendment to appropriations bill (2005)

**(Miami Area)**

**Seattle/**

**Spokane**

**Portland**

**Oakland**

**(San Francisco Area)**

**San Jose**

**(San Francisco Area)**

**Denver**

**Kansas City**

Quarterly Financial Data ( Unaudited)

Three Months Ended

|  |  |  |  |  |
| --- | --- | --- | --- | --- |
| (in millions, except per share amounts) | March 31 | June 30 | September 30 | December 31 |
| 2005  Operating revenues | $ 1 , 663 | $1 , 944 | $1 , 989 | $ 1 , 987 |
| Operating income | 106 | 277 | 273 | 1 6 3 |
| Income before income taxes | 1 1 4 | 256 | 368 | 1 3 6 |
| Net income | 76 | 1 59 | 227 | 86 |
| Net income per share, basic | . 1 0 | . 20 | . 29 | . 1 1 |
| Net income per share, diluted | .09 | . 20 | . 28 | . 1 0 |
| 2004  Operating revenues | $ 1 , 484 | $ 1 , 7 1 6 | $ 1 , 674 | $ 1 , 655 |
| Operating income | 46 | 1 97 | 1 9 1 | 120 |
| Income before income taxes | 4 1 | 1 79 | 1 8 1 | 89 |
| Net income | 26 | 1 1 3 | 1 1 9 | 56 |
| Net income per share, basic | .03 | . 1 4 | . 1 5 | .07 |
| Net income per share, diluted | .03 | . 1 4 | . 1 5 | .07 |

Commmon Stock Price Ranges and Dividends

Southwest’s common stock is listed on the New York Stock Exchange and is traded under the symbol LUV. The high, low, and close sales prices of the common stock on the Composite Tape and the quarterly dividends per share paid on the common stock were:

|  |  |  |  |  |
| --- | --- | --- | --- | --- |
| PERIOD | DIVIDENDS | HIGH | LOW | CLOSE |
| 2005  1 st Quarter | $ 0.0045 | $ 16. 45 | $ 13.60 | $ 14. 24 |
| 2nd Quarter | 0.0045 | 15. 50 | 13. 56 | 13. 93 |
| 3rd Quarter | 0.0045 | 14. 85 | 13.05 | 14. 85 |
| 4th Quarter | 0.0045 | 16. 95 | 14.54 | 16. 43 |
| 2004  1 st Quarter | $ 0.0045 | $ 16. 60 | $ 12. 88 | $ 1 4 . 2 1 |
| 2nd Quarter | 0.0045 | 1 7.06 | 13. 56 | 1 6 . 77 |
| 3rd Quarter | 0.0045 | 16. 85 | 13. 1 8 | 13. 62 |
| 4th Quarter | 0.0045 | 1 6. 74 | 13.45 | 16. 28 |

85,173

90,000

76,861

80,000

65,295

68,887 71,790

70,000

60,000

50,000

2001 2002 2003 2004 2005

60,223 65,000

47,943 53,418

55,000

45,392

44,494

45,000

35,000

25,000

2001 2002 2003 2004 2005

|  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- |
|  |  |  |  |  | 75% |
| 68.1% |  |  | 69.5% | 70.7% | 70% |
|  | 65.9% | 66.8% |  |  | 65% |
|  |  |  |  |  | 60% |
|  |  |  |  |  | 55% |
|  |  |  |  |  | 50% |
| 2001 | 2002 | 2003 | 2004 | 2005 |  |

Available Seat Miles (in millions)

Revenue Passenger Miles (in millions)

Passenger Load Factor

TEN-YEAR SUMMARY Selected Consolidated Financial Data

|  |  |  |  |
| --- | --- | --- | --- |
| (Dollars in millions, except per share amounts) 2005 | 2004 | 2003(4) | 2002(3) |
| Operating revenues: |  |  |  |
| Passenger(2) $ 7, 279 | $ 6,28 0 | $ 5 , 741 | $ 5,34 1 |
| Freight 1 3 3 | 1 1 7 | 94 | 85 |
| Other(2) 1 7 2 | 1 3 3 | 102 | 96 |
| Total operating revenues 7, 584 | 6,530 | 5,937 | 5,522 |
| Operating expenses 6,764 | 5, 976 | 5,454 | 5,105 |
| Operating income 820 | 554 | 483 | 4 1 7 |
| Other expenses (income), net (54) | 6 5 | (225) | 24 |
| Income before income taxes 874 | 489 | 708 | 393 |
| Provision for income taxes 326 | 1 76 | 266 | 1 52 |
| Net income $ 548 | $ 3 1 3 | $ 442 | $ 24 1 |
| Net income per share, basic $ .70 | $ . 40 | $ .56 | $ .3 1 |
| Net income per share, diluted $ . 67 | $ . 38 | $ .54 | $ .30 |
| Cash dividends per common share $ . 0 1 80 | $ . 0 1 80 | $ . 0 1 80 | $ . 0 1 80 |
| Total assets $ 14, 2 1 8 | $ 1 1,3 37 | $ 9,878 | $ 8,954 |
| Long-term debt less current maturities $ 1 , 394 | $ 1,700 | $ 1,332 | $ 1 , 553 |
| Stockholders’ equity $ 6,675 | $ 5,524 | $ 5,052 | $ 4,422 |
| CONSOLIDATED FINANCIAL RATIOS  Return on average total assets(6) 4.3% | 3.0% | 4.7% | 2.7% |
| Return on average stockholders’ equity(6) 9.0% | 5.9% | 9.3% | 5.7% |
| Operating margin 10.8% | 8.5% | 8.1% | 7.6% |
| Net margin(6) 7. 2% | 4.8% | 7.4% | 4.4% |
| CONSOLIDATED OPERATING STATISTICS  Revenue passengers carried 77, 6 9 3 , 875 | 70, 902,773 | 65,673,945 | 63,045,988 |
| Enplaned passengers 88, 37 9, 900 | 8 1 , 066,038 | 74,719,340 | 72,462 ,1 23 |
| RPMs (000s) 60 ,22 3 ,100 | 53,4 1 8 , 353 | 47,943,066 | 45,391,903 |
| ASMs (000s) 8 5 , 1 7 2 , 795 | 76, 861 , 296 | 71,790,425 | 68,886,546 |
| Passenger load factor 70.7% | 69.5% | 66.8% | 65.9% |
| Average length of passenger haul (miles) 775 | 753 | 730 | 720 |
| Average stage length (miles) 607 | 576 | 558 | 537 |
| Trips flown 1,028, 639 | 981 , 59 1 | 949,882 | 947, 3 3 1 |
| Average passenger fare(2) $93.68 | $88.5 7 | $87.42 | $84.72 |
| Passenger revenue yield per RPM(2) 12.09¢ | 1 1.76¢ | 11.97¢ | 1 1.77¢ |
| Operating revenue yield per ASM 8.90¢ | 8.50¢ | 8.27¢ | 8.02¢ |
| Operating expenses per ASM 7.94¢ | 7.77¢ | 7.60¢ | 7. 41 ¢ |
| Operating expenses per ASM, excluding fuel 6.37¢ | 6.47¢ | 6.44¢ | 6.30¢ |
| Fuel cost per gallon (average) 1 03.3 ¢ | 82.8¢ | 72.3¢ | 68.0¢ |
| Fuel consumed, in gallons (millions) 1 , 287 | 1 ,20 1 | 1 ,1 43 | 1 , 1 1 7 |
| Number of Employees at yearend 31 ,729 | 31 ,0 1 1 | 32,847 | 33,705 |
| Size of fleet at yearend(1 ) 445 | 4 1 7 | 388 | 375 |

1. Includes leased aircraft
2. Includes effect of reclassification of revenue reported in 1999 through 1996 related to the sale of flight segment credits from Other to Passenger due to an accounting change in 2000
3. Certain figures in 2001 and 2002 include special items related to the September 11, 2001, terrorist attacks and Stabilization Act grant
4. Certain figures in 2003 include special items related to the Wartime Act grant (5) After cumulative effect of change in accounting principle

(6) Before cumulative effect of change in accounting principle

2001(3) 2000

$ 5,379 $ 5,468

9 1 1 1 1

85 7 1

5,555 5,650

4,924 4,629

631 1,02 1

(197) 4

828 1,0 1 7

31 7 392

1999 1998

$ 4,563 $ 4,01 0

103 99

70 55

4,736 4, 1 64

3,954 3,480

782 684

8 (2 1)

774 705

299 272

1997 1996

$ 3,670 $ 3,285

95 80

52 4 1

3,8 1 7 3,406

3,293 3,055

524 35 1

7 10

5 1 7 34 1

199 134

|  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- |
| $ 5 1 1 | $ 603 (5) $ 475 $ 433 $ 3 1 8 $ 207 | | | | |
| $ .67 | $ .8 1 (5) $ .63 $ .58 $ .43 $ .28 | | | | |
| $ .63 | $ .76(5) $ .59 $ .55 $ . 41 $ .27 | | | | |
| $ . 0 1 80 | $ .0 1 4 8 | $ .0 143 | $ .0 1 2 6 | $ .0098 | $ .0087 |
| $ 8,997 | $ 6,670 | $ 5,654 | $ 4,7 1 6 | $ 4,246 | $ 3,723 |
| $ 1,327 | $ 76 1 | $ 872 | $ 623 | $ 628 | $ 650 |
| $ 4,014 | $ 3,4 5 1 | $ 2,836 | $ 2,398 | $ 2,009 | $ 1,648 |

|  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- |
| 6.5% | 1 0 .1 % | 9.2% | 9.7% | 8.0% | 5.9% |
| 13.7% | 1 9.9% | 1 8.1% | 19.7% | 17.4% | 13.5% |
| 11.4% | 1 8. 1 % | 16.5% | 16.4% | 13.7% | 10.3% |
| 9.2% | 1 1 . 1 % | 10.0% | 10.4% | 8.3% | 6.1% |

|  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- |
| 64,446,773 | 63,678,26 1 | 57,500,2 1 3 | 52,586,400 | 50,399,960 | 49,621,504 |
| 73,628,723 | 72,566,8 17 | 65,287,540 | 59,053,2 1 7 | 55,943,540 | 55,372,36 1 |
| 44,493,9 1 6 | 42,21 5 ,1 62 | 36,479,322 | 3 1 , 41 9 , 1 1 0 | 28,355,1 69 | 27,083,483 |
| 65,295,290 | 59,909,965 | 52,855,467 | 47, 543, 51 5 | 44,487,496 | 40,727,495 |
| 68.1% | 70.5% | 69.0% | 66.1 % | 63.7% | 66.5% |
| 690 | 663 | 634 | 597 | 563 | 546 |
| 51 4 | 492 | 465 | 4 41 | 425 | 41 0 |
| 940,426 | 903,754 | 846,823 | 806,822 | 786,288 | 748,634 |
| $83.46 | $85.87 | $79.35 | $76.26 | $72. 81 | $66.20 |
| 12.09¢ | 12.95¢ | 12.51¢ | 1 2.76¢ | 12.94¢ | 1 2.1 3¢ |
| 8.5 1¢ | 9.43¢ | 8.96¢ | 8.76¢ | 8.58¢ | 8.36¢ |
| 7.54¢ | 7.73¢ | 7.48¢ | 7.32¢ | 7.40¢ | 7.50¢ |
| 6.36¢ | 6.38¢ | 6.55¢ | 6.50¢ | 6.29¢ | 6.3 1 ¢ |
| 70.9¢ | 78.7¢ | 52.7¢ | 45.7¢ | 62.5¢ | 65.5¢ |
| 1,086 | 1 ,013 | 924 | 843 | 788 | 737 |
| 31,580 | 29,274 | 27,653 | 25,844 | 23, 974 | 22,944 |
| 355 | 344 | 312 | 280 | 2 61 | 243 |

Note: The schedule inside the front cover reconciles the non-GAAP financial measures included in this report to the most comparable GAAP financial measures. The special items, which are net of profitsharing and income taxes as appropriate, consist primarily of: charges resulting from the September 11, 2001, terrorist attacks (2001); certain passenger revenue adjustments (2001, 2002); government grants received under the Air Transportation Safety and System Stabilization Act as a result of the 2001 terrorist attacks (2001, 2002); government grants received under the Emergency Wartime Supplemental Appropriations Act as a result of the U.S. war with Iraq (2003); and unrealized gains or losses for derivative instruments associated with the Company’s fuel hedging program that settle in future accounting periods, recorded as a result of SFAS 133, “Accounting for Derivative Instruments and Hedging Activities,” as amended (2001, 2002, 2003, 2004, 2005). In management’s view, comparative analysis of results can be enhanced by excluding the impact of these items as the amounts are not indicative of the Company’s operating performance for the applicable period, nor should they be considered in developing trend analysis for future periods.

TRANSFER AGENT AND REGISTRAR

Registered shareholder inquiries regarding stock transfers, address changes, lost stock certificates, dividend payments, or account consolidation should be directed to:

Wells Fargo Shareowner Services 161 N. Concord Exchange

South St. Paul, MN 55075

(866) 877-6206 (651 ) 450-4064

[www. shareowneronline.com](http://www.shareowneronline.com/)

STOCK EXCHANGE LISTING

New York Stock Exchange Ticker Symbol: LUV

INDEPENDENT AUDITORS

Ernst & Young LLP Dallas, Texas

GENERAL OFFICES

P.O. Box 36611

Dallas, Texas 75235-1611

FINANCIAL INFORMATION

A copy of the Company’s Annual Report on Form 10-K as filed with the U. S. Securities and Exchange Commission (SEC) is included herein. Other financial information can be found on Southwest’s web site (southwest.com) or may be obtained without charge by writing or calling:

Southwest Airlines Co. Investor Relations

P.O. Box 36611

Dallas, Texas 75235-1611

Telephone (214) 792-4908

WEB SITES

[**www.southwest.com**](http://www.southwest.com/)[**www.swabiz.com**](http://www.swabiz.com/)[**www.swavacations.com**](http://www.swavacations.com/)[**www.swacargo.com**](http://www.swacargo.com/)

ANNUAL MEETING

The Annual Meeting of Shareholders of Southwest Airlines Co. will be held at 10:00 a.m. on May 17, 2006, at the Southwest Airlines Corporate Headquarters, 2702 Love Field Drive, Dallas, Texas.

DIRECTORS

COLLEEN C. BARRETT

President and Corporate Secretary, Southwest Airlines Co., Dallas, Texas

LOUIS CALDERA

President and Professor of Law at The University of New Mexico, Albuquerque, New Mexico; Audit and Nominating and Corporate Governance Committees

C. WEBB CROCKETT Attorney, Fennemore Craig,

Attorneys at Law, Phoenix, Arizona; Compensation and Nominating and Corporate Governance Committees

WILLIAM H. CUNNINGHAM, Ph.D.

James L. Bayless Professor of Marketing, University of Texas School of Business; Former Chancellor, The University of Texas System, Austin, Texas; Audit (Chairman) and Nominating and Corporate Governance Committees

WILLIAM P. HOBBY

Chairman of the Board, Hobby Communications, L.L.C.; Former Lieutenant Governor of Texas; Houston, Texas; Audit, Compensation (Chairman), and Nominating and Corporate Governance Committees

TRAVIS C. JOHNSON

Attorney at Law, El Paso, Texas; Audit, Executive, and Nominating and Corporate Governance Committees

HERBERT D. KELLEHER

Chairman of the Board, Southwest Airlines Co., Dallas, Texas; Executive Committee

GARY C. KELLY

Vice Chairman and Chief Executive Officer, Southwest Airlines Co., Dallas, Texas

ROLLIN W. KING

Retired, Dallas, Texas;

Audit, Executive, and Nominating and Corporate Governance Committees

NANCY LOEFFLER

Longtime advocate of volunteerism, San Antonio, Texas

JOHN T. MONTFORD

Senior Vice President — State Legislative and Regulatory Affairs, AT&T Western States, San Antonio, Texas; Audit and Nominating and Corporate Governance (Chairman) Committees

JUNE M. MORRIS

Founder and former Chief Executive Officer, Morris Air Corporation, Salt Lake City, Utah; Audit, Compensation, and Nominating and Corporate Governance Committees

OFFICERS GARY C. KELLY\*

Vice Chairman and Chief Executive Officer

COLLEEN C. BARRETT\*

President and Corporate Secretary

DONNA D. CONOVER\*

Executive Vice President — Customer Operations

MICHAEL G. VAN DE VEN\*

Executive Vice President — Aircraft Operations

GINGER C. HARDAGE\*

Senior Vice President — Corporate Communications

ROBERT E. JORDAN\*

Senior Vice President — Enterprise Spend Management

TOM NEALON\*

Senior Vice President — Technology and Chief Information Officer

RON RICKS\*

Senior Vice President — Law, Airports, and Public Affairs

JOYCE C. ROGGE\*

Senior Vice President — Marketing

LAURA H. WRIGHT\*

Senior Vice President — Finance and Chief Financial Officer

GREG WELLS

Senior Vice President — Ground Operations

DEBORAH ACKERMAN

Vice President and General Counsel

BARRY BROWN

Vice President — Safety and Security

GREGORY N. CRUM

Vice President — Flight Operations

JOE HARRIS

Vice President — Labor and Employee Relations

CAMILLE T. KEITH

Vice President — Special Marketing

DARYL KRAUSE

Vice President — Inflight Services

KEVIN M. KRONE

Vice President — Marketing, Sales, and Distribution

JEFF LAMB

Vice President — People and Leadership Development

PETE MCGLADE

Vice President — Schedule Planning

BOB MONTGOMERY

Vice President — Properties

ROB MYRBEN

Vice President — Fuel Management

TAMMY ROMO

Vice President — Controller

JAMES A. RUPPEL

Vice President — Customer Relations and Rapid Rewards

LINDA B. RUTHERFORD

Vice President — Public Relations and Community Affairs

RAY SEARS

Vice President — Purchasing

JIM SOKOL

Vice President — Maintenance and Engineering

KEITH L. TAYLOR

Vice President — Revenue Management

ELLEN TORBERT

Vice President — Reservations

CHRIS WAHLENMAIER

Vice President — Station Operations

\*Member of Executive Planning Committee

(Mark One)

**SECURITIES AND EXCHANGE COMMISSION**

# Washington, D.C. 20549

**Form 10-K**

# ¥ ANNUAL REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934

## For the fiscal year ended December 31, 2005

**or**

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

**For the transition period from to**

**Commission File No. 1-7259**

**Southwest Airlines Co.**

*(Exact name of registrant as specified in its charter)*

## Texas 74-1563240

*(State or other jurisdiction of (I.R.S. employer*

*incorporation or organization) identification no.)*

## P.O. Box 36611

**Dallas, Texas 75235-1611**

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

## Registrant's telephone number, including area code: (214) 792-4000

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

**Title of Each Class Name of Each Exchange on Which Registered**

Common Stock ($1.00 par value) New York Stock Exchange, Inc.

## SECURITIES REGISTERED PURSUANT TO SECTION 12(g) OF THE ACT:

**None**

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

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

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

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

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, or a non-accelerated filer.

See definition of ""accelerated filer and large accelerated filer'' in Rule 12b-2 of the Exchange Act.

Large accelerated filer ¥ Accelerated filer n Non-accelerated filer n

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

The aggregate market value of the Common Stock held by non-affiliates of the registrant was approximately

$10,876,320,000, computed by reference to the closing sale price of the stock on the New York Stock Exchange on June 30, 2005, the last trading day of the registrant's most recently completed second fiscal quarter.

Number of shares of Common Stock outstanding as of the close of business on January 24, 2006: 804,661,597 shares

## DOCUMENTS INCORPORATED BY REFERENCE

Proxy Statement for Annual Meeting of

Shareholders, May 17, 2006: **PART III**

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**PART I** excluding fuel taxes, over the past five years was as follows:

**Item 1. *Business* Cost Average Cost Percent of**

**Year (Millions) Per Gallon Operating Expenses**

## Description of Business

2001 ÏÏÏÏÏ $ 771 $ .71 15.6%

Southwest Airlines Co. (""Southwest'' or the 2002 ÏÏÏÏÏ $ 762 $ .68 14.9% ""Company'') is a major domestic airline that provides

point-to-point, low-fare service. Historically, routes served by Southwest had been predominantly short-haul, with high frequencies. In recent years, the Company has complemented this service with more medium to long- haul routes, including transcontinental service. South- west was incorporated in Texas in 1967 and com- menced Customer Service on June 18, 1971, with three Boeing 737 aircraft serving three Texas cities Ì Dallas, Houston, and San Antonio.

At year-end 2005, Southwest operated 445 Boeing

2003 ÏÏÏÏÏ $ 830 $ .72 15.2%

2004 ÏÏÏÏÏ $1,000 $ .83 16.7%

2005 ÏÏÏÏÏ $1,342 $1.03 19.8%

From October 1, 2005, through December 31, 2005, the average cost per gallon was $1.20. See ""Management's Discussion and Analysis of Financial Condition and Results of Operations'' for a discussion of fuel costs and more detail on Southwest's fuel hedging activities.

737 aircraft and provided service to 61 cities in 31 states **Regulation**

throughout the United States. Based on monthly data

for October 2005 (the latest available data), Southwest Airlines is the largest carrier in the United States based on originating domestic passengers boarded and sched- uled domestic departures. The Company began service to Pittsburgh, Pennsylvania in May 2005, Ft. Myers, Florida in October 2005, and Denver, Colorado in January 2006.

*Economic.* The Dallas Love Field section of the

International Air Transportation Competition Act of 1979, as amended in 1997 and 2005 (commonly known as the ""Wright Amendment''), as it affects Southwest's scheduled service, provides that no common carrier may provide scheduled passenger air transporta- tion for compensation between Love Field and one or more points outside Texas, except that an air carrier

One of Southwest's primary competitive strengths may transport individuals by air on a flight between is its low operating costs. Southwest has the lowest Love Field and one or more points within the states of costs, adjusted for stage length, on a per mile basis, of Alabama, Arkansas, Kansas, Louisiana, Mississippi, all the major airlines. Among the factors that contribute Missouri, New Mexico, Oklahoma, and Texas if to its low cost structure are a single aircraft type, an (a) ""such air carrier does not offer or provide any efficient, high-utilization, point-to-point route struc- through service or ticketing with another air carrier'' ture, and hardworking, innovative, and highly produc- and (b) ""such air carrier does not offer for sale tive Employees. transportation to or from, and the flight or aircraft does

The business of the Company is somewhat sea- sonal. Quarterly operating income and, to a lesser extent, revenues tend to be lower in the first quarter (January 1 - March 31) and fourth quarter (Octo- ber 1 - December 31) of most years.

Southwest's filings with the Securities and Ex- change Commission (""SEC''), including its annual report on Form 10-K, quarterly reports on Form 10-Q, current reports on Form 8-K and amendments to those reports, are accessible free of charge at [www.southwest.com.](http://www.southwest.com/)

## Fuel

not serve, any point which is outside any such states.'' The Wright Amendment does not restrict flights oper- ated with aircraft having 56 or fewer passenger seats. The Wright Amendment does not restrict Southwest's intrastate Texas flights or its air service from points other than Love Field.

The Department of Transportation (""DOT'') has significant regulatory jurisdiction over passenger air- lines. Unless exempted, no air carrier may furnish air transportation over any route without a DOT certificate of public convenience and necessity, which does not confer either exclusive or proprietary rights. The Com- pany's certificates are unlimited in duration and permit the Company to operate among any points within the

The cost of fuel is an item that has significant United States, its territories and possessions, except as impact on the Company's operating results. The Com- limited by the Wright Amendment, as do the certifi- pany's average cost of jet fuel, net of hedging gains and cates of all other U.S. carriers. DOT may revoke such

certificates, in whole or in part, for intentional failure to gers, baggage, cargo, mail, employees, and vendors, comply with certain provisions of the enhanced training and qualifications of security screen-

U.S. Transportation Code, or any order or regulation ing personnel, additional provision of passenger data to issued thereunder or any term of such certificate; pro- U.S. Customs, and enhanced background checks. Be- vided that, with respect to revocation, the certificate ginning February 1, 2002, a $2.50 per enplanement holder has first been advised of the alleged violation and security fee is imposed on passengers (maximum of fails to comply after being given a reasonable time to do $5.00 per one-way trip). This fee was suspended by so. Congress from June 1 through September 30, 2003.

DOT prescribes uniform disclosure standards re- garding terms and conditions of carriage and prescribes that terms incorporated into the Contract of Carriage by reference are not binding upon passengers unless notice is given in accordance with its regulations.

Pursuant to authority granted to the TSA to impose additional fees on air carriers if necessary to cover additional federal aviation security costs, the TSA has imposed an annual Security Infrastructure Fee, which approximated $26 million for Southwest in 2004 and

$50 million in 2005. Like the FAA, the TSA may

*Safety.* The Company and its third-party mainte- impose and collect fines for violations of its regulations. nance providers are subject to the jurisdiction of the

Federal Aviation Administration (""FAA'') with respect to its aircraft maintenance and operations, including equipment, ground facilities, dispatch, communications, flight training personnel, and other matters affecting air safety. To ensure compliance with its regulations, the FAA requires airlines to obtain operating, airworthiness, and other certificates, which are subject to suspension or revocation for cause. The Company has obtained such certificates. The FAA, acting through its own powers or through the appropriate U.S. Attorney, also has the power to bring proceedings for the imposition and collection of fines for violation of the Federal Air Regulations.

Enhanced security measures have had, and will

continue to have, a significant impact on the airport experience for passengers. While these security require- ments have not impacted aircraft utilization, they have impacted our business. The Company has invested significantly in facilities, equipment, and technology to process Customers efficiently and restore the airport experience. The Company has implemented its Auto- mated Boarding Passes and RAPID CHECK-IN self service kiosks in all airports it serves to reduce the number of lines in which a Customer must wait. The Company has installed gate readers at all of its airports to improve the boarding reconciliation process, has introduced baggage checkin through RAPID CHECK-

The Company is subject to various other federal, IN kiosks at certain airport locations, and has also state, and local laws and regulations relating to occupa- introduced Internet checkin and transfer boarding tional safety and health, including Occupational Safety passes at the time of checkin.

and Health Administration (OSHA) and Food and

Drug Administration (FDA) regulations.

*Environmental.* Certain airports, including

San Diego and Orange County, have established airport

*Security.* In November 2001, President Bush restrictions to limit noise, including restrictions on signed into law the Aviation and Transportation Secur- aircraft types to be used, and limits on the number of ity Act, or the Aviation Security Act. This law federal- hourly or daily operations or the time of such opera- ized substantially all aspects of civil aviation security, tions. In some instances, these restrictions have caused creating the Transportation Security Administration curtailments in service or increases in operating costs (""TSA''), which is part of the Department of Home- and such restrictions could limit the ability of Southwest land Security. The Aviation Security Act generally to expand its operations at the affected airports. Local provides for enhanced aviation security measures. Under authorities at other airports may consider adopting the Aviation Security Act, substantially all security similar noise regulations, but such regulations are sub- screeners at airports are federal employees and signifi- ject to the provisions of the Airport Noise and Capacity cant other elements of airline and airport security are Act of 1990 and regulations promulgated thereunder. overseen and performed by federal employees, including

federal security managers, federal law enforcement of- Operations at John Wayne Airport, Orange ficers, and federal air marshals. The law mandates, County, California, are governed by the Airport's among other things, improved flight deck security, Phase 2 Commercial Airline Access Plan and Regula- deployment of federal air marshals onboard flights, tion (the ""Plan''). Pursuant to the Plan, each airline is improved airport perimeter access security, airline crew allocated total annual seat capacity to be operated at the security training, enhanced security screening of passen- airport, subject to renewal/reallocation on an annual

basis. Service at this airport may be adjusted annually to mately 1.7 hours. Examples of markets offering frequent meet these requirements. daily flights are: Dallas to Houston Hobby, 29 weekday roundtrips; Phoenix to Las Vegas, 19 weekday round-

The Company is subject to various other federal, trips; and Los Angeles International to Oakland, state, and local laws and regulations relating to the 22 weekday roundtrips. Southwest complements these protection of the environment, including the discharge high-frequency shorthaul routes with longhaul nonstop or disposal of materials such as chemicals, hazardous service between markets such as Baltimore and Los waste, and aircraft deicing fluid. Regulatory develop- Angeles, Phoenix and Tampa Bay, Las Vegas and ments pertaining to such things as control of engine Nashville, and Houston and Oakland.

exhaust emissions from ground support equipment and

prevention of leaks from underground aircraft fueling systems could increase operating costs in the airline industry. The Company does not believe, however, that such environmental regulatory developments will have a material impact on the Company's capital expenditures or otherwise adversely effect its operations, operating costs, or competitive position. Additionally, in conjunc- tion with airport authorities, other airlines, and state and local environmental regulatory agencies, the Com- pany is undertaking voluntary investigation or remedia- tion of soil or groundwater contamination at several airport sites. The Company does not believe that any environmental liability associated with such sites will have a material adverse effect on the Company's opera- tions, costs, or profitability.

Southwest's point-to-point route system, as com-

pared to hub-and-spoke, provides for more direct non- stop routings for Customers and, therefore, minimizes connections, delays, and total trip time. Southwest focuses on nonstop, not connecting, traffic. As a result, approximately 79 percent of the Company's Customers fly nonstop. In addition, Southwest serves many conve- niently located secondary or downtown airports such as Dallas Love Field, Houston Hobby, Chicago Midway, Baltimore-Washington International, Burbank, Manchester, Oakland, San Jose, Providence, Ft. Lauderdale/Hollywood, and Long Island Islip air- ports, which are typically less congested than other airlines' hub airports and enhance the Company's ability to sustain high Employee productivity and reliable on- time performance. This operating strategy also permits

*Customer Service Commitment.* From time to the Company to achieve high asset utilization. Aircraft time, the airline transportation industry has been faced are scheduled to minimize the amount of time the with possible legislation dealing with certain Customer aircraft are at the gate, currently approximately 25 service practices. As a compromise with Congress, the minutes, thereby reducing the number of aircraft and industry, working with the Air Transport Association, gate facilities than would otherwise be required. The has responded by adopting and filing with the DOT Company operates only one aircraft type, the Boeing written plans disclosing how it would commit to im- 737, which simplifies scheduling, maintenance, flight proving performance. Southwest Airlines' Customer operations, and training activities.

Service Commitment is a comprehensive plan which

embodies the Mission Statement of Southwest Airlines: dedication to the highest quality of Customer Service delivered with a sense of warmth, friendliness, individual pride, and Company Spirit. The Customer Service Commitment can be reviewed by clicking on ""About SWA'' at [www.southwest.com.](http://www.southwest.com/) The DOT and Congress monitor the industry's plans, and there can be no assurance that legislation or regulations will not be proposed in the future to regulate airline Customer service practices.

## Marketing and Competition

In first quarter 2005, Southwest began its first

codeshare arrangement, with ATA Airlines. Under its codeshare arrangement with ATA, Southwest may mar- ket and sell tickets for certain flights on ATA that are identified by Southwest's designator code, e.g., WN Flight 123. Conversely, ATA may market and sell tickets under its code designator (TZ) for certain flights on Southwest Airlines. Any flight bearing a Southwest code designator that is operated by ATA is disclosed in Southwest's reservations systems and on the Customer's flight itinerary, boarding pass, and ticket, if a paper ticket is issued. In December 2005, Southwest enhanced the codeshare arrangement with ATA, subject

Southwest focuses principally on point-to-point, to certain conditions, including ATA's confirmed Plan rather than hub-and-spoke, service in markets with of Reorganization, which must be fulfilled by Febru- frequent, conveniently timed flights and low fares. At ary 28, 2006. Other than the ATA agreement, South- year-end, Southwest served 374 nonstop city pairs. west does not interline or offer joint fares with other Southwest's average aircraft trip stage length in 2005 airlines, nor does Southwest have any commuter feeder was 607 miles with an average duration of approxi- relationships.

Southwest employs a relatively simple fare struc- has reduced its cost structure (excluding fuel) through ture, featuring low, unrestricted, unlimited, everyday increased productivity.

coach fares, as well as even lower fares available on a The Company is also subject to varying degrees of restricted basis. The Company's highest non-codeshare, competition from surface transportation in its shorthaul oneway unrestricted walkup fare offered is $299 for any markets, particularly the private automobile. In flight. Even lower walkup fares are available on South- shorthaul air services that compete with surface trans- west's short and medium haul flights. portation, price is a competitive factor, but frequency

Southwest was the first major airline to introduce a Ticketless travel option, eliminating the need to print and then process a paper ticket altogether, and the first

and convenience of scheduling, facilities, transportation safety and security procedures, and Customer Service are also of great importance to many passengers.

to offer Ticketless travel through the Company's home **Insurance**

page on the Internet, [www.southwest.com.](http://www.southwest.com/) For the year

ended December 31, 2005, more than 93 percent of The Company carries insurance of types customary Southwest's Customers chose the Ticketless travel op- in the airline industry and at amounts deemed adequate tion and approximately 65 percent of Southwest's pas- to protect the Company and its property and to comply senger revenues came through its Internet site, which both with federal regulations and certain of the Com- has become a vital part of the Company's distribution pany's credit and lease agreements. The policies princi- strategy. The Company has not paid commissions to pally provide coverage for public and passenger liability, travel agents for sales since December 15, 2003. property damage, cargo and baggage liability, loss or

damage to aircraft, engines, and spare parts, and work- The airline industry is highly competitive as to ers' compensation.

fares, frequent flyer benefits, routes, and service, and Following the terrorist attacks, commercial avia- some carriers competing with the Company have larger tion insurers significantly increased the premiums and fleets and wider name recognition. Certain major reduced the amount of war-risk coverage available to United States airlines have established marketing or commercial carriers. The federal Homeland Security codesharing alliances with each other, including North- Act of 2002 requires the federal government to provide west Airlines/Continental Airlines/Delta Air Lines; third party, passenger, and hull war-risk insurance cov- American Airlines/Alaska Airlines; and United Air- erage to commercial carriers through a period of time lines/US Airways. that has now been extended to December 31, 2006.

Since the terrorist attacks on September 11, 2001, the airline industry, as a whole, has incurred substantial losses. The war in Iraq and significant increases in the cost of fuel have exacerbated industry challenges. As a result, a number of carriers, including UAL, the parent of United Airlines, US Airways, Delta Air Lines, Inc., Northwest Airlines Corporation, the parent of North-

The Company is unable to predict whether the govern- ment will extend this insurance coverage past Decem- ber 31, 2006, whether alternative commercial insurance with comparable coverage will become available at rea- sonable premiums, and what impact this will have on the Company's ongoing operations or future financial performance.

west Airlines, Aloha, and ATA Airlines, Inc. have **Frequent Flyer Awards**

sought relief from financial obligations in bankruptcy.

Other, smaller carriers have ceased operation entirely. Southwest's frequent flyer program, Rapid Re- America West Airlines, US Airways, Aloha, ATA, and wards, is based on trips flown rather than mileage. others received federal loan guarantees authorized by Rapid Rewards Customers earn a credit for each one- federal law; America West Airlines and USAirways have way trip flown or two credits for each roundtrip flown. since merged. Since September 11, low cost carriers Rapid Rewards Customers can also receive credits by such as AirTran, JetBlue, and Frontier have accelerated using the services of non-airline partners, which include their growth. Faced with increasing low fare and lower car rental agencies, hotels, telecommunication compa- cost competition, growing customer demand for lower nies, and credit card partners, including the Southwest fares, and record high energy costs, legacy carriers have Airlines Chase» Visa card. Rapid Rewards offers two aggressively sought to reduce their cost structures, types of travel awards. The Rapid Rewards Award largely through downsized work forces and renegotiated Ticket (""Award Ticket'') offers one free roundtrip collective bargaining and vendor agreements. Southwest award valid to any destination available on Southwest has maintained its low cost competitive advantage and after the accumulation of 16 credits. The Rapid Re-

wards Companion Pass (""Companion Pass'') is granted 6.8 million, approximately 78 percent of which were for flying 50 roundtrips (or 100 one-way trips) on partially earned awards. However, due to the expected Southwest or earning 100 credits within a consecutive expiration of a portion of credits making up these twelve-month period. The Companion Pass offers un- partial awards, not all of them will eventually turn into limited free roundtrip travel to any destination available useable Award Tickets. Also, not all Award Tickets will on Southwest for a designated companion of the qualify- be redeemed for future travel. Since the inception of ing Rapid Rewards member. In order for the designated Rapid Rewards in 1987, approximately 14 percent of all companion to use this pass, the Rapid Rewards member fully earned Award Tickets have expired without being must purchase a ticket or use an Award Ticket. Addi- used. The number of Companion Passes for Southwest tionally, the Rapid Rewards member and designated outstanding at December 31, 2005 and 2004 was companion must travel together on the same flight. approximately 60,000 for each date. The Company

Award Tickets and Companion Passes are auto- matically generated when earned by the Customer

currently estimates that an average of 3 to 4 trips will be redeemed per outstanding Companion Pass.

rather than allowing the Customer to bank credits The Company accounts for its frequent flyer pro- indefinitely. Beginning August 10, 2005, all Rapid gram obligations by recording a liability for the esti- Rewards credits are valid for 24 months, rather than the mated incremental cost of flight awards the Company previous period of 12 months. Any credits in a Rapid expects to be redeemed (except for credits sold to Rewards member's account as of August 10, 2005 are business partners). This method recognizes an average valid for an additional 12 months. Award Tickets are incremental cost to provide roundtrip transportation to valid for 12 months after issuance. one additional passenger. The estimated incremental

Award Tickets issued before February 10, 2006 have no seat restrictions, but are subject to published ""Black out'' dates. Beginning February 10, 2006, there will be no systemwide ""Black out'' dates for Award Tickets, but Award Tickets will be subject to seat restrictions. Companion travel will still have no seat restrictions or ""Black out'' dates.

cost includes direct passenger costs such as fuel, food, and other operational costs, but does not include any contribution to overhead or profit. The incremental cost is accrued at the time an award is earned and revenue is subsequently recognized, at the amount accrued, when the free travel award is used. Revenue from the sale of credits and associated with future travel is deferred and recognized when the ultimate free travel award is flown

The Company also sells credits to business partners or the credits expire unused. Accordingly, Southwest including credit card companies, hotels, telecommunica- does not accrue incremental cost for the expected tion companies, and car rental agencies. These credits redemption of free travel awards for credits sold to may be redeemed for Award Tickets having the same business partners. The liability for free travel awards program characteristics as those earned by flying. earned but not used at December 31, 2005 and 2004

Customers redeemed approximately 2.6 million, was not material.

2.5 million and 2.5 million Award Tickets and flights

on Companion Passes during 2005, 2004, and 2003, **Employees**

respectively. The amount of free travel award usage as a

percentage of total Southwest revenue passengers carried At December 31, 2005, Southwest had 31,729 was 6.6 percent in 2005, 7.1 percent in 2004, and active Employees, consisting of 12,230 flight, 1,987

7.5 percent in 2003. The number of fully earned Award maintenance, 13,351 ground, Customer, and fleet ser- Tickets and partially earned awards outstanding at each vice and 4,161 management, accounting, marketing, of December 31, 2005 and 2004 was approximately and clerical personnel.

Southwest has ten collective bargaining agreements covering approximately 82 percent of its Employees. The following table sets forth the Company's Employee groups and collective bargaining status:

|  |  |  |
| --- | --- | --- |
| **Employee Group** | **Represented by** | **Agreement Amendable on** |
| Customer Service and Reservations Agents ÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏ | International Association of | November 2008 (or 2006 at the |
|  | Machinists and Aerospace Workers,  AFL-CIO | Union's option under certain  conditions) |
| Flight Attendants ÏÏÏÏÏÏÏÏÏÏÏÏÏÏ | Transportation Workers of America, AFL-CIO (""TWU'') | June 2008 |
| Ramp, Operations, and Provisioning and Freight Agents ÏÏÏÏÏÏÏÏÏÏÏ | TWU | June 2008 (or 2006 at the Union's |
|  |  | option under certain conditions) |
| Pilots ÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏ | Southwest Airlines Pilots' Association | September 2006 |
| Flight Dispatchers ÏÏÏÏÏÏÏÏÏÏÏÏÏÏ | Southwest Airlines Employee Association | December 2009 |
| Aircraft Appearance Technicians ÏÏ | Aircraft Mechanics Fraternal Association (""AMFA'') | February 2009 |
| Stock Clerks ÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏ | International Brotherhood of Teamsters (""Teamsters'') | August 2008 |
| Mechanics ÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏ | AMFA | August 2008 |
| Flight Simulator Technicians ÏÏÏÏÏ | Teamsters | November 2011 |
| Flight/Ground School Instructors |  |  |

and Flight Crew Training

Instructors ÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏ Southwest Airlines Professional December 2012

Instructors Association

**Item 1A. *Risk Factors*** rising fuel costs. Changes in the Company's overall fuel hedging strategy, the continued ability of the commodi-

In addition to the other information contained in ties used in fuel hedging (principally crude oil, heating this Form 10-K, the following risk factors should be oil, and unleaded gasoline) to qualify for special hedge considered carefully in evaluating Southwest's business. accounting, and the continued effectiveness of the Com- The Company's business, financial condition, or results pany's fuel hedges pursuant to highly complex account- of operations could be materially adversely affected by ing rules, are all significant factors impacting the any of these risks. Please note that additional risks not Company's operating results. For more information on presently known to the Company or that the Company Southwest's fuel hedging arrangements, see ""Manage- currently deems immaterial may also impair its business ment's Discussion and Analysis of Financial Condition and operations. and Results of Operations,'' and Note 10 to the Consol-

idated Financial Statements.

### *Southwest's business is dependent on the price and*

***availability of aircraft fuel. Southwest's business is labor-intensive.***

The cost of fuel is largely unpredictable, and has a significant impact on the Company's operating results. Also, significant disruptions in the supply of aircraft fuel could have a negative impact on the Company's opera- tions and operating results. Due to the competitive nature of the airline industry, the Company generally has not been able to increase fares when fuel prices have risen in the past and the Company may not be able to do so in the future. From time to time the Company enters into hedging arrangements to protect against

Historically, the Company's relationships with its Employees have been very good. However, the results of labor contract negotiations (approximately 82% of the Company's Employees are represented for collective bargaining purposes by labor unions), Employee hiring and retention rates, and costs for health care are items with potentially significant impact on the Company's operating results.

***Southwest relies on technology to operate its business*** insurance premiums and a decrease in the insurance ***and any failure of these systems could harm the*** coverage available to commercial airline carriers. Ac- ***Company's business.*** cordingly, the Company's insurance costs increased significantly. The federal Homeland Security Act of

Southwest is increasingly dependent on automated 2002 requires the federal government to provide third systems and technology to operate its business, enhance party, passenger, and hull war-risk insurance coverage to Customer service, and increase Employee productivity, commercial carriers through a period of time that has including the Company's computerized airline reserva- now been extended to December 31, 2006. If the tion system, flight operations systems, telecommunica- federal insurance program terminates, the Company tion systems, website, Automated Boarding Passes would likely face a material increase in the cost of war system, and the RAPID CHECK-IN self service kiosks. risk insurance.

Any disruptions in these systems due to internal failures

of technology or large-scale external interruptions in

technology infrastructure, such as power, telecommuni- cations, or the internet, could result in the loss of revenue or important data, increase the Company's expenses, and generally harm the Company's business.

### *The travel industry continues to face on-going* security concerns and cost burdens.

The attacks of September 11, 2001 materially impacted, and continue to impact, air travel and the results of operations for Southwest and the airline

### *Changes in or additional government regulation*

***could increase the Company's operating costs or limit the Company's ability to conduct business.***

Airlines are subject to extensive regulatory require- ments. These requirements often impose substantial costs on airlines. Additional laws, regulations, taxes, and airport rates and charges have been proposed from time to time that could significantly increase the Company's costs or reduce revenues.

industry generally. Substantially all security screeners at ***The airline industry is intensely competitive.***

airports are now federal employees and significant other

elements of airline and airport security are now overseen The airline industry is extremely competitive. and performed by federal employees, including federal Southwest's competitors include other major domestic security managers, federal law enforcement officers, and airlines as well as regional and new entrant airlines, and federal air marshals. Enhanced security procedures, in- other forms of transportation, including rail and private cluding enhanced security screening of passengers, bag- automobiles. The Company's revenues are sensitive to gage, cargo, mail, employees and vendors, introduced at the actions of other carriers in the areas of capacity, airports since the terrorist attacks of September 11 have pricing, scheduling, codesharing, and promotions. Ad- increased costs to airlines. ditional mergers and acquisitions in the airline industry,

Additional terrorist attacks, even if not made di- rectly on the airline industry, or the fear of such attacks (including elevated national threat warnings or selective

and airline restructuring through bankruptcy may make other carriers more competitive with the Company.

cancellation or redirection of flights due to terror ***Disruptions to operations due to factors beyond*** threats) could negatively affect Southwest and the air- ***Southwest's control could adversely affect the*** line industry. The war in Iraq further decreased demand ***Company.***

for air travel during the first half of 2003, and additional

international hostilities could potentially have a material Like all other airlines, Southwest is subject to adverse impact on the Company's results of operations. delays caused by factors beyond its control, including

adverse weather conditions, air traffic congestion at

### *Insurance cost increases or reductions in insurance* coverage may adversely impact the Company's operations and financial results.

airports, and increased security measures. Delays frus- trate passengers, reduce aircraft utilization, and increase costs, all of which negatively affect profitability. During snow, rain, fog, storms, or other adverse weather condi-

The Company carries insurance for public liability, tions, flights may be cancelled or significantly delayed. passenger liability, property damage, and all-risk cover- Catastrophic weather conditions such as hurricanes may age for damage to its aircraft. The terrorist attacks of disrupt operations, and revenues, for a substantial period September 11, 2001 led to a significant increase in of time.

### *Southwest's low cost structure is one of its primary* Item 1B. *Unresolved Staff Comments* competitive advantages and many factors could

***affect the Company's ability to control its costs.***

None.

Factors affecting the Company's ability to control **Item 2. *Properties***

its costs include the price and availability of fuel, results

of Employee labor contract negotiations, Employee hir- **Aircraft**

ing and retention rates, costs for health care, capacity

decisions by the Company and its competitors, un- Southwest operated a total of 445 Boeing 737 scheduled required aircraft airframe or engine repairs, aircraft as of December 31, 2005, of which 84 and 9 regulatory requirements, availability of capital markets, were under operating and capital leases, respectively. and future financing decisions made by the Company. The remaining 352 aircraft were owned.

The following table details information on the 445 aircraft in the Company's fleet as of December 31, 2005:

|  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- |
| **737 Type** | **Seats** | **Average Age**  **(Yrs)** | **Number of**  **Aircraft** | **Number**  **Owned** | **Number**  **Leased** |
| -300 ÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏ | 137 | 14.7 | 194 | 112 | 82 |
| -500 ÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏ | 122 | 14.7 | 25 | 16 | 9 |
| -700 ÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏ | 137 | 3.8 | 226 | 224 | 2 |
| **Totals**ÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏ |  | 9.1 | 445 | 352 | 93 |

In total, at December 31, 2005, the Company had firm orders and options to purchase Boeing 737 aircraft as follows:

## Firm Orders and Options to Purchase Boeing 737-700 Aircraft

|  |  |  |  |
| --- | --- | --- | --- |
| **Delivery Year** | **Firm Orders** | **Options** | **Purchase Rights** |
| 2006 ÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏ | 33 | Ì | Ì |
| 2007 ÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏ | 28 | 8 | 20 |
| 2008 ÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏ | 6 | 25 | 20 |
| 2009-2012 ÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏ | Ì | Ì | 177 |
| **Totals** ÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏ | 67 | 33 | 217 |

In January 2006, the Company exercised one of its Company owns its Houston, Phoenix, and San Antonio 2007 options to bring firm orders and options to 29 reservation centers.

and 7, respectively, for that year.

## Ground Facilities and Services

Southwest has entered into a concession agreement

with the Town of Islip, New York which gives the Company the right to construct, furnish, occupy, and

Southwest leases terminal passenger service facili- maintain a new concourse at the airport. Phase I of this

ties at each of the airports it serves, to which it has project, which began operations in August 2004, in- added various leasehold improvements. The Company cludes four gates. Phase II of the project, which includes leases land on a long-term basis for its maintenance an additional four gates, is currently expected to be centers located at Dallas Love Field, Houston Hobby, completed in June 2006. When all phases of construc- Phoenix Sky Harbor, and Chicago Midway, its training tion are complete, the entire new concourse will become center near Love Field, which houses seven 737 simula- the property of the Town of Islip. In return for con- tors, and its corporate headquarters, also located near structing the new concourse, Southwest will receive Love Field. The maintenance, training center, and fixed-rent abatements for a total of 25 years; however, corporate headquarters buildings on these sites were the Company will still be required to pay variable rents built and are owned by Southwest. At December 31, for common use areas and manage the new concourse. 2005, the Company operated six reservation centers.

The reservation centers located in Chicago, Albuquer- The Company performs substantially all line main- que, and Oklahoma City occupy leased space. The tenance on its aircraft and provides ground support

services at most of the airports it serves. However, the the insurance maintained by the Company. Conse- Company has arrangements with certain aircraft main- quently, the Company does not expect any litigation tenance firms for major component inspections and arising from the accident involving Flight 1248 to have repairs for its airframes and engines, which comprise the a material adverse affect on the financial position or majority of the annual aircraft maintenance costs. results of operation of the Company.

The Company is subject to various legal proceed-

**Item 3. Legal Proceedings** ings and claims arising in the ordinary course of busi-

On December 8, 2005, Southwest Airlines Flight 1248 was involved in an accident at Chicago Midway Airport while the aircraft, a Boeing 737-700, was landing. The aircraft overran the runway onto a roadway and collided with an automobile. Several occupants of the vehicles involved in the accident were injured, one fatally. The Company continues to cooperate fully with all federal, state, and local regulatory and investigatory agencies to determine the cause of this accident. The Company is currently unable to predict the amount of claims, if any, relating to this accident which may ultimately be made against it and how those claims might be resolved. At this time, the Company has no reason to believe that the costs to defend any claims and any potential liability exposure will not be covered by

ness, including, but not limited to, examinations by the Internal Revenue Service (IRS). The IRS regularly examines the Company's federal income tax returns and, in the course of those examinations, proposes adjust- ments to the Company's federal income tax liability reported on such returns. It is the Company's practice to vigorously contest those proposed adjustments that it deems lacking merit. The Company's management does not expect the outcome in any of its currently ongoing legal proceedings or the outcome of any proposed adjustments presented to date by the IRS, individually or collectively, will have a material adverse effect on the Company's financial condition, results of operations, or cash flows.

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

None to be reported.

## EXECUTIVE OFFICERS OF THE REGISTRANT

The executive officers of Southwest, their positions, and their respective ages (as of January 1, 2006) are as follows:

**Name Position Age**

|  |  |  |
| --- | --- | --- |
| Herbert D. Kelleher ÏÏÏÏÏÏÏÏÏÏÏÏ | Chairman of the Board | 74 |
| Gary C. Kelly ÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏ | Vice Chairman of the Board and Chief Executive Officer | 50 |
| Colleen C. Barrett ÏÏÏÏÏÏÏÏÏÏÏÏÏÏ | President and Secretary | 61 |
| Donna D. Conover ÏÏÏÏÏÏÏÏÏÏÏÏÏ | Executive Vice President Ì Customer Operations | 52 |
| Michael G. Van de Ven ÏÏÏÏÏÏÏÏÏ | Executive Vice President Ì Aircraft Operations | 44 |
| Laura H. Wright ÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏ | Senior Vice President Ì Finance and Chief Financial Officer | 45 |
| Joyce C. Rogge ÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏ | Senior Vice President Ì Marketing | 48 |

Executive officers are elected annually at the first meeting of Southwest's Board of Directors following the annual meeting of shareholders or appointed by the Chief Executive Officer pursuant to Board authorization. Each of the above individuals has worked for Southwest Airlines Co. for more than the past five years.

## PART II Recent Sales of Unregistered Securities

During 2005, Herbert D. Kelleher, Chairman of

**Item 5. *Market for Registrant's Common Equity,*** the Board, exercised unregistered options to purchase

***Related Stockholder Matters, and Issuer*** Southwest Common Stock as follows:

***Purchases of Equity Securities* Number of Shares Exercise Date of Date of Purchased Price Exercise Option Grant**

Southwest's common stock is listed on the New

York Stock Exchange and is traded under the symbol

948,830ÏÏÏÏÏÏÏÏÏ $4.64 12/15/05 01/01/96

LUV. The high and low sales prices of the common The issuance of the above options and shares to stock on the Composite Tape and the quarterly divi- Mr. Kelleher were deemed exempt from the registration dends per share paid on the common stock were: provisions of the Securities Act of 1933, as amended

**Period Dividend High Low** (the ""Securities Act''), by reason of the provision of

Section 4(2) of the Securities Act because, among other things, of the limited number of participants in such transactions and the agreement and representation of Mr. Kelleher that he was acquiring such securities for investment and not with a view to distribution thereof. The certificates representing the shares issued to Mr. Kelleher contain a legend to the effect that such shares are not registered under the Securities Act and may not be transferred except pursuant to a registration statement which has become effective under the Securi- ties Act or to an exemption from such registration. The issuance of such shares was not underwritten.

|  |  |  |  |
| --- | --- | --- | --- |
| **2005** |  | | |
| 1st Quarter ÏÏÏÏÏ | $0.00450 | $16.45 | $13.60 |
| 2nd QuarterÏÏÏÏÏ | 0.00450 | 15.50 | 13.56 |
| 3rd Quarter ÏÏÏÏÏ | 0.00450 | 14.85 | 13.05 |
| 4th Quarter ÏÏÏÏÏ | 0.00450 | 16.95 | 14.54 |
| **2004** |  |  |  |
| 1st Quarter ÏÏÏÏÏ | $0.00450 | $16.60 | $12.88 |
| 2nd QuarterÏÏÏÏÏ | 0.00450 | 17.06 | 13.56 |
| 3rd Quarter ÏÏÏÏÏ | 0.00450 | 16.85 | 13.18 |
| 4th Quarter ÏÏÏÏÏ | 0.00450 | 16.74 | 13.45 |

As of December 31, 2005, there were 11,496 holders of record of the Company's common stock.

## Securities Authorized for Issuance under Equity Compensation Plans

The following table provides information as of December 31, 2005, regarding compensation plans (including individual compensation arrangements) under which equity securities of Southwest are authorized for issuance.

## Equity Compensation Plan Information

**Number of Securities Remaining**

**Number of Securities to be Weighted-Average Available for Future Issuance Under Issued upon Exercise of Exercise Price of Equity Compensation Plans Outstanding Options, Outstanding Options, (Excluding Securities Warrants, and Rights Warrants, and Rights\* Reflected in Column (a))**

**Plan Category (a) (b) (c) (In thousands) (In thousands)**

Equity Compensation Plans Approved

by Security Holders ÏÏÏÏÏÏÏÏÏÏÏÏ 30,045 13.67 5,872 Equity Compensation Plans not

|  |  |  |  |
| --- | --- | --- | --- |
| Approved by Security Holders ÏÏÏÏ | 111,574 | 11.89 | 30,317 |
| Total ÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏ | 141,619 | 12.27 | 36,189 |

\* As adjusted for stock splits.

See Note 13 to the Consolidated Financial Statements for information regarding the material features of the above plans. Each of the above plans provides that the number of shares with respect to which options may be granted, and the number of shares of Common Stock subject to an outstanding option, shall be proportionately adjusted in the event of a subdivision or consolidation of shares or the payment of a stock dividend on Common Stock, and the purchase price per share of outstanding options shall be proportionately revised.

**Item 6. *Selected Financial Data***

The following financial information for the five years ended December 31, 2005, has been derived from the Company's Consolidated Financial Statements. This information should be read in conjunction with the Consolidated Financial Statements and related notes thereto included elsewhere herein.

**Years Ended December 31,**

**2005 2004 2003 2002 2001**

**(In millions, except per share amounts)**

|  |  |  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- | --- | --- |
| **Financial Data:** |  | | | | | | |
| Operating revenues ÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏ | $ 7,584 | $ 6,530 |  | $ 5,937 | $ 5,522 |  | $ 5,555 |
| Operating expensesÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏ | 6,764 | 5,976 |  | 5,454 | 5,105 |  | 4,924 |
| Operating incomeÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏ | 820 | 554 |  | 483 | 417 |  | 631 |
| Other expenses (income) net ÏÏÏÏÏÏ | (54) | 65 |  | (225) | 24 |  | (197) |
| Income before income taxes ÏÏÏÏÏÏÏÏ | 874 | 489 |  | 708 | 393 |  | 828 |
| Provision for income taxes ÏÏÏÏÏÏÏÏÏ | 326 | 176 |  | 266 | 152 |  | 317 |
| Net incomeÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏ | $ 548 | $ 313 |  | $ 442 | $ 241 |  | $ 511 |
| Net income per share, basic ÏÏÏÏÏÏÏÏ | $ .70 | $ .40 |  | $ .56 | $ .31 |  | $ .67 |
| Net income per share, diluted ÏÏÏÏÏÏ | $ .67 | $ .38 |  | $ .54 | $ .30 |  | $ .63 |
| Cash dividends per common share ÏÏÏ | $ .0180 | $ .0180 |  | $ .0180 | $ .0180 |  | $ .0180 |
| Total assets at period-end ÏÏÏÏÏÏÏÏÏ | $ 14,218 | $ 11,337 |  | $ 9,878 | $ 8,954 |  | $ 8,997 |
| Long-term obligations at period-end | $ 1,394 | $ 1,700 |  | $ 1,332 | $ 1,553 |  | $ 1,327 |
| Stockholders' equity at period-end ÏÏÏ | $ 6,675 | $ 5,524 |  | $ 5,052 | $ 4,422 |  | $ 4,014 |
| **Operating Data:** |  |  |  |  |  |  |  |
| Revenue passengers carriedÏÏÏÏÏÏÏÏÏ | 77,693,875 | 70,902,773 | | 65,673,945 | 63,045,988 | | 64,446,773 |
| Enplaned passengers ÏÏÏÏÏÏÏÏÏÏÏÏÏÏ | 88,379,900 | 81,066,038 | | 74,719,340 | 72,462,123 | | 73,628,723 |
| Revenue passenger miles (RPMs) (000s) ÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏ | 60,223,100 | 53,418,353 | | 47,943,066 | 45,391,903 | | 44,493,916 |
| Available seat miles (ASMs) (000s) | 85,172,795 | 76,861,296 | | 71,790,425 | 68,886,546 | | 65,295,290 |
| Load factor(1) ÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏ | 70.7% | 69.5% | | 66.8% | 65.9% | | 68.1% |
| Average length of passenger haul (miles) ÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏ | 775 | 753 | | 730 | 720 | | 690 |
| Average stage length (miles) ÏÏÏÏÏÏÏ | 607 | 576 | | 558 | 537 | | 514 |
| Trips flownÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏ | 1,028,639 | 981,591 | | 949,882 | 947,331 | | 940,426 |
| Average passenger fare ÏÏÏÏÏÏÏÏÏÏÏÏ | $ 93.68 | $ 88.57 | | $ 87.42 | $ 84.72 | | $ 83.46 |
| Passenger revenue yield per RPM ÏÏÏ | 12.09„ | 11.76„ | | 11.97„ | 11.77„ | | 12.09„ |
| Operating revenue yield per ASM ÏÏÏ | 8.90„ | 8.50„ | | 8.27„ | 8.02„ | | 8.51„ |
| Operating expenses per ASMÏÏÏÏÏÏÏ | 7.94„ | 7.77„ | | 7.60„ | 7.41„ | | 7.54„ |
| Operating expenses per ASM, excluding fuel ÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏ | 6.37„ | 6.47„ | | 6.44„ | 6.30„ | | 6.36„ |
| Fuel cost per gallon (average) ÏÏÏÏÏÏ | $ 1.03 | $ .83 | | $ .72 | $ .68 | | $ .71 |
| Number of Employees at year-end ÏÏÏ | 31,729 | 31,011 | | 32,847 | 33,705 | | 31,580 |
| Size of fleet at year-end(2) ÏÏÏÏÏÏÏÏ | 445 | 417 | | 388 | 375 | | 355 |

1. Revenue passenger miles divided by available seat miles.
2. Includes leased aircraft.

**Item 7. *Management's Discussion and Analysis of*** Although the Company's fuel hedge in place for ***Financial Condition and Results of*** 2006 is not as strong as that in 2005, absent a ***Operations*** significant decrease from the current level of market energy prices the Company will continue to have a

**Year in Review** considerable competitive advantage compared to airlines

In 2005, Southwest posted a profit for its 33rd consecutive year, and also extended its number of consecutive profitable quarters to 59. Southwest's 2005 profit was $548 million, representing a 75.1% increase compared to our 2004 profit of $313 million. This performance was driven primarily by strong revenue growth, as the Company grew capacity, and effective cost control measures, including a successful fuel hedge program. For the fifth consecutive year, the airline industry as a whole is expected to suffer a substantial net loss, as additional carriers filed for bankruptcy protec- tion and many underwent or continued massive efforts to restructure or merge their businesses, gain wage concessions from their employees, and slash costs.

The revenue environment in the airline industry strengthened considerably throughout 2005. As a result of the extensive restructuring in the domestic airline industry in 2004 and 2005, several carriers reduced domestic capacity. Industry capacity reductions and strong demand resulted in high load factors for many airlines. In fact, Southwest set new monthly load-factor records for four separate months during 2005, and recorded a Company-record load factor of 70.7 percent for the full year. The Company was also able to modestly raise its fares over the course of the year, resulting in an increase in passenger revenue yield per RPM (passenger revenues divided by revenue passenger miles) of 2.8 percent compared to 2004. Unit revenue (total revenue divided by ASMs) also increased a healthy 4.7 percent compared to 2004 levels, as a result of the higher load factors and higher RPM yields.

that have not hedged fuel. The Company hopes to overcome the impact of higher anticipated 2006 fuel prices through improved revenue management and con- trol of non-fuel costs. As a result of cost-control efforts instituted over the past 3 years, the Company was able to produce a reduction in non-fuel unit costs (cost per ASM) of 1.5 percent in 2005 compared to 2004. The Company's Employees again increased their productiv- ity and improved the overall efficiency of the Company's operations. The Company's headcount per aircraft de- creased from 74 at December 31, 2004, to 71 at December 31, 2005. Furthermore, since the end of 2003, the Company's headcount per aircraft has de- creased 16.5 percent.

The Company moves forward into 2006 with a focused and measured growth plan. The Company's low-cost competitive advantage, protective fuel hedging position, and excellent Employees will allow Southwest to continue to react quickly to market opportunities. The Company added Pittsburgh, Pennsylvania, and Fort Myers, Florida, to its route system in 2005, and continued to grow its Chicago Midway service. The Company has increased its capacity at Chicago Midway Airport nearly 60 percent since third quarter 2004 and plans to continue to add service to this market. The Company began service to Denver, Colorado, in January 2006, and has already announced plans to add service and destinations in March 2006. Denver represents the 62nd city to which the Company flies.

In December 2005, we completed a transaction with ATA Airlines, Inc. (ATA), as a part of ATA's

The Company once again benefited from a strong bankruptcy proceedings, acquiring the leasehold rights fuel hedge and an intense focus on controlling non-fuel to four additional gates at Chicago Midway in exchange costs. As reflected in the Consolidated Statement of for a $20 million reduction in our outstanding Income, the Company's fuel hedging program resulted debtor-in-possession loan. The codeshare agreement in a reduction to ""Fuel and oil expense'' during 2005 of with ATA was recently expanded to include ATA

$892 million. The Company's hedge program also flights from DFW International Airport to Chicago resulted in earnings variability throughout 2005, prima- Midway. The Company also recently announced an rily due to unrealized gains and losses relating to fuel additional codeshare expansion to include connecting contracts settling in future periods, recorded in accor- service through Houston Hobby and Oakland, begin- dance with Statement of Financial Accounting Standard ning April 2006. Based on current codeshare markets,

133 (SFAS 133), *Accounting for Derivative Instru-* first quarter 2006 codeshare revenue is estimated to be *ments and Hedging Activities,* as amended. For 2005, in the $10 million range. See Note 3 to the Consoli- these amounts total a net gain of $110 million, and are dated Financial Statements for further information on reflected in ""Other (gains) losses, net,'' in the Consoli- the Company's relationship and recent transactions with dated Statement of Income. ATA.

During 2005, the Company added 33 new 737- 70.7 percent load factor for 2005 represented the 700 aircraft to its fleet and retired its remaining five highest annual load factor in the Company's history. 737-200 aircraft, resulting in a net available seat mile

(ASM) capacity increase of 10.8 percent. This brought The Company continues to be encouraged by the the Company's all-737 fleet to 445 aircraft at the end of airline revenue environment. Although the Company 2005. ASM capacity currently is expected to grow significantly downsized its New Orleans operations fol- approximately 8 percent in 2006 with the planned lowing Hurricane Katrina during third quarter 2005, addition of 33 new Boeing 737-700 aircraft. some of those flights have been added back as demand

has increased to that city. In addition, because of strong

**Results of Operations** industry demand, the Company was able to quickly re-

### *2005 Compared With 2004*

deploy available aircraft from the New Orleans reduc- tion in service to meet service needs in other cities

The Company's consolidated net income for 2005 within the Company's network. The outlook for first was $548 million ($.67 per share, diluted), as com- quarter 2006 is favorable as the Company continues to pared to 2004 net income of $313 million ($.38 per enjoy strong revenue momentum and benefit from re- share, diluted), an increase of $235 million or 75.1 per- ductions in competitive capacity. Based on current cent. Operating income for 2005 was $820 million, an traffic and revenue trends, the Company expects its increase of $266 million, or 48.0 percent, compared to January load factor and unit revenues to exceed January 2004. The increase in operating income primarily was 2005 levels. While bookings for February and March are due to higher revenues from the Company's fleet excellent, the shift in timing of the Easter holiday into growth, improved load factors, and higher fares, which April during 2006 versus March of 2005 will impact more than offset a significant increase in the cost of jet first quarter 2006 year-over-year trends. As a result, our fuel. The larger percentage increase in net income first quarter 2006 unit revenue growth may not match compared to operating income primarily was due to fourth quarter 2005's superb growth rate of variability in Other (gains) losses, net, due to unreal- 11.7 percent.

ized 2005 gains resulting from the Company's fuel

hedging activities, in accordance with SFAS 133. Consolidated freight revenues increased $16 mil- *Operating Revenues.* Consolidated operating rev- lion, or 13.7 percent. Approximately 65 percent of the enues increased $1.1 billion, or 16.1 percent, primarily increase was due to an increase in freight and cargo due to a $1.0 billion, or 15.9 percent, increase in revenues, primarily due to higher rates charged on passenger revenues. The increase in passenger revenues shipments. The remaining 35 percent of the increase primarily was due to an increase in capacity, an increase was due to higher mail revenues. The U.S. Postal in RPM yield, and an increase in load factor. Holding Service periodically reallocates the amount of mail busi- other factors constant (such as yields and load factor), ness given to commercial and freight air carriers and, almost 70 percent of the increase in passenger revenue during 2005, shifted more business to commercial carri- was due to the Company's 10.8 percent increase in ers. Other revenues increased $39 million, or 29.3 per- available seat miles compared to 2004. The Company cent, compared to 2004. Approximately 35 percent of increased available seat miles as a result of the net the increase was from commissions earned from pro- addition of 28 aircraft (33 new 737-700 aircraft net of grams the Company sponsors with certain business five 737-200 aircraft retirements). Approximately partners, such as the Company sponsored Chase» Visa 18 percent of the increase in passenger revenue was due card. An additional 35 percent of the increase was due to the 2.8 percent increase in passenger yields. Average to an increase in excess baggage charges, as the Com- passenger fares increased 5.8 percent compared to 2004, pany modified its fee policy related to the weight of primarily due to lower fare discounting because of the checked baggage during second quarter 2005. Among strong demand for air travel coupled with the availability other changes, the limit at which baggage charges apply of fewer seats from industrywide domestic capacity was reduced to 50 pounds per checked bag. The reductions. The remainder of the passenger revenue Company expects continued year-over-year increases in increase primarily was due to the 1.2 point increase in both freight and other revenues in first quarter 2006,

the Company's load factor compared to 2004. The although at lower rates than experienced in 2005.

*Operating Expenses.* Consolidated operating expenses for 2005 increased $788 million, or 13.2 percent, compared to the 10.8 percent increase in capacity. To a large extent, changes in operating expenses for airlines are driven by changes in capacity, or ASMs. The following presents Southwest's operating expenses per ASM for 2005 and 2004 followed by explanations of these changes on a per-ASM basis:

|  |  |  |  |  |
| --- | --- | --- | --- | --- |
| Salaries, wages, and benefits ÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏ | **2005**  **3.17**„ | **2004**  3.18„ | **Increase**  **(Decrease)**  (.01)„ | **Percent**  **Change**  (.3)% |
| Fuel and oil ÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏ | **1.57** | 1.30 | .27 | 20.8 |
| Maintenance materials and repairsÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏ | **.51** | .59 | (.08) | (13.6) |
| Aircraft rentalsÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏ | **.19** | .23 | (.04) | (17.4) |
| Landing fees and other rentals ÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏ | **.53** | .53 | Ì | Ì |
| Depreciation and amortizationÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏ | **.55** | .56 | (.01) | (1.8) |
| Other ÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏ | **1.42** | 1.38 | .04 | 2.9 |
| Total ÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏ | **7.94**„ | 7.77„ | .17„ | 2.2% |

Operating expenses per ASM increased 2.2 percent quarter 2006 salaries, wages, and benefits to experience to 7.94 cents, primarily due to an increase in jet fuel an increase in expense of approximately $20 million that prices, net of hedging gains. The Company was able to was not present in first quarter 2005, due to the Com- hold flat or reduce unit costs in every cost category, pany's previous method of accounting under SFAS 123. except fuel expense and other operating expense, Based on stock options issued to Employees prior to through a variety of cost reduction and productivity January 1, 2006, for the full year 2006, the Company efforts. These efforts, however, were entirely offset by expects salaries, wages, and benefits to experience an the significant increase in the cost of fuel. Excluding expense increase of approximately $65 million due to the fuel, CASM was 1.5 percent lower than 2004, at 6.37 adoption of SFAS 123R. See Note 2 to the Consolidated cents. For first quarter 2006, the Company currently Financial Statements for more information on the 2006 expects operating expenses per ASM, excluding fuel, to adoption of SFAS 123R.

exceed the first quarter 2005 level of 6.32 cents, but

improve from fourth quarter 2005's 6.57 cents. A portion of the expected year-over-year increase com- pared to first quarter 2005 will be attributable to the Company's January 1, 2006, adoption of SFAS 123R, *Share-Based Payment* (SFAS 123R).

The Company's Pilots are subject to an agreement

with the Southwest Airlines Pilots' Association, which becomes amendable during September 2006. The Com- pany's Customer Service and Reservations Agents are subject to an agreement with the International Associa- tion of Machinists and Aerospace Workers (""IAM''),

Salaries, wages, and benefits expense per ASM which becomes amendable during November 2008, but decreased .3 percent compared to 2004, primarily due which may become amendable during 2006 at the to productivity efforts that have enabled the Company IAM's option, under certain conditions. The Com- to grow overall headcount at a rate that is less than the pany's Ramp, Operations, and Provisioning and Freight growth in ASMs. This decrease was partially offset by Agents are subject to an agreement with the Transpor- higher average wage rates, and higher profitsharing tation Workers of America, AFL-CIO (""TWU''), expense associated with the Company's higher earnings. which becomes amendable during November 2008, but

which may become amendable during 2006 at the On January 1, 2006, the Company will be required TWU's option, under certain conditions. The Company

to adopt SFAS 123R, which, among other things, will is currently unable to predict whether its contracts with require the recording in the financial statements of non- the IAM and TWU will become amendable during cash compensation expense related to stock options. Prior 2006.

to 2006, the Company had only shown, as permitted by

SFAS 123, pro forma financial results including the Fuel and oil expense per ASM increased 20.8 per- effects of share-based compensation expense in the foot- cent, primarily due to a 24.8 percent increase in the notes to the financial statements. See Note 1 to the average jet fuel cost per gallon, net of hedging gains. Consolidated Financial Statements for these pro forma The average cost per gallon of jet fuel in 2005 was results related to years 2005, 2004, and 2003. As a result $1.03 compared to 82.8 cents in 2004, excluding fuel- of this accounting change, the Company expects its first related taxes and net of hedging gains. The Company's

2005 and 2004 average jet fuel costs are net of approxi- 2006 capacity increases and current aircraft financing mately $892 million and $455 million in gains from plans, the Company expects a year-over-year decline in hedging activities, respectively. See Note 10 to the aircraft rental expense per ASM in first quarter 2006 Consolidated Financial Statements. The increase in fuel versus first quarter 2005.

prices was partially offset by steps the Company has

taken to improve the fuel efficiency of its aircraft. These steps primarily included the addition of blended wing- lets to all of the Company's 737-700 aircraft, and the upgrade of certain engine components on many aircraft. The Company estimates that these and other efficiency gains saved the Company approximately $70 million during 2005, at average unhedged market jet fuel prices.

Depreciation expense per ASM decreased 1.8 per-

cent. An increase in depreciation expense per ASM from 33 new 737-700 aircraft purchased during 2005 and the higher percentage of owned aircraft, was more than offset by lower expense associated with the Com- pany's retirement of its 737-200 fleet and all 737-200 remaining spare parts by the end of January 2005. Based on the Company's scheduled 2006 aircraft purchase

As detailed in Note 10 to the Consolidated Finan- commitments and capital expenditure plans, the Com- cial Statements, the Company has hedges in place for pany expects first quarter 2006 depreciation expense per over 70 percent of its anticipated fuel consumption in ASM to be slightly above the first quarter 2005 level of 2006 with a combination of derivative instruments that 55 cents per ASM.

effectively cap prices at average crude oil equivalent

price of approximately $36 per barrel, and has hedged the refinery margins on the majority of those positions. Considering current market prices, the Company is forecasting a significant increase compared to the Com- pany's first quarter 2005 average fuel price per gallon of

90.3 cents, primarily because the Company's hedge position is not as strong and market jet fuel prices are currently higher in 2006. The Company has a lower percentage of its fuel hedged, and the hedges in place are at higher average crude oil-equivalent prices. The majority of the Company's near term hedge positions are in the form of option contracts, which protect the Company in the event of rising jet fuel prices and allow the Company to benefit in the event of declining prices.

Other operating expenses per ASM increased

2.9 percent compared to 2004. Approximately 75 per- cent of the increase relates to higher 2005 security fees in the form of a $24 million retroactive assessment the Company received from the Transportation Security Administration in January 2006. The Company intends to vigorously contest this assessment; however, if it is unsuccessful in reversing or modifying it, 2006 security fees will be at similar levels. The remainder of the increase primarily related to higher fuel taxes as a result of the substantial increase in fuel prices compared to 2004. Based on current market jet fuel prices and expected higher security fees in 2006, the Company presently expects an increase in Other operating ex- penses per ASM in first quarter compared to the same

Maintenance materials and repairs per ASM de- 2005 period.

creased 13.6 percent compared to 2004, primarily due

to a decrease in repair events for aircraft engines. Currently, the Company expects a decrease in mainte- nance materials and repairs expense per ASM in first quarter 2006, versus first quarter 2005, due to a de- crease in the number of scheduled maintenance events. Also, see Note 2 to the Consolidated Financial State- ments for discussion of a first quarter 2006 change in the Company's accounting for heavy maintenance on its 737-300 and 737-500 aircraft.

*Other.* ""Other expenses (income)'' included in-

terest expense, capitalized interest, interest income, and other gains and losses. Interest expense increased by

$34 million, or 38.6 percent, primarily due to an increase in floating interest rates. The majority of the Company's long-term debt is at floating rates. Exclud- ing the effect of any new debt offerings the Company may execute during 2006, the Company expects an increase in interest expense compared to 2005, due to higher expected floating interest rates, partially offset by

Aircraft rentals per ASM decreased 17.4 percent. the borrowings due to be repaid in 2006 on their Of the 33 aircraft the Company acquired during 2005, redemption dates. See Note 10 to the Consolidated all are owned. In addition, during 2005, the Company Financial Statements for more information. Capitalized renegotiated the leases on four aircraft, and, as a result, interest was flat compared to 2004 as lower 2005 reclassified these aircraft from operating leases to capital progress payment balances for scheduled future aircraft leases. These transactions have increased the Company's deliveries were offset by higher interest rates. Interest percentage of aircraft owned or on capital lease to income increased $26 million, or 123.8 percent, prima- 81 percent at December 31, 2005, from 79 percent at rily due to an increase in rates earned on cash and December 31, 2004. Based on the Company's scheduled investments. ""Other (gains) losses, net'' primarily in-

cludes amounts recorded in accordance with SFAS 133. *Income Taxes.* The provision for income taxes, as See Note 10 to the Consolidated Financial Statements a percentage of income before taxes, increased to for more information on the Company's hedging activi- 37.29 percent in 2005 from 35.94 percent in 2004. ties. During 2005, the Company recognized approxi- The 2004 rate was favorably impacted by an adjustment mately $35 million of expense related to amounts related to the ultimate resolution of an airline industry- excluded from the Company's measurements of hedge wide issue regarding the tax treatment of certain aircraft effectiveness. Also during 2005, the Company recog- engine maintenance costs, and lower state income taxes. nized approximately $110 million of additional income Although the Company expects its 2006 effective tax in ""Other (gains) losses, net,'' related to the ineffec- rate to be in the 38 percent range, the adoption of tiveness of its hedges and the loss of hedge accounting SFAS 123R will make it more difficult to forecast future for certain hedges. Of this additional income, approxi- rates, due to the difference in treatment of certain types mately $77 million was unrealized, mark-to-market of stock options for tax purposes. See Note 2 to the changes in the fair value of derivatives due to the Consolidated Financial Statements for further discontinuation of hedge accounting for certain con- information.

tracts that will settle in future periods, approximately

$9 million was unrealized ineffectiveness associated with

hedges designated for future periods, and $24 million ***2004 Compared With 2003***

was ineffectiveness and mark-to-market gains related to

contracts that settled during 2005. For 2004, the Com- The Company's consolidated net income for 2004 pany recognized approximately $24 million of expense was $313 million ($.38 per share, diluted), as com- related to amounts excluded from the Company's mea- pared to 2003 net income of $442 million ($.54 per surements of hedge effectiveness and $13 million in share, diluted), a decrease of $129 million or 29.2 per- expense related to the ineffectiveness of its hedges and cent. Operating income for 2004 was $554 million, an unrealized mark-to-market changes in the fair value of increase of $71 million, or 14.7 percent compared to certain derivative contracts. 2003.

As disclosed in Note 17 to the Consolidated Financial Statements, results for 2003 included $271 million as ""Other gains'' from the Emergency Wartime Supplemental Appropriations Act (Wartime Act). The Company believes that excluding the impact of this special item enhances comparative analysis of results. The grant was made to stabilize and support the airline industry as a result of the 2003 war with Iraq. Financial results including the grant were not indicative of the Company's operating performance for 2003, nor should they be considered in developing trend analysis for future periods. There were no special items in 2004. The following table reconciles and compares results reported in accordance with Generally Accepted Accounting Principles (GAAP) for 2004 and 2003 with results excluding the impact of the government grant received in 2003:

**2004 2003**

**(In millions, except per share and per ASM amounts)**

|  |  |  |
| --- | --- | --- |
| Operating expenses, as reported ÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏ | **$5,976** | $5,454 |
| Profitsharing impact of government grant ÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏ | Ì | (40) |
| Operating expenses, excluding grant impact ÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏ | **$5,976** | $5,414 |
| Operating expenses per ASM, as reported ÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏ | **$.0777** | $.0760 |
| Profitsharing impact of government grant ÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏ | Ì | (.0006) |
| Operating expenses per ASM, excluding grant impact ÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏ | **$.0777** | $.0754 |
| Operating income, as reported ÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏ | **$ 554** | $ 483 |
| Profitsharing impact of government grant ÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏ | Ì | 40 |
| Operating income, excluding impact of government grants ÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏ | **$ 554** | $ 523 |
| Net income, as reported ÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏ | **$ 313** | $ 442 |
| Government grant, net of income taxes and profitsharing ÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏ | Ì | (144) |
| Net income, excluding government grants ÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏ | **$ 313** | $ 298 |
| Net income per share, diluted, as reported ÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏ | **$ .38** | $ .54 |
| Government grant, net of income taxes and profitsharing ÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏ | Ì | (.18) |
| Net income per share, diluted, excluding government grantsÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏ | **$ .38** | $ .36 |
| Excluding the government grant received, consoli- The Company increased | ASMs by | 7.1 percent |
| dated net income for 2004 increased $15 million, or compared to 2003, primarily | as a result | of the net |

5.0 percent, compared to 2003 net income of $298 mil- addition of 29 aircraft during 2004 (47 new aircraft, lion. The increase primarily was due to higher revenues net of 18 aircraft retirements). The Company's load from the Company's fleet growth and addition of capac- factor for 2004 (RPMs divided by ASMs) was ity, which slightly exceeded higher costs. Excluding the 69.5 percent, compared to 66.8 percent for 2003. impact of the 2003 government grant, 2004 operating Although this represented a strong load factor perform- income increased $31 million, or 5.9 percent, compared ance for the Company, passenger yields for 2004 (pas- to 2003. senger revenue divided by RPMs) remained under

*Operating Revenues.* Consolidated operating rev- enues increased $593 million, or 10.0 percent, primarily due to a $539 million, or 9.4 percent, increase in passenger revenues. The increase in passenger revenues primarily was due to an 11.4 percent increase in RPMs flown, driven by the Company's growth and a 2.7 point

considerable pressure due to significant capacity in- creases by a large majority of carriers. Passenger yields for 2004 declined to $.1176, compared to $.1197 in 2003, a decrease of 1.8 percent, because of heavy fare discounting arising as a result of the glut in industry seats available.

increase in the Company's load factor compared to Consolidated freight revenues increased $23 mil- 2003. lion, or 24.5 percent. Approximately 70 percent of the increase was due to an increase in freight and cargo

revenues, primarily due to more units shipped. The

remaining 30 percent of the increase was due to higher an increase in commissions earned from programs the mail revenues, as the U.S. Postal Service shifted more Company sponsors with certain business partners, such business to commercial carriers. Other revenues in- as the Company-sponsored Chase» Visa card.

creased $31 million, or 30.4 percent, primarily due to

*Operating Expenses.* Consolidated operating expenses for 2004 increased $522 million, or 9.6 percent, compared to the 7.1 percent increase in capacity. To a large extent, changes in operating expenses for airlines are driven by changes in capacity, or ASMs. The following presents Southwest's operating expenses per ASM for 2004 and 2003 followed by explanations of these changes on a per-ASM basis:

|  |  |  |  |  |
| --- | --- | --- | --- | --- |
| Salaries, wages, and benefits ÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏ | **2004**  **3.18**„ | **2003**  3.10„ | **Increase**  **(Decrease)**  .08„ | **Percent**  **Change**  2.6% |
| Fuel and oil ÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏ | **1.30** | 1.16 | .14 | 12.1 |
| Maintenance materials and repairsÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏ | **.59** | .60 | (.01) | (1.7) |
| Aircraft rentalsÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏ | **.23** | .25 | (.02) | (8.0) |
| Landing fees and other rentals ÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏ | **.53** | .52 | .01 | 1.9 |
| Depreciation and amortizationÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏ | **.56** | .53 | .03 | 5.7 |
| Other ÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏ | **1.38** | 1.44 | (.06) | (4.2) |
| Total ÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏ | **7.77**„ | 7.60„ | .17„ | 2.2% |

Operating expenses per ASM increased 2.2 percent ment, which is for the period from June 1, 2002, to to $.0777, primarily due to an increase in jet fuel prices, May 31, 2008.

net of hedging gains, and an increase in salaries, wages,

and benefits. These increases were partially offset by the Company's elimination of commissions paid to travel agents, which was effective December 15, 2003.

During third quarter 2004, the Company and the

Aircraft Mechanics Fraternal Association, representing the Company's Mechanics, agreed to extend the date the current agreement becomes amendable to August

Salaries, wages, and benefits expense per ASM 2008. The extension included both pay raises and the increased 2.6 percent, inclusive of $40 million in addi- issuance of stock options, and was ratified by a majority tional expense from the profitsharing impact of the of the Company's Mechanics.

2003 government grant. Excluding the profitsharing

impact of the 2003 government grant, approximately 70 percent of the increase per ASM was due to higher salaries expense, primarily from higher average wage rates, and 25 percent was due to higher benefits costs, primarily health care and workers' compensation. For fourth quarter 2004 versus 2003, salaries, wages, and benefits per ASM decreased 1.0 percent, as the Com- pany benefited from increased labor productivity. This

During third quarter 2004, the Company and the

International Brotherhood of Teamsters, representing the Company's Flight Simulator Technicians, agreed to extend the date the current agreement becomes amend- able to November 2011. The extension included both pay raises and the issuance of stock options, and was ratified by a majority of the Company's Simulator Technicians.

increase in productivity was driven primarily by Fuel and oil expense per ASM increased 12.1 per- headcount reductions from the Company's reservations cent, primarily due to a 14.5 percent increase in the center consolidation and early-out program during average jet fuel cost per gallon, net of hedging gains. 2004, and reduced hiring. See Note 9 to the Consoli- The average cost per gallon of jet fuel in 2004 was 82.8 dated Financial Statements. cents compared to 72.3 cents in 2003, excluding fuel-

During second quarter 2004, the Company and the Transport Workers Union Local 556 reached a tentative labor agreement for the Company's Flight Attendants, which included both pay increases and the issuance of stock options. During July 2004, a majority of the Company's Flight Attendants ratified the labor agree-

related taxes but including the effects of hedging activi- ties. The Company's 2004 and 2003 average jet fuel costs are net of approximately $455 million and

$171 million in gains from hedging activities, respec- tively. See Note 10 to the Consolidated Financial State- ments. The increase in fuel prices was partially offset by steps the Company took to improve the fuel efficiency of its aircraft. These steps primarily included the addi-

tion of blended winglets to 177 of the Company's 737- to the Wartime Act. See Note 17 to the Consolidated 700 aircraft as of December 31, 2004, and the upgrade Financial Statements for further discussion of the grant. of certain engine components on many aircraft. The Other losses in 2004 primarily include amounts re- Company estimates that these and other efficiency gains corded in accordance with SFAS 133. See Note 10 to saved the Company approximately $28 million in 2004, the Consolidated Financial Statements for more infor- at average unhedged market jet fuel prices. mation on the Company's hedging activities. During

Aircraft rentals per ASM and depreciation and amortization expense per ASM were both impacted by a higher percentage of the aircraft fleet being owned. Aircraft rentals per ASM decreased 8.0 percent while depreciation and amortization expense per ASM in- creased 5.7 percent. Of the 47 aircraft the Company

2004, the Company recognized approximately $24 mil- lion of expense related to amounts excluded from the Company's measurements of hedge effectiveness and

$13 million in expense related to the ineffectiveness of its hedges and unrealized mark-to-market changes in the fair value of certain derivative contracts.

acquired during 2004, 46 are owned and one is on *Income Taxes.* The provision for income taxes, as operating lease. This, along with the retirement of 16 a percentage of income before taxes, decreased to owned and two leased aircraft, increased the Company's 35.94 percent in 2004 from 37.60 percent in 2003. percentage of aircraft owned or on capital lease to Approximately half of the rate reduction was due to 79 percent at December 31, 2004, from 77 percent at lower effective state income tax rates. The remainder of December 31, 2003. the decrease primarily was due to a favorable adjustment

Landing fees and other rentals per ASM increased

1.9 percent primarily due to the Company's expansion of gate and counter space at several airports across our system.

Other operating expenses per ASM decreased

4.2 percent compared to 2003 primarily due to the elimination of commissions paid to travel agents, effec- tive December 15, 2003. In addition to this change, an increase in expense from higher fuel taxes as a result of the substantial increase in fuel prices was mostly offset by lower advertising expense.

related to the ultimate resolution of an industry-wide issue regarding the tax treatment of certain aircraft engine maintenance costs.

## Liquidity and Capital Resources

Net cash provided by operating activities was

$2.2 billion in 2005 compared to $1.2 billion in 2004. For the Company, operating cash inflows primarily are derived from providing air transportation for Customers. The vast majority of tickets are purchased prior to the day on which travel is provided and, in some cases, several months before the anticipated travel date. Oper-

*Other.* ""Other expenses (income)'' included in- ating cash outflows primarily are related to the recurring terest expense, capitalized interest, interest income, and expenses of operating the airline. For 2005, the increase other gains and losses. Interest expense decreased by in operating cash flows primarily was due to an increase

$3 million, or 3.3 percent, primarily due to the Com- in ""Accounts payable and accrued liabilities'' and pany's October 2003 redemption of $100 million of higher net income in 2005 versus 2004. There was a senior unsecured 83/4% Notes originally issued in 1991. $1.0 billion increase in accrued liabilities, primarily This decrease was partially offset by the Company's related to a $620 million increase in counterparty September 2004 issuance of $350 million 5.25% senior deposits associated with the Company's fuel hedging unsecured notes and the fourth quarter 2004 issuance of program. For further information on the Company's

$112 million in floating-rate financing. Concurrently hedging program and counterparty deposits, see with the September 2004 issuance, the Company en- Note 10 to the Consolidated Financial Statements, and tered into an interest-rate swap agreement to convert Item 7A. Qualitative and Quantitative Disclosures about this fixed-rate debt to floating rate. See Note 10 to the Market Risk, respectively. Cash generated in 2005 and Consolidated Financial Statements for more information in 2004 primarily was used to finance aircraft-related on the interest-rate swap agreement. Capitalized inter- capital expenditures and to provide working capital. est increased $6 million, or 18.2 percent, primarily as a

result of higher 2004 progress payment balances for Cash flows used in investing activities in 2005 scheduled future aircraft deliveries, compared to 2003. totaled $1.2 billion compared to $1.7 billion in 2004. Interest income decreased $3 million, or 12.5 percent, Investing activities in both years primarily consisted of primarily due to a decrease in average invested cash payments for new 737-700 aircraft delivered to the balances. Other gains in 2003 primarily resulted from Company and progress payments for future aircraft the government grant of $271 million received pursuant deliveries. The Company purchased 33 new 737-700

aircraft in 2005 versus the purchase of 46 new 737-700s public debt securities and pass through certificates, in 2004. In addition, progress payments for future which it may utilize for aircraft financings or other deliveries were higher in 2004 than 2005. See Note 4 to purposes in the future. The Company may issue a the Consolidated Financial Statements. Investing activi- portion of these securities in 2006, primarily to replace ties for 2004 were also reduced $124 million by a debt that is coming due and to fund current fleet growth change in the balance of the Company's short-term plans.

investments, namely auction rate securities. Also, 2005

and 2004 included payments of $6 million and $34 mil-

lion, respectively, for certain ATA assets. See Note 3 to the Consolidated Financial Statements for further infor- mation on the Company's transaction with ATA.

## Off-Balance Sheet Arrangements, Contractual Obli-

**gations, and Contingent Liabilities and Commitments**

Net cash provided by financing activities was Southwest has contractual obligations and commit-

$213 million in 2005, primarily from the issuance of ments primarily with regard to future purchases of

$300 million senior unsecured 5.125% notes in Febru- aircraft, payment of debt, and lease arrangements. ary 2005, net of the redemption of the Company's Along with the receipt of 33 new 737-700 aircraft in

$100 million senior unsecured 8% notes in March 2005, the Company has exercised its remaining options 2005. During 2005, the Company also received pro- for aircraft to be delivered in 2006, and some of its ceeds of $132 million from Employee exercises of stock options for aircraft to be delivered in 2007. As of options under its stock plans and repurchased $55 mil- January 2006, the Company had firm orders for 33 lion of its common stock. In 2004, net cash provided by 737-700 aircraft in 2006, 29 in 2007, and six in 2008. financing activities was $133 million, primarily from the The Company also had options for seven 737-700 issuance of $520 million in long-term debt. The major- aircraft in 2007, 25 in 2008, and an additional 217 ity of the debt issuance was the $350 million senior purchase rights for 737-700 aircraft for the years 2007 unsecured notes issued in September 2004, and the through 2012. The Company has the option to substi- fourth quarter 2004 issuance of $112 million in float- tute 737-600s or -800s for the -700s. This option is ing-rate financing. The largest 2004 cash outflows in applicable to aircraft ordered from the manufacturer and financing activities were from the Company's repur- must be exercised two years prior to the contractual chase of $246 million of its common stock during 2004, delivery date.

and the redemption of long-term debt, primarily the

$175 million Aircraft Secured Notes that came due in The Company has engaged in off-balance sheet November 2004. See Note 7 to the Consolidated Finan- arrangements in the leasing of aircraft. The leasing of cial Statements for more information on the issuance aircraft provides flexibility to the Company effectively as and redemption of long-term debt. a source of financing. Although the Company is respon-

The Company has various options available to meet its 2006 capital and operating commitments, including cash on hand and short-term investments at December 31, 2005, of $2.5 billion, internally gener- ated funds, and a $600 million bank revolving line of credit. In addition, the Company will also consider various borrowing or leasing options to maximize earn- ings and supplement cash requirements. The Company believes it has access to a wide variety of financing arrangements because of its excellent credit ratings, unencumbered assets, modest leverage, and consistent profitability.

sible for all maintenance, insurance, and expense associ- ated with operating the aircraft, and retains the risk of loss for leased aircraft, it has not made any guarantees to the lessors regarding the residual value (or market value) of the aircraft at the end of the lease terms.

As shown in Item 2., and as disclosed in Note 8 to the Consolidated Financial Statements, the Company operates 93 aircraft leased from third parties, of which 84 are operating leases. As prescribed by GAAP, assets and obligations under operating leases are not included in the Company's Consolidated Balance Sheet. Disclo- sure of the contractual obligations associated with the

The Company currently has outstanding shelf re- Company's leased aircraft are included below as well as gistrations for the issuance of up to $1.3 billion in in Note 8 to the Consolidated Financial Statements.

The following table aggregates the Company's material expected contractual obligations and commitments as of December 31, 2005:

**Obligations by Period**

**Beyond**

**Contractual Obligations 2006 2007-2008 2009-2010 2010 Total**

**(In millions)**

|  |  |  |  |  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- | --- | --- | --- | --- |
| Long-term debt(1) ÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏ | $ 596 |  | $ 123 |  | $ 28 |  | $1,222 |  | $1,969 |
| Interest commitments(2) ÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏ | 37 |  | 51 |  | 45 |  | 214 |  | 347 |
| Capital lease commitments(3) ÏÏÏÏÏÏÏÏÏÏÏÏÏÏ | 16 |  | 32 |  | 31 |  | 12 |  | 91 |
| Operating lease commitments ÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏ | 332 |  | 583 |  | 454 |  | 1,164 |  | 2,533 |
| Aircraft purchase commitments(4)ÏÏÏÏÏÏÏÏÏÏÏ | 740 |  | 538 |  | Ì |  | Ì |  | 1,278 |
| Other purchase commitments ÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏ | 44 |  | 26 |  | 24 |  | 11 |  | 105 |
| Total contractual obligations ÏÏÏÏÏÏÏÏÏÏÏÏÏÏ | $1,765 |  | $1,353 |  | $582 |  | $2,623 |  | $6,323 |

1. Includes current maturities, but excludes amounts associated with interest rate swap agreements
2. Related to fixed-rate debt
3. Includes amounts classified as interest
4. Firm orders from the manufacturer

The Company may issue a portion of its $1.3 bil- Financial Statements. The preparation of financial state- lion in outstanding shelf registrations as public debt ments in accordance with GAAP requires the Com- securities during 2006. pany's management to make estimates and assumptions

There were no outstanding borrowings under the revolving credit facility at December 31, 2005. See Note 6 to the Consolidated Financial Statements for more information on the Company's revolving credit facility.

In January 2004, the Company's Board of Direc- tors authorized the repurchase of up to $300 million of the Company's common stock, utilizing present and anticipated proceeds from the exercise of Employee stock options. Repurchases were made in accordance with applicable securities laws in the open market or in private transactions from time to time, depending on market conditions. This program was completed during

that affect the amounts reported in the Consolidated Financial Statements and accompanying footnotes. The Company's estimates and assumptions are based on historical experience and changes in the business envi- ronment. However, actual results may differ from esti- mates under different conditions, sometimes materially. Critical accounting policies and estimates are defined as those that are both most important to the portrayal of the Company's financial condition and results and re- quire management's most subjective judgments. The Company's most critical accounting policies and esti- mates are described below.

### *Revenue Recognition*

first quarter 2005, resulting in the total repurchase of As described in Note 1 to the Consolidated Finan- approximately 20.9 million of its common shares. cial Statements, tickets sold for passenger air travel are

In January 2006, the Company's Board of Direc- tors authorized the repurchase of up to $300 million of the Company's common stock. Repurchases will be made in accordance with applicable securities laws in the open market or in private transactions from time to time, depending on market conditions.

## Critical Accounting Policies and Estimates

initially deferred as ""Air traffic liability.'' Passenger revenue is recognized and air traffic liability is reduced when the service is provided (i.e., when the flight takes place). ""Air traffic liability'' represents tickets sold for future travel dates and estimated future refunds and exchanges of tickets sold for past travel dates. The balance in ""Air traffic liability'' fluctuates throughout the year based on seasonal travel patterns and fare sale activity. The Company's ""Air traffic liability'' balance

The Company's Consolidated Financial State- at December 31, 2005 was $649 million, compared to ments have been prepared in accordance with United $529 million as of December 31, 2004.

States GAAP. The Company's significant accounting

policies are described in Note 1 to the Consolidated

Estimating the amount of tickets that will be tual historical experience and other data available at the refunded, exchanged, or forfeited involves some level of time estimates were made.

subjectivity and judgment. The majority of the Com-

pany's tickets sold are nonrefundable, which is the ***Accounting for Long-Lived Assets***

primary source of forfeited tickets. According to the

Company's ""Contract of Carriage'', tickets that are sold but not flown on the travel date can be reused for another flight, up to a year from the date of sale, or can be refunded (if the ticket is refundable). A small percentage of tickets (or partial tickets) expire unused. Fully refundable tickets are rarely forfeited. ""Air traffic liability'' includes an estimate of the amount of future refunds and exchanges, net of forfeitures, for all unused tickets once the flight date has passed. These estimates are based on historical experience over many years. The Company and members of the airline industry have consistently applied this accounting method to estimate revenue from forfeited tickets at the date travel is provided. Estimated future refunds and exchanges in-

As of December 31, 2005, the Company had

approximately $12.9 billion (at cost) of long-lived assets, including $11.0 billion (at cost) in flight equip- ment and related assets. Flight equipment primarily relates to the 361 Boeing 737 aircraft in the Company's fleet at December 31, 2005, which are either owned or on capital lease. The remaining 84 Boeing 737 aircraft in the Company's fleet at December 31, 2005, are on operating lease. In accounting for long-lived assets, the Company must make estimates about the expected useful lives of the assets, the expected residual values of the assets, and the potential for impairment based on the fair value of the assets and the cash flows they generate.

cluded in the air traffic liability account are constantly The following table shows a breakdown of the evaluated based on subsequent refund and exchange Company's long-lived asset groups along with informa- activity to validate the accuracy of the Company's tion about estimated useful lives and residual values of estimates with respect to forfeited tickets. Holding other these groups:

factors constant, a ten-percent change in the Company's **Estimated**

estimate of the amount of refunded, exchanged, or **Residual**

forfeited tickets for 2005 would have resulted in a

**Estimated Useful Life Value**

$13 million change in Passenger revenues recognized Aircraft and engines 23 to 25 years 15% for that period. Aircraft parts ÏÏÏÏÏÏ Fleet life 4%

Ground property and

Events and circumstances outside of historical fare equipmentÏÏÏÏÏÏÏ 5 to 30 years 0%-10% sale activity or historical Customer travel patterns, as Leasehold

noted, can result in actual refunds, exchanges, or for- improvements ÏÏÏÏ 5 years or lease term 0%

feited tickets differing significantly from estimates. The

Company evaluates its estimates within a narrow range In estimating the lives and expected residual values of acceptable amounts. If actual refunds, exchanges, or of its aircraft, the Company primarily has relied upon forfeiture experience results in an amount outside of this actual experience with the same or similar aircraft types range, estimates and assumptions are reviewed and and recommendations from Boeing, the manufacturer of adjustments to ""Air traffic liability'' and to ""Passenger the Company's aircraft. Aircraft estimated useful lives revenue'' are recorded, as necessary. Additional factors are based on the number of ""cycles'' flown (one take- that may affect estimated refunds and exchanges in- off and landing). The Company has made a conversion clude, but may not be limited to, the Company's refund of cycles into years based on both its historical and and exchange policy, the mix of refundable and anticipated future utilization of the aircraft. Subsequent nonrefundable fares, and promotional fare activity. The revisions to these estimates, which can be significant, Company's estimation techniques have been consistently could be caused by changes to the Company's mainte- applied from year to year; however, as with any esti- nance program, changes in utilization of the aircraft mates, actual refund, exchange, and forfeiture activity (actual cycles during a given period of time), govern- may vary from estimated amounts. No material adjust- mental regulations on aging aircraft, and changing ments were recorded for years 2003, 2004, or 2005. market prices of new and used aircraft of the same or

similar types. The Company evaluates its estimates and The Company believes it is unlikely that materially assumptions each reporting period and, when war- different estimates for future refunds, exchanges, and ranted, adjusts these estimates and assumptions. Gener- forfeited tickets would be reported based on other ally, these adjustments are accounted for on a reasonable assumptions or conditions suggested by ac- prospective basis through depreciation and amortization

expense, as required by GAAP. The Company does not to the dramatic increase in energy prices throughout expect its transition to a new, more efficient heavy 2005, and the Company's addition of derivative instru- maintenance program for 737-300 and 737-500 air- ments to increase its hedge positions in future years. frames in 2006 to have an impact on the estimated Changes in the fair values of these instruments can vary useful lives for those aircraft. See Note 2 to the Consoli- dramatically, as was evident during 2005, based on dated Financial Statements for more information on this changes in the underlying commodity prices. Market change. price changes can be driven by factors such as supply

When appropriate, the Company evaluates its long-lived assets for impairment. Factors that would indicate potential impairment may include, but are not limited to, significant decreases in the market value of the long-lived asset(s), a significant change in the long- lived asset's physical condition, and operating or cash flow losses associated with the use of the long-lived asset. While the airline industry as a whole has exper-

and demand, inventory levels, weather events, refinery capacity, political agendas, and general economic condi- tions, among other items. The financial derivative in- struments utilized by the Company primarily are a combination of collars, purchased call options, and fixed price swap agreements. The Company does not purchase or hold any derivative instruments for trading purposes.

ienced many of these indicators, Southwest has contin- The Company enters into financial derivative in- ued to operate all of its aircraft, generate positive cash struments with third party institutions in ""over-the- flow, and produce profits. Consequently, the Company counter'' markets. Since the majority of the Company's has not identified any impairments related to its existing financial derivative instruments are not traded on a aircraft fleet. The Company will continue to monitor its market exchange, the Company estimates their fair long-lived assets and the airline operating environment. values. Depending on the type of instrument, the values

The Company believes it unlikely that materially different estimates for expected lives, expected residual values, and impairment evaluations would be made or reported based on other reasonable assumptions or conditions suggested by actual historical experience and other data available at the time estimates were made.

### *Financial Derivative Instruments*

are determined by the use of present value methods or standard option value models with assumptions about commodity prices based on those observed in underlying markets. Also, since there is not a reliable forward market for jet fuel, the Company must estimate the future prices of jet fuel in order to measure the effective- ness of the hedging instruments in offsetting changes to those prices, as required by SFAS 133. Forward jet fuel prices are estimated through the observation of similar

The Company utilizes financial derivative instru- commodity futures prices (such as crude oil, heating oil, ments primarily to manage its risk associated with and unleaded gasoline) and adjusted based on historical changing jet fuel prices, and accounts for them under variations to those like commodities.

Statement of Financial Accounting Standards No. 133,

""Accounting for Derivative Instruments and Hedging Activities'', as amended (SFAS 133). See ""Qualitative and Quantitative Disclosures about Market Risk'' for more information on these risk management activities and see Note 10 to the Consolidated Financial State- ments for more information on SFAS 133, the Com- pany's fuel hedging program, and financial derivative instruments.

Fair values for financial derivative instruments and

forward jet fuel prices are both estimated prior to the time that the financial derivative instruments settle, and the time that jet fuel is purchased and consumed, respectively. However, once settlement of the financial derivative instruments occurs and the hedged jet fuel is purchased and consumed, all values and prices are known and are recognized in the financial statements. Based on these actual results once all values and prices

SFAS 133 requires that all derivatives be marked become known, the Company's estimates have proved to market (fair value) and recorded on the Consolidated to be materially accurate.

Balance Sheet. At December 31, 2005, the Company

was a party to over 400 financial derivative instruments, Estimating the fair value of these fuel hedging related to fuel hedging, for year 2006 and beyond. The derivatives and forward prices for jet fuel will also result fair value of the Company's fuel hedging financial in changes in their values from period to period and thus derivative instruments recorded on the Company's Con- determine how they are accounted for under SFAS 133. solidated Balance Sheet as of December 31, 2005, was To the extent that the total change in the estimated fair

$1.7 billion, compared to $796 million at December 31, value of a fuel hedging instrument differs from the 2004. The large increase in fair value primarily was due change in the estimated price of the associated jet fuel

to be purchased, both on a cumulative and a period-to- ences in the correlation of crude oil-related products are period basis, ineffectiveness of the fuel hedge can result, leveraged over large dollar volumes.

as defined by SFAS 133. This could result in the

immediate recording of noncash charges or income, even though the derivative instrument may not expire until a future period. Likewise, if a cash flow hedge ceases to qualify for hedge accounting, those periodic changes in the fair value of derivative instruments are recorded to ""Other gains and losses'' in the income statement in the period of the change.

Ineffectiveness is inherent in hedging jet fuel with derivative positions based in other crude oil-related commodities, especially considering the recent volatility in the prices of refined products. In addition, given the magnitude of the Company's fuel hedge portfolio total market value, ineffectiveness can be highly material to financial results. Due to the volatility in markets for crude oil and related products, the Company is unable

SFAS 133 is a complex accounting standard with

stringent requirements, including the documentation of a Company hedging strategy, statistical analysis to qual- ify a commodity for hedge accounting both on a historical and a prospective basis, and strict contempo- raneous documentation that is required at the time each hedge is executed by the Company. As required by SFAS 133, the Company assesses the effectiveness of each of its individual hedges on a quarterly basis. The Company also examines the effectiveness of its entire hedging program on a quarterly basis utilizing statistical analysis. This analysis involves utilizing regression and other statistical analyses that compare changes in the price of jet fuel to changes in the prices of the commod- ities used for hedging purposes (crude oil, heating oil, and unleaded gasoline).

to predict the amount of ineffectiveness each period, The Company continually looks for better and including the loss of hedge accounting, which could be more accurate methodologies in forecasting future cash determined on a derivative by derivative basis or in the flows relating to its jet fuel hedging program. These aggregate. This may result in increased volatility in the estimates are used in the measurement of effectiveness Company's results. Prior to 2005, the Company had not for the Company's fuel hedges, as required by experienced significant ineffectiveness in its fuel hedges SFAS 133. Any changes to the Company's methodol- accounted for under SFAS 133, in relation to the fair ogy for estimating future cash flows (i.e., jet fuel prices) value of the underlying financial derivative instruments. will be applied prospectively, in accordance with The significant increase in the amount of hedge ineffec- SFAS 133. While the Company would expect that a tiveness and unrealized gains on derivative contracts change in the methodology for estimating future cash settling in future periods recorded during 2005 was due flows would result in more effective hedges over the to a number of factors. These factors included: the long-term, such a change could result in more ineffec- recent significant increase in energy prices, the number tiveness, as defined, in the short-term, due to the of derivative positions the Company holds, significant prospective nature of enacting the change.

weather events that have affected refinery capacity and

the production of refined products, and the volatility of The Company also utilizes financial derivative the different types of products the Company uses in instruments in the form of interest rate swap agree- hedging. The number of instances in which the Com- ments. The primary objective for the Company's use of pany has discontinued hedge accounting for specific interest rate hedges is to reduce the volatility of net hedges has increased recently, primarily due to the interest income by better matching the repricing of its foregoing reasons. In these cases, the Company has assets and liabilities. Concurrently, the Company's in- determined that the hedges will not regain effectiveness terest rate hedges are also intended to take advantage of in the time period remaining until settlement and market conditions in which short-term rates are signifi- therefore must discontinue special hedge accounting, as cantly lower than the fixed longer term rates on the defined by SFAS 133. When this happens, any changes Company's long-term debt. During 2003, the Company in fair value of the derivative instruments are marked to entered into interest rate swap agreements relating to its market through earnings in the period of change. As the $385 million 6.5% senior unsecured notes due 2012, fair value of the Company's hedge positions increases in and $375 million 5.496% Class A-2 pass-through cer- amount, there is a higher degree of probability that tificates due 2006. The floating rate paid under each there will be continued and correspondingly higher agreement sets in arrears. Under the first agreement, the variability recorded in the income statement and that Company pays the London InterBank Offered Rate the amount of hedge ineffectiveness and unrealized (LIBOR) plus a margin every six months and receives gains or losses recorded in future periods will be mate- 6.5% every six months on a notional amount of rial. This is primarily due to the fact that small differ- $385 million until 2012. The average floating rate paid

under this agreement during 2005 is estimated to be **Forward-Looking Statements**

6.46 percent based on actual and forward rates at

December 31, 2005. Under the second agreement, the Company pays LIBOR plus a margin every six months and receives 5.496% every six months on a notional amount of $375 million until November 1, 2006. Based on actual and forward rates at December 31, 2005, the average floating rate paid under this agreement during 2005 is estimated to be 6.73 percent.

Some statements in this Form 10-K (or otherwise

made by the Company or on the Company's behalf from time to time in other reports, filings with the Securities and Exchange Commission, news releases, conferences, World Wide Web postings or otherwise) which are not historical facts, may be ""forward-looking statements'' within the meaning of Section 21E of the Securities Exchange Act of 1934 and the Private Securities Litiga- tion Reform Act of 1995. Forward-looking statements

During 2004, the Company also entered into an include statements about Southwest's estimates, expec- interest rate swap agreement relating to its $350 million tations, beliefs, intentions or strategies for the future, 5.25% senior unsecured notes due 2014. Under this and the assumptions underlying these forward-looking agreement, the Company pays LIBOR plus a margin statements. Southwest uses the words ""anticipates,'' every six months and receives 5.25% every six months ""believes,'' ""estimates,'' ""expects,'' ""intends,'' ""fore- on a notional amount of $350 million until 2014. The casts,'' ""may,'' ""will,'' ""should,'' and similar expressions floating rate is set in advance. The average floating rate to identify these forward-looking statements. Forward- paid under this agreement during 2005 was looking statements involve risks and uncertainties that

3.82 percent. could cause actual results to differ materially from historical experience or the Company's present expecta-

The Company's interest rate swap agreements qualify as fair value hedges, as defined by SFAS 133. In addition, these interest rate swap agreements qualify for the ""shortcut'' method of accounting for hedges, as defined by SFAS 133. Under the ""shortcut'' method, the hedges are assumed to be perfectly effective, and, thus, there is no ineffectiveness to be recorded in earnings. The fair value of the interest rate swap agree- ments, which are adjusted regularly, are recorded in the Consolidated Balance Sheet, as necessary, with a corre- sponding adjustment to the carrying value of the long- term debt. The fair value of the interest rate swap agreements, excluding accrued interest, at Decem- ber 31, 2005, was a liability of approximately $31 mil-

tions. Factors that could cause these differences include, but are not limited to, those set forth under Item 1A Ì Risk Factors.

Caution should be taken not to place undue reli- ance on the Company's forward-looking statements, which represent the Company's views only as of the date this report is filed. The Company undertakes no obliga- tion to update publicly or revise any forward-looking statement, whether as a result of new information, future events, or otherwise.

### Item 7A. *Qualitative and Quantitative Disclosures* About Market Risk

lion. The comparable fair value of these same Southwest has interest rate risk in its floating rate agreements at December 31, 2004, was a liability of debt obligations and interest rate swaps, and has com-

$16 million. The long-term portion of these amounts modity price risk in jet fuel required to operate its are recorded in ""Other deferred liabilities'' in the aircraft fleet. The Company purchases jet fuel at prevail- Consolidated Balance Sheet for each respective year and ing market prices, but seeks to manage market risk the current portion is reflected in ""Accrued liabilities.'' through execution of a documented hedging strategy. In accordance with fair value hedging, the offsetting Southwest has market sensitive instruments in the form entry is an adjustment to decrease the carrying value of of fixed rate debt instruments and financial derivative long-term debt. See Note 10 to the Consolidated Finan- instruments used to hedge its exposure to jet fuel price cial Statements. increases. The Company also operates 93 aircraft under

operating and capital leases. However, leases are not The Company believes it is unlikely that materially considered market sensitive financial instruments and, different estimates for the fair value of financial deriva- therefore, are not included in the interest rate sensitivity tive instruments, and forward jet fuel prices, would be analysis below. Commitments related to leases are dis- made or reported based on other reasonable assumptions closed in Note 8 to the Consolidated Financial State- or conditions suggested by actual historical experience ments. The Company does not purchase or hold any and other data available at the time estimates were derivative financial instruments for trading purposes. See made. Note 10 to the Consolidated Financial Statements for

information on the Company's accounting for its hedg- with each counterparty. At December 31, 2005, the ing program and for further details on the Company's Company had agreements with seven counterparties financial derivative instruments. containing early termination rights and/or bilateral collateral provisions whereby security is required if

*Fuel hedging.* The Company utilizes its fuel market risk exposure exceeds a specified threshold hedges, on both a short-term and a long-term basis, as a amount or credit ratings fall below certain levels. At form of insurance against significant increases in fuel December 31, 2005, the Company held $950 million in prices. The Company believes there is significant risk in cash collateral deposits under these bilateral collateral not hedging against the possibility of such fuel price provisions. These collateral deposits serve to decrease, increases. The Company expects to consume approxi- but not totally eliminate, the credit risk associated with mately 1.4 billion gallons of jet fuel in 2006. Based on the Company's hedging program. The deposits are this usage, a change in jet fuel prices of just one cent per included in ""Accrued liabilities'' on the Consolidated gallon would impact the Company's ""Fuel and oil Balance Sheet. See also Note 10 to the Consolidated expense'' by approximately $14 million per year, ex- Financial Statements.

cluding any impact of the Company's fuel hedges.

*Financial market risk.* The vast majority of the The fair values of outstanding financial derivative Company's assets are aircraft, which are long-lived. The instruments related to the Company's jet fuel market Company's strategy is to maintain a conservative bal- price risk at December 31, 2005, were net assets of ance sheet and grow capacity steadily and profitably.

$1.7 billion. The current portion of these financial While the Company uses financial leverage, it has derivative instruments, or $640 million, is classified as maintained a strong balance sheet and an ""A'' credit ""Fuel hedge contracts'' in the Consolidated Balance rating on its senior unsecured fixed-rate debt with Sheet. The long-term portion of these financial deriva- Standard & Poor's and Fitch ratings agencies, and a tive instruments, or $1.0 billion, is included in ""Other ""Baa1'' credit rating with Moody's rating agency. The assets.'' The fair values of the derivative instruments, Company's 1999 and 2004 French Credit Agreements depending on the type of instrument, were determined do not give rise to significant fair value risk but do give by use of present value methods or standard option value rise to interest rate risk because these borrowings are models with assumptions about commodity prices based floating-rate debt. In addition, as disclosed in Note 10 on those observed in underlying markets. An immediate to the Consolidated Financial Statements, the Company ten-percent increase or decrease in underlying fuel- has converted certain of its long-term debt to floating related commodity prices from the December 31, 2005, rate debt by entering into interest rate swap agreements. prices would correspondingly change the fair value of This includes the Company's $385 million 6.5% senior the commodity derivative instruments in place by ap- unsecured notes due 2012, the $375 million 5.496% proximately $420 million. Changes in the related com- Class A-2 pass-through certificates due 2006, and the modity derivative instrument cash flows may change by $350 million 5.25% senior unsecured notes due 2014. more or less than this amount based upon further Although there is interest rate risk associated with these fluctuations in futures prices as well as related income floating rate borrowings, the risk for the 1999 and 2004 tax effects. This sensitivity analysis uses industry stan- French Credit Agreements is somewhat mitigated by dard valuation models and holds all inputs constant at the fact that the Company may prepay this debt under December 31, 2005, levels, except underlying futures certain conditions. See Notes 6 and 7 to the Consoli- prices. dated Financial Statements for more information on the

Outstanding financial derivative instruments ex- pose the Company to credit loss in the event of nonper-

material terms of the Company's short-term and long- term debt.

formance by the counterparties to the agreements. Excluding the $385 million 6.5% senior unsecured However, the Company does not expect any of the notes, and the $350 million 5.25% senior unsecured counterparties to fail to meet their obligations. The notes that were converted to a floating rate as previously credit exposure related to these financial instruments is noted, the Company had outstanding senior unsecured represented by the fair value of contracts with a positive notes totaling $500 million at December 31, 2005. fair value at the reporting date. To manage credit risk, These senior unsecured notes currently have a weighted- the Company selects and will periodically review average maturity of 11.3 years at fixed rates averaging counterparties based on credit ratings, limits its expo- 6.125 percent at December 31, 2005, which is compa- sure to a single counterparty, and monitors the market rable to average rates prevailing for similar debt instru- position of the program and its relative market position ments over the last ten years. The fixed-rate portion of

the Company's pass-through certificates consists of its flows associated with its floating rate debt, invested Class A certificates and Class B certificates, which cash, and short-term investments because of the float- totaled $154 million at December 31, 2005. These ing-rate nature of these items. Assuming floating mar- Class A and Class B certificates had fixed rates averag- ket rates in effect as of December 31, 2005, were held ing 5.7 percent at December 31, 2005 and mature constant throughout a 12-month period, a hypothetical during 2006. The carrying value of the Company's ten percent change in those rates would correspondingly floating rate debt totaled $1.2 billion, and this debt had change the Company's net earnings and cash flows a weighted-average maturity of 6.0 years at floating associated with these items by less than $2 million. rates averaging 6.27 percent at December 31, 2005. In Utilizing these assumptions and considering the Com- total, the Company's fixed rate debt and floating rate pany's cash balance, short-term investments, and float- debt represented 6.2 percent and 11.6 percent, respec- ing-rate debt outstanding at December 31, 2005, an tively, of total noncurrent assets at December 31, 2005. increase in rates would have a net positive effect on the

The Company also has some risk associated with changing interest rates due to the short-term nature of its invested cash, which totaled $2.3 billion, and short- term investments, which totaled $251 million, at De- cember 31, 2005. The Company invests available cash in certificates of deposit, highly rated money market

Company's earnings and cash flows, while a decrease in rates would have a net negative effect on the Company's earnings and cash flows. However, a ten percent change in market rates would not impact the Company's earn- ings or cash flow associated with the Company's pub- licly traded fixed-rate debt.

instruments, investment grade commercial paper, auc- The Company is also subject to various financial tion rate securities, and other highly rated financial covenants included in its credit card transaction process- instruments. Because of the short-term nature of these ing agreement, the revolving credit facility, and out- investments, the returns earned parallel closely with standing debt agreements. Covenants include the short-term floating interest rates. The Company has not maintenance of minimum credit ratings. For the revolv- undertaken any additional actions to cover interest rate ing credit facility, the Company shall also maintain, at market risk and is not a party to any other material all times, a Coverage Ratio, as defined in the agreement, market interest rate risk management activities. of not less than 1.25 to 1.0. The Company met or

A hypothetical ten percent change in market inter- est rates as of December 31, 2005, would not have a material effect on the fair value of the Company's fixed rate debt instruments. See Note 10 to the Consolidated Financial Statements for further information on the fair value of the Company's financial instruments. A change in market interest rates could, however, have a corre- sponding effect on the Company's earnings and cash

exceeded the minimum standards set forth in these agreements as of December 31, 2005. However, if conditions change and the Company fails to meet the minimum standards set forth in the agreements, it could reduce the availability of cash under the agreements or increase the costs to keep these agreements intact as written.

### Item 8. *Financial Statements and Supplementary Data*

**SOUTHWEST AIRLINES CO. CONSOLIDATED BALANCE SHEET**

Current assets:

## ASSETS

**December 31,**

**2005 2004**

**(In millions, except share data)**

|  |  |  |  |
| --- | --- | --- | --- |
| Cash and cash equivalents ÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏ | **$ 2,280** | $ 1,048 | |
| Short-term investmentsÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏ | **251** | 257 | |
| Accounts and other receivables ÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏ | **258** | 248 | |
| Inventories of parts and supplies, at cost ÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏ | **150** | 137 | |
| Fuel hedge contracts ÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏ | **641** | 428 | |
| Prepaid expenses and other current assets ÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏ | **40** | 54 | |
| Total current assets ÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏ | **3,620** | 2,172 | |
| Property and equipment, at cost: |  |  | |
| Flight equipment ÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏ | **10,999** |  | 10,037 |
| Ground property and equipment ÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏ | **1,256** |  | 1,202 |
| Deposits on flight equipment purchase contracts ÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏ | **660** |  | 682 |
|  | **12,915** |  | 11,921 |
| Less allowance for depreciation and amortization ÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏ | **3,488** |  | 3,198 |
|  | **9,427** |  | 8,723 |
| Other assets ÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏ | **1,171** |  | 442 |
|  | **$14,218** |  | $11,337 |

## LIABILITIES AND STOCKHOLDERS' EQUITY

Current liabilities:

|  |  |  |  |
| --- | --- | --- | --- |
| Accounts payable ÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏ | **$ 524** | $ 420 | |
| Accrued liabilities ÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏ | **2,074** | 1,047 | |
| Air traffic liability ÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏ | **649** | 529 | |
| Current maturities of long-term debt ÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏ | **601** | 146 | |
| Total current liabilities ÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏ | **3,848** | 2,142 | |
| Long-term debt less current maturities ÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏ | **1,394** | 1,700 | |
| Deferred income taxes ÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏ | **1,896** | 1,610 | |
| Deferred gains from sale and leaseback of aircraft ÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏ | **136** | 152 | |
| Other deferred liabilitiesÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏ | **269** | 209 | |
| Commitments and contingencies |  |  | |
| Stockholders' equity: |  |  | |
| Common stock, $1.00 par value: 2,000,000,000 shares authorized; 801,641,645 and |  |  | |
| 790,181,982 shares issued in 2005 and 2004, respectively ÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏ | **802** |  | 790 |
| Capital in excess of par value ÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏ | **424** |  | 299 |
| Retained earnings ÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏ | **4,557** |  | 4,089 |
| Accumulated other comprehensive incomeÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏ | **892** |  | 417 |
| Treasury stock, at cost: 5,199,192 shares in 2004 ÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏ | Ì |  | (71) |
| Total stockholders' equity ÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏ | **6,675** |  | 5,524 |
|  | **$14,218** |  | $11,337 |

## CONSOLIDATED STATEMENT OF INCOME

**OPERATING REVENUES:**

**Years Ended December 31,**

**2005 2004 2003**

**(In millions, except per share amounts)**

|  |  |  |  |
| --- | --- | --- | --- |
| PassengerÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏ | **$7,279** | $6,280 | $5,741 |
| FreightÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏ | **133** | 117 | 94 |
| OtherÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏ | **172** | 133 | 102 |
| Total operating revenues ÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏ | **7,584** | 6,530 | 5,937 |
| **OPERATING EXPENSES:** |  |  |  |
| Salaries, wages, and benefits ÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏ | **2,702** | 2,443 | 2,224 |
| Fuel and oil ÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏ | **1,342** | 1,000 | 830 |
| Maintenance materials and repairs ÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏ | **430** | 457 | 430 |
| Aircraft rentals ÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏ | **163** | 179 | 183 |
| Landing fees and other rentals ÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏ | **454** | 408 | 372 |
| Depreciation and amortization ÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏ | **469** | 431 | 384 |
| Other operating expenses ÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏ | **1,204** | 1,058 | 1,031 |
| Total operating expenses ÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏ | **6,764** | 5,976 | 5,454 |
| **OPERATING INCOME ÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏ** | **820** | 554 | 483 |
| **OTHER EXPENSES (INCOME):** |  |  |  |
| Interest expense ÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏ | **122** | 88 | 91 |
| Capitalized interest ÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏ | **(39)** | (39) | (33) |
| Interest income ÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏ | **(47)** | (21) | (24) |
| Other (gains) losses, net ÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏ | **(90)** | 37 | (259) |
| Total other expenses (income)ÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏ | **(54)** | 65 | (225) |
| **INCOME BEFORE INCOME TAXES ÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏ** | **874** | 489 | 708 |
| **PROVISION FOR INCOME TAXESÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏ** | **326** | 176 | 266 |
| **NET INCOME ÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏ** | **$ 548** | $ 313 | $ 442 |
| **NET INCOME PER SHARE, BASICÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏ** | **$ .70** | $ .40 | $ .56 |
| **NET INCOME PER SHARE, DILUTED ÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏ** | **$ .67** | $ .38 | $ .54 |

## CONSOLIDATED STATEMENT OF STOCKHOLDERS' EQUITY

**Years Ended December 31, 2005, 2004, and 2003**

|  |  |  |  |  |  |  |  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- |
| **Accumulated** | | | | | | | | | | | | |
|  | | | | **Capital in** | | |  | **Other** | | |  |  |
| **Common** | | | | **Excess of** | | | **Retained** | **Comprehensive Treasury** | | | |  |
| **Stock** | | | | **Par Value** | | | **Earnings** | **Income (Loss)** | | | **Stock** | **Total** |
| **(In millions, except per share amounts)** | | | | | | | | | | | | |
| Balance at December 31, 2002 ÏÏÏÏÏÏÏÏÏÏ $777 | | | | $136 | | | $3,455 | $ 54 | | | $ Ì | $4,422 |
| Issuance of common stock pursuant to Employee stock plans ÏÏÏÏÏÏÏÏÏÏÏÏÏÏ | 12 | | | 81 | | | Ì | Ì | | | Ì | 93 |
| Tax benefit of options exercised ÏÏÏÏÏÏÏ | Ì | | | 41 | | | Ì | Ì | | | Ì | 41 |
| Cash dividends, $.018 per share ÏÏÏÏÏÏÏ | Ì | | | Ì | | | (14) | Ì | | | Ì | (14) |
| Comprehensive income (loss) |  | | |  | | |  |  | | |  |  |
| Net income ÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏ | Ì | | | Ì | | | 442 | Ì | | | Ì | 442 |
| Unrealized gain on derivative instruments ÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏ | Ì | | | Ì | | | Ì | 66 | | | Ì | 66 |
| Other ÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏ | Ì | | | Ì | | | Ì | 2 | | | Ì | 2 |
| Total comprehensive income ÏÏÏÏÏÏ |  | | |  | | |  |  | | |  | 510 |
| Balance at December 31, 2003 ÏÏÏÏÏÏÏÏÏÏ | $789 | | | $258 | | | $3,883 | $122 | | | $ Ì | $5,052 |
| Purchase of shares of treasury stockÏÏÏÏÏ | Ì | | | Ì | | | Ì | Ì | | | (246) | (246) |
| Issuance of common and treasury stock pursuant to Employee stock plans ÏÏÏÏ | 1 | | | 6 | | | (93) | Ì | | | 175 | 89 |
| Tax benefit of options exercised ÏÏÏÏÏÏÏ | Ì | | | 35 | | | Ì | Ì | | | Ì | 35 |
| Cash dividends, $.018 per share ÏÏÏÏÏÏÏ | Ì | | | Ì | | | (14) | Ì | | | Ì | (14) |
| Comprehensive income (loss) |  | | |  | | |  |  | | |  |  |
| Net income ÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏ Ì | | | | Ì | | | 313 | Ì | | | Ì | 313 |
| Unrealized gain on derivative instruments ÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏ | | Ì |  | | Ì |  | Ì | | 293 |  | Ì | 293 |
| Other ÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏ | | Ì |  | | Ì |  | Ì | | 2 |  | Ì | 2 |
| Total comprehensive income ÏÏÏÏÏÏ | |  |  | |  |  |  | |  |  |  | 608 |
| Balance at December 31, 2004 ÏÏÏÏÏÏÏÏÏÏ | | $790 |  | | $299 |  | $4,089 | | $417 |  | $ (71) | $5,524 |
| **Purchase of shares of treasury stock ÏÏÏ** | | **Ì** |  | | **Ì** |  | **Ì** | | **Ì** |  | **(55)** | **(55)** |
| **Issuance of common and treasury stock pursuant to Employee stock plans ÏÏÏ** | | **12** |  | | **60** |  | **(66)** | | **Ì** |  | **126** | **132** |
| **Tax benefit of options exercised ÏÏÏÏÏÏ** | | **Ì** |  | | **65** |  | **Ì** | | **Ì** |  | **Ì** | **65** |
| **Cash dividends, $.018 per shareÏÏÏÏÏÏÏ** | | **Ì** |  | | **Ì** |  | **(14)** | | **Ì** |  | **Ì** | **(14)** |
| **Comprehensive income (loss)** | |  |  | |  |  |  | |  |  |  |  |
| **Net income ÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏ** | | **Ì** |  | | **Ì** |  | **548** | | **Ì** |  | **Ì** | **548** |
| **Unrealized gain on derivative instruments ÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏ** | | **Ì** |  | | **Ì** |  | **Ì** | | **474** |  | **Ì** | **474** |
| **Other ÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏ** | | **Ì** |  | | **Ì** |  | **Ì** | | **1** |  | **Ì** | **1** |
| **Total comprehensive income ÏÏÏÏÏ** | |  |  | |  |  |  | |  |  |  | **1,023** |
| **Balance at December 31, 2005 ÏÏÏÏÏÏÏÏÏ** | | **$802** |  | | **$424** |  | **$4,557** | | **$892** |  | **$ Ì** | **$6,675** |

## CONSOLIDATED STATEMENT OF CASH FLOWS

**Years Ended December 31,**

**2005 2004 2003**

**(In millions)**

|  |  |  |  |
| --- | --- | --- | --- |
| **CASH FLOWS FROM OPERATING ACTIVITIES:**  Net income ÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏ | **$ 548** | $ 313 | $ 442 |
| Adjustments to reconcile net income to net cash provided by operating activities: |  |  |  |
| Depreciation and amortization ÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏ | **469** | 431 | 384 |
| Deferred income taxes ÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏ | **257** | 184 | 183 |
| Amortization of deferred gains on sale and leaseback of aircraft ÏÏÏÏÏÏÏÏÏ | **(16)** | (16) | (16) |
| Amortization of scheduled airframe inspections and repairs ÏÏÏÏÏÏÏÏÏÏÏÏÏ | **49** | 52 | 49 |
| Income tax benefit from Employee stock option exercises ÏÏÏÏÏÏÏÏÏÏÏÏÏÏ | **65** | 35 | 41 |
| Changes in certain assets and liabilities: |  |  |  |
| Accounts and other receivables ÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏ | **(9)** | (75) | 43 |
| Other current assetsÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏ | **(59)** | (44) | (19) |
| Accounts payable and accrued liabilities ÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏ | **855** | 231 | 129 |
| Air traffic liability ÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏ | **120** | 68 | 50 |
| OtherÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏ | **(50)** | (22) | 50 |
| Net cash provided by operating activities ÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏ | **2,229** | 1,157 | 1,336 |
| Purchases of property and equipment, net ÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏ | **(1,210)** | (1,775) | (1,238) |
| Change in short-term investments, net ÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏ | **6** | 124 | (381) |
| Payment for assets of ATA Airlines, Inc. ÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏ | **(6)** | (34) | Ì |
| Debtor in possession loan to ATA Airlines, Inc. ÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏ | **Ì** | (40) | Ì |
| OtherÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏ | **Ì** | (1) | Ì |
| Net cash used in investing activities ÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏ | **(1,210)** | (1,726) | (1,619) |
| **CASH FLOWS FROM FINANCING ACTIVITIES:** |  |  |  |
| Issuance of long-term debt ÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏ | **300** | 520 | Ì |
| Proceeds from Employee stock plans ÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏ | **132** | 88 | 93 |
| Payments of long-term debt and capital lease obligationsÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏ | **(149)** | (207) | (130) |
| Payments of cash dividends ÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏ | **(14)** | (14) | (14) |
| Repurchase of common stock ÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏ | **(55)** | (246) | Ì |
| Other, net ÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏ | **(1)** | (8) | 3 |
| Net cash provided by (used in) financing activities ÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏ | **213** | 133 | (48) |
| **NET INCREASE (DECREASE) IN CASH AND CASH EQUIVALENTSÏÏÏ** | **1,232** | (436) | (331) |
| **CASH AND CASH EQUIVALENTS AT BEGINNING OF PERIOD ÏÏÏÏÏÏ** | **1,048** | 1,484 | 1,815 |
| **CASH AND CASH EQUIVALENTS AT END OF PERIOD ÏÏÏÏÏÏÏÏÏÏÏÏÏ** | **$ 2,280** | $ 1,048 | $ 1,484 |
| **CASH PAYMENTS FOR:** |  |  |  |
| Interest, net of amount capitalized ÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏ | **$ 71** | $ 38 | $ 62 |
| Income taxes ÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏ | **$ 8** | $ 2 | $ 51 |

## CASH FLOWS FROM INVESTING ACTIVITIES:

**SUPPLEMENTAL SCHEDULE OF NONCASH INVESTING ACTIVITIES:**

In December 2005, the Company obtained the rights to four of ATA Airlines, Inc. (ATA) leased Chicago Midway Airport gates in exchange for a $20 million reduction of the Debtor in possession loan to ATA:

Rights to Chicago Midway Gates acquired ÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏ **$ 20**

Debtor in possession loan to ATA reductionÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏ **$(20)**

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

**December 31, 2005**

1. **Summary of Significant Accounting Policies** *Inventories.* Inventories of flight equipment ex-

pendable parts, materials, and supplies are carried at

*Basis Of Presentation.* Southwest Airlines Co. average cost. These items are generally charged to (Southwest) is a major domestic airline that provides expense when issued for use.

point-to-point, low-fare service. The Consolidated Fi-

nancial Statements include the accounts of Southwest and its wholly owned subsidiaries (the Company). All significant intercompany balances and transactions have been eliminated. The preparation of financial state- ments in conformity with accounting principles gener- ally accepted in the United States (GAAP) requires management to make estimates and assumptions that affect the amounts reported in the financial statements and accompanying notes. Actual results could differ from these estimates.

*Property And Equipment.* Depreciation is pro-

vided by the straight-line method to estimated residual values over periods generally ranging from 23 to 25 years for flight equipment and 5 to 30 years for ground property and equipment once the asset is placed in service. Residual values estimated for aircraft are

15 percent and for ground property and equipment range from zero to 10 percent. Property under capital leases and related obligations are recorded at an amount equal to the present value of future minimum lease payments computed on the basis of the Company's

Certain prior period amounts have been reclassified incremental borrowing rate or, when known, the inter- to conform to the current presentation. In the Consoli- est rate implicit in the lease. Amortization of property dated Balance Sheet as of December 31, 2004, the under capital leases is on a straight-line basis over the Company has reclassified certain amounts as ""Short- lease term and is included in depreciation expense. term investments'', that were previously classified as

""Cash and cash equivalents.'' In the Consolidated State- ment of Cash Flows for 2004 and 2003, changes in the amounts of ""Short-term investments'' are classified as cash flows from investing activities. In the Consolidated Statement of Income for 2004 and 2003, amounts previously classified as ""Agency commissions'' are now classified in ""Other operating expenses.''

In estimating the lives and expected residual values

of its aircraft, the Company primarily has relied upon actual experience with the same or similar aircraft types and recommendations from Boeing, the manufacturer of the Company's aircraft. Subsequent revisions to these estimates, which can be significant, could be caused by changes to the Company's maintenance program, modi- fications or improvements to the aircraft, changes in

*Cash And Cash Equivalents.* Cash in excess of utilization of the aircraft (actual flight hours or cycles that necessary for operating requirements is invested in during a given period of time), governmental regula- short-term, highly liquid, income-producing invest- tions on aging aircraft, changing market prices of new ments. Investments with maturities of three months or and used aircraft of the same or similar types, etc. The less are classified as cash and cash equivalents, which Company evaluates its estimates and assumptions each primarily consist of certificates of deposit, money mar- reporting period and, when warranted, adjusts these ket funds, and investment grade commercial paper estimates and assumptions. Generally, these adjustments issued by major corporations and financial institutions. are accounted for on a prospective basis through depre- Cash and cash equivalents are stated at cost, which ciation and amortization expense, as required by approximates market value. GAAP.

*Short-Term Investments.* Short-term investments When appropriate, the Company evaluates its consist of auction rate securities with auction reset long-lived assets used in operations for impairment. periods of less than 12 months. These investments are Impairment losses would be recorded when events and classified as available-for-sale securities and are stated at circumstances indicate that an asset might be impaired fair value. Unrealized gains and losses, net of tax, are and the undiscounted cash flows to be generated by that recognized in ""Accumulated other comprehensive in- asset are less than the carrying amounts of the asset. come (loss)'' in the accompanying Consolidated Bal- Factors that would indicate potential impairment in- ance Sheet. Realized gains and losses are reflected in clude, but are not limited to, significant decreases in the ""Interest income'' in the accompanying Consolidated market value of the long-lived asset(s), a significant Income Statement. change in the long-lived asset's physical condition,

operating or cash flow losses associated with the use of liability'' primarily represents tickets sold for future the long-lived asset, etc. While the airline industry as a travel dates and estimated refunds and exchanges of whole has experienced many of these indicators, South- tickets sold for past travel dates. The majority of the west has continued to operate all of its aircraft and Company's tickets sold are nonrefundable. Tickets that continues to experience positive cash flow. are sold but not flown on the travel date can be reused

for another flight, up to a year from the date of sale, or *Aircraft And Engine Maintenance.* The cost of refunded (if the ticket is refundable). A small percent- scheduled engine inspections and repairs and routine age of tickets (or partial tickets) expire unused. The maintenance costs for all aircraft and engines are Company estimates the amount of future refunds and charged to maintenance expense as incurred. For the exchanges, net of forfeitures, for all unused tickets once Company's 737-300 and 737-500 aircraft fleet types, the flight date has passed. These estimates are based on scheduled airframe inspections and repairs, known as D historical experience over many years. The Company checks, are generally performed every ten years. Costs and members of the airline industry have consistently related to D checks are capitalized and amortized over applied this accounting method to estimate revenue the estimated period benefited, presently the least of ten from forfeited tickets at the date travel is provided. years, the time until the next D check, or the remaining Estimated future refunds and exchanges included in the life of the aircraft. Modifications that significantly en- air traffic liability account are constantly evaluated based hance the operating performance or extend the useful on subsequent refund and exchange activity to validate lives of aircraft or engines are capitalized and amortized the accuracy of the Company's revenue recognition

over the remaining life of the asset. method with respect to forfeited tickets.

As of December 31, 2005, the majority of the

Company's fleet was made up of its newest aircraft type, Events and circumstances outside of historical fare the 737-700. This aircraft type is maintained under a sale activity or historical Customer travel patterns can ""next-generation'' maintenance program, called MSG- result in actual refunds, exchanges or forfeited tickets 3, in which tasks are bundled based on data gathered differing significantly from estimates; however, these relative to fleet performance. Scheduled maintenance is differences have historically not been material. Addi- still performed at recommended intervals; however, this tional factors that may affect estimated refunds, ex- program does not contain a D check. The costs of changes, and forfeitures include, but may not be limited scheduled airframe inspections and repairs under this to, the Company's refund and exchange policy, the mix maintenance program are expensed as incurred, as those of refundable and nonrefundable fares, and fare sale expenses more readily approximate the underlying activity. The Company's estimation techniques have scheduled maintenance tasks. See Note 2 regarding a been consistently applied from year to year; however, as 2006 change in the Company's maintenance program with any estimates, actual refund and exchange activity for 737-300 and 737-500 aircraft. may vary from estimated amounts.

*Intangible Assets.* Intangible assets primarily con-

sist of leasehold rights to airport owned gates acquired by the Company during 2004 and 2005. These assets are amortized on a straight-line basis over the expected useful life of the lease, approximately 20 years. The accumulated amortization related to the Company's intangible assets at December 31, 2004, and 2005, was not material. The Company periodically assesses its intangible assets for impairment in accordance with SFAS 142, *Goodwill and Other Intangible As- sets;*however, no impairments have been noted.

*Frequent Flyer Program.* The Company accrues

the estimated incremental cost of providing free travel for awards earned under its Rapid Rewards frequent flyer program. The Company also sells frequent flyer credits and related services to companies participating in its Rapid Rewards frequent flyer program. Funds re- ceived from the sale of flight segment credits are accounted for under the residual value method. The portion of those funds associated with future travel are deferred and recognized as ""Passenger revenue'' when the ultimate free travel awards are flown or the credits

*Revenue Recognition.* Tickets sold are initially expire unused. The portion of the funds not associated deferred as ""Air traffic liability''. Passenger revenue is with future travel are recognized in ""Other revenue'' in recognized when transportation is provided. ""Air traffic the period earned.

*Advertising.* The Company expenses the costs of stock-based compensation utilizing the intrinsic value advertising as incurred. Advertising expense for the method in accordance with the provisions of Account- years ended December 31, 2005, 2004, and 2003 was ing Principles Board Opinion No. 25 (APB 25), ""Ac-

$173 million, $158 million, and $155 million, counting for Stock Issued to Employees'' and related respectively. Interpretations. Accordingly, no compensation expense is recognized for fixed option plans because the exercise

*Stock-based Employee Compensation.* The Com- prices of Employee stock options equal or exceed the pany has stock-based compensation plans covering the market prices of the underlying stock on the dates of majority of its Employee groups, including a plan grant. Compensation expense for other stock options is covering the Company's Board of Directors and plans not material.

related to employment contracts with certain Executive

Officers of the Company. The Company accounts for

The following table represents the effect on net income and earnings per share if the Company had applied the fair value based method and recognition provisions of Statement of Financial Accounting Standards (SFAS) No. 123, ""Accounting for Stock-Based Compensation'', to stock-based Employee compensation:

**2005 2004 2003**

**(In millions, except per share amounts)**

Net income, as reported ÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏ **$548** $313 $442

Add: Stock-based Employee compensation expense included in reported

income, net of related tax effects ÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏ **Ì** Ì Ì Deduct: Stock-based Employee compensation expense determined under fair

value based methods for all awards, net of related tax effects ÏÏÏÏÏÏÏÏÏÏÏÏÏ **(43)** (74) (57)

Pro forma net income ÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏ **$505** $239 $385

Net income per share

Basic, as reported ÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏ **$ .70** $ .40 $ .56 Basic, pro forma ÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏ **$ .63** $ .31 $ .49 Diluted, as reported ÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏ **$ .67** $ .38 $ .54 Diluted, pro forma ÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏ **$ .62** $ .30 $ .48

As required, the pro forma disclosures above in- oil, unleaded gasoline, and heating oil-based derivatives, clude options granted since January 1, 1995. For pur- to hedge a portion of its exposure to jet fuel price poses of pro forma disclosures, the estimated fair value increases. These instruments primarily consist of pur- of stock-based compensation plans and other options is chased call options, collar structures, and fixed-price amortized to expense primarily over the vesting period. swap agreements, and are accounted for as cash-flow For options with graded vesting, expense is recognized hedges, as defined by SFAS 133. The Company has also on a straight-line basis over the vesting period. See entered into interest rate swap agreements to convert a Note 13 for further discussion of the Company's stock- portion of its fixed-rate debt to floating rates. These based Employee compensation and Note 2 for further interest rate hedges are accounted for as fair value information regarding the Company's January 1, 2006, hedges, as defined by SFAS 133.

adoption of SFAS 123R.

Since the majority of the Company's financial

*Financial Derivative Instruments.* The Company derivative instruments are not traded on a market ex- accounts for financial derivative instruments utilizing change, the Company estimates their fair values. De- Statement of Financial Accounting Standards No. 133 pending on the type of instrument, the values are (SFAS 133), ""Accounting for Derivative Instruments determined by the use of present value methods or and Hedging Activities'', as amended. The Company standard option value models with assumptions about utilizes various derivative instruments, including crude commodity prices based on those observed in underlying

markets. Also, since there is not a reliable forward SFAS 123R for all share-based payments granted after market for jet fuel, the Company must estimate the that date, and based on the requirements of SFAS 123 future prices of jet fuel in order to measure the effective- for all unvested awards granted prior to the effective ness of the hedging instruments in offsetting changes to date of SFAS 123R. Under the ""modified retrospective'' those prices, as required by SFAS 133. Forward jet fuel method, the requirements are the same as under the prices are estimated through the observation of similar ""modified prospective'' method, but also permit entities commodity futures prices (such as crude oil, heating oil, to restate financial statements of previous periods based and unleaded gasoline) and adjusted based on historical on proforma disclosures made in accordance with variations to those like commodities. See Note 10 for SFAS 123.

further information on SFAS 133 and financial deriva- The Company currently utilizes a standard option tive instruments. pricing model (i.e., Black-Scholes) to measure the fair

*Income Taxes.* The Company accounts for de- ferred income taxes utilizing Statement of Financial Accounting Standards No. 109 (SFAS 109), ""Ac- counting for Income Taxes'', as amended. SFAS 109 requires an asset and liability method, whereby deferred tax assets and liabilities are recognized based on the tax effects of temporary differences between the financial statements and the tax bases of assets and liabilities, as measured by current enacted tax rates. When appropri- ate, in accordance with SFAS 109, the Company evalu-

value of stock options granted to Employees. While SFAS 123R permits entities to continue to use such a model, the standard also permits the use of a more complex binomial, or ""lattice'' model. Based upon re- search done by the Company on the alternative models available to value option grants, and in conjunction with the type and number of stock options expected to be issued in the future, the Company has determined that it will continue to use the Black-Scholes model for option valuation as of the current time.

ates the need for a valuation allowance to reduce SFAS 123R includes several modifications to the deferred tax assets. way that income taxes are recorded in the financial

statements. The expense for certain types of option

1. **Accounting Changes** grants is only deductible for tax purposes at the time

### *Share-based Compensation*

that the taxable event takes place, which could cause variability in the Company's effective tax rates recorded

In December 2004, the FASB issued throughout the year. SFAS 123R does not allow compa- SFAS No. 123R, ""Share-Based Payment''. nies to ""predict'' when these taxable events will take SFAS No. 123R is a revision of SFAS No. 123, place. Furthermore, it requires that the benefits associ- ""Accounting for Stock Based Compensation'', and su- ated with the tax deductions in excess of recognized persedes APB 25. Among other items, SFAS 123R compensation cost be reported as a financing cash flow, eliminates the use of APB 25 and the intrinsic value rather than as an operating cash flow as required under method of accounting, and requires companies to recog- current literature. This requirement will reduce net nize the cost of employee services received in exchange operating cash flows and increase net financing cash for awards of equity instruments, based on the grant flows in periods after the effective date. These future date fair value of those awards, in the financial state- amounts cannot be estimated, because they depend on, ments. Pro forma disclosure is no longer an alternative among other things, when employees exercise stock under the new standard. Although early adoption is options. However, the amount of operating cash flows allowed, the Company will adopt SFAS 123R as of the recognized in prior periods for such excess tax deduc- required effective date for calendar year companies, tions, as shown in the Company's Consolidated State- which is January 1, 2006. ment of Cash Flows, were $65 million, $35 million, and

SFAS 123R permits companies to adopt its re-

$41 million, respectively, for 2005, 2004, and 2003.

quirements using either a ""modified prospective'' The Company is still evaluating which method of method, or a ""modified retrospective'' method. Under adoption it will use. Subject to a complete review of the the ""modified prospective'' method, compensation cost requirements of SFAS 123R, based on stock options is recognized in the financial statements beginning with granted to Employees through December 31, 2005, the the effective date, based on the requirements of Company expects that the adoption of SFAS 123R on

January 1, 2006, will reduce first quarter net earnings by requires that all elective accounting changes be made on approximately $10 million ($.01 per share, diluted). a retrospective basis, resulting in the restatement of all See Note 13 for further information on the Company's prior period financial statements presented. As such, stock-based compensation plans. concurrent with the filing of the Company's first quarter 2006 Form 10-Q, the Company will restate prior period

***Aircraft and Engine Maintenance*** results as a result of this change.

In first quarter 2006, the Company will begin

transitioning the maintenance program for performing

## Acquisition of Certain Assets

planned airframe maintenance on its fleet of 737-300 In fourth quarter 2004, Southwest was selected as and 737-500 aircraft. The previous program utilized the winning bidder at a bankruptcy-court approved was a periodic ""hard time'' program, which required auction for certain ATA Airlines, Inc. (ATA) assets. specific activities, including replacement of specified As part of the transaction, which was approved in components, and D checks that were capitalized and December 2004, Southwest agreed to pay $40 million amortized over the estimated period benefited. This for certain ATA assets, consisting of the leasehold estimated period was the least of ten years, the next D rights to six of ATA's leased Chicago Midway Airport check, or the remaining life of the aircraft (the MSG-2 gates and the rights to a leased aircraft maintenance program.) The Company's new program for these hangar at Chicago Midway Airport. In addition, South- aircraft is a ""top-down'' program, which requires more west provided ATA with $40 million in debtor-in- frequent inspections in many cases, with repairs and possession financing while ATA remains in bankruptcy, replacements performed when defects are detected and also guaranteed the repayment of an ATA construc- rather than at stipulated intervals without regard to the tion loan to the City of Chicago for $7 million. As part condition of the components (the ""MSG-3 program''). of this original transaction, Southwest also committed, The MSG-3 program does not include D checks. upon ATA's emergence from bankruptcy, to convert

Due to the change in the nature of the mainte- nance activities performed, the Company will change its method of accounting for scheduled airframe and in-

the debtor-in-possession financing to a term loan, paya- ble over five years, and to invest $30 million in cash into ATA convertible preferred stock.

spection repairs for 737-300 and 737-500 aircraft from During fourth quarter 2005, ATA, although still the deferral method to the direct expense method, in bankruptcy, entered into an agreement in which an effective January 1, 2006. Under the direct expense investor, MatlinPatterson Global Opportunities Part- method, the cost of scheduled airframe and inspection ners II (""MatlinPatterson'') would provide financing to repairs is expensed as incurred. The Company believes enable ATA to emerge from bankruptcy in early 2006. the direct expense method is preferable to its former As part of this transaction, Southwest entered into an method because it more closely aligns with the nature of agreement with ATA to acquire the leasehold rights to activities performed, it eliminates any judgment in de- four additional leased gates at Chicago Midway Airport termining which costs should be deferred versus ex- in exchange for a $20 million reduction in the Com- pensed, it matches the method currently utilized on the pany's debtor-in-possession loan. This resulted in a Company's 737-700 fleet, and it is the predominant $20 million increase to intangible assets, classified in method utilized for airframe maintenance in the airline Other assets, and a corresponding $20 million decrease industry, particularly among the largest airlines. The in Accounts and other receivables on the Consolidated remaining net unamortized balance of previously capi- Balance Sheet. Since this transaction was non-cash, it is talized D checks in the Company's Consolidated Bal- not reflected in the Consolidated Statement of Cash ance Sheet was a net asset of $216 million at Flows. Upon ATA's emergence from bankruptcy, it will December 31, 2005. repay the remaining $20 million balance of the

The Company will record the change in account- debtor-in-possession financing, and will provide a letter ing in accordance with Statement of Financial Account- of credit to support Southwest's obligation under the ing Standards No. 154, *Accounting Changes and Error* construction loan to the City of Chicago. In addition, as *Corrections* (SFAS 154), which is also effective for part of the 2005 agreement, Southwest has also been calendar year companies on January 1, 2006. SFAS 154 relieved of its commitment to purchase ATA converti-

ble preferred stock. The 2005 agreement is subject to from Boeing. As of December 31, 2005, the Company certain conditions including ATA's successful emer- had contractual purchase commitments with Boeing for gence from bankruptcy on or before February 28, 2006. 33 737-700 aircraft deliveries in 2006, 28 scheduled for

Southwest and ATA agreed on a code share ar- rangement, which was approved by the Department of Transportation in January 2005. Under the agreement, which has since been expanded, each carrier can ex- change passengers on certain designated flights. Sales of the code share flights began January 16, 2005, with travel dates beginning February 4, 2005. As part of the December 2005 agreement with ATA, Southwest has enhanced its codeshare arrangement with ATA, subject to certain conditions, including ATA's confirmation of a Plan of Reorganization, which must be fulfilled by February 28, 2006.

## Commitments

The Company's contractual purchase commit- ments primarily consist of scheduled aircraft acquisitions

## Accrued Liabilities

delivery in 2007, and six in 2008. During January 2006, the Company exercised an additional option for 2007 to bring our commitment to 29 aircraft for that year. In addition, the Company has options and purchase rights for an additional 249 737-700s that it may acquire during 2007-2012, following the January 2006 option exercise. The Company has the option, which must be exercised two years prior to the contractual delivery date, to substitute 737-600s or 737-800s for the 737-700s. As of December 31, 2005, aggregate funding needed for firm commitments is approximately $1.3 bil- lion, subject to adjustments for inflation, due as follows:

$740 million in 2006, $458 million in 2007, and

$80 million in 2008.

**2005 2004**

**(In millions)**

|  |  |  |  |
| --- | --- | --- | --- |
| Retirement plans (Note 14) ÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏ | **$ 142** |  | $ 89 |
| Aircraft rentals ÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏ | **116** |  | 127 |
| Vacation payÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏ | **135** |  | 120 |
| Advances and deposits ÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏ | **955** |  | 334 |
| Deferred income taxes ÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏ | **489** |  | 218 |
| Other ÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏ | **237** |  | 159 |
| Accrued liabilities ÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏ | **$2,074** |  | $1,047 |

1. **Revolving Credit Facility** drawn, the spread over LIBOR would be 62.5 basis

The Company has a revolving credit facility under which it can borrow up to $600 million from a group of banks. The facility expires in August 2010 and is unsecured. At the Company's option, interest on the facility can be calculated on one of several different bases. For most borrowings, Southwest would anticipate choosing a floating rate based upon LIBOR. If fully

points given Southwest's credit rating at December 31, 2005. The facility also contains a financial covenant requiring a minimum coverage ratio of adjusted pretax income to fixed obligations, as defined. As of Decem- ber 31, 2005, the Company is in compliance with this covenant, and there are no outstanding amounts bor- rowed under this facility.

## Long-Term Debt

**2005 2004**

**(In millions)**

|  |  |  |  |
| --- | --- | --- | --- |
| 8% Notes due 2005 ÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏ | **$ Ì** |  | $ 100 |
| Zero coupon Notes due 2006 ÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏ | **58** |  | 58 |
| Pass Through Certificates ÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏ | **523** |  | 544 |
| 77/8% Notes due 2007 ÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏ | **100** |  | 100 |
| French Credit Agreements due 2012ÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏ | **41** |  | 44 |
| 61/2% Notes due 2012 ÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏ | **370** |  | 377 |
| 51/4% Notes due 2014 ÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏ | **340** |  | 348 |
| 51/8% Notes due 2017 ÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏ | **300** |  | Ì |
| French Credit Agreements due 2017ÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏ | **106** |  | 111 |
| 73/8% Debentures due 2027 ÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏ | **100** |  | 100 |
| Capital leases (Note 8) ÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏ | **74** |  | 80 |
|  | **2,012** |  | 1,862 |
| Less current maturities ÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏ | **601** |  | 146 |
| Less debt discount and issue costs ÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏ | **17** |  | 16 |
|  | **$1,394** |  | $1,700 |

In first quarter 2005, the Company redeemed its In September 2004, the Company issued

$100 million senior unsecured 8% Notes on their $350 million senior unsecured Notes due 2014. The maturity date of March 1, 2005. notes bear interest at 5.25 percent, payable semi-annu- ally in arrears, on April 1 and October 1. Concurrently,

During February 2005, the Company issued

$300 million senior unsecured Notes due 2017. The Notes bear interest at 5.125 percent, payable semi- annually in arrears, with the first payment made on September 1, 2005. Southwest used the net proceeds from the issuance of the notes, approximately $296 mil-

the Company entered into an interest-rate swap agree- ment to convert this fixed-rate debt to a floating rate. See Note 10 for more information on the interest-rate swap agreement. Southwest used the net proceeds from the issuance of the notes, approximately $346 million, for general corporate purposes.

lion, for general corporate purposes. In February 2004 and April 2004, the Company issued two separate $29 million two-year notes, each

In fourth quarter 2004, the Company entered into secured by one new 737-700 aircraft. Both of the notes four identical 13-year floating-rate financing arrange- are non-interest bearing and accrete to face value at ments, whereby it borrowed a total of $112 million from maturity at annual rates of 2.9 percent and 3.4 percent, French banking partnerships. Although the interest on respectively. The proceeds of these borrowings were the borrowings are at floating rates, the Company used to fund the individual aircraft purchases. estimates that, considering the full effect of the ""net

present value benefits'' included in the transactions, the On March 1, 2002, the Company issued $385 mil- effective economic yield over the 13-year term of the lion senior unsecured Notes due March 1, 2012. The loans will be approximately LIBOR minus 45 basis notes bear interest at 6.5 percent, payable semi-annually points. Principal and interest are payable semi-annually on March 1 and September 1. Southwest used the net on June 30 and December 31 for each of the loans, and proceeds from the issuance of the notes, approximately the Company may terminate the arrangements in any $380 million, for general corporate purposes. During year on either of those dates, with certain conditions. 2003, the Company entered into an interest rate swap The Company pledged four aircraft as collateral for the agreement relating to these notes. See Note 10 for transactions. further information.

On October 30, 2001, the Company issued the Company may terminate the arrangements in any

$614 million Pass Through Certificates consisting of year on either of those dates, with certain conditions.

$150 million 5.1% Class A-1 certificates, $375 million The Company pledged two aircraft as collateral for the 5.5% Class A-2 certificates, and $89 million 6.1% transactions.

Class B certificates. A separate trust was established for

each class of certificates. The trusts used the proceeds from the sale of certificates to acquire equipment notes, which were issued by Southwest on a full recourse basis. Payments on the equipment notes held in each trust will be passed through to the holders of certificates of such trust. The equipment notes were issued for each of 29 Boeing 737 -700 aircraft owned by Southwest and are secured by a mortgage on such aircraft. Interest on the equipment notes held for the certificates is payable semiannually, on May 1 and November 1. Beginning May 1, 2002, principal payments on the equipment notes held for the Class A-1 certificates are due semian- nually until the balance of the certificates mature on

On February 28, 1997, the Company issued

$100 million of senior unsecured 73/8% Debentures due March 1, 2027. Interest is payable semi-annually on March 1 and September 1. The debentures may be redeemed, at the option of the Company, in whole at any time or in part from time to time, at a redemption price equal to the greater of the principal amount of the debentures plus accrued interest at the date of redemp- tion or the sum of the present values of the remaining scheduled payments of principal and interest thereon, discounted to the date of redemption at the comparable treasury rate plus 20 basis points, plus accrued interest at the date of redemption.

May 1, 2006. The entire principal of the equipment During 1992, the Company issued $100 million of notes for the Class A-2 and Class B certificates are senior unsecured 77/8% Notes due September 1, 2007. scheduled for payment on November 1, 2006. During Interest is payable semi-annually on March 1 and 2003, the Company entered into an interest rate swap September 1. The notes are not redeemable prior to agreement relating to the $375 million 5.5% Class A-2 maturity.

certificates. See Note 10 for further information.

The net book value of the assets pledged as In fourth quarter 1999, the Company entered into collateral for the Company's secured borrowings, prima-

two identical 13-year floating rate financing arrange- rily aircraft and engines, was $856 million at Decem- ments, whereby it borrowed a total of $56 million from ber 31, 2005.

French banking partnerships. Although the interest on

the borrowings are at floating rates, the Company As of December 31, 2005, aggregate annual prin- estimates that, considering the full effect of the ""net cipal maturities (not including amounts associated with present value benefits'' included in the transactions, the interest rate swap agreements, and interest on capital effective economic yield over the 13-year term of the leases) for the five-year period ending December 31, loans will be approximately LIBOR minus 67 basis 2010, were $612 million in 2006, $127 million in points. Principal and interest are payable semi-annually 2007, $28 million in 2008, $29 million in 2009, on June 30 and December 31 for each of the loans and $30 million in 2010, and $1.2 billion thereafter.

## Leases

The Company had nine aircraft classified as capital leases at December 31, 2005. The amounts applicable to these aircraft included in property and equipment were:

**2005 2004**

**(In millions)**

|  |  |  |
| --- | --- | --- |
| Flight equipment ÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏ **$164** |  | $173 |
| Less accumulated depreciation ÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏ **113** |  | 126 |
| **$ 51** |  | $ 47 |

Total rental expense for operating leases, both aircraft and other, charged to operations in 2005, 2004, and 2003 was $409 million, $403 million, and $386 million, respectively. The majority of the Company's terminal operations

space, as well as 84 aircraft, were under operating leases at December 31, 2005. Future minimum lease payments under capital leases and noncancelable operating leases with initial or remaining terms in excess of one year at December 31, 2005, were:

**Capital Leases Operating Leases**

|  |  |  |
| --- | --- | --- |
|  | | **(In millions)** |
| 2006 ÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏ | $16 | $ 332 |
| 2007 ÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏ | 16 | 309 |
| 2008 ÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏ | 16 | 274 |
| 2009 ÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏ | 16 | 235 |
| 2010 ÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏ | 15 | 219 |
| After 2010 ÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏ | 12 | 1,164 |
| Total minimum lease paymentsÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏ | 91 | $2,533 |
| Less amount representing interest ÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏ | 17 |  |
| Present value of minimum lease payments ÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏ | 74 |  |
| Less current portion ÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏ | 11 |  |
| Long-term portionÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏ | $63 |  |

The aircraft leases generally can be renewed at quarter 2004, was approximately $18 million. Employee rates based on fair market value at the end of the lease severance and benefit costs were reflected in ""Salaries, term for one to five years. Most aircraft leases have wages, and benefits,'' and the majority of other costs in purchase options at or near the end of the lease term at ""Other operating expenses'' in the Consolidated State- fair market value, generally limited to a stated percent- ment of Income. The total remaining amount accrued age of the lessor's defined cost of the aircraft. (not yet paid) was immaterial at December 31, 2005.

## Consolidation of Reservations Centers

In November 2003, the Company announced the

## Derivative and Financial Instruments

### *Fuel Contracts*

consolidation of its nine Reservations Centers into six, Airline operators are inherently dependent upon effective February 28, 2004. This decision was made in energy to operate and, therefore, are impacted by response to the established shift by Customers to the changes in jet fuel prices. Jet fuel and oil consumed in internet as a preferred way of booking travel. The 2005, 2004, and 2003 represented approximately Company's website, [**www.southwest.com,**](http://www.southwest.com/)now ac- 19.8 percent, 16.7 percent, and 15.2 percent of South- counts for almost 70 percent of ticket bookings and, as west's operating expenses, respectively. The Company a consequence, demand for phone contact has dramati- endeavors to acquire jet fuel at the lowest possible cost. cally decreased. During first quarter 2004, the Company Because jet fuel is not traded on an organized futures closed its Reservations Centers located in Dallas, Texas, exchange, liquidity for hedging is limited. However, the Salt Lake City, Utah, and Little Rock, Arkansas. The Company has found commodities for effective hedging Company provided the 1,900 affected Employees at of jet fuel costs, primarily crude oil, and refined prod- these locations the opportunity to relocate to another of ucts such as heating oil and unleaded gasoline. The the Company's remaining six centers. Those Employees Company utilizes financial derivative instruments as choosing not to relocate, approximately 55% of the total hedges to decrease its exposure to jet fuel price in- affected, were offered support packages, which included creases. The Company does not purchase or hold any severance pay, flight benefits, medical coverage, and derivative financial instruments for trading purposes. job-search assistance, depending on length of service

with the Company. The total cost associated with the The Company has utilized financial derivative in- Reservations Center consolidation, recognized in first struments for both short-term and long-term time

frames. In addition to the significant hedging positions refined products. Due to the volatility in markets for the Company had in place during 2005, the Company crude oil and related products, the Company is unable also has significant future hedging positions. The Com- to predict the amount of ineffectiveness each period, pany currently has a mixture of purchased call options, including the loss of hedge accounting, which could be collar structures, and fixed price swap agreements in determined on a derivative by derivative basis or in the place to hedge over 70 percent of its 2006 total aggregate. This may result in increased volatility in the anticipated jet fuel requirements at average crude oil Company's results. The significant increase in the equivalent prices of approximately $36 per barrel, and amount of hedge ineffectiveness and unrealized gains on has also hedged the refinery margins on most of those derivative contracts settling in future periods recorded positions. The Company is also over 60 percent hedged during the Company's most recent five fiscal quarters for 2007 at approximately $39 per barrel, over 35 per- was due to a number of factors. These factors included: cent hedged for 2008 at approximately $38 per barrel, the recent significant fluctuation in energy prices, the and approximately 30 percent hedged for 2009 at number of derivative positions the Company holds, approximately $39 per barrel. significant weather events that have affected refinery capacity and the production of refined products, and the

The Company accounts for its fuel hedge deriva- volatility of the different types of products the Company tive instruments as cash flow hedges, as defined in uses in hedging. The number of instances in which the Statement of Financial Accounting Standards No. 133, Company has discontinued hedge accounting for spe- *Accounting for Derivative Instruments and Hedging* cific hedges has increased recently, primarily due to *Activities,* as amended (SFAS 133). Under SFAS 133, these reasons. In these cases, the Company has deter- all derivatives designated as hedges that meet certain mined that the hedges will not regain effectiveness in requirements are granted special hedge accounting the time period remaining until settlement and therefore treatment. Generally, utilizing the special hedge ac- must discontinue special hedge accounting, as defined counting, all periodic changes in fair value of the by SFAS 133. When this happens, any changes in fair derivatives designated as hedges that are considered to value of the derivative instruments are marked to market be effective, as defined, are recorded in ""Accumulated through earnings in the period of change. As the fair other comprehensive income'' until the underlying jet value of the Company's hedge positions increases in fuel is consumed. See Note 11 for further information amount, there is a higher degree of probability that on Accumulated other comprehensive income. The there will be continued variability recorded in the Company is exposed to the risk that periodic changes income statement and that the amount of hedge ineffec- will not be effective, as defined, or that the derivatives tiveness and unrealized gains or losses recorded in future will no longer qualify for special hedge accounting. periods will be material. This is primarily due to the fact Ineffectiveness, as defined, results when the change in that small differences in the correlation of crude oil the total fair value of the derivative instrument does not related products are leveraged over large dollar volumes. exactly equal the change in the value of the Company's

expected future cash outlay to purchase jet fuel. To the extent that the periodic changes in the fair value of the derivatives are not effective, that ineffectiveness is re- corded to ""Other gains and losses'' in the income statement. Likewise, if a hedge ceases to qualify for hedge accounting, those periodic changes in the fair value of derivative instruments are recorded to ""Other gains and losses'' in the income statement in the period of the change.

During 2005, the Company recognized approxi-

mately $110 million of additional income in ""Other (gains) losses, net,'' related to the ineffectiveness of its hedges and the loss of hedge accounting for certain hedges. Of this amount, approximately $77 million of the additional income was unrealized, mark-to-market changes in the fair value of derivatives due to the discontinuation of hedge accounting for certain con- tracts that will settle in future periods, approximately

$9 million was ineffectiveness associated with hedges

Ineffectiveness is inherent in hedging jet fuel with designated for future periods, and $24 million was derivative positions based in other crude oil related ineffectiveness and mark-to-market gains related to commodities, especially given the magnitude of the hedges that settled during 2005. During 2004, the current fair market value of the Company's fuel hedge Company recognized approximately $13 million of ad- derivatives and the recent volatility in the prices of ditional expense in ""Other (gains) losses, net,'' related

to the ineffectiveness of its hedges. During 2003, the on actual and forward rates at December 31, 2005. Company recognized approximately $16 million of ad- Under the second agreement, the Company pays ditional income in ""Other (gains) losses, net,'' related LIBOR plus a margin every six months and receives to the ineffectiveness of its hedges. During 2005, 2004, 5.496% every six months on a notional amount of and 2003, the Company recognized approximately $375 million until 2006. Based on actual and forward

$35 million, $24 million, and $29 million of net rates at December 31, 2005, the average floating rate expense, respectively, related to amounts excluded from paid under this agreement during 2005 is estimated to the Company's measurements of hedge effectiveness, in be 6.73 percent.

""Other (gains) losses, net''. During 2004, the Company entered into an inter- During 2005, 2004, and 2003, the Company est rate swap agreement relating to its $350 million recognized gains in ""Fuel and oil'' expense of $890 mil- 5.25% senior unsecured notes due 2014. Under this lion, $455 million, and $171 million, respectively, from agreement, the Company pays LIBOR plus a margin hedging activities. At December 31, 2005 and 2004, every six months and receives 5.25% every six months approximately $83 million and $51 million, respec- on a notional amount of $350 million until 2014. The tively, due from third parties from expired derivative floating rate is set in advance. The average floating rate contracts, is included in ""Accounts and other receiv- paid under this agreement during 2005 was

ables'' in the accompanying Consolidated Balance 3.82 percent.

Sheet. The fair value of the Company's financial deriva- The primary objective for the Company's use of tive instruments at December 31, 2005, was a net asset interest rate hedges is to reduce the volatility of net of approximately $1.7 billion. The current portion of interest income by better matching the repricing of its these financial derivative instruments, $640 million, is assets and liabilities. Concurrently, the Company's in- classified as ""Fuel hedge contracts'' and the long-term terest rate hedges are also intended to take advantage of portion, $1.1 billion, is classified as ""Other assets'' in market conditions in which short-term rates are signifi- the Consolidated Balance Sheet. The fair value of the cantly lower than the fixed longer term rates on the derivative instruments, depending on the type of instru- Company's long-term debt. The Company's interest ment, was determined by the use of present value rate swap agreements qualify as fair value hedges, as methods or standard option value models with assump- defined by SFAS 133. The fair value of the interest rate tions about commodity prices based on those observed swap agreements, which are adjusted regularly, are in underlying markets. recorded in the Consolidated Balance Sheet, as neces-

As of December 31, 2005, the Company had sary, with a corresponding adjustment to the carrying approximately $890 million in unrealized gains, net of value of the long-term debt. The fair value of the tax, in ""Accumulated other comprehensive income interest rate swap agreements, excluding accrued inter- (loss)'' related to fuel hedges. Included in this total are est, at December 31, 2005, was a liability of approxi- approximately $327 million in net unrealized gains that mately $31 million. The long-term portion of this are expected to be realized in earnings during 2006. amount is recorded in ""Other deferred liabilities'' in the

Consolidated Balance Sheet and the current portion is

***Interest Rate Swaps*** reflected in ""Accrued liabilities''. In accordance with

During 2003, the Company entered into interest rate swap agreements relating to its $385 million 6.5% senior unsecured notes due 2012 and $375 million

fair value hedging, the offsetting entry is an adjustment to decrease the carrying value of long-term debt. See Note 7.

5.496% Class A-2 pass-through certificates due 2006. Outstanding financial derivative instruments ex- The floating rate paid under each agreement is set in pose the Company to credit loss in the event of nonper- arrears. Under the first agreement, the Company pays formance by the counterparties to the agreements. the London InterBank Offered Rate (LIBOR) plus a However, the Company does not expect any of the margin every six months and receives 6.5% every six counterparties to fail to meet their obligations. The months on a notional amount of $385 million until credit exposure related to these financial instruments is 2012. The average floating rate paid under this agree- represented by the fair value of contracts with a positive ment during 2005 is estimated to be 6.46 percent based fair value at the reporting date. To manage credit risk,

the Company selects and periodically reviews The carrying amounts and estimated fair values of counterparties based on credit ratings, limits its expo- the Company's long-term debt and fuel contracts at sure to a single counterparty, and monitors the market December 31, 2005 were as follows:

position of the program and its relative market position **Carrying Estimated**

with each counterparty. At December 31, 2005, the

Company had agreements with seven counterparties

**Value Fair Value**

**(In millions)**

bilateral collateral provisions. These collateral deposits

|  |  |  |  |
| --- | --- | --- | --- |
| containing early termination rights and/or bilateral | Zero coupon Notes due 2006 ÏÏ | $ 58 | $ 58 |
| collateral provisions whereby security is required if | Pass Through Certificates ÏÏÏÏÏ | 523 | 525 |
| market risk exposure exceeds a specified threshold 77/8% Notes due 2007 ÏÏÏÏÏÏÏÏ | | 100 | 104 |
| amount or credit ratings fall below certain levels. At French Credit Agreements due  December 31, 2005, the Company held $950 million in 2012 ÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏ | | 41 | 41 |
| fuel hedge related cash collateral deposits under these 61/2% Notes due 2012 ÏÏÏÏÏÏÏÏ | | 370 | 392 |
| serve to decrease, but not totally eliminate, the credit 51/4% Notes due 2014 ÏÏÏÏÏÏÏÏ | | 340 | 332 |
| risk associated with the Company's hedging program. 51/8% Notes due 2017 ÏÏÏÏÏÏÏÏ | | 300 | 282 |
| The cash deposits, which can have a significant impact French Credit Agreements due | |  |  |
| on the Company's cash balance and cash flows as of and | 2017 ÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏ | 106 | 106 |
| for a particular operating period, are included in ""Ac- | 73/8% Debentures due 2027ÏÏÏÏ | 100 | 111 |

crued liabilities'' on the Consolidated Balance Sheet and Fuel ContractsÏÏÏÏÏÏÏÏÏÏÏÏÏÏ 1,678 1,678 are included as ""Operating cash flows'' in the Consoli-

dated Statement of Cash Flows. The estimated fair values of the Company's pub- licly held long-term debt were based on quoted market prices. The carrying values of all other financial instru- ments approximate their fair value.

## Comprehensive Income

Comprehensive income includes changes in the fair value of certain financial derivative instruments, which qualify for hedge accounting, and unrealized gains and losses on certain investments. Comprehensive income totaled

$1.0 billion, $608 million, and $510 million for 2005, 2004, and 2003, respectively. The differences between ""Net income'' and ""Comprehensive income'' for these years are as follows:

|  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- |
| **2005** | | **2004** | | **2003** | |
| **(In millions)** | | | | | |
| **Net income ÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏ** | **$ 548** | $313 | | $442 | |
| Unrealized gain (loss) on derivative |  |  | |  | |
| instruments, net of deferred taxes of $300, $185 and $43 ÏÏÏÏÏÏÏÏÏÏÏÏ | **474** |  | 293 |  | 66 |
| Other, net of deferred taxes of $0, $1 and $1 ÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏ | **1** |  | 2 |  | 2 |
| Total other comprehensive income ÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏ | **475** |  | 295 |  | 68 |
| **Comprehensive income ÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏ** | **$1,023** |  | $608 |  | $510 |

A rollforward of the amounts included in ""Accumulated other comprehensive income (loss)'', net of taxes for 2005, 2004, and 2003, is shown below:

**Fuel Accumulated Other**

**Hedge Comprehensive Derivatives Other Income (Loss)**

|  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- |
|  | | | | **(In millions)** |  |
| Balance at December 31, 2003 ÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏ |  | $ 123 |  | $(1) | $ 122 |
| 2004 changes in fair value ÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏ |  | 558 |  | 2 | 560 |
| Reclassification to earnings ÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏ |  | (265) |  | Ì | (265) |
| Balance at December 31, 2004 ÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏ |  | 416 |  | 1 | 417 |
| **2005 changes in fair value ÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏ** |  | **999** |  | **1** | **1,000** |
| **Reclassification to earnings ÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏ** |  | **(525)** |  | **Ì** | **(525)** |
| **Balance at December 31, 2005 ÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏ** |  | **$ 890** |  | **$ 2** | **$ 892** |

1. **Common Stock** bargaining plans) and stock plans covering Employees not subject to collective bargaining agreements (other

The Company has one class of common stock. Employee plans). None of the collective bargaining Holders of shares of common stock are entitled to plans were required to be approved by shareholders. receive dividends when and if declared by the Board of Options granted to Employees under collective bargain- Directors and are entitled to one vote per share on all ing plans are granted at or above the fair market value of matters submitted to a vote of the shareholders. At the Company's common stock on the date of grant, and December 31, 2005, the Company had 236 million generally have terms ranging from six to twelve years. shares of common stock reserved for issuance pursuant Vesting terms differ based on the grant made, and have to Employee stock benefit plans (of which 36 million ranged in length from immediate vesting to vesting shares have not been granted.) periods in accordance with the period covered by the

In January 2004, the Company's Board of Direc- tors authorized the repurchase of up to $300 million of the Company's common stock, utilizing proceeds from the exercise of Employee stock options. Repurchases were made in accordance with applicable securities laws in the open market or in private transactions from time to time, depending on market conditions. During first quarter 2005, the Company completed this program. In total, the Company repurchased approximately

20.9 million of its common shares during the course of the program.

respective collective bargaining agreement. Neither Ex- ecutive Officers nor members of the Company's Board of Directors are eligible to participate in any of these collective bargaining plans. Options granted to Employ- ees through other Employee plans are granted at the fair market value of the Company's common stock on the date of grant, have ten-year terms, and vest and become fully exercisable over three, five, or ten years of contin- ued employment, depending upon the grant type. All of the options included under the heading of ""Other Employee Plans'' have been approved by shareholders, except the plan covering non-management, non-con-

In January 2006, the Company's Board of Direc- tract Employees, which had 6.3 million options out- tors authorized the repurchase of up to $300 million of standing to purchase the Company's common stock as the Company's common stock. Repurchases will be of December 31, 2005.

made in accordance with applicable securities laws in the open market or in private transactions from time to time, depending on market conditions.

## Stock Plans

The Company has stock plans covering Employees subject to collective bargaining agreements (collective

Aggregated information regarding the Company's fixed stock option plans is summarized below:

**Collective Bargaining Plans Other Employee Plans Wtd. Average Wtd. Average**

**Options Exercise Price Options Exercise Price**

**(In thousands, except exercise prices)**

|  |  |  |  |  |
| --- | --- | --- | --- | --- |
| Outstanding December 31, 2002 ÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏ | 104,020 | $ 9.51 | 34,152 | $11.47 |
| Granted ÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏ | 26,674 | 13.53 | 4,770 | 14.63 |
| Exercised ÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏ | (7,422) | 6.78 | (3,318) | 7.95 |
| Surrendered ÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏ | (3,214) | 12.69 | (1,052) | 13.57 |
| Outstanding December 31, 2003 ÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏ | 120,058 | 10.47 | 34,552 | 12.21 |
| Granted ÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏ | 14,131 | 14.41 | 4,255 | 15.05 |
| Exercised ÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏ | (7,222) | 6.59 | (3,133) | 6.79 |
| Surrendered ÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏ | (6,264) | 13.62 | (1,453) | 14.54 |
| Outstanding December 31, 2004 ÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏ | 120,703 | 10.98 | 34,221 | 12.94 |
| **GrantedÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏ** | **1,697** | **14.91** | **6,662** | **15.60** |
| **Exercised ÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏ** | **(14,739)** | **6.13** | **(3,800)** | **7.09** |
| **Surrendered ÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏ** | **(2,417)** | **13.89** | **(1,263)** | **15.60** |
| **Outstanding December 31, 2005ÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏ** | **105,244** | **$11.65** | **35,820** | **$13.96** |
| **Exercisable December 31, 2005 ÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏ** | **76,283** | **$10.73** | **20,395** | **$13.78** |
| **Available for grant in future periods ÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏ** | **28,798** |  | **5,359** |  |

The following table summarizes information about stock options outstanding under the fixed option plans at December 31, 2005:

**Options Outstanding Options Exercisable Options Wtd-Average Options**

**Outstanding at Remaining Wtd-Average Exercisable at Wtd-Average**

**Range of Exercise Prices 12/31/05 (000s) Contractual Life Exercise Price 12/31/05 (000s) Exercise Price**

|  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- |
| $ 3.95 to $5.87 ÏÏÏÏÏÏ | 25,906 | 1.0 yrs | $ 4.12 | 25,272 | $ 4.12 |
| $ 7.04 to $10.49 ÏÏÏÏÏ | 6,565 | 3.1 yrs | 8.91 | 4,274 | 8.78 |
| $10.87 to $16.30 ÏÏÏÏÏ | 93,277 | 5.8 yrs | 13.74 | 58,479 | 13.60 |
| $16.32 to $23.93 ÏÏÏÏÏ | 15,316 | 6.1 yrs | 18.27 | 8,653 | 18.81 |
| $ 3.72 to $23.93 ÏÏÏÏÏ | 141,064 | 4.9 yrs | $12.24 | 96,678 | $11.37 |

Under the amended 1991 Employee Stock the plan received 1.5 million shares in 2005, 1.5 million Purchase Plan (ESPP), which has been approved by shares in 2004, and 1.4 million shares in 2003, at shareholders, as of December 31, 2005, the Company is average prices of $13.19, $13.47, and $14.04, respec- authorized to issue up to a remaining balance of tively. The weighted-average fair value of each purchase

2.0 million shares of common stock to Employees of the right under the ESPP granted in 2005, 2004, and 2003, Company. These shares may be issued at a price equal which is equal to the ten percent discount from the to 90 percent of the market value at the end of each market value of the common stock at the end of each purchase period. Common stock purchases are paid for purchase period, was $1.47, $1.50, and $1.56, through periodic payroll deductions. Participants under respectively.

Pro forma information regarding net income and net income per share, as disclosed in Note 1, has been determined as if the Company had accounted for its Employee stock-based compensation plans and other stock options under the fair value method of SFAS 123. The fair value of each option grant is estimated on the date of grant using a modified Black-Scholes option pricing model with the following weighted-average assumptions used for grants under the fixed option plans:

|  |  |  |  |
| --- | --- | --- | --- |
| **2005** | | **2004** | **2003** |
| Wtd-average risk-free interest rate ÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏ | **4.1%** | 3.1% | 2.6% |
| Expected life of option (years)ÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏ | **4.7** | 4.0 | 4.2 |
| Expected stock volatility ÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏ | **26.2%** | 34.0% | 34.0% |
| Expected dividend yieldÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏ | **0.09%** | 0.11% | 0.13% |

The Black-Scholes option valuation model was Company contributions to all retirement plans developed for use in estimating the fair value of short- expensed in 2005, 2004, and 2003 were $264 million, term traded options that have no vesting restrictions and $200 million, and $219 million, respectively.

are fully transferable. In addition, option valuation mod-

els require the input of somewhat subjective assumptions ***Postretirement Benefit Plans***

including expected stock price volatility. During 2005,

the Company modified its method of determining ex- pected future volatility associated with options granted. Prior to 2005, the Company primarily had determined this volatility by observation of historical volatility trends, subject to adjustment by exclusion of outliers that were not deemed typical of trends noted during the periods observed. For 2005, the Company relied on observations of both historical volatility trends as well as implied future volatility observations as determined by

The Company provides postretirement benefits to

qualified retirees in the form of medical and dental coverage. Employees must meet minimum levels of service and age requirements as set forth by the Com- pany, or as specified in collective bargaining agreements with specific workgroups. Employees meeting these requirements, as defined, may use accrued sick time to pay for medical and dental premiums from the age of retirement until age 65.

independent third parties. The following table shows the change in the

The fair value of options granted under the fixed option plans during 2005 ranged from $2.90 to $6.79. The fair value of options granted under the fixed option plans during 2004 ranged from $3.45 to $7.83. The fair value of options granted under the fixed option plans during 2003 ranged from $3.33 to $8.17.

Company's accumulated postretirement benefit obliga- tion (APBO) for the years ended December 31, 2005 and 2004:

**2005 2004**

**(In millions)** APBO at beginning of period ÏÏÏÏÏÏÏÏ $80 $77 Service cost ÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏ 12 10

1. **Employee Retirement Plans** Interest cost ÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏ 4 5

### *Defined Contribution Plans*

Benefits paid ÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏ (2) (1)

Actuarial (gain) loss ÏÏÏÏÏÏÏÏÏÏÏÏÏ Ì (11)

The Company has defined contribution plans cov- Plan amendments ÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏ Ì Ì ering substantially all Southwest Employees. The South-

west Airlines Co. Profitsharing Plan is a money purchase defined contribution plan and Employee stock

APBO at end of period ÏÏÏÏÏÏÏÏÏÏÏÏÏ $94 $80

purchase plan. The Company also sponsors Employee During first quarter 2004, the Company closed its savings plans under section 401(k) of the Internal Reservations Centers located in Dallas, Texas, Salt Lake Revenue Code, which include Company matching con- City, Utah, and Little Rock, Arkansas. In excess of tributions. The 401(k) plans cover substantially all 1,000 Employees at these locations did not elect to Employees. Contributions under all defined contribu- relocate to the Company's remaining centers and, in- tion plans are primarily based on Employee compensa- stead, accepted severance packages offered by the Com- tion and performance of the Company. pany. See Note 9 for further information. Also during

2004, the Company offered an early-out option to The Company's periodic postretirement benefit substantially all Employees, primarily in an effort to cost for the years ended December 31, 2005, 2004, and alleviate overstaffing in certain areas of the Company. 2003, included the following:

As a result of the reduction in headcount associated with **2005 2004 2003**

these events, the Company remeasured its benefit obli- **(In millions)**

|  |  |  |  |  |
| --- | --- | --- | --- | --- |
| gation, resulting in the 2004 gain. Service cost ÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏ | | **$12** | $10 | $ 9 |
| The assumed healthcare cost trend rates have a Interest costÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏ | | **4** | 5 | 4 |
| significant effect on the amounts reported for the Com- Amortization of prior service | |  |  |  |
| pany's plan. A one-percent change in all healthcare cost | cost ÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏ | **2** | 2 | 2 |
| trend rates used in measuring the APBO at Decem- | Recognized actuarial lossÏÏÏÏÏÏ | Ì | 1 | 1 |

ber 31, 2005, would have the following effects: Net periodic postretirement

**1% Increase 1% Decrease** benefit cost ÏÏÏÏÏÏÏÏÏÏÏÏÏÏ **$18** $18 $16

**(In millions)**

Increase (decrease) in total Unrecognized prior service cost is expensed using a service and interest costs $2 $(1) straight-line amortization of the cost over the average

Increase (decrease) in the future service of Employees expected to receive benefits

APBO ÏÏÏÏÏÏÏÏÏÏÏÏÏÏ $7 $(7) under the plan. The Company used the following

actuarial assumptions to account for its postretirement The Company's plans are unfunded, and benefits benefit plans at December 31:

are paid as they become due. For 2005, both benefits

paid and Company contributions to the plans were each

$2 million. For 2004, both benefits paid and Company

**2005 2004 2003**

Wtd-average discount rate ÏÏ **5.25%** 6.25% 6.75%

contributions to the plans were each $1 million. Esti- Assumed healthcare cost

mated future benefit payments expected to be paid for trend rate(1)ÏÏÏÏÏÏÏÏÏÏ **9.00%** 10.00% 10.00% each of the next five years are $4 million in 2006,

$6 million in 2007, $8 million in 2008, $10 million in 2009, $12 million in 2010, and $84 million for the next five years thereafter.

The following table shows the calculation of the accrued postretirement benefit cost recognized in ""Other deferred liabilities'' on the Company's Consoli- dated Balance Sheet at December 31, 2005 and 2004:

**2005 2004**

**(In millions)**

(1) The assumed healthcare cost trend rate is assumed to decrease to 8.50% for 2006, then decline gradu- ally to 5% by 2013 and remain level thereafter.

|  |  |  |
| --- | --- | --- |
| Funded status ÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏ | $(94) | $(80) |
| Unrecognized net actuarial loss ÏÏÏÏÏ | 6 | 4 |
| Unrecognized prior service cost ÏÏÏÏÏ | 4 | 8 |
| Cost recognized on Consolidated Balance Sheet ÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏ | $(84) | $(68) |

## Income Taxes

Deferred income taxes reflect the net tax effects of temporary differences between the carrying amounts of assets and liabilities for financial reporting purposes and the amounts used for income tax purposes. The components of deferred tax assets and liabilities at December 31, 2005 and 2004, are as follows:

## DEFERRED TAX LIABILITIES:

**2005 2004**

**(In millions)**

## DEFERRED TAX ASSETS:

|  |  |  |  |
| --- | --- | --- | --- |
| Accelerated depreciationÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏ | **$2,251** | $2,027 | |
| Scheduled airframe maintenance ÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏ | **87** | 83 | |
| Fuel hedges ÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏ | **564** | 264 | |
| Other ÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏ | **3** | 11 | |
| Total deferred tax liabilities ÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏ | **2,905** | 2,385 | |
| Deferred gains from sale and leaseback of aircraft ÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏ | **76** |  | 83 |
| Capital and operating leases ÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏ | **70** |  | 73 |
| Accrued employee benefits ÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏ | **132** |  | 110 |
| State taxes ÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏ | **57** |  | 52 |
| Net operating loss carry forward ÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏ | **164** |  | 186 |
| Other ÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏ | **21** |  | 53 |
| Total deferred tax assets ÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏ | **520** |  | 557 |
| Net deferred tax liability ÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏ | **$2,385** |  | $1,828 |

The provision for income taxes is composed of the following:

## CURRENT:

**2005 2004 2003**

**(In millions)**

## DEFERRED:

|  |  |  |  |  |
| --- | --- | --- | --- | --- |
| Federal ÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏ **$ 60** | $ (8) | | | $ 73 |
| State ÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏ **9** | Ì | | | 10 |
| Total current ÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏ **69** | (8) | | | 83 |
| Federal ÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏ **241** |  | 178 |  | 170 |
| State ÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏ **16** |  | 6 |  | 13 |
| Total deferredÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏ **257** |  | 184 |  | 183 |
| **$326** |  | $176 |  | $266 |

For the year 2004, Southwest Airlines Co. had a year, resulting in the payment of no federal taxes for this tax net operating loss of $616 million for federal income year. The $69 million current tax provision relates to tax purposes. The Company carried a portion of this net the tax benefit of stock options exercised during 2005. operating loss back to prior periods, resulting in a The remaining portion of the Company's federal net

$35 million refund of federal taxes previously paid. This operating loss that can be carried forward to future years refund was received during 2005. The Company applied is estimated at $453 million, and expires in 2024.

a portion of this 2004 net operating loss to the 2005 tax

The effective tax rate on income before income taxes differed from the federal income tax statutory rate for the following reasons:

**2005 2004 2003**

**(In millions)**

|  |  |  |  |
| --- | --- | --- | --- |
| Tax at statutory U.S. tax rates ÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏ | **$306** | $171 | $247 |
| Nondeductible itemsÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏ | **8** | 7 | 7 |
| State income taxes, net of federal benefitÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏ | **16** | 4 | 15 |
| Other, netÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏ | **(4)** | (6) | (3) |
| Total income tax provisionÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏ | **$326** | $176 | $266 |

The Internal Revenue Service (IRS) regularly ex- ing of merit. The Company's management does not amines the Company's federal income tax returns and, expect that the outcome of any proposed adjustments in the course of which, may propose adjustments to the presented to date by the IRS, individually or collectively, Company's federal income tax liability reported on such will have a material adverse effect on the Company's returns. It is the Company's practice to vigorously financial condition, results of operations, or cash flows. contest those proposed adjustments that it deems lack-

## Net Income Per Share

The following table sets forth the computation of net income per share, basic and diluted:

**2005 2004 2003**

**(In millions, except per share amounts)**

|  |  |  |  |  |
| --- | --- | --- | --- | --- |
| Net incomeÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏ **$548** |  | $313 |  | $442 |
| Weighted-average shares outstanding, basic ÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏ **789** |  | 783 |  | 783 |
| Dilutive effect of Employee stock options ÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏ **25** |  | 32 |  | 39 |
| Adjusted weighted-average shares outstanding, diluted ÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏ **814** |  | 815 |  | 822 |
| Net income per share, basic ÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏ **$ .70** |  | $ .40 |  | $ .56 |
| Net income per share, diluted ÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏ **$ .67** |  | $ .38 |  | $ .54 |

The Company has excluded 12 million, 31 million, $2.3 billion government grant for airlines. Southwest and 10 million shares from its calculations of net received $271 million as its proportional share of the income per share, diluted, in 2005, 2004, and 2003, grant during second quarter 2003. This amount is respectively, as they represent antidilutive stock options included in ""Other (gains) losses'' in the accompanying for the respective periods presented. Consolidated Income Statement for 2003. Also as part of the Wartime Act, the Company received approxi-

## Federal Grant

On April 16, 2003, as a result of the United States war with Iraq, the Emergency Wartime Supplemental Appropriations Act (Wartime Act) was signed into law. Among other items, the legislation included a

mately $5 million as a reimbursement for the direct cost of reinforcing cockpit doors on all of the Company's aircraft. The Company accounted for this reimburse- ment as a reduction of capitalized property and equipment.

## REPORT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM

THE BOARD OF DIRECTORS AND SHAREHOLDERS SOUTHWEST AIRLINES CO.

We have audited the accompanying consolidated balance sheets of Southwest Airlines Co. as of December 31, 2005 and 2004, and the related consolidated statements of income, stockholders' equity, and cash flows for each of the three years in the period ended December 31, 2005. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the financial statements referred to above present fairly, in all material respects, the consolidated financial position of Southwest Airlines Co. at December 31, 2005 and 2004, and the consolidated results of its operations and its cash flows for each of the three years in the period ended December 31, 2005, in conformity with United States generally accepted accounting principles.

We have also audited, in accordance with the standards of the Public Company Accounting Oversight Board (United States), the effectiveness of Southwest Airlines Co.'s internal control over financial reporting as of December 31, 2005, based on criteria established in Internal Control Ì Integrated Framework issued by the Committee of Sponsoring Organizations of the Treadway Commission and our report dated January 30, 2006 expressed an unqualified opinion thereon.

ERNST & YOUNG LLP

Dallas, Texas January 30, 2006

## REPORT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM

THE BOARD OF DIRECTORS AND SHAREHOLDERS SOUTHWEST AIRLINES CO.

We have audited management's assessment, included in the accompanying Management's Report on Internal Control over Financial Reporting, that Southwest Airlines Co. maintained effective internal control over financial reporting as of December 31, 2005, based on criteria established in Internal Control Ì Integrated Framework issued by the Committee of Sponsoring Organizations of the Treadway Commission (the COSO criteria). Southwest Airlines' management is responsible for maintaining effective internal control over financial reporting and for its assessment of the effectiveness of internal control over financial reporting. Our responsibility is to express an opinion on management's assessment and an opinion on the effectiveness of the company's internal control over financial reporting based on our audit.

We conducted our audit in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether effective internal control over financial reporting was maintained in all material respects. Our audit included obtaining an understanding of internal control over financial reporting, evaluating management's assessment, testing and evaluating the design and operating effectiveness of internal control, and performing such other procedures as we considered necessary in the circumstances. We believe that our audit provides a reasonable basis for our opinion.

A company's internal control over financial reporting is a process designed to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles. A company's internal control over financial reporting includes those policies and procedures that (1) pertain to the maintenance of records that, in reasonable detail, accurately and fairly reflect the transactions and dispositions of the assets of the company; (2) provide reasonable assurance that transactions are recorded as necessary to permit preparation of financial statements in accordance with generally accepted accounting principles, and that receipts and expenditures of the company are being made only in accordance with authorizations of management and directors of the company; and (3) provide reasonable assurance regarding prevention or timely detection of unauthorized acquisition, use, or disposition of the company's assets that could have a material effect on the financial statements.

Because of its inherent limitations, internal control over financial reporting may not prevent or detect misstatements. Also, projections of any evaluation of effectiveness to future periods are subject to the risk that controls may become inadequate because of changes in conditions, or that the degree of compliance with the policies or procedures may deteriorate.

In our opinion, management's assessment that Southwest Airlines Co. maintained effective internal control over financial reporting as of December 31, 2005, is fairly stated, in all material respects, based on the COSO criteria. Also, in our opinion, Southwest Airlines Co. maintained, in all material respects, effective internal control over financial reporting as of December 31, 2005, based on the COSO criteria.

We also have audited, in accordance with the standards of the Public Company Accounting Oversight Board (United States), the consolidated balance sheets of Southwest Airlines Co. as of December 31, 2005 and 2004, and the related consolidated statements of income, stockholder's equity, and cash flows for each of the three years in the period ended December 31, 2005 of Southwest Airlines Co. and our report dated January 30, 2006 expressed an unqualified opinion thereon.

ERNST & YOUNG LLP

Dallas, TX January 30, 2006

## QUARTERLY FINANCIAL DATA

**(Unaudited)**

2005

**Three Months Ended March 31 June 30 Sept. 30 Dec. 31 (In millions except per share amounts)**

|  |  |  |  |  |
| --- | --- | --- | --- | --- |
| Operating revenues ÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏ | $1,663 | $1,944 | $1,989 | $1,987 |
| Operating income ÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏ | 106 | 277 | 273 | 163 |
| Income before income taxes ÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏ | 114 | 256 | 368 | 136 |
| Net income ÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏ | 76 | 159 | 227 | 86 |
| Net income per share, basic ÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏ | .10 | .20 | .29 | .11 |
| Net income per share, diluted ÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏ | .09  **March 31** | .20  **June 30** | .28  **Sept. 30** | .10  **Dec. 31** |

2004

|  |  |  |  |  |
| --- | --- | --- | --- | --- |
| Operating revenues ÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏ | $1,484 | $1,716 | $1,674 | $1,655 |
| Operating income ÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏ | 46 | 197 | 191 | 120 |
| Income before income taxes ÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏ | 41 | 179 | 181 | 89 |
| Net income ÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏ | 26 | 113 | 119 | 56 |
| Net income per share, basic ÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏ | .03 | .14 | .15 | .07 |
| Net income per share, diluted ÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏÏ | .03 | .14 | .15 | .07 |

**Item 9. *Changes In and Disagreements With*** to the New York Stock Exchange (""NYSE'') that he ***Accountants on Accounting and Financial*** was not aware of any violation by the Company of the ***Disclosure*** NYSE's corporate governance listing standards.

None. *Management's Report on Internal Control over Fi- nancial Reporting.* Management of the Company is

**Item 9A. *Controls and Procedures***

responsible for establishing and maintaining effective

internal control over financial reporting as defined in

*Disclosure Controls and Procedures.* The Com- Rules 13a-15(f) under the Securities Exchange Act of pany maintains controls and procedures designed to 1934. The Company's internal control over financial ensure that it is able to collect the information it is reporting is designed to provide reasonable assurance to required to disclose in the reports it files with the SEC, the Company's management and board of directors and to process, summarize and disclose this information regarding the preparation and fair presentation of pub- within the time periods specified in the rules of the lished financial statements.

SEC. Based on an evaluation of the Company's disclo-

sure controls and procedures as of the end of the period covered by this report conducted by the Company's management, with the participation of the Chief Execu- tive and Chief Financial Officers, the Chief Executive and Chief Financial Officers believe that these controls and procedures are effective to ensure that the Company

Because of its inherent limitations, internal control over financial reporting may not prevent or detect misstatements. Therefore, even those systems deter- mined to be effective can provide only reasonable assur- ance with respect to financial statement preparation and presentation.

is able to collect, process and disclose the information it Management assessed the effectiveness of the is required to disclose in the reports it files with the SEC Company's internal control over financial reporting as within the required time periods. of December 31, 2005. In making this assessment,

The certifications of the Company's Chief Execu- management used the criteria set forth by the Commit- tive Officer and Chief Financial Officer required under tee of Sponsoring Organizations of the Treadway Com- Section 302 of the Sarbanes-Oxley Act have been filed mission (COSO) in *Internal Control Ì Integrated* as Exhibits 31.1 and 31.2 to this report. Additionally, in *Framework.* Based on this assessment, management 2005 the Company's Chief Executive Officer certified believes that, as of December 31, 2005, the Company's

internal control over financial reporting is effective leadership to do so in a way which does not inhibit or based on those criteria. constrain Southwest's unique culture, and which does not unduly impose a bureaucracy of forms and checkl-

Management's assessment of the effectiveness of ists. Accordingly, formal, written policies and proce- internal control over financial reporting as of Decem- dures have been adopted in the simplest possible way, ber 31, 2005, has been audited by Ernst & Young, LLP, consistent with legal requirements. The Company's the independent registered public accounting firm who Corporate Governance Guidelines, its charters for each also audited the Company's consolidated financial state- of its Audit, Compensation and Nominating and Cor- ments. Ernst & Young's attestation report on manage- porate Governance Committees and its Code of Ethics ment's assessment of the Company's internal control covering all Employees are available on the Company's over financial reporting is included herein. website, [www.southwest.com,](http://www.southwest.com/) and a copy will be mailed

upon request to Investor Relations, Southwest Airlines

**Item 9B. *Other Information***

None.

Co., P.O. Box 36611, Dallas, TX 75235. The Com- pany intends to disclose any amendments to or waivers of the Code of Ethics on behalf of the Company's Chief Executive Officer, Chief Financial Officer, Controller, and persons performing similar functions on the Com-

**PART III** pany's website, at [www.southwest.com,](http://www.southwest.com/) under the ""About SWA'' caption, promptly following the date of

### Item 10. *Directors and Executive Officers of the* Registrant

The information required by Item 401 of Regula-

such amendment or waiver.

**Item 11. *Executive Compensation***

tion S-K regarding directors is included under ""Election See ""Compensation of Executive Officers,'' incor- of Directors'' in the definitive Proxy Statement for porated herein by reference from the definitive Proxy Southwest's Annual Meeting of Shareholders to be held Statement for Southwest's Annual Meeting of Share- May 17, 2006, and is incorporated herein by reference. holders to be held May 17, 2006.

The information required by Item 401 of Regula-

tion S-K regarding executive officers is included under

""Executive Officers of the Registrant'' in Part I follow- ing Item 4 of this Report. The information required by Item 405 of Regulation S-K is included under ""Sec- tion 16(a) Beneficial Ownership Reporting Compli- ance'' in the definitive Proxy Statement for Southwest's Annual Meeting of Shareholders to be held May 17, 2006, and is incorporated herein by reference.

In the wake of well-publicized corporate scandals,

### Item 12. *Security Ownership of Certain Beneficial*

***Owners and Management and Related Stockholder Matters***

See ""Voting Securities and Principal Sharehold- ers,'' incorporated herein by reference from the defini- tive Proxy Statement for Southwest's Annual Meeting of Shareholders to be held May 17, 2006.

the Securities and Exchange Commission and the New **Item 13. *Certain Relationships and Related***

York Stock Exchange have issued multiple new regula- ***Transactions***

tions, requiring the implementation of policies and

procedures in the corporate governance area. Since See ""Election of Directors'' incorporated herein by beginning business in 1971, Southwest has thrived on a reference from the definitive Proxy Statement for South- culture that encourages an entrepreneurial spirit in its west's Annual Meeting of Shareholders to be held Employees, and has emphasized personal responsibility, May 17, 2006.

initiative, and the use of independent, good judgment.

The Golden Rule is one of the core values, and there is a

""top-down'' insistence on the highest ethical standards at all times.

**Item 14. *Principal Accounting Fees and Services***

See ""Relationship with Independent Auditors'' in-

In complying with new regulations requiring the corporated herein by reference from the definitive Proxy institution of policies and procedures, it has been the Statement for Southwest's Annual Meeting of Share- goal of Southwest's Board of Directors and senior holders to be held May 17, 2006.

## PART IV

### Item 15. *Exhibits, Financial Statement Schedules*

* 1. 1. *Financial Statements:*

The financial statements included in Item 8 above are filed as part of this annual report.

1. *Financial Statement Schedules:*

There are no financial statement schedules filed as part of this annual report, since the required information is included in the consolidated financial statements, including the notes thereto, or the circumstances requiring inclusion of such schedules are not present.

1. *Exhibits:*
   1. Restated Articles of Incorporation of Southwest (incorporated by reference to Exhibit 4.1 to Southwest's Registration Statement on Form S-3 (File No. 33-52155)); Amendment to Restated Articles of Incorpora- tion of Southwest (incorporated by reference to Exhibit 3.1 to Southwest's Quarterly Report on Form 10-Q for the quarter ended June 30, 1996 (File No. 1-7259)); Amendment to Restated Articles of Incorporation of Southwest (incorporated by reference to Exhibit 3.1 to Southwest's Quarterly Report on Form 10-Q for the quarter ended June 30, 1998 (File No. 1-7259)); Amendment to Restated Articles of Incorporation of Southwest (incorporated by reference to Exhibit 4.2 to Southwest's Registration Statement on Form S-8 (File No. 333-82735); Amendment to Restated Articles of Incorporation of Southwest (incorporated by reference to Exhibit 3.1 to Southwest's Quarterly Report on Form 10-Q for the quarter ended June 30, 2001 (File No. 1-7259)).
   2. Bylaws of Southwest, as amended through January 2005 (incorporated by reference to Exhibit 3.2 to Southwest's Current Report on Form 8-K dated January 25, 2005 (File No. 1-7259)).
   3. $600,000,000 Competitive Advance and Revolving Credit Facility Agreement dated as of April 20, 2004 (incorporated by reference to Exhibit 10.1 to Southwest's Quarterly Report on Form 10-Q for the quarter ended June 30, 2004 (File No. 1-7259)); First Amendment, dated as of August 9, 2005, to Competitive Advance Revolving Credit Agreement (incorporated by reference to Exhibit 10.1 to Southwest's Current Report on Form 8-K dated August 12, 2005 (File No. 1-7259)).
   4. Specimen certificate representing Common Stock of Southwest (incorporated by reference to Exhibit 4.2 to Southwest's Annual Report on Form 10-K for the year ended December 31, 1994 (File No. 1-7259)).
   5. Indenture dated as of February 14, 2005, between Southwest Airlines Co. and The Bank of New York Trust Company, N.A., Trustee (incorporated by reference to Exhibit 4.2 to Southwest's Current Report on Form 8-K dated February 14, 2005 (File No. 1-7259))
   6. Indenture dated as of September 17, 2004 between Southwest Airlines Co. and Wells Fargo Bank, N.A., Trustee (incorporated by reference to Exhibit 4.1 to Southwest's Registration Statement on Form S-3 dated October 30, 2002 (File No. 1-7259)).
   7. Indenture dated as of June 20, 1991, between Southwest Airlines Co. and Bank of New York, successor to NationsBank of Texas, N.A. (formerly NCNB Texas National Bank), Trustee (incorporated by reference to Exhibit 4.1 to Southwest's Current Report on Form 8-K dated June 24, 1991 (File No. 1-7259)).
   8. Indenture dated as of February 25, 1997, between the Company and U.S. Trust Company of Texas, N.A. (incorporated by reference to Exhibit 4.2 to Southwest's Annual Report on Form 10-K for the year ended December 31, 1996 (File No. 1-7259)).

Southwest is not filing any other instruments evidencing any indebtedness because the total amount of securities authorized under any single such instrument does not exceed 10% of its total consolidated assets. Copies of such instruments will be furnished to the Securities and Exchange Commission upon request.

* 1. Purchase Agreement No. 1810, dated January 19, 1994, between The Boeing Company and Southwest (incorporated by reference to Exhibit 10.4 to Southwest's Annual Report on Form 10-K for the year ended December 31, 1993 (File No. 1-7259)); Supplemental Agreement No. 1. (incorporated by reference to Exhibit 10.3 to Southwest's Annual Report on Form 10-K for the year ended December 31, 1996 (File No. 1-7259)); Supplemental Agreements No. 2, 3 and 4 (incorporated by reference to Exhibit 10.2 to Southwest's Annual Report on Form 10-K for the year ended December 31, 1997 (File No. 1-7259)); Supplemental Agreements Nos. 5, 6, and 7; (incorporated by reference to Exhibit 10.1 to Southwest's Annual Report on Form 10-K for the year ended December 31, 1998 (File No. 1-7259)); Supplemental Agreements Nos. 8, 9, and 10 (incorporated by reference to Exhibit 10.1 to Southwest's Annual Report on Form 10-K for the year ended December 31, 1999 (File No. 1-7259)); Supplemental Agreements Nos. 11, 12, 13 and 14 (incorporated by reference to Exhibit 10.1 to Southwest's Quarterly Report on Form 10-Q for the quarter ended September 30, 2000 (File No. 1-7259)); Supplemental Agreements Nos. 15, 16, 17, 18 and 19 (incorporated by reference to Exhibit 10.1 to Southwest's Quarterly Report on Form 10-Q for the quarter ended September 30, 2001 (File No. 1-7259)); Supplemental Agreements Nos. 20, 21, 22, 23 and 24 (incorporated by reference to Exhibit 10.3 to Southwest's Quarterly Report on Form 10-Q for the quarter ended September 30, 2002 (File No. 1-7259)); Supplemental Agreements Nos. 25, 26, 27, 28 and 29 to Purchase Agreement No. 1810, dated January 19, 1994, between The Boeing Company and Southwest (incorporated by reference to Exhibit 10.8 to Southwest's Quarterly Report on Form 10-Q for the quarter ended June 30, 2003 (File No. 1-7259)); Supplemental Agreements Nos. 30, 31, 32, and 33 to Purchase Agreement No. 1810, dated January 19, 1993 between The Boeing Company and Southwest; (incorporated by reference to Exhibit 10.1 to Southwest's Annual Report on Form 10-K for the year ended December 31, 2003 (File No. 1-7259)); Supplemental Agreements Nos. 34, 35, 36, 37, and 38 (incorporated by reference to Exhibit 10.3 to Southwest's Quarterly Report on Form 10-Q for the quarter ended June 30, 2004 (File No. 1-7259)); Supplemental Agreements Nos. 39 and 40 (incorporated by reference to Exhibit 10.6 to Southwest's Quarterly Report on Form 10-Q for the quarter ended September 30, 2004 (File No. 1-7259)); Supplemental Agreement No. 41; Supplemental Agreement Nos. 42, 43 and 44 (incorporated by reference to Exhibit 10.1 to Southwest's Quarterly Report on Form 10-Q for the quarter ended March 31, 2005 (File No. 1-7259)); Supplemental Agreement No. 45 (incorporated by reference to Exhibit 10.1 to Southwest's Quarterly Report on Form 10-Q for the quarter ended June 30, 2005 (File No. 1-7259)).

Pursuant to 17 CFR 240.24b-2, confidential information has been omitted and has been filed separately with the Securities and Exchange Commission pursuant to a Confidential Treatment Application filed with the Commission.

The following exhibits filed under paragraph 10 of Item 601 are the Company's compensation plans and arrangements.

* 1. Form of Executive Employment Agreement between Southwest and certain key employees pursuant to Executive Service Recognition Plan (incorporated by reference to Exhibit 28 to Southwest Quarterly Report on Form 10-Q for the quarter ended June 30, 1987 (File No. 1-7259)).
  2. 1996 stock option agreements between Southwest and Herbert D. Kelleher (incorporated by reference to Exhibit 10.8 to Southwest's Annual Report on Form 10-K for the year ended December 31, 1996 (File No. 1-7259)).
  3. 2001 stock option agreements between Southwest and Herbert D. Kelleher (incorporated by reference to Exhibit 10 to Southwest's Quarterly Report on Form 10-Q for the quarter ended March 31, 2001 (File No. 1- 7259)).
  4. 1991 Incentive Stock Option Plan (incorporated by reference to Exhibit 10.6 to Southwest's Annual Report on Form 10-K for the year ended December 31, 2002 (File No. 1-7259)).
  5. 1991 Non-Qualified Stock Option Plan (incorporated by reference to Exhibit 10.7 to Southwest's Annual Report on Form 10-K for the year ended December 31, 2002 (File No. 1-7259)).
  6. 1991 Employee Stock Purchase Plan as amended September 21, 2000 (incorporated by reference to Exhibit 4 to Amendment No. 1 to Registration Statement on Form S-8 (file No. 33-40653)).
  7. Southwest Airlines Co. Profit Sharing Plan (incorporated by reference to Exhibit 10.8 to Southwest's Annual Report on Form 10-K for the year ended December 31, 2000 (File No. 1-729)); Amendment No. 1 to Southwest Airlines Co. Profit Sharing Plan (incorporated by reference to Exhibit 10.11 to Southwest's Annual Report on Form 10-K for the year ended December 31, 2001 (File No. 1-7259)); Amendment No. 2 to Southwest Airlines Co. Profit Sharing Plan (incorporated by reference to Exhibit 10.9 to Southwest's Annual Report on Form 10-K for the year ended December 31, 2002 (File No. 1-7259)); Amendment No. 3 to Southwest Airlines Co. Profit Sharing Plan (incorporated by reference to Exhibit 10.1 to Southwest's Quarterly Report on Form 10-Q for the quarter ended June 30, 2003 (File No. 1-7259)); Amendment No. 4 to Southwest Airlines Co. Profit Sharing Plan (incorporated by reference to Exhibit 10.8 to Southwest's Annual Report on Form 10-K for the year ended December 31, 2003 (File No. 1-7259)); Amendment No. 5 to Southwest Airlines Co. Profit Sharing Plan (incorporated by reference to Exhibit 10.2 to Southwest's Quarterly Report on Form 10-Q for the quarter ended June 30, 2004 (File No. 1-7259)); Amendment No. 6 to Southwest Airlines Co. Profit Sharing Plan (incorporated by reference to Exhibit 10.8 to Southwest's Annual Report on Form 10-K for the year ended December 31, 2004 (File No. 1-7259)); Amendment No. 7 to Southwest Airlines Co. Profit Sharing Plan.
  8. Southwest Airlines Co. 401(k) Plan (incorporated by reference to Exhibit 10.12 to Southwest's Annual Report on Form 10-K for the year ended December 31, 2001 (File No. 1-7259)); Amendment No. 1 to Southwest Airlines Co. 401(k) Plan (incorporated by reference to Exhibit 10.10 to Southwest's Annual Report on Form 10-K for the year ended December 31, 2002 (File No. 1-7259)); Amendment No. 2 to Southwest Airlines Co. 401(k) Plan (incorporated by reference to Exhibit 10.10 to Southwest's Annual Report on Form 10-K for the year ended December 31, 2002 (File No. 1-7259)); Amendment No. 3 to Southwest Airlines Co. 401(k) Plan (incorporated by reference to Exhibit 10.2 to Southwest's Quarterly Report on Form 10-Q for the quarter ended June 30, 2003 (File No. 1-7259)); Amendment No. 4 to Southwest Airlines Co. 401(k) Plan (incorporated by reference to Exhibit 10.9 to Southwest's Annual Report on Form 10-K for the year ended December 31, 2003 (File No. 1-7259)); Amendment No. 5 to Southwest Airlines Co. 401(k) Plan (incorporated by reference to Exhibit 10.9 to Southwest's Annual Report on Form 10-K for the year ended December 31, 2004 (File No. 1-7259)); Amendment No. 6 to Southwest Airlines Co. 401(k) Plan.
  9. Southwest Airlines Co. 1995 SWAPA Non-Qualified Stock Option Plan (incorporated by reference to Exhibit 10.14 to Southwest's Annual Report on Form 10-K for the year ended December 31, 1994 (File No. 1-7259)).
  10. 1996 Incentive Stock Option Plan (incorporated by reference to Exhibit 10.12 to Southwest's Annual Report on Form 10-K for the year ended December 31, 2002 (File No. 1-7259)).
  11. 1996 Non-Qualified Stock Option Plan (incorporated by reference to Exhibit 10.13 to Southwest's Annual Report on Form 10-K for the year ended December 31, 2002 (File No. 1-7259)).
  12. Employment Contract dated as of July 15, 2004, between Southwest and Herbert D. Kelleher (incorporated by reference to Exhibit 10.3 to Southwest's Quarterly Report on Form 10-Q the quarter ended September 30, 2004 (File No. 1-7259)).
  13. Employment Contract dated as of July 15, 2004, between Southwest and Gary C. Kelly (incorporated by reference to Exhibit 10.4 to Southwest's Quarterly Report on Form 10-Q for the quarter ended September 30, 2004 (File No. 1-7259)).
  14. Employment Contract dated as of July 15, 2004, between Southwest and Colleen C. Barrett (incorporated by reference to Exhibit 10.5 to Southwest's Quarterly Report on Form 10-Q for the quarter ended September 30, 2004 (File No. 1-7259)).
  15. Severance Contract dated as of July 15, 2004, between Southwest and James F. Parker (incorporated by reference to Exhibit 10.2 to Southwest's Quarterly Report on Form 10-Q for the quarter ended September 30, 2004 (File No. 1-7259)).
  16. Southwest Airlines Co. Outside Director Incentive Plan (incorporated by reference to Exhibit 10.1 to Southwest's Quarterly Report on Form 10-Q for the quarter ended March 31, 2002 (File No. 1-7259)).
  17. 1998 SAEA Non-Qualified Stock Option Plan (incorporated by reference to Exhibit 10.17 to Southwest's Annual Report on Form 10-K for the year ended December 31, 2002 (File No. 1-7259)).
  18. 1999 SWAPIA Non-Qualified Stock Option Plan (incorporated by reference to Exhibit 10.18 to Southwest's Annual Report on Form 10-K for the year ended December 31, 2002 (File No. 1-7259)).
  19. LUV 2000 Non-Qualified Stock Option Plan (incorporated by reference to Exhibit 4.1 to Registration Statement on Form S-8 (File No. 333-53610)).
  20. 2000 Aircraft Appearance Technicians Non-Qualified Stock Option Plan (incorporated by reference to Exhibit 4.1 to Registration Statement on Form S-8 (File No. 333-52388)); Amendment No. 1 to 2000 Aircraft Appearance Technicians Non-Qualified Stock Option Plan (incorporated by reference to Exhibit 10.4 to Southwest's Quarterly Report on Form 10-Q for the quarter ended June 30, 2003 (File No. 1-7259)).
  21. 2000 Stock Clerks Non-Qualified Stock Option Plan (incorporated by reference to Exhibit 4.1 to Registration Statement on Form S-8 (File No. 333-52390)); Amendment No. 1 to 2000 Stock Clerks Non- Qualified Stock Option Plan (incorporated by reference to Exhibit 10.5 to Southwest's Quarterly Report on Form 10-Q for the quarter ended June 30, 2003 (File No. 1-7259)).
  22. 2000 Flight Simulator Technicians Non-Qualified Stock Option Plan (incorporated by reference to Exhibit 4.1 to Registration Statement on Form S-8 (File No. 333-53616)); Amendment No. 1 to 2000 Flight Simulator Technicians Non-Qualified Stock Option Plan (incorporated by reference to Exhibit 10.6 to Southwest's Quarterly Report on Form 10-Q for the quarter ended June 30, 2003 (File No. 1-7259)).
  23. 2002 SWAPA Non-Qualified Stock Option Plan (incorporated by reference to Exhibit 4.1 to Registration Statement on Form S-8 (File No. 333-98761)).
  24. 2002 Bonus SWAPA Non-Qualified Stock Option Plan (incorporated by reference to Exhibit 4.1 to Registration Statement on Form S-8 (File No. 333-98761)).
  25. 2002 SWAPIA Non-Qualified Stock Option Plan (incorporated by reference to Exhibit 4.2 to Registration Statement on Form S-8 (File No. 333-100862)).
  26. 2002 Mechanics Non-Qualified Stock Option Plan (incorporated by reference to Exhibit 4.2 to Registration Statement on Form S-8 (File No. 333-100862)).
  27. 2002 Ramp, Operations, Provisioning and Freight Non-Qualified Stock Option Plan (incorporated by reference to Exhibit 10.27 to Southwest's Annual Report on Form 10-K for the year ended December 31, 2002 (File No. 1-7259)).
  28. 2002 Customer Service/Reservations Non-Qualified Stock Option Plan (incorporated by reference to Exhibit 10.28 to Southwest's Annual Report on Form 10-K for the year ended December 31, 2002 (File No. 1-7259))); Amendment No. 1 to 2002 Customer Service/Reservations Non-Qualified Stock Option Plan (incorporated by reference to Exhibit 4.3 to Registration Statement on Form S-8 (File No. 333-104245)).
  29. 2003 Non-Qualified Stock Option Plan (incorporated by reference to Exhibit 10.3 to Southwest's Quarterly Report on Form 10-Q for the quarter ended June 30, 2003 (File No. 1-7259)).

14 Code of Ethics (incorporated by reference to Exhibit 14 to Southwest's Annual Report on Form 10-K for the year ended December 31, 2003 (File No. 1-7259)).

21 Subsidiaries of Southwest (incorporated by reference to Exhibit 22 to Southwest's Annual Report on Form 10-K for the year ended December 31, 1997 (File No. 1-7259)).

23 Consent of Ernst & Young LLP, Independent Registered Public Accounting Firm.

* 1. Rule 13a-14(a) Certification of Chief Executive Officer.
  2. Rule 13a-14(a) Certification of Chief Financial Officer.

1. Section 1350 Certification of Chief Executive Officer and Chief Financial Officer.

A copy of each exhibit may be obtained at a price of 15 cents per page, $10.00 minimum order, by writing to: Investor Relations, Southwest Airlines Co., P.O. Box 36611, Dallas, Texas 75235-1611.

## SIGNATURES

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

SOUTHWEST AIRLINES CO.

January 31, 2006

By /s/ LAURA WRIGHT

Laura Wright

*Senior Vice President Ì Finance, Chief Financial Officer*

Pursuant to the requirements of the Securities Exchange Act of 1934, this report has been signed below by the following persons on January 31, 2006 on behalf of the registrant and in the capacities indicated.

**Signature Capacity**

/s/ HERBERT D. KELLEHER Chairman of the Board of Directors Herbert D. Kelleher

/s/ GARY C. KELLY Chief Executive Officer and Director Gary C. Kelly

/s/ COLLEEN C. BARRETT President and Director Colleen C. Barrett

/s/ LAURA WRIGHT Sr. Vice President Ì Finance and Chief Financial Officer

Laura Wright

(Chief Financial and Accounting Officer)

/s/ C. WEBB CROCKETT Director

C. Webb Crockett

/s/ WILLIAM H. CUNNINGHAM Director William H. Cunningham

/s/ WILLIAM P. HOBBY Director William P. Hobby

/s/ TRAVIS C. JOHNSON Director Travis C. Johnson

/s/ R. W. KING Director

R. W. King

/s/ JOHN T. MONTFORD Director John T. Montford

**Signature Capacity**

/s/ JUNE M. MORRIS Director June M. Morris

/s/ LOUIS CALDERA Director Louis Caldera

/s/ NANCY LOEFFLER Director Nancy Loeffler