$700

$645

$484

$578

$499

$471

$372

$425

$248

$226 $215

6.3%

6.4% 5.6%

6.5% 6.5%

5.5%

3.8%

4.8%

3.3% 3.8%

$600

$500

$400

$300

$200

2003 2004 2005 2006 2007 2003 2004 2005 2006 2007

10%

8%

|  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- |
| (in millions) | 2003 | 2004 | 2005 | 2006 | 2007 |
| Net income, as reported | $372 | $215 | $484 | $499 | $645 |
| Impact of fuel contracts, net | (2) | 11 | (59) | 88 | (197) |
| Impact of government |  |  |  |  |  |
| grant proceedings, net | (144) | - | - | - |  |
| Other net | - | 22 | - | (9) | 23 |
| Net income——non-GAAP | $226 | $248 | $425 | $578 | $471 |

6%

4%

2%

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 14.) (unaudited)

|  |  |  |  |
| --- | --- | --- | --- |
| Consolidated Highlights (GAAP)  ( Dollars In Millions, Except Per Share Amounts) 2007 2006 CHANGE | | | |
| Operating revenues | $9,861 | $9,086 | 8.5 % |
| Operating expenses | $9,070 | $8,152 | 11.3 % |
| Operating income | $791 | $934 | (15.3)% |
| Operating margin | 8.0 % | 10.3 % | (2.3)pts. |
| Net income | $645 | $499 | 29.3 % |
| Net margin | 6.5 % | 5.5 % | 1.0pts. |
| Net income per share——basic | $.85 | $.63 | 34.9 % |
| Net income per share——diluted | $.84 | $.61 | 37.7 % |
| Stockholders’ equity | $6,941 | $6,449 | 7.6 % |
| Return on average stockholders’ equity | 9.6 % | 7.6 % | 2.0pts. |
| Stockholders’ equity per common share outstanding | $9.44 | $8.24 | 14.6 % |
| Revenue passengers carried | 88,713,472 | 83,814,823 | 5.8 % |
| Revenue passenger miles (RPMs) (000s) | 72,318,812 | 67,691,289 | 6.8 % |
| Available seat miles (ASMs) (000s) | 99,635,967 | 92,663,023 | 7.5 % |
| Passenger load factor | 72.6 % | 73.1 % | (0.5)pts. |
| Passenger revenue yield per RPM | 13.08 ¢ | 12.93 ¢ | 1.2 % |
| Operating revenue yield per ASM | 9.90 ¢ | 9.81 ¢ | 0.9 % |
| Operating expenses per ASM | 9.10 ¢ | 8.80 ¢ | 3.4 % |
| Size of fleet at yearend | 520 | 481 | 8.1 % |
| Fulltime equivalent Employees at yearend | 34,378 | 32,664 | 5.2 % |

Southwest Airlines Co. provides single-class, comfortable air transportation which targets both business and leisure travelers. SWA is a profitable, highly efficient, high-quality airline with a schedule that fits our Customers’ needs. Our warm, caring, and spirited Employees deliver an outstanding Customer Experience for our Valued Customers. 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 2007, Southwest operated 520 Boeing 737 aircraft and provided service to 64 airports in 32 states throughout the United States. Southwest has one of the lowest operating cost structures in the domestic airline industry and consistently offers low and simple fares. We currently offer 3,400+ flights a day. Southwest has had the best cumulative Customer Satisfaction record among those carriers with whom we compete since the Department of Transportation has kept these statistics. LUV is our stock exchange symbol, selected to represent both our home at Dallas Love Field and the unique, warm, and LUVing relationships among Employees, Shareholders, and Customers.

DING!® You are now free to move about the country.

Southwest Airlines is in the business of life. We offer low fares, which allows our Customers to affordably fly wherever life takes them. We also understand the value of time, especially in today’s busy world. In 2007, we launched bold initiatives to help our Customers be more productive and to further enhance our already outstanding Customer Service. The year began with Operation Kick Tail, a multiyear call to action for Employees to continue their legendary focus on providing high-quality Customer Service, maintaining low costs, and nurturing our famous Southwest Culture. We made changes every season in 2007 to enhance our strong Brand. In the spring, Southwest inked a ten-year distribution agreement with Galileo to make our convenient flights and low fares available to Galileo-connected travel agencies in North America. We celebrated a “Summer of LUV” with super low fares in Philadelphia and California, including our return to San Francisco International Airport. Our lowest fares continue to be delivered to your desktop through DING!, and “DING! You are now free to move about the country” was named America’s Favorite Advertising Slogan in September. In the fall, we began implementing exciting new improvements to our overall Customer experience, including a makeover in our gate areas; an enhanced boarding procedure; a new Business SelectTM fare; perks to our Rapid Rewards® program; and a new look to our low-fare offerings on **southwest.com®**. At year’s end, we are proud to report that Southwest Airlines truly can make your travel experience more productive so that you can get on with the important business of your life without putting a huge dent in your pocketbook.

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SOUTHWEST AIRLINES CO. ANNUAL REPORT 2007

To Our Shareholders:

The year 2007 turned out to be momentous for Southwest Airlines. We encountered a variety of financial challenges unforeseen a year ago. Nevertheless, we were well prepared and recorded our 35th consecutive year of profitability, a record unmatched in commercial airline history.

Our 2007 GAAP net income was $645 million, or $.84 per diluted share, compared to $499 million, or $.61 per diluted share, for 2006. Each year includes special items (in particular inclusion of unrealized gains or losses as required by Statement of Financial Accounting Standard No. 133, “Accounting for Derivative Instruments and Hedging Activities” related to our successful fuel hedging activities). Excluding the special items from both years produces a year-over-year profit decline of 18.5 percent to $471 million and earnings per diluted share decline of 12.9 percent to $.61.

Earnings declines are always unwelcome. However, steeply rising energy prices continued to be a challenge to overcome completely, and revenue trends, which were very encouraging in 2006, slowed considerably in 2007. Overall, domestic air traffic growth has been anemic the last two years. And while we were able to grow unit revenues (revenues per available seat mile) by 0.9 percent in 2007 versus 2006, it was not sufficient to offset unit cost increases of 3.3 percent (excluding special items in both years).

Jet fuel prices have been rising every year for the last five years. Our fuel hedging program has consistently mitigated such price increases dating back to year 2000. Since then, in each year, we have striven to hedge at least 70 percent of our consumption. In 2007, we were approximately 90 percent protected at approximately

$51 a barrel. That protection saved us $727 million last year and limited us to an 11.3 percent increase in the economic cost per gallon, year-over-year.

It was, indeed, a wild year for energy prices. A year ago, crude oil was hovering around $50 a barrel. By fourth quarter 2007, crude oil prices had skyrocketed to $100 a barrel. Fortunately, we are again well-hedged for 2008 with approximately 70 percent of our fuel needs protected at approximately $51 a barrel.

In general, the domestic air travel environment today reflects higher fares (to offset higher energy costs) accompanied by more delays and cancellations. Our Brand sets us apart by offering low fares and excellent Customer Service. In a year of multitudinous reports of poor airline service, it is notable that our ontime performance was among the best in the industry and as good as the year before. Our flight cancellations were no more than one percent of flights scheduled, also consistent with the year before, and we were, once again, among the industry’s leaders in terms of Customer Satisfaction, or fewest complaints filed with the U.S. Department of Transportation per 100,000 Customers.

In fall 2007, we launched a major initiative to further enhance our Brand through an improved Customer Airport Experience, as well as to drive more revenue per departure. After extensive study and Customer research, we elected to stay with our famous open seating but to improve our boarding process with a reserved place in the boarding line. Our new way to board reduces the time Customers spend in queue, and they love it. We also modified and simplified our fare structure and **southwest.com®** presentation. This change, along with our new boarding process, enabled us to offer Business Select,TM which allows Customers to be among the first to board the aircraft; earn additional Rapid Rewards credit; and receive a complimentary cocktail. In short, we now give Customers more choices when they fly. We also enhanced our Rapid Rewards program by virtually guaranteeing an “A” boarding pass to our most frequent flyers and by creating Freedom Awards,TM which carry no seat restrictions other than a few blackout dates. Customer feedback has been very positive based on the early returns.

These changes lay the foundation for future enhancements and initiatives. Our goals are to enhance the overall Customer Experience; appeal to more business travelers; and drive more revenue per flight. We have significant technology projects under construction, to be implemented in 2008 and 2009, that support these

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SOUTHWEST AIRLINES CO. ANNUAL REPORT 2007

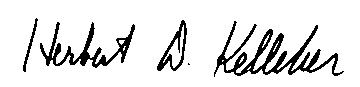
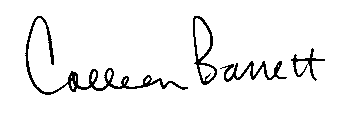
goals. These projects range from foundational to frontline; from **southwest.com** to Rapid Rewards to international codeshare. Achieving these goals is critical to our drive to maintain our Low-Fare Brand while producing satisfactory financial results.

The U.S. domestic airline revenue growth rate clearly slowed in 2007, and concerns abound regarding the overall health of our domestic economy for 2008. Given these concerns, coupled with sky-high energy prices, we decided to slow our fleet growth in 2008 to a planned net seven aircraft, for an anticipated ASM increase of four to five percent. We have already seen benefits from trimming unproductive flights from our fourth quarter 2007 flight schedule, as the increase in energy costs over the last several years has changed the profit equation on our marginal flights. We have more such adjustments implemented in our May 2008 flight schedule.

On the other hand, even with higher operating costs, we remain the industry’s low-cost producer, and there is significant economic demand for new Southwest flights. Denver rejoined the Southwest schedule in January 2006 and has proved to be a very large and rapidly developing market. In our May 2008 schedule, we will grow to 79 daily departures from just 13 in January 2006. Likewise, we restarted service to San Francisco International Airport in August 2007. We are already up to 26 daily departures, soon to be at 35, with load factors consistent with our overall system average. We are delighted and encouraged with these very strong results.

While our nearterm outlook is cautious, we are prepared for bad times, and our longterm outlook is enthusiastic. Our People have Warrior Spirits, Servants’ Hearts, and Fun-LUVing Attitudes. They are the source of all that is good about Southwest Airlines. We are most grateful to them for our 2007 results; for embracing necessary change; and for stepping up to the challenge, once more. They are the key to our success and the reason we are confident about the future of Southwest Airlines.

January 23, 2008



Herbert D. Kelleher Executive Chairman

Gary C. Kelly

Chief Executive Officer

Colleen C. Barrett President

Checking in with family to coordinate birthday party



Packed running shoes and shorts for workout

Searching for recipes for tomorrow night’s dinner

Charging laptop for afternoon presentation

*To make our gate areas more productive for our business and family travelers alike, Southwest has added power ports for personal computers and colorful seating areas for children.*

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SOUTHWEST AIRLINES CO. ANNUAL REPORT 2007

**In the Business of Life**

More than 36 years ago, Southwest Airlines created a revolution in air travel for busy people. We sought to democratize the skies by making it affordable and easy for travelers——both business and leisure. For more than 36 years, our cause has been to offer the most productive, efficient, and profitable point-to-point, high frequency, ontime airline in America. As a result of our success, we have built one of the most popular brands in America and now carry more Customers than any other airline in the world. In 2007, we introduced exciting major initiatives to further enhance our Brand.

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**Taking Care of Business: Our Financial and Operational Performance**

For 2007, we posted our 35th consecutive year of profitability, a feat unmatched in the airline industry. Despite unprecedented energy prices, anemic domestic air traffic growth, and an increasingly uncertain domestic economy, Southwest grew the fleet in 2007 by 39 aircraft. We marked a milestone with The Boeing Co. at our June birthday celebration when we took delivery of our 500th Boeing 737. We celebrated with a heartwarming dedication ceremony at the Company’s headquarters in Dallas. The event was an opportunity to celebrate our relationship with Boeing and to pay tribute to all of our military Employees. Onboard the new jet’s inaugural Seattle–Dallas flight were 36 Employees who were selected from a large, impressive pool of nominees who had honorably served in the various branches of the U.S. military.

Although we slowed our capacity growth in the fourth quarter, we ended 2007 with year-over-year available seat mile growth of almost eight percent and more than 3,400 daily departures.

While the industry struggled with poor operating performance that often made front-page headlines, our Customer Service performance was once again among the best in the airline industry. Our People helped us achieve among the highest marks in both ontime performance and Customer Satisfaction in 2007, according to statistics published by the U.S. Department of Transportation. They were also able to keep our flight cancellations consistent with last year’s performance of no more than one percent of all flights scheduled. It’s no secret that our Employees take great pride in making Southwest the most dependable, warm, and friendly airline in the industry today.

On the financial side, we fell disappointingly short of our earnings goals due to rising energy prices throughout the year and softer than expected demand for domestic air travel. As a result of the weak pricing environment, our year-over-year unit revenue growth was less than one percent in 2007. Even with reduced industry seat capacity, our Customers demanded more low fares, with almost a two-point decline in our full-fare mix from 2006. Our 2007 unit costs, excluding special items, rose 3.3 percent year-over-year, driven primarily by an 11.3 percent increase in our economic jet fuel price per gallon from 2006. However, our People continued their excellent cost control efforts through productivity improvements. When it comes to efficiency, Southwest is the standard, and our People are committed to our ongoing efforts to further improve our productivity and improve asset utilization. Our Employees per aircraft declined to 66 at yearend, among the lowest since 1972.

We continue to hold the best fuel hedge in the airline industry. We started 2007 with crude oil around $50 a barrel. At year’s end, it was hovering around $100 a barrel. Fortunately, we were approximately 90 percent protected for all of 2007 at approximately $51 a barrel. The fuel hedge program continued to give us tremendous protection against the volatility of energy prices. Since 2000, we have saved more than $3 billion in fuel costs through our fuel hedging program. Although we are once again well-hedged in 2008 with approximately 70 percent of our planned consumption protected at around $51 a barrel, we currently expect fuel headwinds in 2008 of more than $500 million. Looking forward, we currently have fuel derivative contracts in place for more than 55 percent of expected fuel needs at

$51 per barrel in 2009; nearly 30 percent at $63 per barrel in 2010; more than 15 percent at $64 per barrel in 2011; and more than 15 percent at $63 per barrel in 2012.

In addition to the protection provided by our fuel hedging program, we are implementing innovative ideas to reduce fuel consumption and improve asset utilization. We currently plan to complete the installation of blended winglets on a significant portion of our 737-300 fleet by the end of 2008, and all of our 737-700s are outfitted with fuel-saving

**\*% @EKIF;L:@E> DFI< EFEJKFG =C@>?KJ =FI PFLI EFEJKFG 9LJ@E<JJ**

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*In fall 2007, Southwest launched a print advertising campaign detailing our new boarding procedure, Business Select perks, and new nonstop service to major business destinations.*

MOM: Here you go, Billy. VO: From day one,

Bill has been told where to sit.

Teacher: Billy, this will be your seat.

BILL: (Sigh)

BOSS: Bill, you’ll be sitting here.

BILL: (Sigh)

AIRLINE EMPLOYEE: You’re in 38E.

VO: And that’s when Bill decided...

BILL: Hey, I don’t want to be told where to sit anymore.

VO: So Bill switched to Southwest Airlines.

Now Bill sits where Bill wants.

2003 2004 2005 2006 2007

|  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- |
| 2003 2004 2005 2006 2007  Passenger  Revenues $5,741 $6,280 $7,279 $8,750 $9,457 | | | | | |
| Internet | 54% | 59% | 65% | 70% | 74% |
| Reservations Center | 19% | 18% | 15% | 12% | 10% |
| Travel Agency | 16% | 13% | 11% | 11% | 10% |
| Other | 11% | 10% | 9% | 7% | 7% |

9.0¢

8.6¢

8.80¢ 9.10¢

7.97¢ 8.05¢

7.74¢

8.2¢

7.8¢

7.4¢

2003 2004 2005 2006 2007

6.7¢

6.6¢

6.67¢

6.59¢

6.56¢

6.48¢ 6.49¢

6.5¢

6.4¢

6.3¢

VO: Freedom to choose on Southwest Airlines.

SFX: Ding

VO: You are now free to move about the country.

Operating Expenses Per Available Seat Mile



Operating Expenses Per Available Seat Mile Excluding Fuel and Related Taxes

Passenger Revenues (in millions) and Distribution Method

©2008 Southwest Airlines Co.

6

Decided to see movie after reading positive review

Charging MP3 player for decompression jog after meeting

Will catch up on latest novel



Has time to enjoy cup of coffee

*Business travelers enjoy our comfy new leather boarding gate seating, complete with side tables and power ports for laptop computers, phones, and other personal devices.*

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SOUTHWEST AIRLINES CO. ANNUAL REPORT 2007

blended winglets. We also announced in 2007 our plans to work with Naverus to install RNP/RNAV technology in our fleet, which will allow for more direct flight plans and reduced fuel burn. The combined effort of Pilots, Dispatchers, Maintenance and Engineering, Ramp Agents, and Operations Agents that began in the fall to raise awareness of the benefits of gate services and flying efficiencies resulted in immediate fuel burn savings.

Because of the Company’s continued conservative and disciplined financial planning, our balance sheet remains strong. We continue to have an investment-grade credit rating and have ample liquidity and access to capital. We ended 2007 with

$2.8 billion in cash, including shortterm investments, and have a fully available unsecured revolving credit line of

2003 2004 2005 2006 2007

11:45

11:35

11:41

11:34

11:25

11:20

11:09

11:25

11:15

11:05

$600 million. We also had approximately $600 million in cash deposits at Boeing for future aircraft deliveries. Our unmortgaged assets have a value of more than $9 billion, and our debt to total capital is approximately 36 percent, including aircraft leases as debt. While our number one priority is to profitably grow our route system, we also have taken opportunities to optimize our capital structure to further enhance Shareholder value. In 2007, Southwest repurchased 66 million shares of common stock for $1 billion. Since January 2006, Southwest has repurchased $1.8 billion of common stock or 116 million shares through these board-authorized repurchase programs.



*In a return to our ’70s roots, Southwest wrapped buses, street cars, and transit shelters with a psychedelic “Summer of LUV” look announcing new service to The City by the Bay.*

Although we have fuel and other cost pressures in 2008, we will continue our efforts to improve productivity and revenue production. We have a stated goal in 2008 to grow earnings per diluted share, excluding special items, 15 percent compared to 2007. Even with challenging cost pressures, we remain among the industry’s low-cost leaders. However, we cannot stand still, and we must overcome rising costs by increasing our revenue contribution to the bottom line while staying true to the longterm vision for Southwest.

**Growing the Business: Our Vision and Strategic Direction**

The longterm vision for Southwest is very clear. We want to operate the safest, most reliable, most efficient airline in the world. We want to be the best place to work; we want to offer Customers the best flight schedule with the most flights to the places they want to fly; we want to deliver the best Customer experience; and we know we must earn excellent financial returns for our Employees and our Shareholders. Finally, we must achieve all this while staying true to our low-fare, low-cost Brand that we made famous.

To realize that vision, we must achieve our financial goals. In 2007, we announced our plans to update our strategy to better equip us to compete with more low-fare competition and overcome higher fuel prices. We launched several initiatives to enhance our Brand, through an improved Customer Airport Experience, and increase our revenue production. We are excited about the changes and believe we will appeal to more business Customers and strengthen overall Customer loyalty.

After much research, we implemented our new Customer boarding method in November 2007. The enhanced boarding process improved our Customer experience with a new way to board the aircraft that allows travelers to be more productive while waiting for their flights, without standing in line. At the same time, we began our Extreme Gate Makeover with an anticipated completion date of mid-year 2008. The updates include plusher seats, power stations for laptops, additional flat-screen TVs, and other electronic equipment to help make business travelers more relaxed and productive. The gate area enhancements also feature a family waiting area with child-friendly seating and entertainment. Business or pleasure, we want to make your time at the airport more comfortable and productive.

During fourth quarter 2007, we were also busy enhancing our revenue management structure, technology, techniques, and processes. As an example, we now have 15 fare classes versus eight, which should increase the revenue potential for Southwest beginning in March 2008. Along with these fare changes, our web site underwent a homepage makeover, and we modified the fare display to simplify the choices for Customers and make it easier to understand. Among the fare classes was a brand-new product called Business SelectTM that allows Customers to be among the first to board, receive extra Rapid Rewards credit, and enjoy a free cocktail onboard.

Aircraft Utilization (hours and minutes per day)

600

520

481

388

417

445

500

400

300

200

2003 2004 2005 2006 2007

Fleet Size (at yearend)

|  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- |
| 2008 2009 2010 2011- Total  2014 | | | | | |
| Firm Orders | 29 | 20 | 10 | 49 | 108 |
| Options | – | 8 | 24 | 52 | 84 |
| Purchase Rights – – – 54 54 Total 29\* 28\*\* 34 155 246 | | | | | |

Boeing 737-700 Firm Orders, Options, and Purchase Rights

\*Currently plan to reduce fleet by 22 aircraft, bringing 2008 net additions to 7 aircraft.

\*\*Exercised one option in January 2008, bringing 2009 firm orders and options to 21 and 7, respectively.

*To celebrate our “Summer of LUV” in California, Southwest personnel cruised around the business district aboard colorful Segways promoting new service to San Francisco.*

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Contemplating room service or dining at local bistro

We’ve saved her place so she grabbed a bite to eat



Huge geography fan gets window seat when boarding first

Hasn’t stressed because she’s had her number in line since Thursday

*To give business and personal travelers a few more minutes to relax and be more productive, Southwest introduced a new way to board designed for a calmer gate experience.*

|  |  |  |  |  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- | --- | --- | --- | --- |
| We were also pleased to introduce changes to our award-winning Rapid Rewards frequent flyer program in November |  |  |  |  |  | $9 | ,86 | 1 | $10,000 |
| 2007, debuting the new A-ListTM and Freedom Awards.TM A-Listers are automatically checked in for their flights and are |  |  |  | $9 | ,08 | 6 |  |  | $9,000 |
| most likely to be in the A boarding group. The new Freedom Award allows our frequent flyers to exchange two |  |  |  | $7,584 |  |  |  |  | $8,000 |
| Standard Awards for one unrestricted Freedom Award, which can be used at any time, except for certain blackout |  |  | $6,530 |  |  |  |  |  | $7,000 |
| dates, on any flight as long as seats are available. We are continuing to work on other significant improvements to the Rapid Rewards loyalty program. | $5 | ,93 | 7 |  |  |  |  |  | $6,000  $5,000 |
| We have future revenue initiatives and Customer experience enhancements in development, including new 2003 2004 2005 2006 2007  Operating Revenues (in millions)  onboard Customer offerings (such as inflight wireless Internet connectivity), enabling international codeshares, implementing further improvements to our revenue management processes, and making **southwest.com** a more robust travel portal. Almost 75 percent of our revenues are booked through **southwest.com**, which is among the | | | | | | | | | |

most-visited travel web sites in the world.

In 2007, we launched a new advertising campaign and began a full-court press to woo more business travelers. We increased our corporate sales efforts by providing our sales force more tools to aggressively pursue corporate business and by ramping up our participation in Global Distribution Systems. We are particularly pleased with the expansion of our agreement with Travelport’s Galileo to include Worldspan, another of Travelport’s global distribution systems. We are extremely excited about all of our plans and strategic initiatives, and we believe that our Brand will have an even greater

2003 2004 2005 2006 2007

10.0¢

9.5¢

9.81¢ 9.90¢

8.90¢

8.50¢

8.27¢

9.0¢

8.5¢

8.0¢

* 1. ¢

appeal to the business traveler. After all, Southwest Airlines was built for the business traveler. Our high frequency, point-to-point service allows for more direct nonstop routings, minimizing connections, delays, and total trip time. Approximately 78 percent of Southwest’s Customers fly nonstop. We’re geared for their nonstop lives, and we have introduced product enhancements that will improve their productivity.

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*In fall 2007, Southwest launched Business Select, a perk for our frequent travelers, who now have a new "first to board" option for a small fee. All Rapid Rewards Customers have a new A-List option based on frequency of travel.*

**Growing the Business: Our Tactical Network Expansion**

From our humble beginnings, we have grown to become a national carrier that now boards more Customers than any other airline in the world. Our low-cost business model has allowed us to profitably provide affordable travel to hundreds of millions of people for the past 35 consecutive years. Significantly higher fuel prices and increased economic uncertainty caused us to take a highly surgical look at our expansive route map in 2007. We were more aggressive than ever in pruning less efficient flights in the fall and strategically shifting capacity to routes with higher Customer demand.

We returned to San Francisco International Airport (SFO), our 64th destination, in August 2007 (after ceasing service there in 2001). We are encouraged by the Customer response to our return, and at the end of 2007, SFO load factors kept pace with our systemwide load factor performance. By March 2008, we will be at 35 daily departures from SFO. Our return to San Francisco anchored our California presence; we now have a 70 percent market share position intra-California and serve nine airports in the Golden State. With the addition of SFO, we now offer more than 100 daily nonstop departures between the Bay Area airports (SFO, Oakland, and San Jose) and the Basin (Burbank, Los Angeles, Ontario, and Orange County).

Our hometown airport, Dallas Love Field, was also a shining star in 2007. In fall 2006, President George W. Bush signed a law to repeal the Wright Amendment, and that move allowed Southwest to immediately begin offering one-stop (same plane) and connecting service between Dallas Love Field and destinations beyond the old perimeter of the Wright/Shelby/ Bond amendments (Alabama, Arkansas, Kansas, Louisiana, Oklahoma, Mississippi, Missouri, and New Mexico). We began selling tickets immediately but weren’t able to fully optimize our Dallas schedule until March 2007, at which point we added ten new flights from Dallas Love Field that were one-stop or quick connections. We realized an annual revenue benefit of $113 million from our ability to offer through-ticketing from Dallas Love Field, exceeding our original expectations. The Wright Amendment Reform Act of 2006 will also allow us to add nonstop service between Dallas Love Field and any domestic airport we serve beginning in 2014.

Operating Revenues Per Available Seat Mile



*On September 26, 2007, “DING! You are now free to move about the country” was inducted into the Madison Avenue Walk of Fame as America’s Favorite Advertising Slogan. Our battle cry, created by GSD&M’s Idea City, has served us well for many years and will continue to remind our Customers that Southwest Airlines is, indeed, A Symbol of Freedom.*

10

Had plenty of time to buy toy at the airport gift shop

Will use her Rapid Rewards credits to visit him at college



Daddy was only gone for one day, but I missed him the whole time!

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SOUTHWEST AIRLINES CO. ANNUAL REPORT 2007

Another exciting growth opportunity was Denver. Since our introduction of service there with 13 flights to three cities in January 2006, we have added flights at a rate that makes Denver the fastest-growing new city in our history. By May 2008, we will offer 79 daily nonstop departures to 23 cities from Denver International Airport.

We continued to see revenue benefit from our codeshare agreement with ATA Airlines and currently offer connecting service through Chicago, Phoenix, Las Vegas, and Oakland to Dallas-Fort Worth International Airport and several Hawaiian destinations.

Overall, we now have the ability to react faster and more decisively to higher fuel prices and a more challenging economic environment. In addition to scrubbing our flight schedule, we made the decision in June 2007 to slow our year-over-year available seat mile growth for full year 2008 to approximately six percent, down from our original eight percent. In December 2007, we further reduced our 2008 growth plans to approximately four to five percent on a year-over-year basis. This growth plan, while more cautious, will still allow us to expand upon our popular domestic route network to take Customers where they want to go.

We will accept 29 new Boeing 737-700s scheduled for 2008 delivery and currently plan to reduce our fleet by 22 aircraft, to end 2008 with seven net aircraft additions. Our 2008–2014 future Boeing orders include 108 firm orders, 84 options, and 54 purchase rights.

Americans today have the Freedom to FlyTM across the nation because of our commitment to keep our costs low and offer low fares. Even today, the “Southwest Effect” (the phenomenon coined by the U.S. Department of Transportation to describe dropping fares and increasing traffic when Southwest enters a market) is alive and well. We consistently rank first in market share in about 90 percent of our top 100 city pairs and in the aggregate hold approximately 64 percent of the total market share in those markets. Keeping airline tickets affordable has helped us grow to become the nation’s largest carrier in terms of domestic passengers carried (based on the most recent figures released by the U.S. Department of Transportation’s Bureau of Transportation Statistics). We enplaned more than 100 million passengers in 2007.

**Nurturing the Business: Our People Are Our Future**

We have a low-cost business model that airlines across the globe have tried to emulate. Our solid business model was instituted largely by strategic decisions made early in our history to fly a single aircraft type; operate an efficient point-to-point route system; and utilize our assets in a highly efficient manner. But the power of our Brand today——what sets us apart from our competitors——is our magnificent People. In 2007, our Employees did a remarkable job embracing the many changes in our products and processes as they rose to the occasion and took care of each other and our Customers. That focus on service helped us to be named to *BusinessWeek* magazine’s first-ever list of “Customer Service Champs.” The *BusinessWeek* list, which appeared in March 2007, ranked the best providers of Customer Service.

Also in 2007, we were recognized for the eleventh consecutive year by *Fortune* magazine as one of the Most Admired Companies in America, and *Business Ethics* magazine recognized us as one of the 100 Best Corporate Citizens for the eighth year in a row. We were also proud to be recognized by City Business Journals Network as the

#1 Brand in the travel segment of the 2007 American Brand Excellence Awards. We received the Frost & Sullivan 2007 CEO Choice Award for the Overall Best Airline in the United States and top ranking in the Zagat Survey of Global Airlines in the categories for Frequent Flyer program and domestic web site. We were also included in the Top 100 Most Innovative Technology Organizations by *InformationWeek* magazine in July 2007.

We are excited about 2008 and beyond because we have one of the best weapons in the Customer Service business——our outstanding Employees. Our 34,000-plus Southwest Warriors are passionate about our mission to give Customers affordable air travel and choices to customize their travel experiences. For more than 36 years, they have demonstrated that they genuinely care about our Customers, the communities we serve, and our Shareholders. Their dedication, work ethic, creativity, and compassion will help ensure our success for years to come. We’re in the business of life, and together we tirelessly endeavor to make YOUR life more productive and prosperous.

GUY SITTING: Todd, sit down.

GUY STANDING: No. You just want my place.

GUY SITTING: Come on, man, sit down.

GUY STANDING: I don’t want to lose my place.

GUY SITTING: Do you see anybody else standing in line?

GUY SITTING: You don’t have to do that anymore. They board by group

and number now and just call you up.

GUY STANDING: You’re wrong. GUY SITTING: You wanna bet?

GUY STANDING: OK. (laughs) Oh, man.

GROUP: (laughs hysterically as guy enters conference room in hot dog costume)

VO: Introducing a new and better way to board from Southwest Airlines.

SFX: Ding

VO: You are now free to move about the country.

©2008 Southwest Airlines Co.

*In summer 2007, Southwest dedicated our 500th Boeing 737, the latest arrival to our Spirit Fleet of jets, with ceremonies honoring our Employees’ service in the U.S. Armed Services.*

LUV

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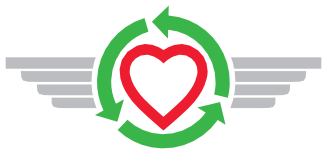
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Customer Satisfaction (Complaints per 1 00,000 Customers boarded) For the year ending December 31, 2007



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*At Southwest Airlines, we recognize that stewardship of the environment is an essential aspect of our business. For more than 36 years, we have led the industry in efficiency and productivity, and we are committed to continually raising the bar on the environmental quality of our operations.*

*Protecting the environment is the responsibility of every Southwest Employee, and our People are the key to our success. A “Green Team” of Employees leads our efforts in sustaining our environment for generations to come. The mission of the Green Team is to identify efforts currently under way, target areas of improvement in all aspects of Southwest business, and search for ways to bring environmental stewardship to the forefront of business decisions while remaining true to our low-cost philosophy.*

*Our dedication to efficient operations, our loyalty to our Employees, and our love for our communities every day reinforces our commitment to environmental and social responsibility. How very Southwest!*

*As part of our Green Team efforts, we have chosen to print this year’s Annual Report with vegetable ink. Vegetable-based inks significantly reduce the amount of VOCs (volatile organic compounds) released into the air during printing, whereas traditional inks do not decompose in landfills and are based on petroleum, a nonrenewable resource.*

*Paper printed with older, petroleum-based inks is also more costly to recycle (and therefore less “green”) because of the difficulty separating ink particles from paper fibers. Vegetable-based inks, on the other hand, are cleaner, print brighter, are more rub-resistant, have lower solvent emissions and less toxic waste, and are more biodegradable than petroleum inks. They are also especially suited to uncoated or recycled stocks because the ink does not spread quite as much, thereby enhancing printability and color control.*

*The paper selected for this year’s Annual Report is “Options” from Mohawk Paper Mills, Inc., the first paper manufacturer in the United States to receive the Green Seal certification. It is 100 percent postconsumer waste fiber printed with vegetable-based inks. The paper is FSC-certified under the Forest Stewardship Council draft guidelines for 100 percent recycled paper. This line of paper is manufactured entirely with nonpolluting, wind-generated energy through a contract between Mohawk and Community Wind Energy.*

SOUTHWEST AIRLINES CO. ANNUAL REPORT 2007

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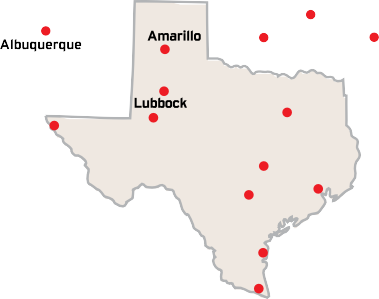
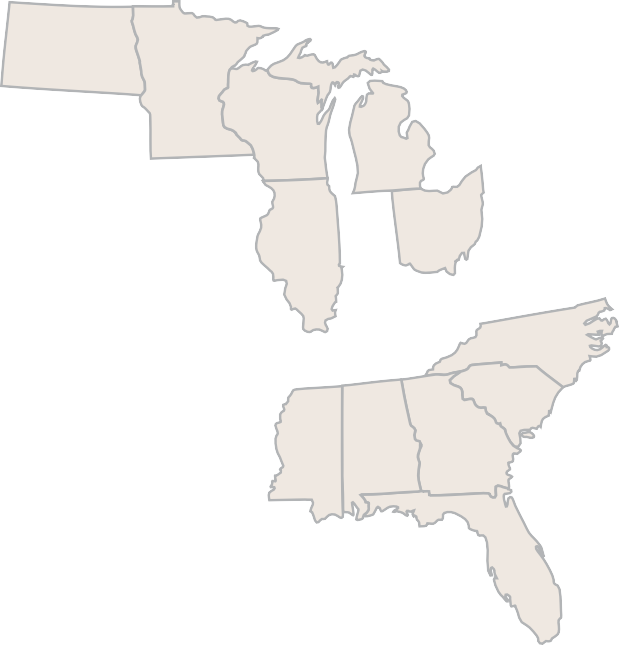
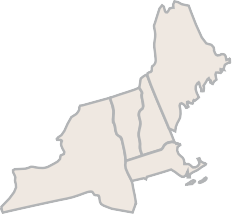
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SOUTHWEST AIRLINES CO. ANNUAL REPORT 2007

Quarterly Financial Data (Unaudited)

Three Months Ended

(in millions, except per share amounts) March 31 June 30 September 30 December 31 2007

|  |  |  |  |  |
| --- | --- | --- | --- | --- |
| Operating revenues | $ 2,198 | $ 2,583 | $ 2,588 | $ 2,492 |
| Operating income | 84 | 328 | 251 | 126 |
| Income before income taxes | 149 | 447 | 277 | 183 |
| Net income | 93 | 278 | 162 | 111 |
| Net income per share, basic | .12 | .36 | .22 | .15 |
| Net income per share, diluted | .12 | .36 | .22 | .15 |

2006

|  |  |  |  |  |
| --- | --- | --- | --- | --- |
| Operating revenues | $ 2,019 | $ 2,449 | $ 2,342 | $ 2,276 |
| Operating income | 98 | 402 | 261 | 174 |
| Income before income taxes | 96 | 515 | 78 | 101 |
| Net income | 61 | 333 | 48 | 57 |
| Net income per share, basic | .08 | .42 | .06 | .07 |
| Net income per share, diluted | .07 | .40 | .06 | .07 |

Common 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

2007

|  |  |  |  |  |
| --- | --- | --- | --- | --- |
| 1st Quarter | $ 0.0045 | $ 16.58 | $ 14.50 | $ 14.70 |
| 2nd Quarter | 0.0045 | 15.90 | 14.03 | 14.91 |
| 3rd Quarter | 0.0045 | 16.96 | 14.21 | 14.80 |
| 4th Quarter | 0.0045 | 15.06 | 12.12 | 12.20 |

2006

|  |  |  |  |  |
| --- | --- | --- | --- | --- |
| 1st Quarter | $ 0.0045 | $ 18.10 | $ 15.51 | $ 17.99 |
| 2nd Quarter | 0.0045 | 18.20 | 15.10 | 16.37 |
| 3rd Quarter | 0.0045 | 18.20 | 15.66 | 16.66 |
| 4th Quarter | 0.0045 | 17.03 | 14.61 | 15.32 |

2003 2004 2005 2006 2007

100,000

90,000

99,636

92,663

85,1 73

76,861

71,790

80,000

70,000

60,000

2003 2004 2005 2006 2007

80,000

70,000

72,319

67,691

60,223

53,418

47,943

60,000

50,000

40,000

2003 2004 2005 2006

2007

75%

70%

73.1% 72.6%

69.5% 70.7%

66.8%

65%

60%

55%

50%

Available Seat Miles (in millions)

Revenue Passenger Miles (in millions)

Passenger Load Factor

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SOUTHWEST AIRLINES CO. ANNUAL REPORT 2007

TEN-YEAR SUMMARY Selected Consolidated Financial Data (GAAP)

(Dollars in millions, except per share amounts)

2007(4)

2006(4)

2005(4)

2004(4)

Operating revenues:

|  |  |  |  |
| --- | --- | --- | --- |
| Passenger(2) $ 9,457 | $ 8,750 | $ 7,279 | $ 6,280 |
| Freight 130 | 134 | 133 | 117 |
| Other(2) 274 | 202 | 172 | 133 |
| Total operating revenues 9,861 | 9,086 | 7,584 | 6,530 |
| Operating expenses 9,070 | 8,152 | 6,859 | 6,126 |
| Operating income 791 | 934 | 725 | 404 |
| Other expenses (income), net (267) | 144 | (54) | 65 |
| Income before income taxes 1,058 | 790 | 779 | 339 |
| Provision for income taxes 413 | 291 | 295 | 124 |
| Net income $ 645 | $ 499 | $ 484 | $ 215 |
| Net income per share, basic $ .85 | $ .63 | $ .61 | $ .27 |
| Net income per share, diluted $ .84 | $ .61 | $ .60 | $ .27 |
| Cash dividends per common share $ .0180 | $ .0180 | $ .0180 | $ .0180 |
| Total assets $ 16,772 | $ 13,460 | $ 14,003 | $ 11,137 |
| Long-term debt less current maturities $ 2,050 | $ 1,567 | $ 1,394 | $ 1,700 |
| Stockholders’ equity $ 6,941 | $ 6,449 | $ 6,675 | $ 5,527 |
| CONSOLIDATED FINANCIAL RATIOS  Return on average total assets 4.3% | 3.6% | 3.9% | 2.1% |
| Return on average stockholders’ equity 9.6% | 7.6% | 7.9% | 4.1% |
| Operating margin 8.0% | 10.3% | 9.6% | 6.2% |
| Net margin 6.5% | 5.5% | 6.4% | 3.3% |
| CONSOLIDATED OPERATING STATISTICS  Revenue passengers carried 88,713,472 | 83,814,823 | 77,693,875 | 70,902,773 |
| Enplaned passengers 101,910,809 | 96,276,907 | 88,379,900 | 81,066,038 |
| RPMs (000s) 72,318,812 | 67,691,289 | 60,223,100 | 53,418,353 |
| ASMs (000s) 99,635,967 | 92,663,023 | 85,172,795 | 76,861,296 |
| Passenger load factor 72.6% | 73.1% | 70.7% | 69.5% |
| Average length of passenger haul (miles) 815 | 808 | 775 | 753 |
| Average stage length (miles) 629 | 622 | 607 | 576 |
| Trips flown 1,160,699 | 1,092,331 | 1,028,639 | 981,591 |
| Average passenger fare(2) $106.60 | $104.40 | $93.68 | $88.57 |
| Passenger revenue yield per RPM(2) 13.08 ¢ | 12.93 ¢ | 12.09 ¢ | 11.76¢ |
| Operating revenue yield per ASM 9.90 ¢ | 9.81 ¢ | 8.90 ¢ | 8.50¢ |
| Operating expenses per ASM 9.10 ¢ | 8.80 ¢ | 8.05 ¢ | 7.97¢ |
| Operating expenses per ASM, excluding fuel 6.56 ¢ | 6.49 ¢ | 6.48 ¢ | 6.67¢ |
| Fuel cost per gallon (average) 170.0 ¢ | 153.0 ¢ | 103.3 ¢ | 82.8¢ |
| Fuel consumed, in gallons (millions) 1,489 | 1,389 | 1,287 | 1,201 |
| Fulltime equivalent Employees at yearend 34,378 | 32,664 | 31,729 | 31,011 |
| Size of fleet at yearend(1) 520 | 481 | 445 | 417 |

* + 1. Includes leased aircraft
    2. Includes effect of reclassification of revenue reported in 1999 and 1998 related to the sale of flight segment credits from Other to Passenger due to the accounting change in 2000
    3. Certain figures include special items related to the September 11, 2001, terrorist attacks and Stabilization Act grant
    4. Includes special items. See note
    5. After cumulative effect of change in accounting principle

NOTE: The schedule included on the inside cover of this report reconciles non-GAAP financial measures included in the report to net income as reported by the Company by excluding certain special items. The special items, which are net of profitsharing and income taxes as appropriate, consist primarily of: a government grant received under the Emergency Wartime Supplemental Appropriations Act as a result of the U.S. war with Iraq (2003); certain changes in state tax laws (2006, 2007); certain gains or losses for derivative instruments associated with the Company’s fuel hedging program, recorded as a result of SFAS 133, “Accounting for Derivative Instruments and Hedging Activities,” as amended (2003, 2004, 2005, 2006, 2007); out of period retroactive pay associated with the execution of certain labor agreements (2004); and charges associated with voluntary early-out programs offered to Employees (2004, 2007). 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.

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SOUTHWEST AIRLINES CO. ANNUAL REPORT 2007

2003(4)

$ 5,741

94

102

5,937

5,558

379

(225)

604

232

2002(3)

$ 5,341

85

96

5,522

5,181

341

24

317

129

2001(3)

$ 5,379

91

85

5,555

5,016

539

(197)

736

285

2000

$ 5,468

111

71

5,650

4,702

948

4

944

367

1999

$ 4,563

103

70

4,736

4,001

735

8

727

283

1998

$ 4,010

99

55

4,164

3,518

646

(21)

667

256

|  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- |
| $ 372 | $ 188 | $ 451 | $ 555 (5) $ 444 $ 411 | | |
| $ .48 | $ .24 | $ .59 | $ .74 (5) $ .59 $ .55 | | |
| $ .46 | $ .23 | $ .56 | $ .70 (5) $ .56 $ .52 | | |
| $ .0180 | $ .0180 | $ .0180 | $ .0148 | $ .0143 | $ .0126 |
| $ 9,693 | $ 8,766 | $ 8,779 | $ 6,500 | $ 5,519 | $ 4,605 |
| $ 1,332 | $ 1,553 | $ 1,327 | $ 761 | $ 872 | $ 623 |
| $ 5,029 | $ 4,374 | $ 3,921 | $ 3,376 | $ 2,780 | $ 2,352 |

|  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- |
| 4.0% | 2.1% | 5.9% | 9.2% | 8.8% | 9.4% |
| 7.9% | 4.5% | 12.4% | 18.0% | 17.3% | 19.0% |
| 6.4% | 6.2% | 9.7% | 16.8% | 15.5% | 15.5% |
| 6.3% | 3.4% | 8.1% | 9.8% | 9.4% | 9.9% |

|  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- |
| 65,673,945 | 63,045,988 | 64,446,773 | 63,678,261 | 57,500,213 | 52,586,400 |
| 74,719,340 | 72,462,123 | 73,628,723 | 72,566,817 | 65,287,540 | 59,053,217 |
| 47,943,066 | 45,391,903 | 44,493,916 | 42,215,162 | 36,479,322 | 31,419,110 |
| 71,790,425 | 68,886,546 | 65,295,290 | 59,909,965 | 52,855,467 | 47,543,515 |
| 66.8% | 65.9% | 68.1% | 70.5% | 69.0% | 66.1% |
| 730 | 720 | 690 | 663 | 634 | 597 |
| 558 | 537 | 514 | 492 | 465 | 441 |
| 949,882 | 947,331 | 940,426 | 903,754 | 846,823 | 806,822 |
| $87.42 | $84.72 | $83.46 | $85.87 | $79.35 | $76.26 |
| 11.97¢ | 11.77¢ | 12.09¢ | 12.95¢ | 12.51¢ | 12.76¢ |
| 8.27¢ | 8.02¢ | 8.51¢ | 9.43¢ | 8.96¢ | 8.76¢ |
| 7.74¢ | 7.52¢ | 7.68¢ | 7.85¢ | 7.57¢ | 7.40¢ |
| 6.59¢ | 6.41¢ | 6.50¢ | 6.50¢ | 6.64¢ | 6.58¢ |
| 72.3¢ | 68.0¢ | 70.9¢ | 78.7¢ | 52.7¢ | 45.7¢ |
| 1,143 | 1,117 | 1,086 | 1,013 | 924 | 843 |
| 32,847 | 33,705 | 31,580 | 29,274 | 27,653 | 25,844 |
| 388 | 375 | 355 | 344 | 312 | 280 |

**Cautionary Statement Regarding Forward-Looking Statements.** This Annual Report contains forward-looking statements relating to the Company’s operations and business outlook and related financial and operational strategies and goals. Specific forward-looking statements include statements relating to (i) the Company’s initiatives to increase revenues and cut costs; (ii) its financial targets and expectations regarding results of operations; and (iii) its plans for fleet growth. These forward-looking statements are based on the Company’s current intent, expectations, and projections and are not guarantees of future performance. These statements involve risks, uncertainties, assumptions, and other factors that are difficult to predict and that could cause actual results to vary materially from those expressed in or indicated by them. Factors include, among others, (i) the price and availability of aircraft fuel; (ii) the Company’s ability to timely and effectively prioritize its initiatives and its related ability to timely implement and maintain the necessary information technology systems and infrastructure to support these initiatives; (iii) the extent and timing of the Company’s investment of incremental operating expenses and capital expenditures to develop and implement its initiatives and its corresponding ability to effectively control its operating expenses; (iv) the Company’s dependence on third-party arrangements to assist with the implementation of certain of its initiatives; (v) competitor capacity and load factors; and (vi) other factors, as described in the Company’s filings with the Securities and Exchange Commission, including the detailed factors discussed under the heading “ Risk Factors” in the Company’s Annual Report on Form 1 0 - K for the fiscal year ended December 31 , 2007.

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SOUTHWEST AIRLINES CO. ANNUAL REPORT 2007

TRANSFER AGENT AND REGISTRAR

Registered shareholder inquiries regarding stock transfers, address changes, lost stock certificates, dividend payments and reinvestments, direct stock purchase, 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

DIRECTORS

COLLEEN C. BARRETT

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

DAVID W. BIEGLER

Chairman of the Board and CEO,

Estrella Energy LP; Retired, Vice Chairman of TXU Corp., Dallas, Texas; Audit and Compensation (Chairman) Committees

LOUIS CALDERA

Professor of Law at The University of New Mexico, Albuquerque, New Mexico; Audit and Compensation Committees

C. WEBB CROCKETT Attorney, Fennemore Craig,

Attorneys at Law, Phoenix, Arizona; Executive 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 Executive Committees

TRAVIS C. JOHNSON

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

HERBERT D. KELLEHER

Executive Chairman, Southwest Airlines Co., Dallas, Texas; Executive Committee (Chairman)

GARY C. KELLY

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

NANCY LOEFFLER

Longtime advocate of volunteerism, San Antonio, Texas

JOHN T. MONTFORD

Senior Vice President——Western Region Legislative and Regulatory Affairs, AT&T Services, Inc., San Antonio, Texas; Audit, Compensation, and Nominating and Corporate Governance (Chairman) Committees

OFFICERS GARY C. KELLY\*

Vice Chairman and Chief Executive Officer

COLLEEN C. BARRETT\*

President and Corporate Secretary

SOUTHWEST AIRLINES CO. 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

ROBERT E. JORDAN\*

Executive Vice President——Strategy and Technology

RON RICKS\*

Executive Vice President——Law, Airports, and Public Affairs

MICHAEL G. VAN DE VEN\*

Executive Vice President——Chief of Operations

GINGER C. HARDAGE\*

Senior Vice President——Corporate Communications

DARYL KRAUSE

Senior Vice President——Inflight and Fleet Services

JEFF LAMB

Senior Vice President——Chief People and Administration Officer

GREG WELLS\*

Senior Vice President——Operations

LAURA H. WRIGHT\*

Senior Vice President——Finance and Chief Financial Officer

BARRY BROWN

Vice President——Safety and Security

GREGORY N. CRUM

Vice President——Director of Operations

DARREN DAYLEY

Vice President——Technology, Customer Experience Portfolio

MATT HAFNER

Vice President——Ground Operations

MIKE HAFNER

Vice President——Inflight Services

SCOTT HALFMANN

Vice President——Provisioning

JOE HARRIS

Vice President——Labor and Employee Relations

LAURIE HULIN

Vice President——Technology, Aircraft Operations and Enterprise Management Portfolios

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/)[**www.swamedia.com**](http://www.swamedia.com/)[**www.blogsouthwest.com**](http://www.blogsouthwest.com/)

ANNUAL MEETING

The Annual Meeting of Shareholders of Southwest Airlines Co. will be held at 10:00 a.m. on May 21 , 2008, at the Southwest Airlines Corporate Headquarters, 2702 Love Field Drive, Dallas, Texas.

KEVIN M. KRONE

Vice President——Marketing, Sales, and Distribution

TERESA LARABA

Vice President——Ground Operations

CHUCK MAGILL

Vice President——Flight Operations

JAN MARSHALL

Vice President——Technology and Chief Information Officer

PETE MCGLADE

Vice President——Schedule Planning

BOB MONTGOMERY

Vice President——Properties

ROB MYRBEN

Vice President——Fuel Management

LORI RAINWATER

Vice President——Internal Audit

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

MICHAEL RYAN

Vice President——Labor Relations

RAY SEARS

Vice President——Purchasing

JIM SOKOL

Vice President——Maintenance and Engineering

SCOTT E. TOPPING

Vice President——Treasurer

ELLEN TORBERT

Vice President——Reservations

CHRIS WAHLENMAIER

Vice President——Ground Operations

\*Member of Executive Planning Committee

**UNITED STATES SECURITIES AND EXCHANGE COMMISSION**

# Washington, D.C. 20549

**Form 10-K**

(Mark One)

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

## For the fiscal year ended December 31, 2007

**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

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

## P.O. Box 36611 Dallas, Texas

*(Address of principal executive offices)*

## 74-1563240

*(I.R.S. Employer Identification No.)*

## 75235-1611

*(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 if the registrant is a well-known seasoned issuer, as defined in Rule 405 of the Securities Act.

Yes ¥ No n

Indicate by check mark if the registrant is not required to file reports pursuant to Section 13 or Section 15(d) of the Act. Yes 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 if the registrant is a large accelerated filer, an accelerated filer, or a non-accelerated filer. See definition of “accelerated filer and large accelerated filer” in Rule 12b-2 of the Exchange Act. (Check one):

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

Indicate by check mark if 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

$11,172,660,474, computed by reference to the closing sale price of the common stock on the New York Stock Exchange on June 29, 2007, 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 30, 2008: 735,665,898 shares

## DOCUMENTS INCORPORATED BY REFERENCE

Portions of the Proxy Statement for the Company’s Annual Meeting of Shareholders to be held May 21, 2008 are

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**Item 1. *Business***

## Overview

**PART I**

Fuel costs, coupled with evidence of slowing eco- nomic growth and the impact of labor costs, led to the Company’s decision in 2007 to slow capacity growth through a combination of schedule adjustments and fleet changes. The Company has been working on optimizing

Southwest Airlines Co. is a major passenger airline that provides scheduled air transportation in the United States. Based on the most recent data available from the U.S. Department of Transportation (“DOT”), Southwest is the largest air carrier in the United States, as measured by the number of originating passengers boarded and the number of scheduled domestic departures. South- west commenced Customer Service on June 18, 1971, with three Boeing 737 aircraft serving three Texas cities — Dallas, Houston, and San Antonio. As of December 31, 2007, Southwest operated 520 Boeing 737 aircraft and provided service to 64 cities in 32 states throughout the United States. In 2007, Southwest recommenced service to San Francisco International Airport.

Southwest focuses principally on point-to-point, rather than hub-and-spoke, service, providing its markets with frequent, conveniently timed flights and low fares. As of December 31, 2007, Southwest served 411 nonstop city pairs. Historically, Southwest has served predomi- nantly short-haul routes, with high frequencies. In recent years, Southwest has complemented this service with more medium to long-haul routes, including transconti- nental service.

Southwest has a low cost structure, enabling it to charge low fares. Adjusted for stage length, Southwest has lower unit costs, on average, than most major network carriers. Southwest’s low cost advantage is facilitated by reliance upon a single aircraft type, an operationally efficient route structure, and highly productive Employees.

## Fuel Cost Impact and Related Growth Plans and Initiatives

Fuel prices can have a significant impact on South- west’s profitability. From October 1, 2007 through December 31, 2007, the average cost per gallon for jet fuel was $1.87. Southwest’s average cost of jet fuel, net of hedging gains and excluding fuel taxes, over the past five years was as follows:

|  |  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- | --- |
| **Year** |  | **Cost (Millions)** |  | **Average Cost Per Gallon** |  | **Percent of Operating Expenses** |
| 2003 | . . | $ 830 |  | $ .72 |  | 14.9% |
| 2004 | . . | $1,000 |  | $ .83 |  | 16.3% |
| 2005 | . . | $1,341 |  | $1.03 |  | 19.6% |
| 2006 | . . | $2,138 |  | $1.53 |  | 26.2% |
| 2007 | . . | $2,536 |  | $1.70 |  | 28.0% |

its flight schedule by reducing frequency on less profitable routes and reallocating capacity to potentially more rewarding markets. This in turn has allowed the Com- pany to reduce the number of aircraft it will add to its fleet in 2008. As discussed further below under “Properties,” the Company has also adjusted its aircraft deliveries from Boeing.

In addition to schedule adjustments, the Company has developed several initiatives designed to enhance Customer Service and to help offset increasing costs through improving future revenues. These initiatives include, among others:

* Implementation of a new Customer boarding method for flights;
* Commencement of a significant gate re-design to enhance the airport experience for Customers;
* Introduction of a new fare structure, including a “Business Select” product;
* Introduction of enhancements to the Company’s Rapid Rewards frequent flyer program;
* Launch of a new advertising campaign;
* Announcement of an expansion of the Company’s GDS (Global Distribution System) and corporate travel account efforts; and
* Exploration of international codeshare alliances.

The Company’s initiatives are discussed in more detail below under “Operating Strategies and Market- ing.” Fuel costs and Southwest’s fuel hedging activities are discussed in more detail below under “Risk Factors” and “Management’s Discussion and Analysis of Financial Condition and Results of Operations.”

## Regulation

The airline industry is regulated heavily, especially by the federal government. Examples of such regulation include:

*Economic and Operational Regulation*

* *Aviation Taxes.* The statutory authority for the federal government to collect aviation taxes, which are used, in part, to finance the nation’s airport and air traffic control systems, and the authority of the

Federal Aviation Administration (“FAA”) to expend those funds must be periodically reautho- rized by the U.S. Congress. This authority was scheduled to expire on September 30, 2007. How- ever, Congress has approved a temporary extension of this authority through February 29, 2008. Similar temporary extensions or a reauthorization for a fixed term are expected to occur in 2009. Other proposals being considered by Congress in connection with the FAA reauthorization legislation include: (i) the imposition of new user fees on jet-powered aircraft,

(ii) an increase in the amount of airport passenger facility charges, and (iii) the adoption of new unfunded mandates on commercial airlines such as passenger-rights standards and labor protection provisions, any of which could have an impact on the Company’s operations.

* *U.S. Department of Transportation.* The DOT has significant regulatory jurisdiction over passenger airlines. To provide passenger transportation in the United States, a domestic airline is required to hold a Certificate of Public Convenience and Necessity issued by the DOT. A certificate is unlim- ited in duration and generally permits the Company to operate among any points within the United States and its territories and possessions. The DOT may revoke a certificate, in whole or in part, for intentional failure to comply with federal avia- tion statutes, regulations, orders, or the terms of the certificate itself. The DOT also has jurisdiction over certain economic and consumer protection matters such as advertising, denied boarding compensation, baggage liability, and access for persons with dis- abilities. The DOT may impose civil penalties on air carriers for violations of its regulations in these areas.
* *Wright Amendment.* The International Air Transportation Competition Act of 1979, as amended (the “Act”), imposed restrictions on the provision of air transportation to and from Dallas Love Field. The applicable portion of the Act, commonly known as the “Wright Amend- ment,” impacted Southwest’s scheduled service by prohibiting the carrying of nonstop and through passengers on commercial flights between Dallas Love Field and all states outside of Texas, with the exception of the following states (the “Wright Amendment States”): Alabama, Arkansas, Kansas, Louisiana, Mississippi, Missouri, New Mexico, and Oklahoma. In addition, the Wright Amendment only permitted an airline to offer flights between Dallas Love Field and the Wright Amendment

States to the extent the airline did not offer or provide any through service or ticketing with another air carrier at Dallas Love Field and did not market service to or from Dallas Love Field and any point outside of a Wright Amendment State. In other words, a Customer could not purchase a single ticket between Dallas Love Field and any destina- tion other than a Wright Amendment State. The Wright Amendment did not restrict flights operated with aircraft having 56 or fewer passenger seats, nor did it restrict Southwest’s intrastate Texas flights or its air service to or from points other than Dallas Love Field.

In 2006, Southwest entered into an agreement with the City of Dallas, the City of Fort Worth, Amer- ican Airlines, Inc., and the DFW International Airport Board. Pursuant to this agreement, the five parties sought enactment of legislation to amend the Act. Congress responded by passing the Wright Amendment Reform Act of 2006 (the “Reform Act”). The Reform Act immediately repealed through service and ticketing restrictions, thereby allowing the purchase of a single ticket between Dallas Love Field and any U.S. destination (while still requiring the Customer to make a stop in a Wright Amendment State), and reduced the max- imum number of gates available for commercial air service at Dallas Love Field from 32 to 20. South- west currently uses 15 gates at Dallas Love Field. Pursuant to the Reform Act and local agreements with the City of Dallas with respect to gates, South- west can expand scheduled service from Dallas Love Field and intends to do so. The Reform Act also provides for substantial repeal of the remainder of the Wright Amendment in 2014.

*Safety and Health Regulation*

The Company and its third-party maintenance pro- viders are subject to the jurisdiction of the FAA with respect to the Company’s aircraft maintenance and oper- ations, 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, and Southwest has obtained, operating, airworthiness, and other certificates. These certificates are subject to sus- pension or revocation for cause. In addition, pursuant to FAA regulations, the Company has established, and the FAA has approved, the Company’s operations specifica- tions and a maintenance program for the Company’s aircraft, ranging from frequent routine inspections to major overhauls. The FAA, acting through its own

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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 Aviation Regulations.

The Company is subject to various other federal, state, and local laws and regulations relating to occupa- tional safety and health, including Occupational Safety and Health Administration and Food and Drug Admin- istration regulations.

*Security Regulation*

Following the terrorist attacks on September 11, 2001, Congress enacted the Aviation and Transportation Security Act (the “Aviation Security Act”). The Avia- tion Security Act established the Transportation Security Administration (the “TSA”), a division of the

U.S. Department of Homeland Security that is respon- sible for certain civil aviation security matters. The Avi- ation Security Act also mandated, among other things, improved flight deck security, deployment of federal air marshals onboard flights, improved airport perimeter access security, airline crew security training, enhanced security screening of passengers, baggage, cargo, mail, employees, and vendors, enhanced training and qualifi- cations of security screening personnel, additional pro- vision of passenger data to U.S. Customs and Border Protection, and enhanced background checks. Under the Aviation Security Act, substantially all security screeners at airports are federal employees, and significant other elements of airline and airport security are overseen and performed by federal employees, including federal secu- rity managers, federal law enforcement officers, and fed- eral air marshals.

Enhanced security measures have impacted the Company’s business. In particular, they have had a sig- nificant impact on the airport experience for passengers. For example, in the third quarter of 2006, the TSA mandated new security measures in response to a terrorist plot uncovered by authorities in London. These rules, which primarily regulate the types of liquid items that can be carried onboard aircraft, have had a negative impact on air travel, especially on shorthaul routes and with business travelers. Although the TSA has relaxed some of its requirements, the Company is not able to predict the ongoing impact, if any, that these security changes will have on passenger revenues, both in the shortterm and the longterm. The Company has made significant invest- ments to address the impact of these types of regulations, including investments in facilities, equipment, and tech- nology to process Customers efficiently and restore the airport experience. The Company’s Automated Boarding

Passes and self service kiosks have reduced the number of lines in which a Customer must wait. In addition, the Company’s gate readers at all of its airports have improved the boarding reconciliation process. The Com- pany also offers baggage checkin through self service kiosks at certain airport locations, as well as Internet checkin and transfer boarding passes at the time of checkin.

Enhanced security measures have also impacted the Company’s business through the imposition of security fees on the Company’s Customers and on the Company. Under the Aviation Security Act, funding for passenger security is provided in part by a $2.50 per enplanement security fee, subject to a maximum of $5.00 per one-way trip. The Aviation Security Act also allows the TSA to assess an Aviation Security Infrastructure Fee (“ASIF”) on each airline. Southwest’s ASIF liability was originally set at $24 million per year. Effective in 2005, the TSA unilaterally increased the amount to $50 million. South- west and 22 other airlines are joined in litigation pres- ently pending in the U.S. Court of Appeals against the TSA to challenge that increase.

*Environmental Regulation*

The Airport Noise and Capacity Act of 1990 gives airport operators the right, under certain circumstances, to implement local noise abatement programs, so long as they do not unreasonably interfere with interstate or foreign commerce or the national air transportation sys- tem. Some airports have established airport restrictions to limit noise, including restrictions on aircraft types to be used, and limits on the number of hourly or daily oper- ations or the time of operations. These types of restric- tions can cause curtailments in service or increases in operating costs and could limit the ability of Southwest to expand its operations at the affected airports.

The Company is subject to various other federal, state, and local laws and regulations relating to the pro- tection of the environment, including the discharge or disposal of materials such as chemicals, hazardous waste, and aircraft deicing fluid. Regulatory developments per- taining to such things as control of engine exhaust emissions from ground support equipment and preven- tion of leaks from underground aircraft fueling systems could increase operating costs in the airline industry. The Company does not believe, however, that presently pend- ing environmental regulatory developments will have a material impact on the Company’s capital expenditures or otherwise adversely affect its operations, operating costs, or competitive position. However, legislation has been introduced in the U.S. Congress to regulate so-called

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“green house gas emissions.” The legislation could impose unknown costs or restrictions on all transporta- tion-related activities, the impact of which is presently unpredictable. Additionally, in conjunction with airport authorities, other airlines, and state and local environ- mental regulatory agencies, the Company is undertaking voluntary investigation or remediation of soil or ground- water contamination at several airport sites. The Com- pany does not believe that any environmental liability associated with such sites will have a material adverse effect on the Company’s operations, costs, or profitability.

The Company has appointed a “Green Team” to target areas of environmental improvement in all aspects of the Company’s business, while at the same time remaining true to the Company’s low cost philosophy. As part of this initiative, during 2008, the Company will be publishing an Environmental Report describing the Company’s strategies to reduce greenhouse gas emissions and addressing other environmental matters such as waste management and recycling.

*Regulation of Customer Service Practices*

From time to time, the airline industry has been faced with possible legislation dealing with certain Cus- tomer Service practices. As a compromise with Congress, the industry, working with the Air Transport Associa- tion, has responded by adopting and filing with the DOT written plans disclosing commitments to improve per- formance. Southwest Airlines’ Customer Service Com- mitment is a comprehensive plan that 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 Com- pany Spirit. The Customer Service Commitment can be reviewed by clicking on “About Southwest” 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.

## Operating Strategies and Marketing

*General Operating Strategies*

Southwest focuses principally on point-to-point ser- vice, rather than the hub-and-spoke service provided by most major U.S. airlines. The “hub-and-spoke” system concentrates most of an airline’s operations at a limited number of hub cities and serves most other destinations in the system by providing one-stop or connecting service through the hub. Point-to-point service allows for more direct nonstop routing than the hub and spoke system,

minimizing connections, delays, and total trip time. As a result, approximately 78 percent of Southwest’s Customers fly nonstop. Southwest’s average aircraft trip stage length in 2007 was 629 miles with an average duration of approx- imately 1.8 hours, as compared to an average aircraft trip stage length of 622 miles and an average duration of approximately 1.7 hours in 2006. Point-to-point service also enables Southwest to provide its markets with fre- quent, conveniently timed flights and low fares. Examples of markets offering frequent daily flights are: Dallas Love Field to Houston Hobby, 30 weekday roundtrips; Phoenix to Las Vegas, 18 weekday roundtrips; and Los Angeles International to Oakland, 20 weekday roundtrips. South- west complements these high-frequency shorthaul routes with longhaul nonstop service between markets such as Phoenix and Tampa Bay, Las Vegas and Orlando, and Nashville and Oakland.

Southwest serves many conveniently located second- ary or downtown airports such as Dallas Love Field, Houston Hobby, Chicago Midway, Baltimore-Washing- ton International, Burbank, Manchester, Oakland, San Jose, Providence, Ft. Lauderdale/Hollywood, and Long Island Islip airports, which are typically less con- gested than other airlines’ hub airports. This operating strategy enables the Company to achieve high asset uti- lization because aircraft can be scheduled to minimize the amount of time they are on the ground. This in turn reduces the number of aircraft and gate facilities that would otherwise be required. The Company is also able to simplify scheduling, maintenance, flight operations, and training activities by operating only one aircraft type, the Boeing 737. All of these strategies enhance the Compa- ny’s ability to sustain high Employee productivity and reliable ontime performance.

*Simplified Fare Structure*

Southwest employs a relatively simple fare structure, featuring low, unrestricted, unlimited, everyday coach fares, as well as even lower fares available on a restricted basis. As of November 1, 2007, Southwest’s highest non- codeshare, one-way unrestricted walkup fare offered was

$399 for its longest flights. Substantially lower walkup fares are generally available on Southwest’s short and medium haul flights.

In November 2007, Southwest announced enhance- ments to its fare structure and unveiled a new fare display on its web site, [**www.southwest.com**.](http://www.southwest.com/) Instead of a large display with numerous fare categories, Southwest has streamlined the process by bundling fares into three major fare columns: “Business Select,” “Business,” and “Wanna Get Away,” with the goal of making it easier for

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Customers to choose the fare they want. The new “Busi- ness Select” fare is part of the Company’s initiative to increase offerings and improve productivity for the busi- ness traveler. Customers who purchase the Business Select fare are allowed to be among the first Customers to board the aircraft. They also receive extra Rapid Rewards credit for the flight and a free drink.

*Enhanced Boarding Method and Updated Gate Design*

During fourth quarter 2007, the Company intro- duced an enhanced boarding method, which is designed to significantly reduce the time a Customer spends stand- ing in line at the gate. The enhanced boarding process automatically reserves a place for a Customer in the Customer’s boarding group at the time of check-in by assigning a specific position number within the A, B, or C boarding group. Customers then board the aircraft in that numerical order. The new boarding method also allows for future enhancements, such as product customization and additional incentives for business and leisure travelers.

The Company has also commenced modification of its gate areas with columns and signage that facilitate the new boarding process. The “extreme gate makeover” is also designed to improve the airport experience for all of the Company’s Customers by including (i) a business focused area with padded seats, tables with power outlets, power stations with stools, and a flat screen television for news programming; and (ii) a family area with smaller tables and chairs, “kid friendly” programming on a flat screen television, and power stations for charging elec- trical devices. The updated gate design is scheduled to be completed during 2008 at virtually all airports served by the Company.

*Rapid Rewards Frequent Flyer Program*

Southwest’s frequent flyer program, Rapid Rewards, is based on trips flown rather than mileage. Rapid Rewards Customers earn a credit for each one-way trip flown or two credits for each roundtrip flown. Rapid Rewards Customers can also earn credits by using the services of non-airline partners, which include car rental agencies, hotels, and credit card partners, including the Southwest Airlines Chase» Visa card. Rapid Rewards offers two types of travel awards. The Rapid Rewards Award Ticket (“Award Ticket”) offers one free round- trip award, valid to any destination available on South- west, after the accumulation of 16 credits within

24 months. The Rapid Rewards Companion Pass (“Companion Pass”) is granted for accumulating

100 credits within a consecutive twelve-month period. The Companion Pass offers unlimited free roundtrip travel, to any destination available on Southwest, for a designated companion of the qualifying Rapid Rewards Member. For the designated companion to use this pass, the Rapid Rewards Member must purchase a ticket or use an Award Ticket. Additionally, the Rapid Rewards Member and designated companion must travel together on the same flight.

Award Tickets and Companion Passes are automat- ically generated when earned by the Customer rather than allowing the Customer to bank credits indefinitely. Award Tickets are valid for 12 months after issuance and are subject to seat restrictions. Companion Passes have no seat restrictions or “Black out” dates.

The Company also sells credits to business partners, including credit card companies, hotels, and car rental agencies. These credits may be redeemed for Award Tickets having the same program characteristics as those earned by flying.

During 2007, the Company enhanced its Rapid Rewards program and rolled out a new business traveler focused marketing campaign. Rapid Rewards Members who fly 32 or more qualifying one-way flights within a 12-month period receive priority boarding privileges for an entire year. In addition, if travel is purchased at least 36 hours prior to flight time, these passengers also receive the best boarding pass number available (generally, an “A” boarding pass). Customers on this “A-List” are also automatically checked in for their flight in advance of departure. During 2007, Southwest also introduced a new Freedom Award, which allows Rapid Rewards Members the opportunity to exchange two standard Award Tickets for one Freedom Award. The Freedom Award is free of seat restrictions, except for a limited number of blackout dates around major holidays.

Customers redeemed approximately 2.8 million,

2.7 million, and 2.6 million Award Tickets and flights on Companion Passes during 2007, 2006, and 2005, respectively. The amount of free travel award usage as a percentage of total Southwest revenue passengers carried was 6.2 percent in 2007, 6.4 percent in 2006, and

* 1. percent in 2005. The number of fully earned Award Tickets and partially earned awards outstanding at December 31, 2007 was approximately 11.6 million, of which approximately 81 percent were partially earned awards. The number of fully earned Award Tickets and partially earned awards outstanding at December 31, 2006 was approximately 10.1 million, of which approx- imately 81 percent were partially earned awards. How- ever, due to the expected expiration of a portion of credits

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making up partial awards, not all of them will eventually turn into useable Award Tickets. In addition, not all Award Tickets will be redeemed for future travel. Since the inception of Rapid Rewards in 1987, approximately 15 percent of all fully earned Award Tickets have expired without being used. The number of Companion Passes outstanding at December 31, 2007 and 2006 was approx- imately 65,000 and 58,000, respectively. The Company currently estimates that an average of three to four trips will be redeemed per outstanding Companion Pass.

The Company accounts for its Rapid Rewards pro- gram obligations by recording, at the time an award is earned, a liability for the estimated incremental cost of the use of flight awards the Company expects to be redeemed. The estimated incremental cost includes direct passenger costs such as fuel, food, and other operational costs, but does not include any contribution to overhead or profit. Revenue from the sale of credits to business partners and associated with future travel is deferred and recognized when the ultimate free travel award is flown or the credits expire unused. The liability for free travel awards earned but not used at December 31, 2007 and 2006 was not material to the Company’s business.

*Southwest.com; Expansion of GDS Participation and Corporate Travel Account Efforts*

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 to offer Ticketless travel through the Company’s web site at [**www.southwest.com**.](http://www.southwest.com/) For the year ended December 31, 2007, more than 95 percent of Southwest’s Customers chose the Ticketless travel option, and nearly 74 percent of Southwest’s passenger revenues came through its web site (including SWABiz revenues), which has become a vital part of the Company’s distribution strategy.

In 2007, in order to better attract business travelers, Southwest began exploring selling tickets through chan- nels in addition to its own reservation system, web site, and the Sabre System. Southwest is continuing its efforts to provide travel agent and professional travel manager partners with increased and cost effective access to its fares and inventory. In particular, during 2007, South- west announced an expansion of its GDS (Global Dis- tribution System) and corporate travel account efforts through a ten-year content distribution agreement with Travelport’s Galileo, a leading provider of global distri- bution services. The agreement has recently been expanded to include Worldspan, another of Travelport’s global distribution systems. Through the agreement, Southwest intends that all of its published fares and

inventory, with the exception of Southwest’s exclusive web fares, will eventually be available to Galileo-con- nected travel agencies in North America.

*RNP*

During 2007, Southwest announced an agreement with Naverus, an aviation consulting firm in Seattle, Washington, to partner on development of a Required Navigation Performance (“RNP”) program. RNP com- bines GPS (Global Positioning System), the capabilities of advanced aircraft avionics, and new flight procedures for the purpose of achieving safer, more efficient, and environmentally friendly flight operations. RNP proce- dures are designed to reduce fuel consumption, improve safety, and minimize emissions and noise, while simul- taneously taking advantage of the high-performance characteristics that exist in an airline’s fleet.

*Codesharing*

Southwest implemented codesharing in 2005 with ATA Airlines. Under its codeshare arrangement with ATA, Southwest may market and sell tickets for certain flights on ATA that are identified by Southwest’s des- ignator code (for example, “WN Flight 123”). Con- versely, ATA may market and sell tickets under its code designator (TZ) for certain flights on Southwest. Any flight bearing a Southwest code designator that is oper- ated 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. As a result of the ATA codeshare arrangement, Southwest’s Customers are able to purchase single ticket service on Southwest connecting to ATA’s service to Hawaii and Dallas Fort Worth International Airport. Also, members of Southwest’s and ATA’s respective frequent flier programs are able to earn and redeem awards in the other carrier’s program. Finally, beginning in 2006, Southwest began selling ATA-only service at [**www.southwest.com**.](http://www.southwest.com/) Other than the ATA arrangement, Southwest does not interline or offer joint fares with other airlines, nor does Southwest have any marketing or commuter feeder relationships with other carriers; however Southwest is currently exploring international codeshare opportunities.

*Management Information Systems*

Southwest is continuing to invest in technology to support the initiatives discussed above as well as South- west’s ongoing operations. Southwest is currently devel- oping a system to replace its current point of sale application in the stations and its refunds system in the back office. Additionally, Southwest has purchased

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technology that will replace its existing Ticketless system and revenue accounting system. The new systems are designed to, among other things, enhance data flow and thereby increase Southwest’s operational efficiencies and Customer Service capabilities. Southwest is also working to replace its back office accounting systems, payroll system, and human resource information system, with a goal of completion sometime during 2009.

## Competition

The airline industry is highly competitive. The Company believes the principal competitive factors in the industry are:

* + - Fares;
    - Customer Service;
    - Costs;
    - Frequency and convenience of scheduling;
    - Frequent flyer benefits; and
    - Efficiency and productivity, including effective selection and use of aircraft.

Southwest currently competes with other airlines on all of its routes. Some of these airlines have larger fleets than Southwest and some may have wider name recog- nition in certain markets. In addition, some major

* 1. airlines have established extensive marketing or codesharing alliances, including Northwest Airlines/ Continental Airlines/Delta Air Lines; American Air- lines/Alaska Airlines; and United Airlines/US Airways. These alliances are more extensive than Southwest’s arrangement with ATA Airlines and enable these carriers to expand their destinations and marketing opportunities. In addition, some airlines are able to offset less profitable domestic fares with more profitable international fares. As discussed above, the Company is evaluating interna- tional code sharing opportunities.

The Company is also subject to varying degrees of competition from surface transportation in its shorthaul markets. This competition can be more significant during economic downturns. Although price is a competitive factor in these instances, the Company believes frequency and convenience of scheduling, facilities, transportation safety and security procedures, and Customer Service are also of great importance to many passengers.

The competitive landscape for airlines has changed significantly over the last few years. Following the ter- rorist attacks on September 11, 2001, the airline indus- try, as a whole, incurred substantial losses through 2005. The war in Iraq and significant increases in the cost of

fuel have exacerbated industry challenges. As a result, a number of carriers have sought relief from financial obligations in bankruptcy, including UAL Corporation, the parent of United Airlines; ATA Airlines; US Airways; Northwest Airlines Corporation, the parent of Northwest Airlines; and Delta Air Lines. UAL Corporation and ATA Airlines emerged from bankruptcy in 2006, and Northwest Airlines Corporation and Delta Air Lines emerged from bankruptcy in 2007. US Airways’ emer- gence from bankruptcy in 2005 culminated in its merger with America West Airlines in September of that year. Other, smaller carriers have ceased operations entirely. In addition, post-9/11, many carriers shrank capacity, grounded their most inefficient aircraft, cut back on unprofitable service, and furloughed employees. Reorga- nization in bankruptcy, and even the threat of bank- ruptcy, has allowed carriers to decrease operating costs through renegotiated labor, supply, and financing con- tracts. As a result, differentials in cost structures between traditional hub-and-spoke carriers and low cost carriers have significantly diminished. Nevertheless, throughout this entire time period, Southwest has continued to maintain its cost advantage, improve Employee produc- tivity, pursue steady, controlled growth, and provide outstanding Service to its Customers. The factors dis- cussed above have, however, led to more intense compe- tition in the airline industry, generally. In 2006, some carriers began reporting profitable results for the first time since 9/11.

The re-emerging competitiveness of some of the larger carriers, such as United, US Airways, and Amer- ican, has put pressure on smaller carriers such as AirTran Airways, JetBlue, and Frontier. Like Southwest, several other carriers, large and small, have announced scaled back growth plans, and some carriers have expressed interest in industry consolidation. The Company cannot predict the timing or extent of any such consolidation or its impact (either positive or negative) on the Company’s operations or results of operations.

## Insurance

The Company carries insurance of types customary in the airline industry and at amounts deemed adequate to protect the Company and its property and to comply both with federal regulations and certain of the Company’s credit and lease agreements. The policies principally provide coverage for public and passenger liability, prop- erty damage, cargo and baggage liability, loss or damage to aircraft, engines, and spare parts, and workers’ compensation.

Following the terrorist attacks, commercial aviation insurers significantly increased the premiums and reduced the amount of war-risk coverage available to commercial carriers. Through the 2003 Emergency Wartime Supple- mental Appropriations Act, the federal government has continued to provide supplemental, first-party, war-risk insurance coverage to commercial carriers for renewable 60-day periods, at substantially lower premiums than pre- vailing commercial rates and for levels of coverage not available in the commercial market. The government-pro- vided supplemental coverage from the Wartime Act is currently set to expire on March 30, 2008. Although another extension beyond this date is expected, if such coverage is not extended by the government, the Company could incur substantially higher insurance costs or unavail- ability of adequate coverage in future periods.

## Seasonality

The business of the Company is somewhat seasonal. Quarterly operating income and, to a lesser extent, rev- enues have historically tended to be lower in the first quarter (January 1 - March 31) and fourth quarter (October 1 - December 31).

## Employees

At December 31, 2007, Southwest had 34,378 active full-time equivalent Employees, consisting of 13,885 flight, 2,079 maintenance, 13,921 ground, Cus- tomer, and fleet service, and 4,493 management, accounting, marketing, and clerical personnel.

Southwest has ten collective bargaining agreements, which covered approximately 82 percent of Southwest’s Employees as of December 31, 2007. Southwest’s relations with labor unions are governed by the Railway Labor Act (the “RLA”), which establishes the right of airline employees to organize and bargain collectively. Under the RLA, a collective bargaining agreement between an airline and a labor union generally does not expire, but instead becomes amendable as of a stated date. If either party wants to modify the terms of the agreement, it must notify the other party in the manner required by the RLA and/or described in the agreement. After receipt of such notice, the parties must meet for direct negotiations, and, if no agreement is reached, either party may request the National Mediation Board (the “NMB”) to appoint a federal mediator. If no agreement is reached in mediation, the NMB may determine that an impasse exists and offer binding arbitration to the parties. If either party rejects binding arbitration, a 30-day “cooling off” period begins. At the end of this 30-day period, the parties may engage in “self-help,” unless a Presidential Emergency Board is established to investigate and report on the dispute. The appointment of a Presidential Emergency Board maintains the “status quo” for an additional 60 days. If the parties do not reach agreement during this period, the parties may then engage in “self-help.” “Self-help” includes, among other things, a strike by the union or the airline’s imposition of any or all of its proposed amendments and the hiring of new employees to replace any striking workers. The following table sets forth the Company’s Employee groups and collective bargaining status:

**Employee Group Represented by Agreement Amendable in**

Pilots Southwest Airlines Pilots’

Association

Flight Attendants Transportation Workers of America, AFL-CIO (“TWU”)

Currently in negotiation June 2008

Ramp, Operations, Provisioning, and Freight Agents

TWU Currently in negotiation

Stock Clerks International Brotherhood of Teamsters (“Teamsters”)

Mechanics Aircraft Mechanics Fraternal Association (“AMFA”)

August 2008

August 2008

Customer Service and Reservations Agents

International Association of Machinists and Aerospace Workers, AFL-CIO

November 2008

Aircraft Appearance Technicians AMFA February 2009

Flight Dispatchers Southwest Airlines Employee Association

December 2009

Flight Simulator Technicians Teamsters November 2011

Flight/Ground School Instructors and Flight Crew Training Instructors

Southwest Airlines Professional Instructors Association

January 2013

During 2007, as part of its efforts to improve future profitability, the Company offered an early retirement program to certain of its Employees. A total of 608 of approximately 8,500 eligible Employees elected to par- ticipate in the program.

## Additional Information About Southwest

Southwest was incorporated in Texas in 1967. The following documents are available free of charge through the Company’s website, [**www.southwest.com:**](http://www.southwest.com/)South- west’s annual report on Form 10-K, quarterly reports on Form 10-Q, current reports on Form 8-K, and any amendments to those reports that are filed with or fur- nished to the SEC pursuant to Sections 13(a) or 15(d)

of the Securities Exchange Act of 1934, as amended. These materials are made available through Southwest’s website as soon as reasonably practicable after they are electronically filed with, or furnished to, the SEC.

The certifications of the Company’s Chief Execu- tive Officer and Chief Financial Officer required under Section 302 of the Sarbanes-Oxley Act have been filed as Exhibits 31.1 and 31.2 to this report. Additionally, in 2007 the Company’s Chief Executive Officer certified to the New York Stock Exchange (“NYSE”) that he was not aware of any violation by the Company of the NYSE’s corporate governance listing standards.

## DISCLOSURE REGARDING FORWARD-LOOKING INFORMATION

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 SEC, news releases, conferences, Internet postings, or otherwise) that are not historical facts may be “forward-looking statements” within the meaning of Section 27A of the Securities Act of 1933, as amended, Section 21E of the Securities Exchange Act of 1934, as amended, and the Private Securities Litigation Reform Act of 1995. Forward-looking statements are based on, and include statements about, Southwest’s estimates, expec- tations, beliefs, intentions, or strategies for the future, and the assumptions underlying these forward-looking statements. Specific forward-looking statements can be identified by the fact that they do not relate strictly to historical or current facts and include, without limitation, words such as “anticipates,” “believes,” “estimates,” “expects,” “intends,” “forecasts,” “may,” “will,” “should,” and similar expressions. While management believes that these forward-looking statements are reasonable as and when made, forward-looking statements are not guarantees of future performance and involve risks and uncertainties that are difficult to predict. Therefore, actual results may differ materially from what is expressed in or indicated by Southwest’s forward-looking statements or from historical experience or the Company’s present expectations. Factors that could cause these differences include, but are not limited to, those set forth below under “Risk Factors.”

Caution should be taken not to place undue reliance 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 obligation to update publicly or revise any forward-looking statement, whether as a result of new information, future events, or otherwise.

**Item 1A. *Risk Factors***

### *Southwest’s business is dependent on the price and* availability of aircraft fuel. Continued periods of high fuel costs and/or significant disruptions in the supply of fuel could adversely affect the Company’s results of operations.

Airlines are inherently dependent upon energy to operate and, therefore, are impacted by changes in the prices of jet fuel. The cost of fuel, which has been at historically high levels over the last three years, is largely unpredictable and has a significant impact on the Com- pany’s results of operations. Jet fuel and oil consumed for fiscal 2007 and 2006 represented approximately 28 per- cent and 26 percent of Southwest’s operating expenses, respectively. In both years, jet fuel costs were the second largest expense incurred by the Company, following only

salaries, wages, and benefits. These costs contributed to the Company’s decision during 2007 to slow growth and could continue to impact growth decisions.

Fuel availability, as well as pricing, is also impacted by political and economic factors. The Company does not currently anticipate a significant reduction in fuel avail- ability; however, it is difficult to predict the future avail- ability of jet fuel due to the following, among other, factors: dependency on foreign imports of crude oil and the potential for hostilities or other conflicts in oil pro- ducing areas; limited refining capacity; and the possibility of changes in governmental policies on jet fuel produc- tion, transportation, and marketing. Significant disrup- tions in the supply of aircraft fuel could adversely affect the Company’s business, financial condition, and results of operations.

The Company’s profitability is impacted in part by its ability to pass fuel cost increases through to the consumer in the form of fare increases. Due to the competitive nature of the airline industry, the Company’s ability to increase fares is limited, and it is not certain that future fuel cost increases can be covered by increasing fares. Fare increases are even more difficult to achieve in uncertain economic environments, as low fares are often used to stimulate demand.

From time to time the Company enters into fuel derivative contracts to protect against rising fuel costs. Changes in the Company’s overall fuel hedging strategy, the ability of the commodities used in fuel hedging (principally crude oil, heating oil, and unleaded gasoline) to qualify for special hedge accounting, and the effec- tiveness of the Company’s fuel hedges pursuant to highly complex accounting rules, are all significant factors impacting the Company’s results of operations. For more information on Southwest’s fuel hedging arrangements, see “Management’s Discussion and Analysis of Financial Condition and Results of Operations” and Note 10 to the Consolidated Financial Statements.

### *Southwest’s business is labor-intensive; Southwest* could be adversely affected if it were unable to maintain satisfactory relations with any unionized or other Employee work group.

The airline business is labor intensive, and the Company’s results are subject to variations in labor- related job actions. Salaries, wages, and benefits repre- sented 35.4 percent of the Company’s operating expenses for the year ended December 31, 2007. In addition, as of December 31, 2007, approximately 82 percent of the Company’s Employees were represented for collective bargaining purposes by labor unions. The Company’s Ramp, Operations, Provisioning, and Freight Agents are subject to an agreement with the Transport Workers Union of America, AFL-CIO (“TWU”), which becomes amendable on June 30, 2008. The Company and TWU are in discussions on a new agreement. The Company’s Pilots are subject to an agreement with the Southwest Airlines Pilots’ Association (“SWAPA”), which became amendable during September 2006. The Company and SWAPA are in discussions on a new agreement. Although, historically, the Company’s rela- tionships with its Employees have been good, the fol- lowing items could have a significant impact on the Company’s results of operations: results of labor contract negotiations, employee hiring and retention rates, pay rates, outsourcing costs, the impact of work rules, and costs for health care.

### *Southwest’s business is affected by many changing* economic conditions and other conditions beyond its control.

The Company’s business, and the airline industry in general, is particularly impacted by changes in economic conditions. Unfavorable general economic conditions, such as higher unemployment rates, higher interest rates, housing-related pressures (such as recent issues in the subprime mortgage market), and increased operating costs can reduce consumer spending or cause shifts in spending. A general reduction or shift in discretionary spending can result in decreased demand for leisure and business travel and can also impact the Company’s ability to raise fares to counteract increased fuel and labor costs.

The Company’s business, and the airline industry in general, is also impacted by other conditions that are largely outside of the Company’s control, including, among others:

* + - Actual or threatened war, terrorist attacks, and political instability;
    - Changes in consumer preferences, perceptions, spending patterns, or demographic trends;
    - Actual or potential disruptions in the air traffic control system;
    - Increases in costs of safety, security, and envi- ronmental measures; and
    - Weather and natural disasters.

Because expenses of a flight do not vary significantly with the number of passengers carried, a relatively small change in the number of passengers can have a dispro- portionate effect on an airline’s operating and financial results. Therefore, any general reduction in airline pas- senger traffic as a result of any of these factors could adversely affect the Company’s business, financial con- dition, and results of operations.

### *The Company relies on technology to operate its* business and continues to implement substantial changes to its information systems; any failure or disruption in the Company’s systems could adversely impact the Company’s operations.

The Company has historically been dependent on automated systems and technology to operate its business, enhance Customer Service and back office support sys- tems, and increase Employee productivity, including the Company’s computerized airline reservation system, flight operations systems, telecommunication systems, website at [**www.southwest.com**,](http://www.southwest.com/) Automated Boarding

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Passes system, and its self service kiosks. The Company has become increasingly dependent on its systems and technology to maintain and support the growth of its business. Therefore, the Company’s ability to expand and update its information technology infrastructure in response to its growth and changing needs is increasingly important to the operation of its business generally and the implementation of its new initiatives. Any issues with transitioning to upgraded or replacement systems, or any material failure, inadequacy, interruption, or security failure of these systems, could harm the Company’s ability to effectively operate its business. In addition, the Company’s growth strategies are dependent on its ability to effectively implement technology advancements.

### *The Company’s inability to successfully implement its* revenue initiatives could adversely affect its results of operations.

As discussed above, the Company has implemented and intends to continue to implement revenue initiatives that are designed to help offset increasing costs. The implementation of the Company’s initiatives has and will involve significant investments by the Company of time and money and could be impacted by (i) the Company’s ability to timely implement and maintain the necessary information technology systems and infrastructure (as discussed above), and (ii) the extent and timing of the Company’s investment of incremental operating expenses and capital expenditures to develop and implement its initiatives and the Company’s corresponding ability to effectively control operating expenses. Because the Com- pany has limited experience with some of its strategic initiatives, it cannot ensure that they will be successful or profitable either over the short or long term. The Com- pany’s ability to effectively and timely prioritize and implement its initiatives will also affect when and if they will have a positive impact on the Company’s profitability.

### *The travel industry continues to face on-going* security concerns and cost burdens; further threatened or actual terrorist attacks, or other hos- tilities, could significantly harm the Company’s industry and its business.

The attacks of September 11, 2001, materially impacted, and continue to impact, air travel and the results of operations for Southwest and the airline indus- try generally. The Department of Homeland Security and the TSA have implemented numerous security measures that affect airline operations and costs. Substantially all security screeners at airports are now federal employees,

and significant other elements of airline and airport security are now overseen and performed by federal employees, including federal security managers, federal law enforcement officers, and federal air marshals. Enhanced security procedures, including enhanced secu- rity screening of passengers, baggage, cargo, mail, employees, and vendors, introduced at airports since the terrorist attacks of September 11 have increased costs to airlines and have from time to time impacted demand for air travel.

Additional terrorist attacks, even if not made directly on the airline industry, or the fear of such attacks or other hostilities (including elevated national threat warnings or selective cancellation or redirection of flights due to terror threats) could have a further significant negative impact on Southwest and the airline industry. Additional international hostilities could potentially have a material adverse impact on the Company’s results of operations.

### *Airport capacity constraints and air traffic control* inefficiencies could limit the Company’s growth; changes in or additional governmental regulation could increase the Company’s operating costs or otherwise limit the Company’s ability to conduct business.

Almost all commercial service airports are owned and/or operated by units of local or state government. Airlines are largely dependent on these governmental entities to provide adequate airport facilities and capacity at an affordable cost. Similarly, the federal government singularly controls all U.S. airspace, and airlines are completely dependent on the FAA to operate that air- space in a safe, efficient, and affordable manner. As discussed above under “Business — Regulation,” airlines are also subject to other extensive regulatory require- ments. These requirements often impose substantial costs on airlines. The Company’s results of operations may be affected by changes in law and future actions taken by governmental agencies having jurisdiction over its oper- ations, including, but not limited to:

* + - Increases in airport rates and charges;
    - Limitations on airport gate capacity or other use of airport facilities;
    - Increases in taxes;
    - Changes in the law that affect the services that can be offered by airlines in particular markets and at particular airports;
    - Restrictions on competitive practices;
    - The adoption of regulations that impact customer service standards, such as security standards; and
    - The adoption of more restrictive locally-imposed noise regulations.

### *The airline industry is intensely competitive.*

As discussed in more detail above under “Busi- ness — Competition,” the airline industry is extremely competitive. Southwest’s competitors include other major domestic airlines, as well as regional and new entrant airlines, and other forms of transportation, including rail and private automobiles. Southwest’s revenues are sensi- tive to the actions of other carriers in the areas of capacity, pricing, scheduling, codesharing, and promotions.

### *Southwest’s low cost structure is one of its primary* competitive advantages, and many factors could affect the Company’s ability to control its costs.

Factors affecting the Company’s ability to control its costs include the price and availability of fuel, results of Employee labor contract negotiations, Employee hiring and retention rates, costs for health care, capacity deci- sions by the Company and its competitors, unscheduled required aircraft airframe or engine repairs, regulatory requirements, ability to access capital or financing at competitive rates in financial markets, and future financ- ing decisions made by the Company. In addition, a key

contributor to the Company’s low cost structure is its use of a single aircraft type, the Boeing 737. Although the Company is able to purchase some of these aircraft from parties other than Boeing, most of its purchases are direct from Boeing. Therefore, if the Company were unable to acquire additional aircraft from Boeing, or Boeing were unable or unwilling to provide adequate support for its products, the Company’s operations could be adversely impacted. In addition, the Company’s dependence on a single aircraft type could result in downtime for part or all of the Company’s fleet if mechanical or regulatory issues relating to the Boeing 737 aircraft type arise. However, given the Company’s years of experience with the Boeing 737 aircraft type and its longterm relationship with Boeing, the Company believes the advantages of operat- ing a single fleet type outweigh the risks of its single aircraft strategy.

**Item 1B. *Unresolved Staff Comments***

None.

**Item 2. *Properties***

## Aircraft

Southwest operated a total of 520 Boeing 737 air- craft as of December 31, 2007, of which 86 and 9 were under operating and capital leases, respectively. The remaining 425 aircraft were owned.

The following table details information on the 520 aircraft in the Company’s fleet as of December 31, 2007:

|  |  |  |  |  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- | --- | --- | --- | --- |
| **737 Type** | **Seats** |  | **Average Age (Yrs)** |  | **Number of Aircraft** |  | **Number Owned** |  | **Number Leased** |
| -300 ..................... ............ | 137 |  | 16.7 |  | 194 |  | 112 |  | 82 |
| -500 ..................... ............ | 122 |  | 16.7 |  | 25 |  | 16 |  | 9 |
| -700 ..................... ............ | 137 |  | 4.2 |  | 301 |  | 297 |  | 4 |
| **Totals** .................... ............ |  |  | 9.4 |  | 520 |  | 425 |  | 95 |

In 2007, the Company announced a reduction in its planned growth rate for fourth quarter 2007 and for full year 2008. A portion of this growth slowdown will be achieved through changes in the Company’s aircraft deliveries from Boeing. In 2008, the Company also plans to return from lease or sell a total of 22 aircraft. In total, at December 31, 2007, the Company had firm orders, options and purchase rights for the purchase of Boeing 737 aircraft as follows:

## Firm Orders, Options and Purchase Rights for Boeing 737-700 Aircraft

**The Boeing Company**

**Delivery Year Firm Orders Options Purchase Rights Total**

|  |  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- | --- |
| 2008 | ..................................... | 29 |  | — |  | — 29 |
| 2009 | ..................................... | 20 |  | 8 |  | — 28\* |
| 2010 | ..................................... | 10 |  | 24 |  | — 34 |
| 2011 | ..................................... | 10 |  | 22 |  | — 32 |
| 2012 | ..................................... | 10 |  | 30 |  | — 40 |
| 2013 | ..................................... | 19 |  | — |  | — 19 |
| 2014 | ..................................... | 10 |  | — |  | — 10 |

|  |  |  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- | --- | --- |
| 2008-2014 ................................. | — |  | — |  | 54 |  | 54 |
| **Total** ..................................... | 108 |  | 84 |  | 54 |  | 246 |

\* The Company exercised one option in January 2008, bring 2009 firm orders and options to 21 and 7, respectively.

## Ground Facilities and Services

Southwest leases terminal passenger service facilities at each of the airports it serves, to which it has made various leasehold improvements. The Company leases the land and structures on a long-term basis for its mainte- nance centers (located at Dallas Love Field, Houston Hobby, Phoenix Sky Harbor, and Chicago Midway), its flight training center at Dallas Love Field (which houses seven 737 simulators), and its corporate headquarters, also located at Dallas Love Field. As of December 31, 2007, the Company operated six reservation centers. The reservation centers located in Chicago, Albuquerque, and Oklahoma City occupy leased space. The Company owns its Houston, Phoenix, and San Antonio reservation centers.

The Company performs substantially all line main- tenance on its aircraft and provides ground support ser- vices at most of the airports it serves. However, the Company has arrangements with certain aircraft main- tenance firms for major component inspections and repairs for its airframes and engines, which comprise the majority of the Company’s annual aircraft mainte- nance costs.

**Item 3. *Legal Proceedings***

The Company is subject to various legal proceedings and claims arising in the ordinary course of business, including, but not limited to, examinations by the Inter- nal Revenue Service (IRS). The IRS regularly examines the Company’s federal income tax returns and, in the course of those examinations, proposes adjustments 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 out- come 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 con- dition, 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 following information regarding the Company’s executive officers is as of January 1, 2008.

**Name Position Age**

Herbert D. Kelleher ......... ... Executive Chairman of the Board 76

Gary C. Kelly ............. ... Vice Chairman of the Board and Chief Executive Officer 52

Colleen C. Barrett .......... ... President and Secretary 63

Robert E. Jordan ........... ... Executive Vice President — Strategy and Technology 47

Ron Ricks ................ ... Executive Vice President — Law, Airports, and Public 58

Affairs

Michael G. Van de Ven ...... ... Executive Vice President — Chief of Operations 46

Davis S. Ridley ............ ... Senior Vice President — Marketing 54

Laura H. Wright ........... ... Senior Vice President — Finance and Chief Financial 47

Officer

Set forth below is a description of the background of each of the Company’s executive officers.

*Herbert D. Kelleher* has been Executive Chairman of the Board of the Company since March 1978. Mr. Kelleher became interim President and Chief Executive Officer of the Company in September 1981, and assumed those offices on a permanent basis in February 1982, relinquishing those titles in June 2001. Mr. Kelleher serves on the Board of the Federal Reserve Bank of Dallas.

*Gary C. Kelly* has been Vice Chairman of the Board and Chief Executive Officer of the Company since July 2004. Prior to that time, Mr. Kelly was Executive Vice President — Chief Financial Officer from June 2001 to July 2004, and Vice President — Finance and Chief Financial Officer from 1989 to 2001. Mr. Kelly joined the Company in 1986 as its Controller.

*Colleen C. Barrett* has been President of the Company since June 2001, at which time she was also named to the Board of Directors. Prior to that time, Ms. Barrett was Executive Vice President — Customers from 1990 to 2001 and Vice President — Administration from 1986 to 1990. Ms. Barrett has been Secretary of the Company since March 1978. Ms. Barrett is a Director of J.C. Penney Company, Inc.

*Robert E. Jordan* has been Executive Vice President — Strategy and Technology since September 2006. Prior to that time, Mr. Jordan served as Senior Vice President — Enterprise Spend Management from August 2004 to September 2006 and as Vice President — Technology from October 2002 to August 2004.

*Ron Ricks* has been Executive Vice President — Law, Airports, and Public Affairs for the Company since September 2006. Prior to that time, Mr. Ricks was Senior Vice President — Law, Airports, and Public Affairs from August 2004 until September 2006. Prior to 2004, Mr. Ricks served as Vice President — Governmental Affairs of the Company.

*Michael G. Van de Ven* has been Executive Vice President — Chief of Operations of the Company since September 2006. Prior to that time, Mr. Van de Ven served as Executive Vice President — Aircraft Operations from November 2005 through August 2006, as Senior Vice President — Planning from August 2004 to November 2005, and as Vice President — Financial Planning & Analysis from June 2001 to August 2004.

*Davis S. Ridley* has been Senior Vice President — Marketing since November 2007. Prior to such time, Mr. Ridley served as Senior Vice President — People & Leadership Development from August 2004 to January 2006, and as Vice President — Ground Operations from May 1998 to August 2004. Mr. Ridley served as a consultant for the Company from January 2006 to November 2007.

*Laura H. Wright* has been Senior Vice President — Finance and Chief Financial Officer of the Company since July 2004. Prior to such time, Ms. Wright served as Vice President — Finance and Treasurer beginning June 2001.

## PART II

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

Southwest’s common stock is listed on the New York Stock Exchange and is traded under the symbol “LUV.” The following table shows, for the periods indicated, the high and low sales prices per share of the Company’s common stock, as reported on the NYSE Composite Tape, and the cash dividends per share paid on the Company’s common stock.

|  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- |
| **Period** | **Dividend** |  | **High** |  | **Low** |
| **2007** |  |  |  |  |  |
| 1st Quarter ................................................ . | $0.00450 |  | $16.58 |  | $14.50 |
| 2nd Quarter ............................................... . | 0.00450 |  | 15.90 |  | 14.03 |
| 3rd Quarter ................................................ . | 0.00450 |  | 16.96 |  | 14.21 |
| 4th Quarter ................................................ .  **2006** | 0.00450 |  | 15.06 |  | 12.12 |
| 1st Quarter ................................................ . | $0.00450 | $18.10 | | $15.51 | |
| 2nd Quarter ............................................... . | 0.00450 | 18.20 | | 15.10 | |
| 3rd Quarter ................................................ . | 0.00450 | 18.20 | | 15.66 | |
| 4th Quarter ................................................ . | 0.00450 | 17.03 | | 14.61 | |

As of January 30, 2008, there were 10,708 holders of record of the Company’s common stock.

## Stock Performance Graph

*The following Performance Graph and related information shall not be deemed “soliciting material” or “filed” with the Securities and Exchange Commission, nor shall such information be incorporated by reference into any future filing under the Securities Act of 1933 or Securities Exchange Act of 1934, each as amended, except to the extent that the Company specifically incorporates it by reference into such filing.*

The following graph compares the cumulative total Shareholder return on the Company’s common stock over the five-year period ended December 31, 2007, with the cumulative total return during such period of the Standard and Poor’s 500 Stock Index and the AMEX Airline Index. The comparison assumes $100 was invested on December 31, 2002, in the Company’s common stock and in each of the foregoing indices and assumes reinvestment of dividends. The stock performance shown on the graph below represents historical stock performance and is not necessarily indicative of future stock price performance.

## COMPARISON OF FIVE YEAR CUMULATIVE TOTAL RETURN AMONG SOUTHWEST AIRLINES CO., S&P 500 INDEX,

**AND AMEX AIRLINE INDEX**

250



Southwest Airlines Co. S&P 500

AMEX Airline

200

**Total Cumulative Return - Dollars**

150

100

50

0

12/31/02

12/31/03

12/31/04

12/31/05

12/31/06

12/31/07

|  |  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- | --- |
|  | **12/31/02** | **12/31/03** | **12/31/04** | **12/31/05** | **12/31/06** | **12/31/07** |
| **Southwest Airlines Co.** | $100 | $116 | $117 | $119 | $111 | $ 88 |
| **S&P 500** | $100 | $128 | $142 | $149 | $172 | $182 |
| **AMEX Airline** | $100 | $158 | $155 | $141 | $151 | $ 89 |

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

The following financial information for the five years ended December 31, 2007, 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.

**Year Ended December 31,**

|  |  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- | --- |
|  | **2007 2006 2005 2004** | | | |  | **2003** |
| **(in millions, except per share amounts)** | | | |  |  |
| **Financial Data:** |  | | | |  |  |
| Operating revenues ............. | $ 9,861 $ 9,086 $ 7,584 $ 6,530 | | | |  | $ 5,937 |
| Operating expenses ............. | 9,070 8,152 6,859 6,126 | | | |  | 5,558 |
| Operating income .............. | 791 934 725 404 | | | |  | 379 |
| Other expenses (income) net...... | (267) 144 (54) 65 | | | |  | (225) |
| Income before taxes ............ | 1,058 790 779 339 | | | |  | 604 |
| Provision for income taxes ........ | 413 291 295 124 | | | |  | 232 |
| Net Income . . . ............... | $ 645 $ 499 $ 484 $ 215 | | | |  | $ 372 |
| Net income per share, basic ....... | $ .85 | $ .63 | $ .61 | $ .27 | $ .48 | |
| Net income per share, diluted ..... | $ .84 | $ .61 | $ .60 | $ .27 | $ .46 | |
| Cash dividends per common share . . | $ .0180 | $ .0180 | $ .0180 | $ .0180 | $ .0180 | |
| Total assets at period-end ........ | $ 16,772 | $ 13,460 | $ 14,003 | $ 11,137 | $ 9,693 | |
| Long-term obligations at period- |  |  |  |  |  | |
| end ....... ............... | $ 2,050 | $ 1,567 | $ 1,394 | $ 1,700 | $ 1,332 | |
| Stockholders’ equity at period-end . . | $ 6,941 | $ 6,449 | $ 6,675 | $ 5,527 | $ 5,029 | |
| **Operating Data:** |  |  |  |  |  |  |
| Revenue passengers carried ....... | 88,713,472 | 83,814,823 | 77,693,875 | 70,902,773 | 65,673,945 | |
| Enplaned passengers ............ | 101,910,809 | 96,276,907 | 88,379,900 | 81,066,038 | 74,719,340 | |
| Revenue passenger miles (RPMs) |  |  |  |  |  | |
| (000s)..... ............... | 72,318,812 | 67,691,289 | 60,223,100 | 53,418,353 | 47,943,066 | |
| Available seat miles (ASMs) |  |  |  |  |  |  |
| (000s)..... ............... | 99,635,967 | 92,663,023 | 85,172,795 | 76,861,296 | | 71,790,425 |
| Load factor(1) . ............... | 72.6% | 73.1% | 70.7% | 69.5% | | 66.8% |
| Average length of passenger haul |  |  |  |  | |  |
| (miles) .... ............... | 815 | 808 | 775 | 753 | | 730 |

Average aircraft stage length

(miles) .... ............... 629 622 607 576 558

Trips flown . . . ............... 1,160,699 1,092,331 1,028,639 981,591 949,882

Average passenger fare .......... $ 106.60 $ 104.40 $ 93.68 $ 88.57 $ 87.42

Passenger revenue yield per RPM . . 13.08¢ 12.93¢ 12.09¢ 11.76¢ 11.97¢ Operating revenue yield per ASM . . 9.90¢ 9.81¢ 8.90¢ 8.50¢ 8.27¢ Operating expenses per ASM ..... 9.10¢ 8.80¢ 8.05¢ 7.97¢ 7.74¢ Fuel costs per gallon (average) .... $ 1.70 $ 1.53 $ 1.03 $ 0.83 $ 0.72

Fuel consumed, in gallons

(millions) . . ............... 1,489 1,389 1,287 1,201 1,143

Fulltime equivalent Employees at

|  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- |
| period-end . . ............... | 34,378 | 32,664 | 31,729 | 31,011 | 32,847 |
| Size of fleet at period-end(2) ..... | 520 | 481 | 445 | 417 | 388 |

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

### Item 7. *Management’s Discussion and Analysis of* Financial Condition and Results of Operations

**Year in Review**

Several events were significant for Southwest during 2007. For example, Southwest:

* Extended its string of consecutive profitable years to 35 and consecutive profitable quarters to 67. Both of these marks are unmatched in the modern era of aviation results.
* Implemented a new Customer boarding method for flights to significantly reduce the average time a Customer spends waiting in line at the gate, while retain- ing the Company’s famous open seating policy once aboard the aircraft.
* Introduced a new fare structure including a “Busi- ness Select” product, which enables Customers to be among the first to board the aircraft. We also unveiled enhancements to our Rapid Rewards program.
* Began a significant gate re-design to enhance the airport experience for Customers, to be installed at vir- tually all airports served by the Company.
* Grew the Company’s fleet by 39 Boeing 737-700 aircraft to a total of 520 737s as of December 31, 2007.
* Earned $727 million (on a cash basis, before profitsharing and income taxes) from the expiration/ settlement of fuel derivative instruments the Company had previously entered into to protect against jet fuel price increases.
* Incurred a one-time $25 million charge (before profitsharing and income taxes) related to an early retire- ment program that was offered by the Company and accepted by more than 600 Employees during third quarter 2007, as one of many efforts underway to improve the Company’s future profitability.
* Announced an expansion of our GDS (Global Distribution System) and corporate travel account efforts through an agreement with Travelport’s Galileo and Worldspan.
* Recommenced service to San Francisco Interna- tional Airport, with the highest initial concentration of flights of any new city in the Company’s history.
* Repurchased 66 million shares of Company com- mon stock totaling $1.0 billion through programs autho- rized by the Company’s Board of Directors.

Although the Company’s 2007 net income of

$645 million ($.84 per share, diluted) exceeded its 2006 net income of $499 million ($.61 per share, diluted), the increase was entirely driven by certain gains and losses, recorded in accordance with Statement of Financial Accounting Standards No. 133, *Accounting for Derivative Instruments and Hedging Activities*, as amended (SFAS 133), that relate to fuel derivatives expiring in future periods. In fact, the Company’s oper- ating income, which excludes these items, actually declined 15.3 percent from 2006 to 2007, primarily due to the significant increase in fuel costs, which the Company was not able to recover through increased revenues. The airline revenue environment was more difficult than the Company envisioned coming into 2007. This was due to a slowing economy as well as continued competitive pressures from both new airlines as well as those that have significantly reduced their cost structures through the bankruptcy process or the threat of bankruptcy. The Company did raise fares several times during 2007 in an attempt to offset fuel cost pressures; however, these increases did not keep up with the rapidly increasing fuel prices.

Looking ahead to 2008, the Company believes it has retained, and in some cases strengthened, its low-cost competitive advantages as demonstrated by its protective fuel hedging position, excellent Employees, and strong balance sheet. These enable Southwest to respond quickly to potential industry consolidation and to favorable mar- ket opportunities in the face of an uncertain economy and record energy prices. Based on current and projected energy prices for 2008 and expected growth plans, the Company believes net cash expenditures for jet fuel, which exclude certain FAS 133 gains and losses, could increase more than $500 million compared to 2007, even including the effects of fuel derivative contracts the Com- pany has in place as of January 2008. The Company’s fuel derivative contracts in place for 2008 provide protection for over 70 percent of the Company’s expected jet fuel consumption at an average price of approximately $51 per barrel of crude oil. The Company is also currently expecting a significant increase in its aircraft engine maintenance activity in 2008. The Company will attempt to overcome the impact of higher anticipated 2008 fuel prices and other cost pressures through improved reve- nues and continued focus on non-fuel costs. Based on this current outlook, Southwest has reduced its previously planned growth rate for 2008. The Company currently plans to grow its fleet by a net seven aircraft. The Com- pany will add 29 new 737-700 aircraft from Boeing, but plans to return from lease or sell a total of 22 aircraft, resulting in a net available seat mile (ASM) capacity

increase of four to five percent. For first quarter 2008, the Company’s year-over-year capacity increase is expected to slightly exceed six percent. Based on current plans, the Company’s fleet is scheduled to total 527 737s by the end of 2008.

## Results of Operations

### *2007 Compared With 2006*

Southwest’s profit of $645 million ($.84 per share, diluted) in 2007 was an increase of $146 million, or

29.3 percent, compared to the Company’s 2006 net income of $499 million ($.61 per share, diluted). How- ever, the Company’s net profit results in both 2007 and 2006 include certain gains and losses, recorded in accor- dance with SFAS 133, that relate to fuel derivatives expiring in future periods. These adjustments, which are related to the ineffectiveness of hedges and the loss of hedge accounting for certain fuel derivatives, are included in “Other (gains) losses,” which is below the operating income line, in both periods. In 2007, these adjustments totaled net gains of $360 million. For 2006, these adjustments totaled net losses of $101 million. Therefore, Southwest believes operating income provides a better indication of the Company’s financial perfor- mance for both 2007 and 2006 than does net income. Southwest’s 2007 operating income was $791 million, a decrease of $143 million, or 15.3 percent, compared to 2006. The decrease in operating income was driven primarily by a substantial increase in fuel expense, despite the fact that the Company once again benefited tremen- dously from its fuel hedging program. The Company had instruments in place to protect against over 90 percent of its fuel consumption needs at an average crude oil equiv- alent price of $50 per barrel. This resulted in a $686 mil- lion reduction to Fuel and oil expense during 2007, although, even with this protection, the Company’s aver- age jet fuel cost per gallon increased from $1.53 in 2006 to $1.70 in 2007. Although fuel prices began 2007 at moderately high levels, they quickly increased and stayed at record levels throughout most of the second half of the year. Market crude oil prices flirted with $100 per barrel several times during 2007 and market (unhedged) jet fuel prices reached as high as $2.87 per gallon during the second half of the year.

### *Operating Revenues*

Consolidated operating revenues increased

$775 million, or 8.5 percent, primarily due to a $707 mil- lion, or 8.1 percent, increase in passenger revenues. The increase in passenger revenues was primarily due to an increase in capacity, as the Company added aircraft and flights, resulting in a 7.5 percent increase in available seat miles compared to 2006. The Company purchased a total of 37 new Boeing 737-700 aircraft during 2007, and added another two leased 737-700s from a previous owner, resulting in the addition of 39 aircraft for the year. The Company attempted to combat high fuel prices through modest fare increases. However, general eco- nomic conditions as well as significant low-fare compe- tition made it difficult to raise fares as much as the Company had done in 2006. The Company’s passenger revenue yield per RPM (passenger revenues divided by revenue passenger miles) increased 1.2 percent compared to 2006. Unit revenue (total revenue divided by available seat miles) also increased 0.9 percent compared to 2006 levels, as a result of the higher RPM yield. The Company has been encouraged by more recent year-over-year unit revenue trends, which improved each month during fourth quarter 2007. The improved trends have continued thus far in first quarter 2008. Because of the uncertainty surrounding our nation’s overall economy, however, it is difficult for the Company to precisely predict first quarter 2008 revenues.

Consolidated freight revenues decreased $4 million, or 3.0 percent, versus 2006. A $10 million, or 8.5 percent, increase in freight revenues, resulting primarily from higher rates, was more than offset by a $14 million decline in mail revenues. The lower mail revenues were due to the Company’s decision to discontinue carrying mail for the U.S. Postal Service effective as of the end of second quarter 2006. The Company expects an increase in consolidated freight revenues during first quarter 2008, primarily due to an increase in capacity and higher rates charged. “Other revenues” increased $72 million, or

35.6 percent, compared to 2006, primarily from higher commissions earned from programs the Company spon- sors with certain business partners, such as the Company sponsored Chase» Visa card. The Company currently expects another increase in first quarter 2008, also due to higher commissions earned, and at a somewhat compa- rable rate to the 2007 increase.

## Operating Expenses

Consolidated operating expenses for 2007 increased $918 million, or 11.3 percent, compared to a 7.5 percent increase in capacity. Historically, changes in operating expenses for airlines are typically driven by changes in capacity, or ASMs. The following presents Southwest’s operating expenses per ASM for 2007 and 2006 followed by explanations of these changes on a per-ASM basis and/or on a dollar basis (in cents, except for percentages):

**2007 2006**

**Increase (Decrease)**

**Percent Change**

Salaries, wages, and benefits ............................ **3.22¢** 3.29¢ (.07)¢ (2.1)%

|  |  |  |  |
| --- | --- | --- | --- |
| Fuel and oil **2.55** | 2.31 | .24 | 10.4 |
| Maintenance materials and repairs **62** | .51 | .11 | 21.6 |
| Aircraft rentals **16** | .17 | (.01) | (5.9) |
| Landing fees and other rentals **56** | .53 | .03 | 5.7 |
| Depreciation and amortization **56** | .56 | — | — |
| Other **1.43** | 1.43 | — | — |
| Total ............ .............................. **9.10¢** | 8.80¢ | .30¢ | 3.4% |

The Company’s 2007 CASM (cost per available seat mile) increased 3.4 percent compared to 2006. Approximately 80 percent of this increase was solely due to the increase in fuel expense, net of gains from the Company’s fuel hedging program. The remainder of the increase was due to higher maintenance expense. All other operating expense categories combined to be approximately flat compared to 2006. Due to higher fuel prices, the Company has intensified its focus on control- ling non-fuel costs and continues to mitigate wage rate and benefit cost pressures through productivity and effi- ciency improvements. The Company’s headcount per aircraft at December 31, 2007, was 66, versus a year- ago level of 68. From the end of 2003 to the end of 2007, Southwest’s headcount per aircraft decreased 22 percent, as the Company implemented various technology improvements, which improved efficiency and enabled the Company to grow capacity without a commensurate increase in headcount. Based on current cost trends, the Company expects first quarter 2008 unit costs to increase from first quarter 2007’s 8.93 cents, due primarily to a significant increase in fuel costs and the continuation of higher maintenance costs. The higher expected fuel costs are due to the fact that the Company’s protective position as to fuel derivative instruments is not as favorable as first quarter 2007, and current physical (unhedged) jet fuel prices are significantly higher than the prior year.

On an absolute dollar basis, Salaries, wages, and benefits increased $161 million, primarily from a

$204 million increase in salaries and wages, partially offset by a $43 million decrease in benefits. The dollar increase in salaries and wages was due primarily to a

5.2 percent headcount increase, and the dollar decrease in benefits was due primarily to a $33 million decrease in

profitsharing, attributable to lower income available for profitsharing, and a $43 million decrease in share-based compensation, due to fewer Employee stock options becoming vested during 2007 versus 2006. These ben- efits decreases were partially offset by higher healthcare costs. Although the Company’s net income was higher than 2006, income available for profitsharing was lower, since the Company’s profitsharing plan does not consider the unrealized gains and/or losses the Company records in its fuel hedging program as a result of SFAS 133. Salaries, wages, and benefits expense per ASM decreased

2.1 percent compared to 2006, primarily due to lower profitsharing expense and lower share-based compensa- tion expense, despite the increase in ASMs. See Note 10 to the Consolidated Financial Statements for further information on SFAS 133 and fuel hedging, and Note 13 for further information on share-based compensation. Based on current trends, the Company expects salaries, wages, and benefits per ASM in first quarter 2008 to be in line with first quarter 2007’s unit cost.

The Company’s Pilots are subject to an agreement with the Southwest Airlines Pilots’ Association (“SWAPA”), which became amendable during Septem- ber 2006. The Company and SWAPA are currently in discussions on a new agreement.

The Company’s Flight Attendants are subject to an agreement with the Transport Workers Union of Amer- ica, AFL-CIO (“TWU”), which becomes amendable in June 2008.

The Company’s Ramp, Operations, Provisioning, and Freight Agents are subject to an agreement with the TWU, which becomes amendable in July 2008. However,

the Company and TWU began negotiations on a new agreement in January 2008.

The Company’s Stock Clerks are subject to an agreement with the International Brotherhood of Team- sters, and the Company’s Mechanics are subject to an agreement with the Aircraft Mechanics Fraternal Asso- ciation. Both of these agreements become amendable in August 2008.

The Company’s Customer Service and Reservations Agents are subject to an agreement with the International Association of Machinists and Aerospace Workers, AFL- CIO, which becomes amendable in November 2008.

Fuel and oil expense increased $398 million, and on a per-ASM basis increased 10.4 percent versus 2006. Approximately 60 percent of the dollar increase was due to an increase in fuel prices, and the remainder was from an increase in gallons consumed to support the 7.5 percent capacity increase versus 2006. On a per-ASM basis, nearly the entire increase was due to higher fuel prices. The fuel derivative instruments the Company held for 2007 were not as favorable as those held in the prior year, as they were at higher average crude-oil equivalent prices than the instruments that settled/expired in 2006. Despite this, the Company’s hedging program resulted in the realization of $727 million in cash settlements during 2007. These settlements generated a 2007 reduc- tion to Fuel and oil expense of $686 million, compared to the prior year when the Company’s fuel derivative instru- ments resulted in a $634 million reduction to Fuel and oil expense. Even with these significant hedge positions in both years, the Company’s jet fuel cost per gallon increased 11.1 percent versus 2006. The average cost per gallon of jet fuel in 2007 was $1.70 compared to

$1.53 in 2006, excluding fuel-related taxes and net of hedging gains. See Note 10 to the Consolidated Financial Statements. The 2007 increase in fuel prices was partially offset by steps the Company has taken to improve the fuel efficiency of its aircraft, including the addition of blended winglets to all of the Company’s 737-700 aircraft. The Company is also in the process of installing blended winglets on a significant number of its 737-300 aircraft.

The Company holds a significant fuel hedge posi- tion for 2008, although for a lower percentage of fore- casted consumption than in 2007. As of mid-January 2008, the Company is nearly 75 percent protected with fuel derivative instruments for its first quarter 2008 jet fuel requirements, at an average crude oil equivalent price of $51 per barrel, and the majority of these positions effectively perform like option contracts — allowing the Company to benefit in most cases from energy price decreases. During first quarter 2007, market prices

(unhedged) for jet fuel averaged $1.81 per gallon, and the Company had fuel derivatives in place to protect against nearly 100 percent of its fuel usage at a crude oil equivalent price of $50 per barrel. January 2008 average market prices (unhedged) for jet fuel have been in the

$2.60 to $2.65 range. Based on this difference in pro- tection and current market conditions, the Company expects its first quarter 2008 jet fuel cost per gallon to be approximately $2.00 per gallon, excluding the impact of any hedge ineffectiveness and derivatives that do not qualify for hedge accounting as defined in SFAS 133. In addition, the Company had fuel derivative contracts in place for over 70 percent of its expected fuel consumption for the remainder of 2008 at approximately $51 per barrel; over 55 percent in 2009 at approximately $51 per barrel; nearly 30 percent in 2010 at approximately

$63 per barrel; over 15 percent in 2011 at $64 per barrel; and over 15 percent in 2012 at $63 per barrel.

Maintenance materials and repairs per ASM increased 21.6 percent compared to 2006, while increas- ing $148 million on a dollar basis. On a dollar basis, engine expense accounted for over 45 percent of the increase and airframe expense accounted for over 43 per- cent of the increase. With respect to airframe expense, the Company completed significantly more planned airframe inspection and repair events than in the prior year. These events, which are required based on the number of flight hours each individual aircraft has flown, were higher in number as well as cost per event, and were also due to the ongoing transition to a new airframe maintenance pro- gram for 737-300 and 737-500 aircraft which began in 2006. In engine expense, there was a significant increase in repairs for the Company’s 737-700 aircraft engines primarily due to the maturation of this fleet, which was introduced in 1997, and more repair events than expected. On a per-ASM basis, approximately 48 percent of the increase in maintenance materials and repairs was a result of the higher airframe expense, and approximately 43 percent of the increase was due to the higher engine expense. In first quarter 2008, the Company expects an increase in maintenance materials and repairs per ASM compared to first quarter 2007 and fourth quarter 2007, due to higher engine expense for 737-700 aircraft as well as continued higher airframe expense from the transition of aircraft to the Company’s new airframe maintenance program for 737-300 and 737-500 aircraft.

Aircraft rentals expense per ASM decreased 5.9 per- cent and, on a dollar basis, decreased slightly. The decrease per ASM was due primarily to the fact that the Company increased overall ASMs by 7.5 percent, but the number of aircraft on operating lease increased by only two from 2006 to 2007. The Company added 37

purchased aircraft to its fleet during 2007, and leased two additional 737-700 aircraft. The Company currently expects similar year-over-year rental expense compari- sons for first quarter 2008.

Landing fees and other rentals increased $65 million on a dollar basis and 5.7 percent on a per-ASM basis, compared to 2006. The dollar increase was due primarily to an increase in airport gate space to support the increase in capacity and trips flown versus 2006. On a per-ASM basis, the increase was due primarily to higher rates paid for airport space. The Company currently expects a year- over-year increase in landing fees and other rentals per ASM for first quarter 2008, primarily due to higher rates paid for airport space.

Depreciation and amortization expense increased

$40 million on a dollar basis compared to 2006, but was flat on a per-ASM basis. The dollar increase was due primarily to 37 new 737-700 aircraft purchased during 2007. Based on current fleet and growth plans, the Company expects a similar year-over-year comparison for first quarter 2008 on a per-ASM basis. See Note 4 to the Consolidated Financial Statements for further infor- mation on the Company’s future aircraft deliveries.

Other operating expenses increased $108 million but were flat on a per-ASM basis, compared to 2006. On a dollar basis, approximately 20 percent of the increase was due to an increase in revenue-related costs associated with the 8.1 percent increase in passenger revenues (such as credit card processing fees) and approximately 20 per- cent was due to higher personnel expenses (which

includes items associated with flight crew travel, such as hotel and per diem costs) caused by the increase in capacity and trips flown. Excluding anticipated gains from the sale of aircraft, the Company currently expects an increase in other operating expenses on a per-ASM basis for first quarter 2008 compared to first quarter 2007, assuming increased revenues.

### *Other*

“Other expenses (income)” included interest expense, capitalized interest, interest income, and other gains and losses. Interest expense decreased by $9 million, or 7.0 percent, primarily due to the Company’s repay- ment of $729 million in debt during 2006 and 2007. This was partially offset by the issuance of $800 million in new debt instruments in 2006 and 2007; however, the timing of the new debt issued compared to the debt repaid resulted in lower expense for 2007. The Company cur- rently expects an increase in interest expense compared to 2007, primarily due to a higher average debt balance associated with recent borrowings in late 2006 and in 2007. See Note 7 to the Consolidated Financial State- ments for more information on long-term debt transac- tions. Capitalized interest declined slightly compared to 2006 due to a reduction in progress payment balances for scheduled future aircraft deliveries. Interest income decreased $40 million, or 47.6 percent, primarily due to a decrease in average cash and short-term investment balances on which the Company earns interest. See Note 1 to the Consolidated Financial Statements for more information.

Other (gains) losses, net, primarily includes amounts recorded in accordance with the Company’s hedging activities and SFAS 133. During 2007, the Company recorded significant gains related to the ineffectiveness of its hedges as well as to the increase in market value of fuel derivative contracts that were marked to market because they didn’t qualify for SFAS 133 hedge accounting. The gains resulted from the dramatic increase in the fair value of the Company’s portfolio of fuel derivative instruments as commodity prices reached record levels. During 2006, the Company recorded losses related to the ineffectiveness of its hedges, as well as the increase in market value of fuel derivative contracts that were marked to market because they didn’t qualify for SFAS 133 hedge accounting, as commodity prices declined during that year. The following table displays the components of Other (gains) losses, net, for the years ended December 31, 2007 and 2006:

**2007 2006**

**(In millions)**

Mark-to-market impact from fuel contracts settling in future periods — included in

Other (gains) losses, net ...... ..................................... **$(219)** $ 42

Ineffectiveness from fuel hedges settling in future periods — included in Other (gains)

losses, net ................. ..................................... **(51)** 39

Realized ineffectiveness and mark-to-market (gains) or losses — included in Other

(gains) losses, net ........... ..................................... **(90)** 20

Premium cost of fuel contracts included in Other (gains) losses, net .............. **58** 52

Other ...................... .....................................  **10** (2)

**$(292)** $151

See Note 10 to the Consolidated Financial Statements for further information on the Company’s hedging activities.

### *Income Taxes*

The provision for income taxes, as a percentage of income before taxes, increased to 39.0 percent in 2007 from 36.8 percent in 2006. The higher 2007 rate included an $11 million ($.01 per share, diluted) net addition related to a revision in Illinois income tax laws enacted in 2007. The 2006 rate included a $9 million net reduction related to a revision in the State of Texas franchise tax law enacted during 2006. The Company currently expects its 2008 effective tax rate to be between 36 and 37 percent. The lower expected 2008 rate is primarily due to the January 2008 reversal of the 2007 Illinois tax law change, that resulted in the $11 million tax increase. The Company currently expects to reverse the $11 million net charge during first quarter 2008.

### *2006 Compared With 2005*

The Company’s consolidated net income for 2006 was $499 million ($.61 per share, diluted), as compared to 2005 net income of $484 million ($.60 per share, diluted), an increase of $15 million, or 3.1 percent. Operating income for 2006 was $934 million, an increase of $209 million, or 28.8 percent, compared to 2005. The 2006 increase in operating income was due primarily to higher revenues from the Company’s fleet growth, improved load factors, and higher fares, which more than offset a significant increase in the cost of jet fuel. In both 2006 and 2005, the Company recognized adjustments related to the ineffectiveness of hedges and the loss of hedge accounting for certain fuel derivatives, which are included in “Other (gains) losses.” For 2006, these adjustments totaled net losses of $101 million. For 2005, these adjustments totaled net gains of $110 million.

### *Operating Revenues*

Consolidated operating revenues increased

$1.5 billion, or 19.8 percent, almost entirely due to a

$1.5 billion, or 20.2 percent, increase in passenger rev- enues. The increase in passenger revenues was due pri- marily to an increase in capacity, an increase in RPM

yield, and an increase in load factor. Approximately

45 percent of the increase in passenger revenue was due to the Company’s 8.8 percent increase in available seat miles compared to 2005. The Company increased available seat miles as a result of the addition of 36 737-700 aircraft. Approximately 35 percent of the increase in passenger revenue was due to a 6.9 percent increase in passenger yields. Average passenger fares increased 11.4 percent compared to 2005, primarily due to less fare discounting because of strong demand for air travel coupled with the availability of fewer seats as a result of industrywide domestic capacity reductions. The remainder of the passenger revenue increase was due primarily to the 2.4 point increase in the Company’s load factor compared to 2005.

The airline revenue environment changed signifi- cantly from the first half of 2006 to the second half of the year. The Company believes this was due to both reduced demand related to domestic economic factors, as well as the effects of the increased carryon baggage restrictions put in place following the terrorist plot uncovered by London authorities in August 2006. The airline revenue environment regained some momentum during late fourth quarter 2006, and, despite growing capacity 10 percent during the quarter, the Company achieved a record load factor of 70.2 percent at healthy yields, which resulted in a unit revenue growth rate of

4.2 percent.

Consolidated freight revenues increased slightly ver- sus 2005. An $18 million, or 17.1 percent, increase in freight and cargo revenues, primarily as a result of higher rates charged, was almost entirely offset by lower mail revenues. The lower mail revenues were due to the Company’s decision to discontinue carrying mail for the U.S. Postal Service effective as of the end of second quarter 2006. “Other revenues” increased $30 million, or

17.4 percent, compared to 2005, primarily from higher commissions earned from programs the Company spon- sors with certain business partners, such as the Company sponsored Chase» Visa card.

### *Operating Expenses*

Consolidated operating expenses for 2006 increased $1.3 billion, or 18.9 percent, compared to the 8.8 percent increase in capacity. Historically, changes in operating expenses for airlines are typically driven by changes in capacity, or

ASMs. The following presents Southwest’s operating expenses per ASM for 2006 and 2005 followed by explanations of these changes on a per-ASM and/or an absolute dollar basis:

|  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- |
|  | **2006** | **2005** | **Increase (Decrease)** |  | **Percent Change** |
| Salaries, wages, and benefits ............................ | **3.29¢** | 3.27¢ | .02¢ |  | .6% |
| Fuel and oil.......... .............................. | **2.31** | 1.58 | .73 |  | 46.2 |
| Maintenance materials and repairs ........................ | **.51** | .52 | (.01) |  | (1.9) |
| Aircraft rentals ....... .............................. | **.17** | .19 | (.02) |  | (10.5) |
| Landing fees and other rentals .......................... | **.53** | .53 | — |  | — |
| Depreciation and amortization .......................... | **.56** | .55 | .01 |  | 1.8 |
| Other .............. .............................. | **1.43** | 1.41 | .02 |  | 1.4 |
| Total ............ .............................. | **8.80¢** | 8.05¢ | .75¢ |  | 9.3% |

Operating expenses per ASM increased 9.3 percent to 8.80 cents, primarily due to an increase in jet fuel prices, net of gains from the Company’s fuel hedging program. The Company’s average cost per gallon of fuel increased 48.5 percent versus the prior year.

Salaries, wages, and benefits expense per ASM increased .6 percent compared to 2005, primarily due to an increase in average wage rates, largely offset by productivity efforts that enabled the Company to grow overall headcount at a rate less than the growth in ASMs. The Company’s headcount at December 31, 2006, was

2.9 percent higher than at December 31, 2005, despite the 8.8 percent growth in available seat miles. On a dollar basis, Salaries, wages and benefits increased $270 million, of which $197 million was solely wages. The $197 million increase in wages represented a 10.1 percent increase compared to 2005, on an 8.8 percent increase in ASMs. Of the $197 million increase in wages, the majority was related to the increase in average wage rates.

Fuel and oil expense increased $797 million, and on a per-ASM basis increased 46.2 percent, net of hedging gains, primarily due to a significant increase in the average cost per gallon of jet fuel. Although the Compa- ny’s fuel hedge position was not as strong as the position the Company held in 2005, the Company’s hedging program still resulted in the realization of $675 million in cash settlements during 2006. These settlements resulted in a 2006 reduction to Fuel and oil expense of

$634 million. However, even with this hedge position, the Company’s jet fuel cost per gallon increased 48.5 per- cent versus 2005. The average cost per gallon of jet fuel in 2006 was $1.53 compared to $1.03 in 2005, excluding fuel-related taxes and net of hedging gains. See Note 10 to the Consolidated Financial Statements. The increase in fuel prices was partially offset by steps the Company has taken to improve the fuel efficiency of its aircraft,

including the addition of blended winglets to all of the Company’s 737-700 aircraft.

On an absolute dollar basis, maintenance materials and repairs expense increased $22 million, primarily due to an increase in the number of aircraft engine repairs. However, on a per-ASM basis, maintenance materials and repairs decreased 1.9 percent compared to 2005, as the dollar increase was only 4.9 percent versus the capacity (ASM) increase of 8.8 percent.

Aircraft rentals per ASM decreased 10.5 percent. The Company’s 8.8 percent increase in ASMs was gen- erated by the 36 aircraft the Company acquired during 2006, all of which were purchased. The number of aircraft on operating lease remained the same, thereby reducing the percentage of these aircraft in the total fleet. On an absolute dollar basis, expense decreased $5 million due to the renegotiation of some aircraft leases at lower rates.

Landing fees and other rentals per ASM was flat compared to 2005. On a dollar basis, expense increased

$41 million, primarily due to the Company’s increase in airport space to support additional flight activity.

Depreciation and amortization expense per ASM increased 1.8 percent, and on a dollar basis increased

$46 million. These increases were primarily due to an increase in depreciation expense per ASM from 36 new 737-700 aircraft purchased during 2006 and the result- ing higher percentage of owned aircraft.

In absolute dollars, Other operating expenses increased

$122 million, of which $39 million related to credit card processing fees. The $39 million increase in credit card processing fees represented a 22.2 percent increase from 2005 compared to the Company’s 20.2 percent increase in Passenger revenues. In excess of 97 percent of Passenger revenues are booked via customer credit cards, resulting in a close correlation between these two measures. The second

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and third largest increases in Other operating expenses on an absolute dollar basis were in Fuel taxes ($18 million, or

14.0 percent, primarily due to a 15.0 percent increase in the unhedged cost of jet fuel per gallon and a 7.9 percent increase in gallons consumed), and Personnel expenses ($16 million, or 11.9 percent, primarily representing hotel and per diem costs for Pilots and Flight Attendants, pri- marily due to a 6.2 percent increase in trips flown). Other operating expenses per ASM increased 1.4 percent com- pared to 2005, primarily due to the increase in revenue- related costs, such as credit card processing fees, related to the Company’s 20.2 percent increase in Passenger revenues.

### *Other*

“Other expenses (income)” included interest expense, capitalized interest, interest income, and other gains and

losses. Interest expense increased by $6 million, or 4.9 per- cent, primarily due to an increase in floating interest rates. This was partially offset by the Company’s repayment during 2006 of $607 million in debt. The majority of the Company’s long-term debt is at floating rates. In addi- tion, the Company issued $300 million in senior unsecured notes during December 2006. See Note 7 to the Consol- idated Financial Statements for more information. Capital- ized interest increased $12 million, or 30.8 percent, compared to 2005, due to higher 2006 progress payment balances for scheduled future aircraft deliveries as well as higher interest rates. Interest income increased $37 million, or 78.7 percent, primarily due to an increase in rates earned on cash and investments.

Other (gains) losses, net, primarily includes amounts recorded in accordance with the Company’s hedging activities and SFAS 133. During 2006, the Company recorded losses related to the ineffectiveness of its hedges as well as the decrease in market value of fuel derivative contracts that were marked to market because they didn’t qualify for SFAS 133 hedge accounting. The losses resulted from the decrease in the fair value of the Company’s portfolio of fuel derivative instruments as commodity prices declined during the year. During 2005, the Company recorded significant gains related to the ineffectiveness of its hedges as well as the increase in market value of fuel derivative contracts that were marked to market because they didn’t qualify for SFAS 133 hedge accounting, as commodity prices increased during that year. The following table displays the components of Other (gains) losses, net, for the years ended December 31, 2007 and 2006:

**(In millions) 2006 2005**

Mark-to-market impact from fuel contracts settling in future periods — included in Other (gains)

losses, net ......................... ..................................... $ 42 $(77)

Ineffectiveness from fuel hedges settling in future periods — included in Other (gains) losses, net . . 39 (9) Realized ineffectiveness and mark-to-market (gains) or losses — included in Other (gains) losses,

net .............................. ..................................... 20 (24)

Premium cost of fuel contracts included in Other (gains) losses, net....................... 52 35

Other .............................. ..................................... (2) (15)

$151 $(90)

See Note 10 to the Consolidated Financial Statements for further information on the Company’s hedging activities.

### *Income Taxes*

The provision for income taxes, as a percentage of income before taxes, decreased to 36.8 percent in 2006 from 37.9 percent in 2005. The decrease in the 2006 rate was due primarily to a $9 million net reduction related to a revision in the State of Texas franchise tax law enacted during 2006.

## Liquidity and Capital Resources

Net cash provided by operating activities was

$2.8 billion in 2007 compared to $1.4 billion in 2006. 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. Operating cash outflows primarily are related to the recurring expenses of operating the airline. The operating cash flows in both 2007 and 2006 were also significantly impacted by fluc- tuations in counterparty deposits associated with the Company’s fuel hedging program (counterparty deposits are reflected as an increase to Cash and a corresponding increase to Accrued liabilities). There was an increase in counterparty deposits of $1.5 billion for 2007, versus a decrease of $410 million during 2006. The increase in these deposits during 2007 was due to the significant increase in fair value of the Company’s fuel derivative portfolio from December 31, 2006, to December 31, 2007. The decrease during 2006 was due primarily to a decrease in the fair value of the Company’s fuel derivative instruments, as a result of a decline in energy commodity

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prices during 2006. Cash flows associated with purchas- ing and/or selling derivatives are also classified as oper- ating cash flows, although these amounts were not material for 2007 or 2006. Cash flows from operating activities for 2007 were also driven by the $645 million in net income, plus noncash depreciation and amortization expense of $555 million. For further information on the Company’s hedging program and counterparty deposits, see Note 10 to the Consolidated Financial Statements, and Item 7A. Qualitative and Quantitative Disclosures about Market Risk, respectively. Cash generated in 2007 and in 2006 was used primarily to finance aircraft-related capital expenditures and to provide working capital.

Net cash flows used in investing activities in 2007 totaled $1.5 billion, approximately the same as in 2006. Investing activities in both years primarily consisted of payments for new 737-700 aircraft delivered to the Company and progress payments for future aircraft deliv- eries. The Company purchased 37 new 737-700 aircraft in 2007 (the remaining two 737-700s added to the fleet during 2007 were leased) versus the purchase of 36 737-700s in 2006. See Note 4 to the Consolidated Financial Statements. Investing activities for 2007 were also reduced by $198 million related to a change in the balance of the Company’s short-term investments, namely auction rate securities.

Net cash used in financing activities was $493 mil- lion in 2007, primarily from the repurchase of $1.0 billion of common stock. The Company repurchased a total of 66 million shares of outstanding common stock during 2007 as a result of buyback programs authorized by the Company’s Board of Directors. These uses were partially offset by the October 2007 issuance of $500 million Pass Through Certificates consisting of $412 million 6.15% Series A certificates and $88 million 6.65% Series B certificates. Net cash used in financing activities was

$801 million in 2006, primarily from the repurchase of $800 million of common stock and the repayment of

$607 million in debt. The Company repurchased a total of 49 million shares of outstanding common stock during 2006 as a result of three buyback programs authorized by the Company’s Board of Directors. These uses were partially offset by the issuance of $300 million senior unsecured 5.75% notes in December 2006 and $260 mil- lion in proceeds from exercises of Employee stock options. See Note 7 to the Consolidated Financial State- ments for more information on the issuance and redemp- tion of long-term debt.

The Company has various options available to meet its 2008 capital and operating commitments, including cash on hand and short-term investments at December 31,

2007, totaling $2.8 billion, internally generated funds, and a $600 million bank revolving line of credit. In addition, the Company will also consider various bor- rowing or leasing options to maximize earnings 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. The Company currently has outstanding shelf registra- tions for the issuance of up to $540 million in public debt securities and pass through certificates, which it may utilize for aircraft financings or other purposes in the future.

## Off-Balance Sheet Arrangements, Contractual Obligations, and Contingent Liabilities and Commitments

Southwest has contractual obligations and commit- ments primarily with regard to future purchases of aircraft, payment of debt, and lease arrangements. The Company received 39 Boeing 737-700 aircraft in 2007 — 37 of which were new aircraft from Boeing, and two of which were pre-owned and leased from a third party. As of December 31, 2007, the Company had exercised all remain- ing options for aircraft to be delivered in 2008, and had firm orders for 29 737-700 aircraft in 2008, 20 in 2009, 10 each in 2010-2012, and 29 thereafter. The Company also had options for 8 737-700 aircraft in 2009, 24 in 2010, 22 in 2011 and 30 in 2012. Southwest also has an additional 54 purchase rights for 737-700 aircraft for the years 2008 through 2014. The Company has the option to substitute 737-600s or -800s for the -700s. This option is applicable to aircraft ordered from Boeing and must be exercised 18 months prior to the contractual delivery date.

The leasing of aircraft effectively provides flexibility to the Company as a source of financing. Although the Company is responsible for all maintenance, insurance, and expense associated 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. The Company operates 95 leased aircraft, of which 86 are operating leases. As prescribed by GAAP, assets and obligations under operating leases are not included in the Company’s Consolidated Balance Sheet. Disclosure of the contractual obligations associated with the Compa- ny’s leased aircraft is included below as well as in Note 8 to the Consolidated Financial Statements.

The Company is required to provide standby letters of credit to support certain obligations that arise in the ordinary course of business. Although the letters of credit

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are an off-balance sheet item, the majority of obligations to which they relate are reflected as liabilities in the

Consolidated Balance Sheet. Outstanding letters of credit totaled $211 million at December 31, 2007.

The following table aggregates the Company’s material expected contractual obligations and commitments as of December 31, 2007:

**Obligations by Period**

|  |  |  |  |  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- | --- | --- | --- | --- |
|  | | | **2009** | **2011** | | | **Beyond** |  | |
| **Contractual Obligations 2008** | |  | **- 2010** | **- 2012** | | | **2012** |  | **Total** |
|  | |  |  | **(In millions)** | | |  |  |  |
| Long-term debt(1) .............. .......... | $ 27 |  | $ 65 |  | $ 451 |  | $1,499 |  | $2,042 |
| Interest commitments(2) .......... .......... | 115 |  | 229 |  | 208 |  | 556 |  | 1,108 |
| Capital lease commitments(3) ...... .......... | 16 |  | 32 |  | 12 |  | — |  | 60 |
| Operating lease commitments ....... .......... | 400 |  | 633 |  | 430 |  | 876 |  | 2,339 |
| Aircraft purchase commitments(4) . . . .......... | 747 |  | 839 |  | 902 |  | 684 |  | 3,172 |
| Other purchase commitments ....... .......... | 60 |  | 64 |  | 14 |  | — |  | 138 |
| Total contractual obligations ...... .......... | $1,365 |  | $1,862 |  | $2,017 |  | $3,615 |  | $8,859 |

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 Boeing

There were no outstanding borrowings under the revolving credit facility at December 31, 2007. See Note 6 to the Consolidated Financial Statements for more infor- mation on the Company’s revolving credit facility.

In January 2004, the Company’s Board of Directors authorized the repurchase of up to $300 million of the Company’s common stock, utilizing present and antic- ipated 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 first quarter 2005, resulting in the total repurchase of approx- imately 21 million of the Company’s common shares.

In 2006 and 2007, the Company’s Board of Direc- tors authorized five separate programs for the repurchase of up to a total of $1.8 billion of the Company’s Common Stock — $300 million authorized in January 2006,

$300 million authorized in May 2006, $400 million authorized in November 2006, $300 million authorized in March 2007, and $500 million authorized in May 2007. Repurchases were made in accordance with appli- cable securities laws in the open market or in private transactions from time to time, depending on market conditions. These programs, the last of which was com- pleted during third quarter 2007, resulted in the repur- chase of a total of approximately 116 million shares.

During January 2008, the Company’s Board of Directors authorized an additional program for the repur- chase of up to $500 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

The Company’s Consolidated Financial Statements have been prepared in accordance with U.S. Generally Accepted Accounting Principles (GAAP). The Com- pany’s significant accounting policies are described in Note 1 to the Consolidated Financial Statements. The preparation of financial statements in accordance with GAAP requires the Company’s management to make estimates and assumptions 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 environment. However, actual results may differ from estimates under different condi- tions, 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 require management’s most subjective judgments. The Company’s most critical accounting policies and estimates are described below.

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### *Revenue Recognition*

As described in Note 1 to the Consolidated Finan- cial Statements, tickets sold for passenger air travel are initially deferred as “Air traffic liability.” Passenger rev- enue 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 Com- pany’s “Air traffic liability” balance at December 31, 2007 was $931 million, compared to $799 million as of December 31, 2006.

Estimating the amount of tickets that will be refunded, exchanged, or forfeited involves some level of subjectivity and judgment. The majority of the Company’s tickets sold are nonrefundable, which is the primary source of forfeited tickets. According to the Company’s “Con- tract of Carriage”, tickets (whether refundable or nonre- fundable) 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 esti- mate revenue from forfeited tickets at the date of travel. Estimated future refunds and exchanges included in the air traffic liability account are constantly evaluated based on subsequent refund and exchange activity to validate the accuracy of the Company’s estimates with respect to for- feited tickets. Holding other factors constant, a ten-per- cent change in the Company’s estimate of the amount of refunded, exchanged, or forfeited tickets for 2007 would have resulted in a $20 million, or .2%, change in Passenger revenues recognized for that period.

Events and circumstances outside of historical fare sale activity or historical Customer travel patterns can result in actual refunds, exchanges, or forfeited tickets differing significantly from estimates. The Company evaluates its estimates within a narrow range of acceptable amounts. If actual refunds, exchanges, or forfeiture expe- rience results in an amount outside of this range, esti- mates and assumptions are reviewed and adjustments to “Air traffic liability” and to “Passenger revenue” are recorded, as necessary. Additional factors that may affect

estimated refunds and exchanges include, but may not be limited to, the Company’s refund and exchange policy, the mix of refundable and nonrefundable fares, and pro- motional fare activity. The Company’s estimation tech- niques have been consistently applied from year to year; however, as with any estimates, actual refund, exchange, and forfeiture activity may vary from estimated amounts. No material adjustments were recorded for years 2005, 2006, or 2007.

The Company believes it is unlikely that materially different estimates for future refunds, exchanges, and forfeited tickets would be reported based on other rea- sonable assumptions or conditions suggested by actual historical experience and other data available at the time estimates were made.

### *Accounting for Long-Lived Assets*

As of December 31, 2007, the Company had approximately $15.2 billion (at cost) of long-lived assets, including $13.0 billion (at cost) in flight equipment and related assets. Flight equipment primarily relates to the

434 Boeing 737 aircraft in the Company’s fleet at December 31, 2007, which are either owned or on capital lease. The remaining 86 Boeing 737 aircraft in the Company’s fleet at December 31, 2007, 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.

The following table shows a breakdown of the Company’s long-lived asset groups along with informa- tion about estimated useful lives and residual values of these groups:

**Estimated Residual**

**Estimated Useful Life value**

Aircraft and engines . . . 23 to 25 years 15% Aircraft parts . . . . . . . . Fleet life 4%

Ground property and

equipment . . . . . . . . 5 to 30 years 0%-10%

Leasehold

improvements . . . . . . 5 years or lease term 0%

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. Aircraft estimated useful lives are based on the number of “cycles” flown (one take-off and landing). The Company has made a conversion of cycles into years based on both its historical and anticipated future utilization of the aircraft.

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Subsequent revisions to these estimates, which can be significant, could be caused by changes to the Company’s maintenance program, changes in utilization of the air- craft (actual cycles during a given period of time), gov- ernmental regulations on aging aircraft, and changing market prices of new and used aircraft of the same or similar types. The Company evaluates its estimates and assumptions each reporting period and, when warranted, adjusts these estimates and assumptions. Generally, these adjustments are accounted for on a prospective basis through depreciation and amortization expense, as required by GAAP.

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 experienced many of these indicators, Southwest has continued to operate all of its aircraft, generate positive cash flow, and produce profits. Consequently, the Company has not identified any impairments related to its existing aircraft fleet. The Company will continue to monitor its long-lived assets and the airline operating environment.

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 con- ditions suggested by actual historical experience and other data available at the time estimates were made.

### *Financial Derivative Instruments*

The Company utilizes financial derivative instru- ments primarily to manage its risk associated with chang- ing jet fuel prices, and accounts for them under Statement of Financial Accounting Standards No. 133, “Account- ing for Derivative Instruments and Hedging Activities”, as amended (SFAS 133). See “Quantitative and Qual- itative Disclosures about Market Risk” for more infor- mation on these risk management activities and see Note 10 to the Consolidated Financial Statements for more information on SFAS 133, the Company’s fuel hedging program, and financial derivative instruments.

SFAS 133 requires that all derivatives be reflected at market (fair value) and recorded on the Consolidated Balance Sheet. At December 31, 2007, the Company was a party to over 346 financial derivative instruments, related to its fuel hedging program, for year 2008 and beyond. The fair value of the Company’s fuel hedging

financial derivative instruments recorded on the Compa- ny’s Consolidated Balance Sheet as of December 31, 2007, was $2.4 billion, compared to $999 million at December 31, 2006. The large increase in fair value was due primarily to the significant increase in energy prices in the second half of 2007, net of the expiration (i.e., settlement) of approximately $727 million in fuel deriv- ative instruments that related to 2007 and net of new derivative instruments the Company added for future years. Of the remaining $2.4 billion in fair value of fuel hedging financial derivative instruments at December 31, 2007, approximately $1.1 billion is expected to settle, or expire during 2008. Changes in the fair values of these instruments can vary dramatically, as was evident during recent years, based on changes in the underlying com- modity prices. Market price changes can be driven by factors such as supply and demand, inventory levels, weather events, refinery capacity, political agendas, and general economic conditions, among other items. The financial derivative instruments 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.

The Company enters into financial derivative instruments with third party institutions in “over-the- counter” markets. Since the majority of the Company’s financial derivative instruments are not traded on a mar- ket exchange, the Company estimates their fair values. Depending on the type of instrument, the values are determined by the use of present value methods or stan- dard option value models with assumptions about com- modity 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 effectiveness 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 commodity futures prices (such as crude oil, heating oil, and unleaded gasoline) and adjusted based on variations of those like commodities to the Company’s ultimate expected price to be paid for jet fuel at the specific locations in which the Company hedges.

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. In recent years,

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because of increased volatility in energy markets, the Company’s estimates of the presumed effectiveness of its hedges made at the time the hedges were initially designated have materially differed from actual results, resulting in increased volatility in the Company’s periodic financial results. For example, historical data had been utilized in qualifying unleaded gasoline for SFAS 133 hedge accounting under the presumption that derivatives of such commodity would result in effective hedges, as defined. This historical data is updated every quarterly reporting period to ascertain whether SFAS 133 hedge accounting is allowed for every commodity the Company uses in its hedging program. During 2006, based on these updates, the Company in fact lost SFAS 133 hedge accounting for all unleaded gasoline derivative instru- ments, and thus has marked all such derivatives to market value in each subsequent quarterly period since that time, with all changes in value reflected as a component of Other gains/losses in the Consolidated Statement of Income. Although commodities such as crude oil and heating oil have continued to qualify for hedge account- ing in most cases, there have been instances in which the Company has also lost hedge accounting in specific geographic locations for these commodities. In these instances, the Company has also marked such derivatives to market value with changes reflected in the income statement each reporting period. Although the Compa- ny’s prospective assessment has been utilized to ensure that crude oil and heating oil in most cases still qualify for SFAS 133 hedge accounting in specific locations where the Company hedges, there are no assurances that these commodities will continue to qualify in the future. This is due to the fact that future price changes in these refined products may not be consistent with historical price changes. If recent volatility in these commodity markets continues for an extended period of time or worsens in the near future, the Company could lose hedge accounting altogether for all crude oil and heating oil derivatives, which would create further volatility in the Company’s financial results.

Estimating the fair value of these fuel derivative instruments and forward prices for jet fuel will also result in changes in their values from period to period and thus determine how they are accounted for under SFAS 133. To the extent that the change in the estimated fair value of a fuel derivative instrument differs from the change in the estimated price of the associated jet fuel to be pur- chased, both on a cumulative and a period-to-period basis, ineffectiveness of the fuel hedge can result, as defined by SFAS 133. This could result in the immediate recording of noncash charges or income, representing the change in the fair value of the derivative, even though the

derivative instrument may not expire/settle until a future period. Likewise, if a derivative contract ceases to qualify for hedge accounting, the changes in the fair value of the derivative instrument is recorded every period 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 com- modities, especially given the magnitude of the current fair market value of the Company’s fuel derivatives and the recent volatility in the prices of refined products. Due to the volatility in markets for crude oil and related products, the Company is unable to predict the amount of ineffectiveness each period, including the loss of hedge accounting, which could be determined on a derivative by derivative basis or in the aggregate for a specific com- modity. This may result, and has resulted, in increased volatility in the Company’s financial statements. The significant increase in the amount of hedge ineffective- ness and unrealized gains and losses on the change in value of derivative contracts settling in future periods recorded during recent periods has been due to a number of factors. These factors include: the significant fluctu- ation in energy prices, the number of derivative positions the Company holds, significant weather events that have affected refinery capacity and the production of refined products, and the volatility of the different types of products the Company uses for protection. The number of instances in which the Company has discontinued hedge accounting for specific hedges and for specific refined products, such as unleaded gasoline, has increased recently, primarily due to these reasons. In these cases, the Company has determined the hedges will not regain effectiveness in the time period remaining until settle- ment and therefore must discontinue special hedge accounting, as defined by SFAS 133. When this happens, any changes in fair value of the derivative instruments are marked to market through earnings in the period of change. As the fair value of the Company’s hedge posi- tions can fluctuate significantly in amount from period to period, it is probable there will be continued variability recorded in the income statement and that the amount of hedge ineffectiveness and unrealized gains or losses recorded in future periods will be material. This is pri- marily because small differences in the correlation of crude oil related products are leveraged over large dollar volumes.

SFAS 133 is a complex accounting standard with stringent requirements, including the documentation of a Company hedging strategy, statistical analysis to qualify a commodity for hedge accounting both on a historical and a prospective basis, and strict contemporaneous

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documentation that is required at the time each hedge is designated 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 commodities used for hedging purposes.

The Company continually looks for better and more accurate methodologies in forecasting future cash flows relating to its jet fuel hedging program. These estimates are an important component used in the measurement of effectiveness for the Company’s fuel hedges, as required by SFAS 133. During first quarter 2006, the Company did revise its method for forecasting these future cash flows. Prior to 2006, the Company had estimated future cash flows using actual market forward prices of a single like commodity and adjusting for historical differences from the Company’s actual jet fuel purchase prices. The Company implemented an improved model for forecast- ing forward jet fuel prices during 2006, due to the fact that different types of commodities are statistically better predictors of forward jet fuel prices, depending on specific geographic locations in which the Company hedges. In accordance with SFAS 133, the Company then adjusts for certain items, such as transportation costs, that are stated in fuel purchasing contracts with its vendors, in order to estimate the actual price paid for jet fuel associated with each hedge. This improved methodology for estimating future cash flows (i.e., jet fuel prices) was applied pro- spectively, in accordance with the Company’s interpre- tation of SFAS 133. The Company did not, however, change its method for either assessing or measuring hedge ineffectiveness. As a result of this new method for forecasting future jet fuel prices, the Company believes its hedges are more likely to be effective over the long-term.

The Company also utilizes financial derivative instruments in the form of interest rate swap agreements. The primary objective for the Company’s use of interest rate hedges is to reduce the volatility of net interest income by better matching the repricing of its assets and liabilities. The Company currently holds interest rate swap agreements related to its $385 million 6.5% senior unsecured notes due 2012, its $350 million 5.25% senior unsecured notes due 2014, its $300 million 5.125% senior unsecured notes due 2017, and its $100 million 7.375% senior unsecured debentures due 2027. The interest rate swaps associated with the $300 million

5.125% notes and $100 million 7.375% debentures were entered into during 2007.

The floating rate paid under the swap associated with the $385 million 6.5% senior unsecured notes due 2012 is set in arrears. The Company pays the London InterBank Offered Rate (LIBOR) plus a margin every six months and receives 6.5 percent every six months on a notional amount of $385 million until 2012. The average floating rate paid under this agreement during 2007 is estimated to be 7.31 percent based on actual and forward rates at December 31, 2007. The floating rate for the swap agreement relating to its $350 million 5.25% senior unsecured notes due 2014 is set at the beginning of each six month period. Under this agreement, the Company pays LIBOR plus a margin every six months and receives

5.25 percent every six months on a notional amount of

$350 million until 2014. The average floating rate paid under this agreement during 2007 was 6.02 percent. For both the swap agreements associated with the $300 mil- lion 5.125% notes and $100 million 7.375% debentures, the Company pays the LIBOR plus a margin every six months on the notional amount of the debt, and receives the fixed stated rate of the notes or debentures every six months until the date the notes or debentures become due. The average floating rate paid during 2007 under the agreement associated with the $300 million 5.125% notes due 2016 was 4.64 percent. The average floating rate paid during 2007 under the agreement associated with the

$100 million 7.375% debentures due 2027 was

6.73 percent.

The Company’s interest rate swap agreements qual- ify 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 values of the interest rate swap agreements, which are adjusted regularly, is recorded in the Consolidated Bal- ance Sheet, as necessary, with a corresponding adjust- ment to the carrying value of the long-term debt. The total fair value of the interest rate swap agreements, excluding accrued interest, at December 31, 2007, was an asset of approximately $16 million. The total fair value of the swap agreements held at December 31, 2006, was a liability of $30 million. The long-term portion of these amounts is recorded in “Other deferred liabilities” in the Consolidated Balance Sheet for each respective year. In accordance with fair value hedging, the offsetting entry is an adjustment to decrease the carrying value of long-term debt. See Note 10 to the Consolidated Financial Statements.

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The Company believes it is unlikely that materially different estimates for the fair value of financial derivative instruments, and forward jet fuel prices, would be made or reported based on other reasonable assumptions or con- ditions suggested by actual historical experience and other data available at the time estimates were made.

### *Share-Based Compensation*

The Company has share-based compensation plans covering the majority of its Employee groups, including plans adopted via collective bargaining, a plan covering the Company’s Board of Directors, and plans related to employment contracts with the Executive Chairman of the Company. Prior to January 1, 2006, the Company accounted for stock-based compensation utilizing the intrinsic value method in accordance with the provisions of Accounting Principles Board Opinion No. 25 (APB 25), “Accounting for Stock Issued to Employees” and related Interpretations. Accordingly, no compensation expense was recognized for fixed option plans because the exercise prices of Employee stock options equaled or exceeded the market prices of the underlying stock on the dates of grant. However, prior to adoption of SFAS 123R, share-based compensation had been included in pro forma disclosures in the financial statement footnotes for periods prior to 2006.

Effective January 1, 2006, the Company adopted the fair value recognition provisions of SFAS No. 123R, “Share-Based Payment” using the modified retrospective transition method. Among other items, SFAS 123R eliminates the use of APB 25 and the intrinsic value method of accounting, and requires companies to recog- nize the cost of Employee services received in exchange for awards of equity instruments, based on the grant date fair value of those awards, in the financial statements.

Under the modified retrospective method, compen- sation cost is recognized in the financial statements beginning with the effective date, based on the require- ments of SFAS 123R for all share-based payments granted after that date, and based on the requirements of SFAS 123 for all unvested awards granted prior to the effective date of SFAS 123R. In addition, results for prior periods were retroactively adjusted utilizing the pro forma disclosures in those prior financial statements. As part of this revision, the Company recorded cumulative share- based compensation expense of $409 million for the period 1995-2005, resulting in a reduction to Retained earnings in the Consolidated Balance Sheet as of Decem- ber 31, 2005. This adjustment, along with the creation of a net Deferred income tax asset in the amount of

$130 million, resulted in an offsetting increase to Capital

in excess of par value in the amount of $539 million in the Consolidated Balance Sheet as of December 31, 2005. The Deferred tax asset represents the portion of the cumulative expense related to stock options that will result in a future tax deduction.

The Company estimates the fair value of stock option awards on the date of grant utilizing a modified Black-Scholes option pricing model. The Black-Scholes option valuation model was developed for use in estimat- ing the fair value of short-term traded options that have no vesting restrictions and are fully transferable. How- ever, certain assumptions used in the Black-Scholes model, such as expected term, can be adjusted to incor- porate the unique characteristics of the Company’s stock option awards. Option valuation models require the input of somewhat subjective assumptions including expected stock price volatility and expected term. For 2006 and 2007, the Company has relied on observations of histor- ical volatility trends, implied future volatility observations as determined by independent third parties, and implied volatility from traded options on the Company’s stock. For both 2007 and 2006 stock option grants, the Com- pany utilized expected volatility based on the expected life of the option, but within a range of 24 percent to 27 percent. Prior to 2005, the Company relied exclusively on historical volatility as an input for determining the estimated fair value of stock options. In determining the expected term of the option grants, the Company has observed the actual terms of prior grants with similar characteristics, the actual vesting schedule of the grant, and assessed the expected risk tolerance of different optionee groups.

Other assumptions required for estimating fair value with the Black-Scholes model are the expected risk-free interest rate and expected dividend yield of the Compa- ny’s stock. The risk-free interest rates used were actual

U.S. Treasury zero-coupon rates for bonds matching the expected term of the option on the date of grant. The expected dividend yield of the Company’s common stock over the expected term of the option on the date of grant was estimated based on the Company’s current dividend yield, and adjusted for anticipated future changes.

Vesting terms for the Company’s stock option plans differ based on the type of grant made and the group to which the options are granted. For grants made to Employees under collective bargaining plans, vesting has ranged in length from immediate vesting to vesting periods in accordance with the period covered by the respective collective bargaining agreement. For “Other Employee Plans,” options generally vest and become fully exercisable over three, five, or ten years of continued

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employment, depending upon the grant type. For grants in any of the Company’s plans that are subject to graded vesting over a service period, the Company recognizes expense on a straight-line basis over the requisite service period for the entire award. None of the Company’s grants include performance-based or market-based vest- ing conditions, as defined.

As of December 31, 2007, the Company had

$37 million in remaining unrecognized compensation cost related to past grants of stock options, which is expected to be recognized over a weighted-average period of 2.25 years. The total recognition period for the remaining unrecognized compensation cost was approx- imately eight years; however, the majority of this cost will be recognized over the next two years, in accordance with vesting provisions. The majority of the $37 million in share-based compensation expense reflected in the Con- solidated Statement of Income for the year ended Decem- ber 31, 2007, was related to options granted prior to the adoption of SFAS 123R. Based on Employee stock options expected to vest during 2008, and the Company’s expectation of future grants, the Company expects the expense related to share-based compensation to once again decrease during 2008 compared to 2007 expense.

The Company believes it is unlikely that materially different estimates for the assumptions used in estimating the fair value of stock options granted would be made based on the conditions suggested by actual historical experience and other data available at the time estimates were made.

### *Recent Accounting Developments*

In September 2006, the FASB issued statement No. 157, “Fair Value Measurements”*,* (SFAS 157). SFAS 157 defines fair value, establishes a framework for measuring fair value in accordance with accounting principles generally accepted in the United States, and expands disclosures about fair value measurements. The Company is subject to the provisions of SFAS 157 begin- ning January 1, 2008. The Company has not yet deter- mined whether SFAS 157 will have a material impact on its financial condition, results of operations, or cash flow. However, the Company believes it will likely be required to provide additional disclosures as part of future financial statements, beginning with first quarter 2008.

In February 2007, the FASB issued Statement No. 159, “The Fair Value Option for Financial Assets and Financial Liabilities” (Statement 159). Statement 159 allows entities the option to measure eligible finan- cial instruments at fair value as of specified dates. Such election, which may be applied on an instrument by

instrument basis, is typically irrevocable once elected. Statement 159 is effective for fiscal years beginning after November 15, 2007. The Company does not believe Statement 159 will result in a material adverse effect on its financial condition, results of operations, or cash flow.

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

Southwest has interest rate risk in its floating rate debt obligations and interest rate swaps, and has com- modity price risk in jet fuel required to operate its aircraft fleet. The Company purchases jet fuel at prevailing mar- ket prices, but seeks to manage market risk through execution of a documented hedging strategy. Southwest has market sensitive instruments in the form of fixed rate debt instruments and financial derivative instruments used to hedge its exposure to jet fuel price increases. The Company also operates 95 aircraft under operating and capital leases. However, leases are not considered market sensitive financial instruments and, therefore, are not included in the interest rate sensitivity analysis below. Commitments related to leases are disclosed in Note 8 to the Consolidated Financial Statements. The Company does not purchase or hold any derivative financial instru- ments for trading purposes. See Note 10 to the Consol- idated Financial Statements for information on the Company’s accounting for its hedging program and for further details on the Company’s financial derivative instruments.

### *Fuel Hedging*

The Company utilizes financial derivative instru- ments, on both a short-term and a long-term basis, as a form of insurance against significant increases in fuel prices. The Company believes there is significant risk in not hedging against the possibility of such fuel price increases. The Company expects to consume approxi- mately 1.5 billion gallons of jet fuel in 2008. Based on this usage, a change in jet fuel prices of just one cent per gallon would impact the Company’s “Fuel and oil expense” by approximately $15 million per year, excluding any impact of the Company’s derivative instruments.

The fair values of outstanding financial derivative instruments related to the Company’s jet fuel market price risk at December 31, 2007, were net assets of

$2.4 billion. The current portion of these financial deriv- ative instruments, or $1.1 billion, is classified as “Fuel derivative contracts” in the Consolidated Balance Sheet. The long-term portion of these financial derivative instruments, or $1.3 billion, is included in “Other assets.”

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The fair values of the derivative instruments, depending on the type of instrument, were determined by use of present value methods or standard option value models with assumptions about commodity prices based on those observed in underlying markets. An immediate ten-per- cent increase or decrease in underlying fuel-related com- modity prices from the December 31, 2007, prices would correspondingly change the fair value of the commodity derivative instruments in place by up to $658 million. Changes in the related commodity derivative instrument cash flows may change by more or less than this amount based upon further fluctuations in futures prices as well as related income tax effects. This sensitivity analysis uses industry standard valuation models and holds all inputs constant at December 31, 2007, levels, except underlying futures prices.

Outstanding financial derivative instruments expose the Company to credit loss in the event of nonperfor- mance by the counterparties to the agreements. However, the Company does not expect any of the counterparties to fail to meet its obligations. The credit exposure related to these financial instruments is represented by the fair value of contracts with a positive fair value at the reporting date. To manage credit risk, the Company selects and will periodically review counterparties based on credit ratings, limits its exposure to a single counterparty, and monitors the market position of the program and its relative market position with each counterparty. At December 31, 2007, the Company had agreements with nine counterparties containing early termination rights and/or bilateral col- lateral provisions whereby security is required if market risk exposure exceeds a specified threshold amount or credit ratings fall below certain levels. At December 31, 2007, the Company held $2.0 billion in cash collateral deposits under these bilateral collateral provisions. These collateral deposits serve to decrease, but not totally elim- inate, the credit risk associated with the Company’s hedging program. The deposits are included in “Accrued liabilities” on the Consolidated Balance Sheet. See also Note 10 to the Consolidated Financial Statements.

### *Financial Market Risk*

The vast majority of the Company’s assets are air- craft, which are long-lived. The Company’s strategy is to maintain a conservative balance sheet and grow capacity steadily and profitably. While the Company uses financial leverage, it has maintained a strong balance sheet and an “A” credit rating on its senior unsecured fixed-rate debt with Standard & Poor’s and Fitch ratings agencies, and a “Baa1” credit rating with Moody’s rating agency as of December 31, 2007. In January 2008, Fitch announced a cut in the Company’s senior unsecured debt rating to

“A-”. The Company’s 1999 and 2004 French Credit Agreements do not give rise to significant fair value risk but do give rise to interest rate risk because these bor- rowings are floating-rate debt. In addition, as disclosed in Note 10 to the Consolidated Financial Statements, the Company has converted certain of its long-term debt to floating rate debt by entering into interest rate swap agreements. This includes the Company’s $385 million 6.5% senior unsecured notes due 2012, the $350 million 5.25% senior unsecured notes due 2014, the $300 million 5.125% senior unsecured notes due 2017, and the

$100 million 7.375% senior unsecured debentures due 2027. Although there is interest rate risk associated with these floating rate borrowings, the risk for the 1999 and 2004 French Credit Agreements is somewhat mitigated by the fact that the Company may prepay this debt under certain conditions. See Notes 6 and 7 to the Consolidated Financial Statements for more information on the mate- rial terms of the Company’s short-term and long-term debt.

Excluding the notes or debentures that were con- verted to a floating rate as previously noted, the Compa- ny’s only fixed-rate senior unsecured notes at December 31, 2007 were its $300 million notes due 2016. These senior unsecured notes have a fixed-rate of

5.75 percent, which is comparable to average rates pre- vailing for similar debt instruments over the last ten years. The Company’s outstanding $500 million EETCs, which are secured by 16 Boeing 737-700 aircraft, had an effective fixed-rate of 6.24 percent. The carrying value of the Company’s floating rate debt totaled $1.3 billion, and this debt had a weighted-average maturity of 6.1 years at floating rates averaging 5.68 percent for the twelve months ended December 31, 2007. In total, the Com- pany’s fixed rate debt and floating rate debt represented

6.5 percent and 10.3 percent, respectively, of total non- current assets at December 31, 2007.

The Company also has some risk associated with changing interest rates due to the short-term nature of its invested cash, which totaled $2.2 billion, and short-term investments, which totaled $566 million, at December 31, 2007. However, the Company generally does not retain the interest earnings on the $2.0 billion in cash collateral deposits from counterparties associated with the Compa- ny’s fuel derivative instruments. See Notes 1 and 10 to the Consolidated Financial Statements for further informa- tion. The Company invests available cash in certificates of deposit, highly rated money market instruments, invest- ment grade commercial paper, auction rate securities, and other highly rated financial instruments. Because of the short-term nature of these investments, the returns earned parallel closely with short-term floating interest

rates. The Company has not undertaken any additional actions to cover interest rate market risk and is not a party to any other material market interest rate risk manage- ment activities.

A hypothetical ten percent change in market inter- est rates as of December 31, 2007, would not have a material affect 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 flows associated with its floating rate debt, invested cash (excluding cash collateral deposits), and short-term investments because of the floating-rate nature of these items. Assuming floating market rates in effect as of December 31, 2007, were held constant throughout a 12-month period, a hypothetical ten percent change in those rates would correspondingly change the Company’s net earnings and cash flows associated with these items by less than $3 million. Utilizing these assumptions and considering the Company’s cash balance (excluding cash collateral deposits), short-term investments, and

floating-rate debt outstanding at December 31, 2007, an increase in rates would have a net positive effect on the 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 earnings or cash flow associated with the Company’s publicly traded fixed-rate debt.

The Company is also subject to various financial covenants included in its credit card transaction process- ing agreement, the revolving credit facility, and outstand- ing debt agreements. Covenants include the maintenance of minimum credit ratings. For the revolving credit facility, the Company must also maintain, at all times, a Coverage Ratio, as defined in the agreement, of not less than 1.00 to 1.25. The Company met or exceeded the minimum standards set forth in these agreements as of December 31, 2007. 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*

Current assets:

## SOUTHWEST AIRLINES CO. CONSOLIDATED BALANCE SHEET

**ASSETS**

**December 31,**

**2007 2006**

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

Cash and cash equivalents ......... ..................................... **$ 2,213** $ 1,390

Short-term investments ........... ..................................... **566** 369

Accounts and other receivables ...... ..................................... **279** 241

Inventories of parts and supplies, at cost .................................... **259** 181

Fuel derivative contracts ........... ..................................... **1,069** 369

Prepaid expenses and other current assets ...................................  **57**  51 Total current assets ............ ..................................... **4,443** 2,601

Property and equipment, at cost:

|  |  |  |  |
| --- | --- | --- | --- |
| Flight equipment................ ..................................... | **13,019** |  | 11,769 |
| Ground property and equipment ..... ..................................... | **1,515** |  | 1,356 |
| Deposits on flight equipment purchase contracts............................... | **626** |  | 734 |
|  | **15,160** |  | 13,859 |
| Less allowance for depreciation and amortization .............................. | **4,286** |  | 3,765 |
|  | **10,874** |  | 10,094 |
| Other assets ..................... ..................................... | **1,455** |  | 765 |
|  | **$16,772** |  | $13,460 |

## LIABILITIES AND STOCKHOLDERS’ EQUITY

Current liabilities:

|  |  |  |
| --- | --- | --- |
| Accounts payable ............... ..................................... | **$ 759** | $ 643 |
| Accrued liabilities ............... ..................................... | **3,107** | 1,323 |
| Air traffic liability ............... ..................................... | **931** | 799 |
| Current maturities of long-term debt. . ..................................... | **41** | 122 |
| Total current liabilities .......... ..................................... | **4,838** | 2,887 |
| Long-term debt less current maturities . . ..................................... | **2,050** | 1,567 |
| Deferred income taxes .............. ..................................... | **2,535** | 2,104 |
| Deferred gains from sale and leaseback of aircraft................................ | **106** | 120 |
| Other deferred liabilities ............ ..................................... | **302** | 333 |
| Commitments and contingencies |  |  |
| Stockholders’ equity: |  |  |
| Common stock, $1.00 par value: 2,000,000,000 shares authorized; 807,611,634 shares  issued in 2007 and 2006 .......... ..................................... | **808** | 808 |
| Capital in excess of par value ....... ..................................... | **1,207** | 1,142 |
| Retained earnings ............... ..................................... | **4,788** | 4,307 |
| Accumulated other comprehensive income ................................... | **1,241** | 582 |
| Treasury stock, at cost: 72,814,104 and 24,302,215 shares in 2007 and 2006,  respectively .................. ..................................... | **(1,103)** | (390) |
| Total stockholders’ equity........ ..................................... | **6,941** | 6,449 |
|  | **$16,772** | $13,460 |

## OPERATING REVENUES:

**SOUTHWEST AIRLINES CO. CONSOLIDATED STATEMENT OF INCOME**

**Years Ended December 31, 2007 2006 2005**

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

|  |  |  |  |
| --- | --- | --- | --- |
| Passenger ............................... ..................... | **$9,457** | $8,750 | $7,279 |
| Freight ................................. ..................... | **130** | 134 | 133 |
| Other .................................. ..................... | **274** | 202 | 172 |
| Total operating revenues................... ..................... | **9,861** | 9,086 | 7,584 |
| **OPERATING EXPENSES:** |  |  |  |
| Salaries, wages, and benefits .................. ..................... | **3,213** | 3,052 | 2,782 |
| Fuel and oil ............................. ..................... | **2,536** | 2,138 | 1,341 |
| Maintenance materials and repairs .............. ..................... | **616** | 468 | 446 |
| Aircraft rentals ........................... ..................... | **156** | 158 | 163 |
| Landing fees and other rentals ................ ..................... | **560** | 495 | 454 |
| Depreciation and amortization ................ ..................... | **555** | 515 | 469 |
| Other operating expenses .................... ..................... | **1,434** | 1,326 | 1,204 |
| Total operating expenses .................. ..................... | **9,070** | 8,152 | 6,859 |
| **OPERATING INCOME**...................... ..................... | **791** | 934 | 725 |
| **OTHER EXPENSES (INCOME):**  Interest expense .......................... ..................... | **119** | 128 | 122 |
| Capitalized interest ........................ ..................... | **(50)** | (51) | (39) |
| Interest income ........................... ..................... | **(44)** | (84) | (47) |
| Other (gains) losses, net .................... ..................... | **(292)** | 151 | (90) |
| Total other expenses (income) .............. ..................... | **(267)** | 144 | (54) |
| **INCOME BEFORE INCOME TAXES** ........... ..................... | **1,058** | 790 | 779 |
| **PROVISION FOR INCOME TAXES** ............ ..................... | **413** | 291 | 295 |
| **NET INCOME** ............................ ..................... | **$ 645** | $ 499 | $ 484 |
| **NET INCOME PER SHARE, BASIC** ............ ..................... | **$ .85** | $ .63 | $ .61 |
| **NET INCOME PER SHARE, DILUTED** ......... ..................... | **$ .84** | $ .61 | $ .60 |

## SOUTHWEST AIRLINES CO. CONSOLIDATED STATEMENT OF STOCKHOLDERS’ EQUITY

**Years Ended December 31, 2007, 2006, and 2005**

**Accumulated**

|  |  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- | --- |
|  | **Stock** | **Par Value Earnings Income (Loss) Stock**  **(In millions, except per share amounts)** | | | | **Total** |
| Balance at December 31, 2004 ........ | $790 | $ 777 | $3,614 | $ 417 | $ (71) $ 5,527 | |
| Purchase of shares of treasury stock . . . | — | — | — | — | (55) (55) | |
| Issuance of common and treasury stock |  |  |  |  |  | |
| pursuant to Employee stock plans . . . | 12 | 59 | (66) | — 126 | | 131 |
| Tax benefit of options exercised ...... | — | 47 | — | — — | | 47 |
| Share-based compensation .......... | — | 80 | — | — — | | 80 |
| Cash dividends, $.018 per share ...... | — | — | (14) | — — | | (14) |
| Comprehensive income (loss) |  |  |  |  | |  |
| Net income ..................  Unrealized gain on derivative | — | — | 484 | — | — | 484 |
| instruments ................. | — | — | — | 474 | — | 474 |
| Other ...................... | — | — | — | 1 | — | 1 |
| Total comprehensive income .... |  |  |  |  |  | 959 |
| Balance at December 31, 2005 ........ | $802 | $ 963 | $4,018 | $ 892 | $ — $ 6,675 | |
| Purchase of shares of treasury stock . . . | — | — | — | — | (800) (800) | |
| Issuance of common and treasury stock |  |  |  |  |  | |
| pursuant to Employee stock plans . . . 6 | | 39 | (196) | — | 410 | 259 |
| Tax benefit of options exercised ...... — | | 60 | — | — | — | 60 |
| Share-based compensation .......... — | | 80 | — | — | — | 80 |
| Cash dividends, $.018 per share ...... — | | — | (14) | — | — | (14) |
| Net income .................. — | | — | 499 | — | — | 499 |
| Unrealized loss on derivative  instruments ................. — | | — | — | (306) | — | (306) |
| Other ...................... | — | — | — | (4) | — | (4) |
| Total comprehensive income .... |  |  |  |  |  | 189 |
| Balance at December 31, 2006 ........ | $808 | $1,142 | $4,307 | $ 582 | $ (390) | $ 6,449 |

**Common**

**Capital in Excess of**

**Retained**

**Other Comprehensive**

**Treasury**

Comprehensive income (loss)

## Purchase of shares of treasury stock .. — — — — (1,001) (1,001)

**Issuance of common and treasury stock pursuant to Employee stock**

|  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- |
| **plans** ....................... | **— —** |  | **(150)** | **— 288** | **138** |
| **Tax benefit of options exercised** ..... | **— 28** |  | **—** | **— —** | **28** |
| **Share-based compensation** ......... | **— 37** |  | **—** | **— —** | **37** |
| **Cash dividends, $.018 per share** ..... | **— —** |  | **(14)** | **— —** | **(14)** |
| **Comprehensive income (loss)** |  |  |  |  |  |
| **Net income** .................. | **— —** |  | **645** | **— —** | **645** |
| **Unrealized gain on derivative instruments** ................ | **— —** |  | **—** | **636 —** | **636** |
| **Other** ...................... | **— —** |  | **—** | **23 —** | **23** |
| **Total comprehensive income** .... |  |  |  |  | **1,304** |
| **Balance at December 31, 2007** ........ | **$808 $1,207** |  | **$4,788** | **$1,241 $(1,103)** | **$ 6,941** |

SOUTHWEST AIRLINES CO. CONSOLIDATED STATEMENT OF CASH FLOWS

**Years Ended December 31, 2007 2006 2005**

**(In millions)**

**CASH FLOWS FROM INVESTING ACTIVITIES:**

|  |  |  |  |
| --- | --- | --- | --- |
| **CASH FLOWS FROM OPERATING ACTIVITIES:** |  | | |
| Net income . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . | **$ 645** | $ 499 | $ 484 |
| Adjustments to reconcile net income to net cash provided by operating activities: |  |  |  |
| Depreciation and amortization. . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . | **555** | 515 | 469 |
| Deferred income taxes . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . | **328** | 277 | 291 |
| Amortization of deferred gains on sale and leaseback of aircraft . . . . . . . . . . . . . . . . . | **(14)** | (16) | (16) |
| Share-based compensation expense . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . | **37** | 80 | 80 |
| Excess tax benefits from share-based compensation arrangements. . . . . . . . . . . . . . . . . | **(28)** | (60) | (47) |
| Changes in certain assets and liabilities: |  |  |  |
| Accounts and other receivables. . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . | **(38)** | (5) | (9) |
| Other current assets . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . | **(229)** | 87 | (59) |
| Accounts payable and accrued liabilities . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . | **1,609** | (223) | 855 |
| Air traffic liability . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . | **131** | 150 | 120 |
| Other, net . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . | **(151)** | 102 | (50) |
| Net cash provided by operating activities . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . | **2,845** | 1,406 | 2,118 |
| Purchases of property and equipment, net . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . | **(1,331)** | (1,399) | (1,146) |
| Purchases of short-term investments . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . | **(5,086)** | (4,509) | (1,804) |
| Proceeds from sales of short-term investments . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . | **4,888** | 4,392 | 1,810 |
| Payment for assets of ATA Airlines, Inc. . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . | **—** | — (6) | |
| Debtor in possession loan to ATA Airlines, Inc. . . . . . . . . . . . . . . . . . . . . . . . . . . . . . | **—** | 20 | — |
| Other, net . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . | **—** | 1 | — |
| Net cash used in investing activities . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . | **(1,529)** | (1,495) | (1,146) |
| **CASH FLOWS FROM FINANCING ACTIVITIES:** |  |  |  |
| Issuance of long-term debt . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . | **500** | 300 | 300 |
| Proceeds from Employee stock plans . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . | **139** | 260 | 132 |
| Payments of long-term debt and capital lease obligations . . . . . . . . . . . . . . . . . . . . . . . . | **(122)** | (607) | (149) |
| Payments of cash dividends . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . | **(14)** | (14) | (14) |
| Repurchase of common stock . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . | **(1,001)** | (800) | (55) |
| Excess tax benefits from share-based compensation arrangements . . . . . . . . . . . . . . . . . . | **28** | 60 | 47 |
| Other, net . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . | **(23)** | — | (1) |
| Net cash provided by (used in) financing activities . . . . . . . . . . . . . . . . . . . . . . . . | **(493)** | (801) | 260 |

**NET INCREASE (DECREASE) IN CASH**

**AND CASH EQUIVALENTS** . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . **823** (890) 1,232

**CASH AND CASH EQUIVALENTS AT**

|  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- |
| **BEGINNING OF PERIOD** . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . | **1,390** |  | 2,280 |  | 1,048 |
| **CASH AND CASH EQUIVALENTS AT END OF PERIOD** . . . . . . . . . . . . . . . . . . . . . | **$ 2,213** |  | $ 1,390 |  | $ 2,280 |
| **SUPPLEMENTAL DISCLOSURES**  Cash payments for:  Interest, net of amount capitalized . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . | **$ 63** |  | $ 78 |  | $ 71 |
| Income taxes . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . | **$ 94** |  | $ 15 |  | $ 8 |

Noncash rights to airport gates acquired through reduction in debtor in possession loan to

ATA Airlines, Inc. . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . **$ —** $ — $ 20

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

**December 31, 2007**

1. **Summary of Significant Accounting Policies**

### *Basis of Presentation*

Southwest Airlines Co. (the Company or Southwest) is a major domestic airline that provides point-to-point, low-fare service. The Consolidated Financial Statements include the accounts of Southwest and its wholly owned subsidiaries. All significant intercompany balances and transactions have been eliminated. The preparation of financial statements in conformity with accounting prin- ciples generally 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.

### *Cash and Cash Equivalents*

Cash in excess of that necessary for operating requirements is invested in short-term, highly liquid, income-producing investments. Investments with matu- rities of three months or less are classified as cash and cash equivalents, which primarily consist of certificates of deposit, money market funds, and investment grade commercial paper issued by major corporations and financial institutions. Cash and cash equivalents are stated at cost, which approximates market value.

### *Short-Term Investments*

Short-term investments consist of auction rate secu- rities with auction reset periods of less than 12 months. These investments are classified as available-for-sale secu- rities and are stated at fair value. At each reset period, the Company accounts for the transaction as “Proceeds from sales of short-term investments” for the security relin- quished, and a “Purchase of short-investments” for the security purchased, in the accompanying Consolidated Statement of Cash Flows. Unrealized gains and losses, net of tax, are recognized in “Accumulated other compre- hensive income (loss)” in the accompanying Consoli- dated Balance Sheet. Realized gains and losses on specific investments, which totaled $17 million in 2007, $17 mil- lion in 2006, and $4 million in 2005, are reflected in “Interest income” in the accompanying Consolidated Income Statement.

The Company’s cash and cash equivalents and short-term investments as of December 31, 2006 and

2007, included $540 million and $2.0 billion, respec-

counterparties of the Company’s fuel derivative instru- ments. Although these amounts are not restricted in any way, the Company generally must remit the investment earnings from these amounts back to the counterparties. Depending on the fair value of the Company’s fuel derivative instruments, the amounts of collateral deposits held at any point in time can fluctuate significantly. Therefore, the Company generally excludes the cash collateral deposits in its decisions related to long-term cash planning and forecasting. See Note 10 for further information on these collateral deposits and fuel deriva- tive instruments.

### *Accounts and Other Receivables*

Accounts and other receivables are carried at cost. They primarily consist of amounts due from credit card companies associated with sales of tickets for future travel and amounts due from counterparties associated with fuel derivative instruments that have settled. The amount of allowance for doubtful accounts as of December 31, 2005, 2006 and 2007 was immaterial. In addition, the provision for doubtful accounts and write-offs for 2005, 2006, and 2007 were immaterial.

### *Inventories*

Inventories primarily consist of flight equipment expendable parts, materials, aircraft fuel, and supplies. All of these items are carried at average cost, less an allowance for obsolescence. These items are generally charged to expense when issued for use. The reserve for obsolescence was immaterial at December 31, 2005, 2006 and 2007. In addition, the Company’s provision for obsolescence and write-offs for 2005, 2006, and 2007 were immaterial.

### *Property and Equipment*

Property and equipment is stated at cost. Depreci- ation is provided 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 ser- vice. Residual values estimated for aircraft are generally 15 percent and for ground property and equipment range from zero to 10 percent. Property under capital leases and related obligations is recorded at an amount equal to the present value of future minimum lease payments com-

puted on the basis of the Company’s incremental bor-

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS — (Continued)

the lease. Amortization of property under capital leases is on a straight-line basis over the lease term and is included in depreciation expense.

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, recommendations from Boeing, the manufacturer of the Company’s aircraft, and current fair values in markets for similar used aircraft. Subsequent revisions to these esti- mates, which can be significant, could be caused by changes to the Company’s maintenance program, mod- ifications or improvements to the aircraft, changes in utilization of the aircraft (actual flight hours or cycles during a given period of time), governmental regulations on aging aircraft, changing market prices of new and used aircraft of the same or similar types, etc. The Company evaluates its estimates and assumptions each reporting period and, when warranted, adjusts these estimates and assumptions. Generally, these adjustments are accounted for on a prospective basis through depreciation and amortization expense, as required by GAAP.

When appropriate, the Company evaluates its long- lived assets used in operations for impairment. Impair- ment losses would be recorded when events and circum- stances indicate that an asset might be impaired and the undiscounted cash flows to be generated by that asset are less than the carrying amounts of the asset. Factors that would indicate potential impairment 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, operating or cash flow losses associated with the use of the long-lived asset, etc. The Company continues to experience positive cash flow and operate all of its aircraft, and there have been no signif- icant impairments of long-lived assets recorded during 2005, 2006, or 2007.

### *Aircraft and Engine Maintenance*

The cost of scheduled inspections and repairs and routine maintenance costs for all aircraft and engines are charged to maintenance expense as incurred. Modifica- tions that significantly enhance the operating perfor- mance or extend the useful lives of aircraft or engines are capitalized and amortized over the remaining life of the asset.

### *Intangible Assets*

Intangible assets primarily consist of leasehold

on a straight-line basis over the expected useful life of the lease, approximately 20 years. The accumulated amorti- zation related to the Company’s intangible assets at December 31, 2007, and 2006, was $9 million and

$5 million, respectively. The Company periodically assesses its intangible assets for impairment in accordance with SFAS 142, *Goodwill and Other Intangible Assets*; however, no impairments have been noted.

### *Revenue Recognition*

Tickets sold are initially deferred as “Air traffic liability”. Passenger revenue is recognized when trans- portation is provided. “Air traffic liability” primarily represents tickets sold for future travel dates and esti- mated refunds and exchanges of tickets sold for past travel dates. The majority of the Company’s tickets sold are nonrefundable. Tickets that are sold but not flown on the travel date (whether refundable or nonrefundable) can be reused for another flight, up to a year from the date of sale, or refunded (if the ticket is refundable). A small percentage of tickets (or partial tickets) expire unused. The Company estimates 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 many 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 included in the air traffic liability account are constantly evaluated based on sub- sequent refund and exchange activity to validate the accuracy of the Company’s revenue recognition method with respect to forfeited tickets.

Events and circumstances outside of historical fare sale activity or historical Customer travel patterns can result in actual refunds, exchanges or forfeited tickets differing significantly from estimates; however, these differences have historically not been material. Additional factors that may affect estimated refunds, exchanges, and forfeitures include, but may not be limited to, the Com- pany’s refund and exchange policy, the mix of refundable and nonrefundable fares, and fare sale activity. The Company’s estimation techniques have been consistently applied from year to year; however, as with any estimates, actual refund and exchange activity may vary from esti- mated amounts.

The Company is also required to collect certain taxes and fees from Customers on behalf of government

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS — (Continued)

governmental entity on a periodic basis. These taxes and fees include U.S. federal transportation taxes, federal security charges, and airport passenger facility charges. These items are collected from Customers at the time they purchase their tickets, but are not included in Pas- senger revenue. The Company records a liability upon collection from the Customer and relieves the liability when payments are remitted to the applicable govern- mental agency.

### *Frequent Flyer Program*

The Company records a liability for the estimated incremental cost of providing free travel under its Rapid Rewards frequent flyer program at the time an award is earned. The estimated incremental cost includes direct passenger costs such as fuel, food, and other operational costs, but does not include any contribution to overhead or profit.

The Company also sells frequent flyer credits and related services to companies participating in its Rapid Rewards frequent flyer program. Funds received from the sale of flight segment credits are accounted for under the residual value method. Under this method, the Company has determined the portion of funds received for sale of flight segment credits that relate to free travel, currently estimated at 75 percent of the amount received per flight segment credit sold. These amounts are deferred and recognized as “Passenger revenue” when the ultimate free travel awards are flown or the credits expire unused. The remaining 25 percent of the amount received per flight segment credit sold, which is assumed not to be associated with future travel, includes items such as access to the Company’s frequent flyer program population for mar- keting/solicitation purposes, use of the Company’s logo on co-branded credit cards, and other trademarks, designs, images, etc. of Southwest for use in marketing materials. This remaining portion is recognized in “Other revenue” in the period earned.

### *Advertising*

The Company expenses the costs of advertising as incurred. Advertising expense for the years ended December 31, 2007, 2006, and 2005 was $191 million,

$182 million, and $173 million, respectively.

### *Share-Based Employee Compensation*

The Company has stock-based compensation plans covering the majority of its Employee groups, including a

plans related to employment contracts with the Executive Chairman of the Company. The Company accounts for stock-based compensation utilizing the fair value recog- nition provisions of SFAS No. 123R, “Share-Based Pay- ment.” See Note 13.

### *Financial Derivative Instruments*

The Company accounts for financial derivative instruments utilizing Statement of Financial Accounting Standards No. 133 (SFAS 133), “Accounting for Deriv- ative Instruments and Hedging Activities,” as amended. The Company utilizes various derivative instruments, including crude oil, unleaded gasoline, and heating oil- based derivatives, to attempt to reduce the risk of its exposure to jet fuel price increases. These instruments primarily consist of purchased call options, collar struc- tures, and fixed-price swap agreements, and upon proper qualification are accounted for as cash-flow hedges, as defined by SFAS 133. The Company has also entered into interest rate swap agreements to convert a portion of its fixed-rate debt to floating rates. These interest rate hedges are accounted for as fair value hedges, as defined by SFAS 133.

Since the majority of the Company’s financial deriv- ative instruments are not traded on a market exchange, the Company estimates their fair values. Depending on the type of instrument, the values 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 effectiveness of the hedging instru- ments in offsetting changes to those prices, as required by SFAS 133. Forward jet fuel prices are estimated through utilization of a statistical-based regression equation with data from market forward prices of like commodities. This equation is then adjusted for certain items, such as transportation costs, that are stated in the Company’s fuel purchasing contracts with its vendors.

For the effective portion of settled hedges, as defined in SFAS 133, the Company records the associated gains or losses as a component of Fuel and oil expense in the Consolidated Statement of Income. For amounts repre- senting ineffectiveness, as defined, or changes in fair value of derivative instruments for which hedge accounting is not applied, the Company records any gains or losses as a

component of Other (gains) losses, net, in the Consol-

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS — (Continued)

received associated with the purchase or sale of financial derivative instruments (i.e., premium costs of option contracts) are classified as a component of Other (gains) losses, net, in the Consolidated Statement of Income in the period in which the instrument settles or expires. All cash flows associated with purchasing and selling deriv- atives are classified as operating cash flows in the Con- solidated Statement of Cash Flows, either as a component of changes in Other current assets or Other, net, depend- ing on whether the derivative will settle within twelve months or beyond twelve months, respectively. See Note 10 for further information on SFAS 133 and financial derivative instruments.

### *Income Taxes*

The Company accounts for deferred income taxes utilizing Statement of Financial Accounting Standards No. 109 (SFAS 109), “Accounting 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 differ- ences between the financial statements and the tax bases of assets and liabilities, as measured by current enacted tax rates. When appropriate, in accordance with SFAS 109, the Company evaluates the need for a valuation allowance to reduce deferred tax assets.

### *Concentration Risk*

A significant number of the Company’s Employees are unionized and are covered by collective bargaining agreements. The following Employee groups are under agreements that are currently amendable or will become amendable during 2008: the Company’s Pilots (became amendable in 2006, and currently in discussions on a new agreement); the Company’s Flight Attendants (becomes amendable in June 2008); the Company’s Ramp, Oper- ations, Provisioning, and Freight Agents (becomes amendable in July 2008, and began negotiations in January 2008); the Company’s Stock Clerks and Mechan- ics (both become amendable in August 2008); and the Company’s Customer Service and Reservations Agents (becomes amendable in November 2008.)

The Company attempts to minimize its concentra- tion risk with regards to its cash, cash equivalents, and its investment portfolio. This is accomplished by diversify- ing and limiting amounts among different counterparties,

the type of investment, and the amount invested in any

To manage risk associated with financial derivative instruments held, the Company selects and will period- ically review counterparties based on credit ratings, limits its exposure to a single counterparty, and monitors the market position of the program and its relative market position with each counterparty. At December 31, 2007, the Company had agreements with nine counterparties containing early termination rights and/or bilateral col- lateral provisions whereby security is required if market risk exposure exceeds a specified threshold amount or credit ratings fall below certain levels. At December 31, 2007, the Company held $2.0 billion in cash collateral deposits under these bilateral collateral provisions. These collateral deposits serve to decrease, but not totally elim- inate, the credit risk associated with the Company’s hedging program.

The Company operates an all-Boeing 737 fleet of aircraft. If the Company was unable to acquire additional aircraft from Boeing, or Boeing was unable or unwilling to provide adequate support for its products, the Company’s operations could be adversely impacted. However, the Company considers its relationship with Boeing to be good and believes the advantages of operating a single fleet type outweigh the risks of such a strategy.

## Recent Accounting Developments

In September 2006, the FASB issued statement No. 157, “Fair Value Measurements”*,* (SFAS 157). SFAS 157 defines fair value, establishes a framework for measuring fair value in accordance with accounting principles generally accepted in the United States, and expands disclosures about fair value measurements. The Company is subject to the provisions of SFAS 157 begin- ning January 1, 2008. The Company has not yet deter- mined whether SFAS 157 will have a material impact on its financial condition, results of operations, or cash flow. However, the Company believes it will likely be required to provide additional disclosures as part of future financial statements, beginning with first quarter 2008.

In February 2007, the FASB issued Statement No. 159, “The Fair Value Option for Financial Assets and Financial Liabilities” (Statement 159). Statement 159 allows entities the option to measure eligible finan- cial instruments at fair value as of specified dates. Such election, which may be applied on an instrument by instrument basis, is typically irrevocable once elected. Statement 159 is effective for fiscal years beginning after

November 15, 2007. The Company does not believe

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS — (Continued)

on its financial condition, results of operations, or cash flow.

## Acquisition of Certain Assets

In fourth quarter 2004, Southwest was selected as the winning bidder at a bankruptcy-court approved auc- tion for certain ATA Airlines, Inc. (ATA) assets. As part of the transaction, which was approved in December 2004, Southwest agreed to pay $40 million for certain ATA assets, consisting of the leasehold rights to six of ATA’s leased Chicago Midway Airport gates and the rights to a leased aircraft maintenance hangar at Chicago Midway Airport. In addition, Southwest provided ATA with $40 million in debtor-in-possession financing while ATA remained in bankruptcy, and also guaranteed the repayment of an ATA construction loan to the City of Chicago for $7 million. As part of this original transac- tion, Southwest committed, upon ATA’s emergence from bankruptcy, to convert the debtor-in-possession financing to a term loan, payable over five years, and to invest $30 million cash in ATA convertible preferred stock.

During fourth quarter 2005, ATA Airlines, Inc. (ATA) entered into an agreement in which an investor, MatlinPatterson Global Opportunities Partners II, would provide financing to enable ATA to emerge from bank- ruptcy. As part of this transaction, Southwest entered into an agreement with ATA to acquire the leasehold rights to four additional leased gates at Chicago Midway Airport in exchange for a $20 million reduction in the Company’s debtor-in-possession loan. Upon ATA’s emergence from bankruptcy, which took place on February 28, 2006,

ATA repaid the remaining $20 million balance of the debtor-in-possession financing to the Company, and provided a letter of credit to support Southwest’s obli- gation under the construction loan to the City of Chi- cago. In addition, Southwest was relieved of its commitment to purchase ATA convertible preferred stock.

Southwest and ATA also agreed on a code share arrangement, under which each carrier can exchange passengers on certain designated flights. This agreement was approved and implemented during first quarter 2005, although it has since been enhanced and adjusted.

## Commitments

The Company’s contractual purchase commitments primarily consist of scheduled aircraft acquisitions from Boeing. As of December 31, 2007, the Company had contractual purchase commitments with Boeing for 29 737-700 aircraft deliveries in 2008, 20 scheduled for

delivery in 2009, 10 each in 2010 thru 2012, and 29 thereafter. In addition, the Company has options and purchase rights for an additional 138 737-700s that it may acquire during 2009-2014. The Company has the option, which must be exercised 18 months prior to the contractual delivery date, to substitute 737-600s or 737-800s for the 737-700s. As of December 31, 2007, aggregate funding needed for firm commitments is approximately $3.2 billion, subject to adjustments for inflation, due as follows: $747 million in 2008, $498 mil- lion in 2009, $341 million in 2010, $444 million in 2011, $458 million in 2012, and $684 million thereafter.

## Accrued Liabilities

**2007 2006**

**(In millions)**

|  |  |  |  |
| --- | --- | --- | --- |
| Retirement plans (Note 14) ........................ ................. | **$ 132** |  | $ 165 |
| Aircraft rentals ................................. ................. | **125** |  | 128 |
| Vacation pay ................................... ................. | **164** |  | 151 |
| Advances and deposits (Note 10) .................... ................. | **2,020** |  | 546 |
| Deferred income taxes ............................ ................. | **370** |  | 78 |
| Other ........................................ ................. | **296** |  | 255 |
| Accrued liabilities.............................. ................. | **$3,107** |  | $1,323 |

## Revolving Credit Facility

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 unse- cured. 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

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS — (Continued)

floating rate based upon LIBOR. If the facility had been fully drawn at December 31, 2007, the spread over LIBOR would have been 62.5 basis points given South- west’s credit rating at that date. The facility also contains a financial covenant requiring a minimum coverage ratio

of adjusted pre-tax income to fixed obligations, as defined. As of December 31, 2007, the Company was in compliance with this covenant, and there were no outstanding amounts borrowed under this facility.

## Long-Term Debt

**2007 2006**

**(In millions)**

|  |  |  |  |
| --- | --- | --- | --- |
| 77⁄8% Notes due 2007 ............................. ................. | $ — |  | $ 100 |
| French Credit Agreements due 2012 .................. ................. | **32** |  | 37 |
| 61⁄2% Notes due 2012 ............................. ................. | **386** |  | 369 |
| 51⁄4% Notes due 2014 ............................. ................. | **352** |  | 336 |
| 53⁄4% Notes due 2016 ............................. ................. | **300** |  | 300 |
| 51⁄8% Notes due 2017 ............................. ................. | **311** |  | 300 |
| French Credit Agreements due 2017 .................. ................. | **94** |  | 100 |
| Pass Through Certificates .......................... ................. | **480** |  | — |
| 73⁄8% Debentures due 2027 ......................... ................. | **103** |  | 100 |
| Capital leases (Note 8) ........................... ................. | **52** |  | 63 |
|  | **2,110** |  | 1,705 |
| Less current maturities ............................ ................. | **41** |  | 122 |
| Less debt discount and issuance costs .................. ................. | **19** |  | 16 |
|  | **$2,050** |  | $1,567 |

On September 1, 2007, the Company redeemed its

$100 million senior unsecured 77⁄8% notes on their scheduled maturity date.

On October 3, 2007, grantor trusts established by the Company issued $500 million Pass Through Certif- icates consisting of $412 million 6.15% Series A certif- icates and $88 million 6.65% Series 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 in the same amounts, which were issued by Southwest on a full recourse basis. Pay- ments 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 16 Boeing 737-700 aircraft owned by Southwest and are secured by a mortgage on each aircraft. Interest on the equipment notes held for the certificates is payable semi-annually, beginning February 1, 2008. Also beginning February 1, 2008, principal payments on the equipment notes held for both series of certificates are due semi-annually until the balance of the certificates mature on August 1, 2022. The Company utilized the proceeds from the issuance of the Pass Through Certificates for general corporate pur- poses. Prior to their issuance, the Company also entered

into swap agreements to hedge the variability in interest rates on the Pass Through Certificates. The swap agree- ments were accounted for as cash flow hedges, and resulted in a payment by the Company of $20 million upon issuance of the Pass Through Certificates. The effective portion of the hedge is being amortized to interest expense concurrent with the amortization of the debt and is reflected in the above table as a reduction in the debt balance. The ineffectiveness of the hedge transaction was immaterial.

During December 2006, the Company issued

$300 million senior unsecured Notes due 2016. The notes bear interest at 5.75 percent, payable semi-annually in arrears, with the first payment made on June 15, 2007. Southwest used the net proceeds from the issuance of the notes for general corporate purposes.

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 for general corporate purposes. In January 2007, the Company entered into an interest-rate swap

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS — (Continued)

agreement to convert this fixed-rate debt to a floating rate. See Note 10 for more information on the interest-rate swap agreement.

In fourth quarter 2004, the Company entered into four identical 13-year floating-rate financing arrange- ments, whereby it borrowed a total of $112 million from French banking partnerships. Although the interest rates on the borrowings float, the Company estimates that, considering the full effect of the “net present value ben- efits” included in the transactions, the effective economic yield over the 13-year term of the loans will be approx- imately LIBOR minus 45 basis points. Principal and interest are payable semi-annually on June 30 and December 31 for each of the loans, and the Company may terminate the arrangements in any year on either of those dates, under certain conditions. The Company pledged four aircraft as collateral for the transactions.

In September 2004, the Company issued $350 million senior unsecured Notes due 2014. The notes bear interest at

5.25 percent, payable semi-annually in arrears, on April 1 and October 1. Concurrently, the Company entered into an interest-rate swap agreement 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 pro- ceeds from the issuance of the notes for general corporate purposes.

On March 1, 2002, the Company issued $385 mil- lion senior unsecured Notes due March 1, 2012. The notes bear interest at 6.5 percent, payable semi-annually on March 1 and September 1. Southwest used the net proceeds from the issuance of the notes for general corporate purposes. During 2003, the Company entered into an interest rate swap agreement relating to these notes. See Note 10 for further information.

In fourth quarter 1999, the Company entered into two identical 13-year floating rate financing arrange- ments, whereby it borrowed a total of $56 million from French banking partnerships. Although the interest rates on the borrowings float, the Company estimates that, considering the full effect of the “net present value ben- efits” included in the transactions, the effective economic

yield over the 13-year term of the loans will be approx- imately LIBOR minus 67 basis points. Principal and interest are payable semi-annually on June 30 and December 31 for each of the loans and the Company may terminate the arrangements in any year on either of those dates, with certain conditions. The Company pledged two aircraft as collateral for the transactions.

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 redemption or the sum of the present values of the remaining sched- uled payments of principal and interest thereon, dis- counted to the date of redemption at the comparable treasury rate plus 20 basis points, plus accrued interest at the date of redemption. In January 2007, the Company entered into an interest-rate swap agreement to convert this fixed-rate debt to a floating rate. See Note 10 for more information on the interest-rate swap agreement.

The Company is required to provide standby letters of credit to support certain obligations that arise in the ordinary course of business. Although the letters of credit are an off-balance sheet item, the majority of obligations to which they relate are reflected as liabilities in the Consolidated Balance Sheet. Outstanding letters of credit totaled $211 million at December 31, 2007.

The net book value of the assets pledged as collateral for the Company’s secured borrowings, primarily aircraft and engines, was $660 million at December 31, 2007.

As of December 31, 2007, aggregate annual prin- cipal maturities of debt and capital leases (not including amounts associated with interest rate swap agreements and interest on capital leases) for the five-year period ending December 31, 2012, were $40 million in 2008,

$42 million in 2009, $50 million in 2010, $44 million in 2011, $418 million in 2012, and $1.5 billion thereafter.

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS — (Continued)

1. **Leases**

The Company had nine aircraft classified as capital leases at December 31, 2007. The amounts applicable to these aircraft included in property and equipment were:

**2007 2006**

**(In millions)**

|  |  |  |
| --- | --- | --- |
| Flight equipment..... ............................................... **$168** |  | $168 |
| Less accumulated depreciation .......................................... **133** |  | 123 |
| **$ 35** |  | $ 45 |

Total rental expense for operating leases, both aircraft and other, charged to operations in 2007, 2006, and 2005 was

$469 million, $433 million, and $409 million, respectively. The majority of the Company’s terminal operations space, as well as 86 aircraft, were under operating leases at December 31, 2007. Future minimum lease payments under capital leases and noncancelable operating leases with initial or remaining terms in excess of one year at December 31, 2007, were:

**Capital Leases Operating Leases**

|  |  |  |  |  |
| --- | --- | --- | --- | --- |
|  | | | **(In millions)** |  |
| 2008 ......................................... ........ |  | $16 | $ 400 |  |
| 2009 ......................................... ........ |  | 17 | 335 |  |
| 2010 ......................................... ........ |  | 15 | 298 |  |
| 2011 ......................................... ........ |  | 12 | 235 |  |
| 2012 ......................................... ........ |  | — | 195 |  |
| After 2012 ..................................... ........ |  | — | 876 |  |
| Total minimum lease payments ...................... ........ |  | 60 | $2,339 |  |
| Less amount representing interest ..................... ........ |  | 8 |  |  |
| Present value of minimum lease payments ............... ........ |  | 52 |  |  |
| Less current portion .............................. ........ |  | 13 |  |  |
| Long-term portion ............................... ........ |  | $39 |  |  |

The aircraft leases generally can be renewed at rates based on fair market value at the end of the lease term for one to five years. Most aircraft leases have purchase options at or near the end of the lease term at fair market value, generally limited to a stated percentage of the lessor’s defined cost of the aircraft.

## Project Early Departure

Project Early Departure was a voluntary early retire- ment program offered in July 2007 to eligible Employees, in which the Company offered a cash bonus of $25,000 plus medical/dental continuation coverage and travel privileges based on eligibility.

A total of 608 out of approximately 8,500 eligible Employees elected to participate in the program. The number of Employees from each group that accepted the package is as follows: 395 from Reservations, 165 from Ground Operations, 41 from Inflight and seven from

Provisioning. The participants’ last day of work falls between September 30, 2007 and April 30, 2008, based on the operational needs of particular work locations and departments. The Company did not have a target or expectation for the number of Employees expected to accept the package.

Project Early Departure resulted in a pre-tax, pre- profitsharing, one-time charge of approximately $25 mil- lion during third quarter 2007, all of which is reflected in “Salaries, wages and benefits” in the accompanying Con- solidated Statement of Income. Approximately $14 mil- lion remained to be paid and is recorded as an accrued liability in the accompanying Consolidated Balance Sheet as of December 31, 2007. The Company will continue to address future staffing needs, but currently anticipates that the majority of the positions will be filled with entry- level Employees at lower wage rates to meet operational demands. The purpose of this voluntary initiative and

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS — (Continued)

other initiatives is to help the Company reduce future operating costs.

## Derivative and Financial Instruments

### *Fuel Contracts*

Airline operators are inherently dependent upon energy to operate and, therefore, are impacted by changes in jet fuel prices. Jet fuel and oil consumed during 2007, 2006, and 2005 represented approximately 28.0 percent,

26.2 percent, and 19.6 percent of Southwest’s operating expenses, respectively. The primary reason that fuel and oil has become an increasingly large portion of the Company’s operating expenses has been due to the dra- matic increase in all energy prices over this period. The Company endeavors to acquire jet fuel at the lowest possible cost. Because jet fuel is not traded on an orga- nized futures exchange, there are limited opportunities to hedge directly in jet fuel. However, the Company has found that financial derivative instruments in other com- modities, such as crude oil, and refined products such as heating oil and unleaded gasoline, can be useful in decreasing its exposure to jet fuel price increases. The Company does not purchase or hold any derivative finan- cial instruments for trading purposes.

The Company has utilized financial derivative instruments for both short-term and long-term time frames. In addition to the significant protective fuel derivative positions the Company had in place during 2007, the Company also has significant future positions. The Company currently has a mixture of purchased call options, collar structures, and fixed price swap agree- ments in place to protect against over 70 percent of its 2008 total anticipated jet fuel requirements at average crude oil equivalent prices of approximately $51 per barrel, and has also added refinery margins on most of those positions. Based on current growth plans, the Company also has fuel derivative contracts in place for over 55 percent of its expected fuel consumption for 2009 at approximately $51 per barrel, nearly 30 percent for 2010 at approximately $63 per barrel, over 15 percent for 2011 at $64 per barrel, and over 15 percent in 2012 at

$63 per barrel.

Upon proper qualification, the Company endeavors to account for its fuel derivative instruments as cash flow hedges, as defined in Statement of Financial Accounting Standards No. 133, *Accounting for Derivative Instru- ments and Hedging Activities*, as amended (SFAS 133). Under SFAS 133, all derivatives designated as hedges that meet certain requirements are granted special hedge

accounting treatment. Generally, utilizing the special hedge accounting, all periodic changes in fair value of the derivatives designated as hedges that are considered to be effective, as defined, are recorded in “Accumulated other comprehensive income” until the underlying jet fuel is consumed. See Note 11 for further information on Accumulated other comprehensive income. The Com- pany is exposed to the risk that periodic changes will not be effective, as defined, or that the derivatives will no longer qualify for special hedge accounting. Ineffective- ness, as defined, results when the change in the fair value of the derivative instrument exceeds the change in the value of the Company’s expected future cash outlay to purchase and consume jet fuel. To the extent that the periodic changes in the fair value of the derivatives are not effective, that ineffectiveness is recorded to Other gains and losses in the income statement. Likewise, if a hedge ceases to qualify for hedge accounting, any change in the fair value of derivative instruments since the last period is recorded to Other gains and losses in the income state- ment in the period of the change; however, in accordance with SFAS 133, any amounts previously recorded to Accumulated other comprehensive income would remain there until such time as the original forecasted transaction occurs, then would be reclassified to Fuel and oil expense. In a situation where it becomes probable that a hedged forecasted transaction will not occur, any gains and/or losses that have been recorded to Accumulated other comprehensive income would be required to be immedi- ately reclassified into earnings. The Company did not have any such situations occur in 2005, 2006, or 2007.

Ineffectiveness is inherent in hedging jet fuel with derivative positions based in other crude oil related com- modities, especially given the magnitude of the current fair market value of the Company’s fuel derivatives and the recent volatility in the prices of refined products. Due to the volatility in markets for crude oil and related products, the Company is unable to predict the amount of ineffectiveness each period, including the loss of hedge accounting, which could be determined on a derivative by derivative basis or in the aggregate for a specific com- modity. This may result, and has resulted, in increased volatility in the Company’s results. The significant increase in the amount of hedge ineffectiveness and unrealized gains and losses on derivative contracts settling in future periods recorded during the past few years has been due to a number of factors. These factors included: the significant fluctuation in energy prices, the number of derivative positions the Company holds, significant weather events that have affected refinery capacity and

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## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS — (Continued)

the production of refined products, and the volatility of the different types of products the Company uses for protection. The number of instances in which the Com- pany has discontinued hedge accounting for specific hedges and for specific refined products, such as unleaded gasoline, has increased recently, primarily due to these

Realized ineffectiveness and mark-to-market (gains) or losses — included in Other

**2007 2006 2005**

**(In millions)**

reasons. In these cases, the Company has determined that the hedges will not regain effectiveness in the time period remaining until settlement and therefore must discon- tinue special hedge accounting, as defined by SFAS 133. When this happens, any changes in fair value of the derivative instruments are marked to market through earnings in the period of change. However, even though these derivatives may not qualify for SFAS 133 special hedge accounting, the Company continues to hold the instruments as it believes they continue to represent good “economic hedges” in its goal to minimize jet fuel costs. As the fair value of the Company’s hedge positions can fluctuate significantly in amount from period to period, it is more probable that there will be continued variability recorded in the income statement and that the amount of hedge ineffectiveness and unrealized gains or losses for changes in value of the derivatives recorded in future periods will be material. This is primarily due to the fact that small differences in the correlation of crude oil related products are leveraged over large dollar volumes.

All cash flows associated with purchasing and selling derivatives are classified as operating cash flows in the Consolidated Statement of Cash Flows, either as a com- ponent of changes in Other current assets or Other, net, depending on whether the derivative will settle within twelve months or beyond twelve months, respectively. The following table presents the location of pre-tax gains and/or losses on derivative instruments within the Con- solidated Statement of Income.

**2007 2006 2005**

**(In millions)**

Fuel hedge (gains) included in Fuel and

oil expense ......... **$(686)** $(634) $(892)

Mark-to-market impact from fuel contracts settling in future periods — included in Other (gains) losses,

net .............. **(219)** 42 (77)

Ineffectiveness from fuel hedges settling in future periods — included in Other

(gains) losses, net . . . **(51)** 39 (9)

(gains) losses, net . . . **(90)** 20 (24)

Premium cost of fuel contracts included in Other (gains) losses,

net .............. **58** 52 35

Also, the following table presents the fair values of the Company’s remaining derivative instruments, receiv- able amounts from settled/expired derivative contracts, and the amounts of unrealized gains, net of tax, in Accumulated other comprehensive income related to fuel hedges within the Consolidated Balance Sheet.

**2007 2006**

**(In millions)**

Fair value of current fuel contracts

(Fuel derivative contracts) ..... **$1,069** $369 Fair value of noncurrent fuel

contracts (Other assets) ....... **1,318** 630

Due from third parties for settled fuel contracts (Accounts and

other receivables) ............ **109** 42

Net unrealized gains from fuel hedges, net of tax (Accumulated

other comprehensive income) . . . **1,221** 584

The fair value of the derivative instruments, depend- ing on the type of instrument, was 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. Included in the above total net unrealized gains from fuel hedges as of Decem- ber 31, 2007, are approximately $556 million in net unrealized gains that are expected to be realized in earnings during 2008. In addition, as of December 31, 2007, the Company had already recognized gains due to ineffectiveness and derivatives that do not qualify for hedge accounting totaling $180 million, net of taxes. These gains were recognized in 2007 and prior periods, and are reflected in Retained earnings as of December 31, 2007, but the underlying derivative instruments will not expire/settle until 2008 or future periods.

### *Interest Rate Swaps*

During first quarter 2007, the Company executed interest rate swap agreements relating to its $300 million

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## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS — (Continued)

5.125% senior unsecured notes due 2017 and its

$100 million 7.375% senior unsecured debentures due 2027. Under the agreement related to its $300 million 5.125% senior unsecured notes due 2017, the average floating rate paid during 2007 was 4.64 percent. Under the agreement related to its $100 million 7.375% senior unsecured debentures due 2027, the average floating rate paid during 2007 was 6.73 percent.

Prior to 2007, the Company had entered into interest rate swap agreements relating to its $385 million 6.5% senior unsecured notes due 2012 and its $350 mil- lion 5.25% senior unsecured notes due 2014. Under each of these interest rate swap agreements, the Company pays the London InterBank Offered Rate (LIBOR) plus a margin every six months on the notional amount of the debt, and receives payments based on the fixed stated rate of the notes every six months until the date the notes become due. Under the agreement related to its $385 mil- lion 6.5% senior unsecured notes due 2012, the average floating rate paid during 2007 is estimated to be 7.31 per- cent based on actual and forward rates at December 31, 2007. Under the agreement related to its $350 million 5.25% senior unsecured notes due 2014, the average floating rate paid during 2007 was 6.02 percent.

The primary objective for the Company’s use of interest rate hedges is to reduce the volatility of net interest income by better matching the repricing of its assets and liabilities. The Company’s interest rate swap agreements qualify as fair value hedges, as defined by SFAS 133. The fair values of the interest rate swap agreements, which are adjusted regularly, are recorded in the Consolidated Balance Sheet, as necessary, with a corresponding adjustment to the carrying value of the long-term debt. The fair value of the interest rate swap agreements, excluding accrued interest, at December 31, 2007, was an asset of approximately $16 million and is recorded in “Other deferred liabilities” in the Consoli- dated Balance Sheet. In accordance with fair value hedg- ing, the offsetting entry is an adjustment to increase the carrying value of long-term debt. See Note 7.

Outstanding financial derivative instruments expose the Company to credit loss in the event of nonperfor- mance by the counterparties to the agreements. However, the Company does not expect any of the counterparties to fail to meet its obligations. The credit exposure related to

these financial instruments is represented by the fair value of contracts with a positive fair value at the reporting date. To manage credit risk, the Company selects and period- ically reviews counterparties based on credit ratings, limits its exposure to a single counterparty, and monitors the market position of the program and its relative market position with each counterparty. At December 31, 2007, the Company had agreements with nine counterparties containing early termination rights and/or bilateral col- lateral provisions whereby security is required if market risk exposure exceeds a specified threshold amount or credit ratings fall below certain levels. At December 31, 2007, the Company held $2.0 billion in fuel hedge related cash collateral deposits under these bilateral col- lateral provisions. These collateral deposits serve to decrease, but not totally eliminate, the credit risk asso- ciated with the Company’s hedging program. The cash deposits, which can have a significant impact on the Company’s cash balance and cash flows as of and for a particular operating period, are included in “Accrued liabilities” on the Consolidated Balance Sheet and are included as “Operating cash flows” in the Consolidated Statement of Cash Flows.

The carrying amounts and estimated fair values of the Company’s long-term debt and fuel contracts at December 31, 2007 were as follows:

**Carrying Estimated Fair**

**Value Value**

**(In millions)**

|  |  |  |  |  |
| --- | --- | --- | --- | --- |
| French Credit Agreem due 2012 ....... | ents  ..... | $ | 32 | $ 32 |
| 61⁄2% Notes due 2012 386 | | | | 402 |
| 51⁄4% Notes due 2014 | ..... | | 352 | 342 |
| 53⁄4% Notes due 2016 | ..... | | 300 | 295 |
| 51⁄8% Notes due 2017 | ..... | | 311 | 291 |
| French Credit Agreem | ents | |  |  |
| due 2017 ............ | | 94 | | 94 |
| Pass Through Certificates. . . | | 480 | | 487 |
| 73⁄8% Debentures due 2027. . | | 103 | | 105 |
| Fuel contracts ........... | | 2,387 | | 2,387 |

The estimated fair values of the Company’s publicly held long-term debt were based on quoted market prices. The carrying values of all other financial instruments approximate their fair value.

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## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS — (Continued)

1. **Comprehensive Income**

Comprehensive income includes changes in the fair value of certain financial derivative instruments, which qualify for hedge accounting, unrealized gains and losses on certain investments, and adjustments to recognize the funded status of the Company’s postretirement obligations. See Note 14 for further information on Employee retirement plans. Comprehensive income totaled $1,304 million, $189 million, and $959 million for 2007, 2006, and 2005, respectively. The differences between “Net income” and “Comprehensive income” for these years are as follows:

|  |  |  |  |  |
| --- | --- | --- | --- | --- |
|  | **2007** | **2006** | | **2005** |
|  | **(In millions)** | |  |
| **Net income**.............................................. . | **$ 645** | $ 499 | | $484 |
| Unrealized gain (loss) on derivative |  |  | |  |
| instruments, net of deferred taxes of $408, ($201) and $300 ....... . | **636** |  | (306) | 474 |
| Other, net of deferred taxes of $14, ($2) and $1 ................. . | **23** |  | (4) | 1 |
| Total other comprehensive income (loss) ....................... . | **659** |  | (310) | 475 |
| **Comprehensive income** ..................................... . | **$1,304** |  | $ 189 | $959 |

A rollforward of the amounts included in “Accumulated other comprehensive income (loss)”, net of taxes for 2007, 2006, and 2005, is shown below:

**Fuel Hedge**

**Derivatives Other**

**Accumulated Other Comprehensive Income (Loss)**

|  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- |
|  | | | | **(In millions)** |  |
| Balance at December 31, 2005 ..................... .... |  | $ 890 |  | $ 2 | $ 892 |
| 2006 changes in fair value ........................ .... |  | 52 |  | (4) | 48 |
| Reclassification to earnings........................ .... |  | (358) |  | — | (358) |
| Balance at December 31, 2006 ..................... .... |  | 584 |  | (2) | 582 |
| **2007 changes in fair value** ....................... .... |  | **1,039** |  | **23** | **1,062** |
| **Reclassification to earnings** ....................... .... |  | **(403)** |  | **—** | **(403)** |
| **Balance at December 31, 2007** .................... .... |  | **$1,220** |  | **$21** | **$1,241** |

## Common Stock

The Company has one class of capital stock, its common stock. Holders of shares of common stock are entitled to receive dividends when and if declared by the Board of Directors and are entitled to one vote per share on all matters submitted to a vote of the shareholders. At December 31, 2007, the Company had 82 million shares of common stock reserved for issuance pursuant to Employee stock benefit plans (of which 32 million shares had not been granted.)

In January 2004, the Company’s Board of Directors 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 21 million of its common shares during the course of the program.

In 2006, the Company’s Board of Directors autho- rized three separate programs for the repurchase of up to a total of $1.0 billion of the Company’s common stock —

$300 million authorized in January 2006, $300 million authorized in May 2006, and $400 million authorized in November 2006. 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. These programs, which were com- pleted during first quarter 2007, resulted in the repur- chase of a total of approximately 63 million shares.

In 2007, the Company’s Board of Directors autho- rized two separate programs for the repurchase of up to a total of $800 million of the Company’s common stock —

$300 million authorized in March 2007, and $500 mil- lion authorized in May 2007. Repurchases were made in

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## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS — (Continued)

accordance with applicable securities laws in the open market or in private transactions from time to time, depending on market conditions. These programs, which were completed during third quarter 2007, resulted in the repurchase of a total of approximately 53 million shares.

During January 2008, the Company’s Board of Directors authorized an additional program for the repur- chase of up to $500 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.

## Stock Plans

### *Share-Based Compensation*

The Company has share-based compensation plans covering the majority of its Employee groups, including plans adopted via collective bargaining, a plan covering the Company’s Board of Directors, and plans related to employment contracts with the Executive Chairman of the Company. Effective January 1, 2006, the Company adopted the fair value recognition provisions of SFAS No. 123R, “Share-Based Payment” using the modified retrospective transition method. Among other items, SFAS 123R eliminated the use of APB 25 and the intrinsic value method of accounting, and requires rec- ognition of the cost of Employee services received in exchange for awards of equity instruments, based on the grant date fair value of those awards, in the financial statements.

Under the modified retrospective method, compen- sation cost is recognized in the financial statements beginning with the effective date, based on the require- ments of SFAS 123R for all share-based payments granted after that date, and based on the requirements of SFAS 123 for all unvested awards granted prior to the effective date of SFAS 123R. In addition, results for prior periods were retrospectively adjusted in first quarter 2006 utilizing the pro forma disclosures in those prior financial statements, except as noted. The Consolidated Statement of Income for the years ended December 31, 2007, 2006, and 2005 reflects share-based compensation cost of

$37 million, $80 million, and $80 million, respectively. The total tax benefit recognized from share-based com- pensation arrangements for the years ended December 31, 2007, 2006, and 2005, was $11 million, $27 million, and

$25 million, respectively. As a result of the SFAS 123R retroactive application, for the year ended December 31, 2005, net income was reduced by $55 million, net income

per share, basic was reduced by $.08, and net income per share, diluted was reduced by $.06.

### *Stock Plans*

The Company has stock plans covering Employees subject to collective bargaining agreements (collective bargaining plans) and stock plans covering Employees not subject to collective bargaining agreements (other Employee plans). None of the collective bargaining plans were required to be approved by shareholders. Options granted to Employees under collective bargaining plans are non-qualified, granted at or above the fair market value of the Company’s Common Stock on the date of grant, and generally have terms ranging from six to twelve years. Neither Executive Officers nor members of the Company’s Board of Directors are eligible to participate in any of these collective bargaining plans. Options granted to Employees through other Employee plans are both qualified as incentive stock options under the Internal Revenue Code of 1986 and non-qualified stock options, granted at no less than the fair market value of the Company’s Common Stock on the date of grant, and have ten-year terms. All of the options included under the heading of “Other Employee Plans” have been approved by shareholders, except the plan covering non-manage- ment, non-contract Employees, which had options out- standing to purchase 5 million shares of the Company’s Common Stock as of December 31, 2007. The Company also has plans related to past employment agreements with its current Executive Chairman. As of December 31, 2007, there were 556,000 options outstanding under these plans, all of which were fully vested. Although the Company does not have a formal policy, upon option exercise, the Company will typically issue treasury stock, to the extent such shares are available.

Vesting terms for the collective bargaining plans differ based on the grant made, and have ranged in length from immediate vesting to vesting periods in accordance with the period covered by the respective collective bar- gaining agreement. For “Other Employee Plans,” options vest and generally become fully exercisable over three, five, or ten years of continued employment, depending upon the grant type. For grants in any of the Company’s plans that are subject to graded vesting over a service period, Southwest recognizes expense on a straight-line basis over the requisite service period for the entire award. None of the Company’s grants include performance-based or market-based vesting conditions, as defined.

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS — (Continued)

The fair value of each option grant is estimated on the date of grant using a modified Black-Scholes option pricing model. The following weighted-average assumptions were used for grants made under the fixed option plans for the current and prior years:

|  |  |  |  |
| --- | --- | --- | --- |
|  | **2007** | **2006** | **2005** |
| Weighted-average risk-free interest rate ............................... | **3.7%** | 4.6% | 4.1% |
| Expected life of option (years) ..................................... | **4.9** | 5.0 | 4.7 |
| Expected stock volatility.......................................... | **25.7%** | 26.0% | 26.2% |
| Expected dividend yield .......................................... | **0.09%** | 0.07% | 0.09% |

The Black-Scholes option valuation model was developed for use in estimating the fair value of short- term traded options that have no vesting restrictions and are fully transferable. In addition, option valuation models require the input of somewhat subjective assumptions including expected stock price volatility. For 2007 and 2006, the Company has relied on observations of both historical volatility trends as well as implied future vol- atility observations as determined by independent third parties. For both 2007 and 2006 stock option grants, the Company utilized expected volatility based on the expected life of the option, but within a range of 24 per- cent to 27 percent. Prior to 2006, the Company relied exclusively on historical volatility as an input for deter- mining the estimated fair value of stock options. In determining the expected life of the option grants, the Company has observed the actual terms of prior grants with similar characteristics, the actual vesting schedule of

the grant, and assessed the expected risk tolerance of different optionee groups. The risk-free interest rates used, which were actual U.S. Treasury zero-coupon rates for bonds matching the expected term of the option as of the option grant date, ranged from .50 percent to

5.37 percent for the year ended December 31, 2007, from 4.26 percent to 5.24 percent for 2006, and from

3.37 percent to 4.47 percent for 2005.

The fair value of options granted under the fixed option plans during the year ended December 31, 2007, ranged from $0.67 to $6.33, with a weighted-average fair value of $4.28. The fair value of options granted under the fixed option plans during 2006 ranged from $2.48 to

$6.99, with a weighted-average fair value of $5.47. The fair value of options granted under the fixed option plans during 2005 ranged from $2.90 to $6.79, with a weighted-average fair value of $4.49.

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

**Collective Bargaining Plans**

|  |  |  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- | --- | --- |
|  | **Options (000)** |  | **Wtd. Average Exercise Price** |  | **Wtd. Average Remaining Contractual Term** |  | **Aggregate Intrinsic Value (Millions)** |
| Outstanding December 31, 2004 .......... | 120,703 |  | $10.98 |  |  |  |  |
| Granted .......................... | 1,697 |  | 14.91 |  |  |  |  |
| Exercised ......................... | (14,739) |  | 6.13 |  |  |  |  |
| Surrendered ....................... | (2,417) |  | 13.89 |  |  |  |  |
| Outstanding December 31, 2005 .......... | 105,244 |  | $11.65 |  |  |  |  |
| Granted .......................... | 1,025 |  | 16.64 |  |  |  |  |
| Exercised ......................... | (24,632) |  | 7.91 |  |  |  |  |
| Surrendered ....................... | (1,427) |  | 14.25 |  |  |  |  |
| Outstanding December 31, 2006 .......... | 80,210 |  | $12.83 |  |  |  |  |
| Granted .......................... | 751 |  | 14.89 |  |  |  |  |
| Exercised ......................... | (14,145) |  | 7.17 |  |  |  |  |
| Surrendered ....................... | (3,440) |  | 16.11 |  |  |  |  |
| Outstanding December 31, 2007 .......... | 63,376 |  | $13.93 |  | 3.8 |  | $2 |
| Vested or expected to vest at December 31, 2007 ............................ | 63,254 |  | $13.93 |  | 3.8 |  | $2 |
| Exercisable at December 31, 2007 ......... | 62,442 |  | $13.92 |  | 3.8 |  | $2 |

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS — (Continued)

**Other Employee Plans**

**Wtd. Average**

**Options (000)**

**Wtd. Average Exercise Price**

**Remaining Contractual Term**

**Aggregate Intrinsic Value (Millions)**

Outstanding December 31, 2004 .......... 34,221 $12.94

Granted .......................... 6,662 15.60

Exercised ......................... (3,800) 7.09

Surrendered ....................... (1,263) 15.60

Outstanding December 31, 2005 .......... 35,820 $13.96

Granted .......................... 2,831 17.52

Exercised ......................... (5,015) 9.57

Surrendered ....................... (1,442) 15.93

Outstanding December 31, 2006 .......... 32,194 $14.87

Granted .......................... 293 16.35

Exercised ......................... (2,506) 8.45

Surrendered ....................... (1,454) 16.49

Outstanding December 31, 2007 .......... 28,527 $15.37 4.9 $8

Vested or expected to vest at December 31,

2007 ............................ 28,407 $15.36 4.9 $7

Exercisable at December 31, 2007 ......... 20,777 $15.29 4.6 $6

The total aggregate intrinsic value of options exer- cised during the years ended December 31, 2007, 2006, and 2005, was $137 million, $262 million, and $179 mil- lion, respectively. The total fair value of shares vesting during the years ended December 31, 2007, 2006, and 2005, was $64 million, $112 million, and $96 million, respectively. As of December 31, 2007, there was

$37 million of total unrecognized compensation cost related to share-based compensation arrangements, which is expected to be recognized over a weighted- average period of 2.25 years. The total recognition period for the remaining unrecognized compensation cost is approximately eight years; however, the majority of this cost will be recognized over the next two years, in accordance with vesting provisions.

### *Employee Stock Purchase Plan*

Under the amended 1991 Employee Stock Purchase Plan (ESPP), which has been approved by shareholders, the Company is authorized to issue up to a remaining balance of 6.5 million shares of Common Stock to Employees of the Company. These shares may be issued at a price equal to 90 percent of the market value at the end of each monthly purchase period. Common Stock purchases are paid for through periodic payroll deduc- tions. For the years ended December 31, 2007, 2006, and 2005, participants under the plan purchased 1.3 million

shares, 1.2 million shares, and 1.5 million shares at average prices of $13.30, $14.86, and $13.19, respec- tively. The weighted-average fair value of each purchase right under the ESPP granted for the years ended Decem- ber 31, 2007, 2006, and 2005, which is equal to the ten percent discount from the market value of the Common Stock at the end of each monthly purchase period, was

$1.48, $1.65, and $1.47, respectively.

### *Non-Employee Director Grants and Incentive Plan*

Upon initial election to the Board, non-Employee Directors receive a one-time option grant to purchase 10,000 shares of Southwest Common Stock at the fair market value of such stock on the date of the grant. These grants are made out of one of the Company’s plans covering Employees not subject to collective bargaining agreements (other Employee plans). Stock option grants to the Board become exercisable over a period of three years from the grant date and have a term of 10 years.

In 2001, the Board adopted the Southwest Airlines Co. Outside Director Incentive Plan. The purpose of the plan is to align more closely the interests of the non- Employee Directors with those of the Company’s Share- holders and to provide the non-Employee Directors with retirement income. To accomplish this purpose, the plan compensates each non-Employee Director based on the

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS — (Continued)

performance of the Company’s Common Stock and defers the receipt of such compensation until after the non- Employee Director ceases to be a Director of the Company. Pursuant to the plan, on the date of the 2002 Annual Meeting of Shareholders, the Company granted 750 non- transferable Performance Shares to each non-Employee Director who had served as a Director since at least May 2001. Thereafter, on the date of each Annual Meeting of Shareholders, the Company granted 750 Performance Shares to each non-Employee Director who has served since the previous Annual Meeting. Effective beginning with the 2007 Annual Meeting, the plan was amended to increase the annual number of Performance Shares to be granted to 1,000. A Performance Share is a unit of value equal to the Fair Market Value of a share of Southwest Common Stock, based on the average closing sale price of the Common Stock as reported on the New York Stock Exchange during a specified period. On the 30th calendar day following the

date a non-Employee Director ceases to serve as a Director of the Company for any reason, Southwest will pay to such former non-Employee Director an amount equal to the Fair Market Value of the Common Stock during the 30 days preceding such last date of service multiplied by the number of Performance Shares then held by such Director. The plan contains provisions contemplating adjustments on changes in capitalization of the Company. The Company accounts for grants made under this plan as liability awards, as defined, and since the awards are not stock options, they are not reflected in the above tables. The fair value of the awards as of December 31, 2007, which is not material to the Company, is included in Accrued liabilities in the accompanying Consolidated Balance Sheet.

### *Taxes*

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

## Employee Retirement Plans

### *Defined Contribution Plans*

The Company has defined contribution plans covering substantially all Southwest Employees. The Southwest Airlines Co. Profit Sharing Plan (Profit Sharing Plan) is a money purchase defined contribution plan and Employee stock purchase plan. However, the Profit Sharing Plan was amended as of January 1, 2008, and is now characterized as simply a Profit Sharing Plan. The Company contributes 15 percent of its eligible pre-tax profits, as defined, to the Profit Sharing Plan on an annual basis. No Employee contributions to the Profit Sharing Plan are allowed.

The Company also sponsors Employee savings plans under section 401(k) of the Internal Revenue Code, which include Company matching contributions. The 401(k) plans cover substantially all Employees. Contri- butions under all defined contribution plans are primarily based on Employee compensation and performance of the Company.

Company contributions to all retirement plans expensed in 2007, 2006, and 2005 were $279 million,

$301 million, and $264 million, respectively.

### *Postretirement Benefit Plans*

The Company provides postretirement benefits to qualified retirees in the form of medical and dental cov- erage. Employees must meet minimum levels of service and age requirements as set forth by the Company, or as specified in collective bargaining agreements with spe- cific workgroups. Employees meeting these require- ments, as defined, may use accrued unused sick time to pay for medical and dental premiums from the age of retirement until age 65.

The following table shows the change in the Com- pany’s accumulated postretirement benefit obligation (APBO) for the years ended December 31, 2007 and 2006:

**2007 2006**

**(In millions)**

APBO at beginning of period ..... . $111 $ 94 Service cost ................ . 16 15

Interest cost ................ . 6 5

Benefits paid ............... . (6) (5)

Actuarial (gain) loss .......... . (39) 2

Plan amendments ............ . — —

APBO at end of period .......... . $ 88 $111

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS — (Continued)

The assumed healthcare cost trend rates have a significant effect on the amounts reported for the Com- pany’s plan. A one-percent change in all healthcare cost trend rates used in measuring the APBO at December 31, 2007, would have the following effects:

**1% Increase 1% Decrease (In millions)**

Increase (decrease) in total service and interest

costs ............... $2 $(2)

Increase (decrease) in the

APBO .............. $7 $(6)

the offset to accumulated other comprehensive income. This actuarial gain is included above and resulted from Congress’ passage of a law to increase the mandatory retirement age for

U.S. commercial airline pilots from 60 to 65, effective immediately. Therefore, since the Company projects that some of its Pilots will now work past age 60, this assumption resulted in a decrease to the Company’s projected future postretirement obligation.

The Company’s periodic postretirement benefit cost for the years ended December 31, 2007, 2006, and 2005, included the following:

each of the next five years are $6 million in 2008,

|  |  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- | --- |
|  | | **2007** | **2006** | | | **2005** |
| The Company’s plans are unfunded, and benefits are |  |  | **(In millions)** | | |  |
| paid as they become due. For 2007, both benefits paid | Service cost ............... | **$16** | $15 | | | $12 |
| and Company contributions to the plans were each Interest cost............... | | **6** | 5 | | | 4 |
| $6 million. For 2006, both benefits paid and Company Amortization of prior service  contributions to the plans were each $5 million. Esti- cost . . . ................ | | **2** | 2 | | | 2 |
| mated future benefit payments expected to be paid for Recognized actuarial loss...... | | — | (1) | | | — |
| $7 million in 2009, $8 million in 2010, $9 million in Net periodic postretirement | |  |  | | |  |
| 2011, $10 million in 2012, and $80 million for the next | benefit cost ............. | **$24** |  | $21 |  | $18 |
| five years thereafter. |  |  |  |  |  |  |

On December 31, 2006, the Company adopted the recognition and disclosure provisions of SFAS 158. SFAS 158 requires the Company to recognize the funded status (i.e., the difference between the fair value of plan assets and the projected benefit obligations) of its benefit plans in the Consolidated Balance Sheet, with a corre- sponding adjustment to accumulated other comprehen- sive income, net of tax. The following table reconciles the funded status of the plan to the Company’s accrued postretirement benefit cost recognized in “Other deferred liabilities” on the Company’s Consolidated Balance Sheet at December 31, 2007 and 2006.

**2007 2006**

**(In millions)**

Funded status ...... ........... $(88) $(111) Unrecognized net actuarial (gain)

loss ........... ........... (31) 7

Unrecognized prior service cost .... 3 4

Accumulated other comprehensive

income (loss) .... ........... 28 (11)

Cost recognized on Consolidated

Balance Sheet .... ........... $(88) $(111)

During 2007, the Company recorded a $31 million actuarial gain as a decrease to the recognized obligation with

Unrecognized prior service cost is expensed using a straight-line amortization of the cost over the average future service of Employees expected to receive benefits under the plan. The Company used the following actu- arial assumptions to account for its postretirement benefit plans at December 31:

|  |  |  |  |
| --- | --- | --- | --- |
|  | **2007** | **2006** | **2005** |
| Wtd-average discount rate .... | **5.75%** | 5.50% | 5.25% |
| Assumed healthcare cost trend rate(1) ............... | **8.00%** | 8.50% | 8.50% |

(1) The assumed healthcare cost trend rate is assumed to decline to 7.50% for 2008, then decline gradually to 5% by 2014 and remain level thereafter.

The selection of a discount rate is made annually and is selected by the Company based upon comparison of the expected cash flows associated with the Company’s future payments under its postretirement obligations to a hypo- thetical bond portfolio created using high quality bonds that closely match those expected cash flows. The assumed healthcare trend rate is also reviewed at least annually and is determined based upon both historical experience with the Company’s healthcare benefits paid and expectations of how those trends may or may not change in future years.

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS — (Continued)

1. **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, 2007 and 2006, are as follows:

## DEFERRED TAX LIABILITIES:

**2007 2006**

**(In millions)**

Accelerated depreciation ......................... ................. **$2,612** $2,405

Fuel hedges .................................. ................. **884** 363

Other ...................................... ................. **19**  1

Total deferred tax liabilities ................... ................. **3,515** 2,769

## DEFERRED TAX ASSETS:

Deferred gains from sale and leaseback of aircraft ....... ................. **65** 70

Capital and operating leases ...................... ................. **58** 65

Accrued employee benefits ....................... ................. **187** 160

Stock-based compensation ........................ ................. **110** 122

State taxes ................................... ................. **75** 55

Business partner income ......................... ................. **78** 37

Net operating loss carry forward ................... ................. **—** 22

Other ...................................... ................. **37**  56

Total deferred tax assets ....................... ................. **610** 587

Net deferred tax liability ....................... ................. **$2,905** $2,182 The provision for income taxes is composed of the following:

|  |  |  |  |  |
| --- | --- | --- | --- | --- |
|  | **2007 2006** | | | **2005** |
| **(In millions)** | | |  |
| **CURRENT:**  Federal ........................ .......................... | **$108** $ 64 | | | $ 43 |
| State .......................... .......................... | **9** 15 | | | 7 |
| Total current .................. .......................... | **117** 79 | | | 50 |
| Federal ........................ .......................... | **246** |  | 220 | 231 |
| State .......................... .......................... | **50** |  | (8) | 14 |
| Total deferred .................. .......................... | **296** |  | 212 | 245 |
|  | **$413** |  | $291 | $295 |

## DEFERRED:

For the year 2004, Southwest had a tax net oper- ating loss of $616 million for federal income tax purposes. The Company carried a portion of this net operating loss back to prior periods, resulting in a $35 million refund of federal taxes previously paid. This refund was received during 2005. The Company applied a portion of this

2004 net operating loss to the 2005 and 2006 tax years, resulting in the payment of no regular federal income taxes for these years. The remaining portion of the Company’s federal net operating loss was utilized during 2007.

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS — (Continued)

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

**2007 2006 2005**

|  |  |  |
| --- | --- | --- |
|  | **(In millions)** |  |
| Tax at statutory U.S. tax rates .......... .......................... **$370** | $276 | $274 |
| Nondeductible items ................. .......................... **6** | 10 | 8 |
| State income taxes, net of federal benefit **38** | 4 | 14 |
| Other, net ........................ .......................... **(1)** 1 | | (1) |
| Total income tax provision........... .......................... **$413** | $291 | $295 |

In July 2006, the Financial Accounting Standards Board (FASB) issued FASB Interpretation No. 48, “Accounting for Uncertainty in Income Taxes — an interpretation of FASB Statement No. 109” (FIN 48), which clarifies the accounting and disclosure for uncer- tainty in tax positions, as defined. FIN 48 seeks to reduce the diversity in practice associated with certain aspects of the recognition and measurement related to accounting for income taxes. The Company is subject to the provi- sions of FIN 48 as of January 1, 2007, and has analyzed filing positions in all of the federal and state jurisdictions where it is required to file income tax returns, as well as all open tax years in these jurisdictions. The Company has identified its federal tax return and its state tax returns in California and Texas as “major” tax jurisdictions, as defined. The only periods subject to examination for the Company’s federal tax returns are the 2005 and 2006 tax years. The periods subject to examination for the Company’s state tax returns in California and Texas

are years 2002 through 2006. The Company believes that its income tax filing positions and deductions will be sustained on audit and does not anticipate any adjust- ments that will result in a material adverse effect on the Company’s financial condition, results of operations, or cash flow. Therefore, no reserves for uncertain income tax positions have been recorded pursuant to FIN 48. In addition, the Company did not record a cumulative effect adjustment related to the adoption of FIN 48.

The Company’s policy for recording interest and penalties associated with audits is to record such items as a component of income before taxes. Penalties are recorded in “Other (gains) losses, net,” and interest paid or received is recorded in interest expense or interest income, respectively, in the statement of income. For the year ended December 31, 2007, the Company recorded approximately $1 million in interest income related to the settlement of audits for certain prior periods.

## Net Income Per Share

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

**2007 2006 2005**

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

|  |  |  |  |  |
| --- | --- | --- | --- | --- |
| Net income ....................... .......................... **$645** |  | $499 |  | $484 |
| Weighted-average shares outstanding, basic **757** |  | 795 |  | 789 |
| Dilutive effect of Employee stock options . . .......................... **11** |  | 29 |  | 17 |
| Adjusted weighted-average shares outstanding, diluted ................... **768** |  | 824 |  | 806 |
| Net income per share, basic ............ .......................... **$ .85** |  | $ .63 |  | $ .61 |
| Net income per share, diluted .......... .......................... **$ .84** |  | $ .61 |  | $ .60 |

The Company has excluded 49 million, 20 million, and 12 million shares from its calculations of net income per share, diluted, in 2007, 2006, and 2005, respectively, as they represent antidilutive stock options for the respective periods presented.

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS — (Continued)

1. **Contingencies**

The Company is subject to various legal proceedings and claims arising in the ordinary course of business, including, but not limited to, examinations by the IRS. The IRS regularly examines the Company’s federal income tax returns and, in the course thereof, proposes adjustments to the Company’s federal income tax liability reported on such returns. It is the Company’s practice to

vigorously contest those proposed adjustments it deems lacking of merit.

The Company’s management does not expect that the outcome in any of its currently ongoing legal pro- ceedings 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 flow.

## 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, 2007 and 2006, and the related consolidated statements of income, stockholders’ equity, and cash flows for each of the three years in the period ended December 31, 2007. 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, 2007 and 2006, and the consolidated results of its operations and its cash flows for each of the three years in the period ended December 31, 2007, in conformity with U.S. generally accepted accounting principles.

We also have audited, in accordance with the standards of the Public Company Accounting Oversight Board (United States), Southwest Airlines Co.’s internal control over financial reporting as of December 31, 2007, based on criteria established in Internal Control-Integrated Framework issued by the Committee of Sponsoring Organizations of the Treadway Commission and our report dated January 31, 2008 expressed an unqualified opinion thereon.

/s/ ERNST & YOUNG LLP

Dallas, Texas January 31, 2008

## REPORT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM

THE BOARD OF DIRECTORS AND SHAREHOLDERS SOUTHWEST AIRLINES CO.

We have audited Southwest Airlines Co.’s internal control over financial reporting as of December 31, 2007, based on criteria established in Internal Control — Integrated Framework issued by the Committee of Sponsoring Organi- zations of the Treadway Commission (the COSO criteria). Southwest Airlines Co.’s management is responsible for maintaining effective internal control over financial reporting, and for its assessment of the effectiveness of internal control over financial reporting included in the accompanying “Management’s Annual Report on Internal Control Over Financial Reporting”. Our responsibility is to express an opinion on 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, assessing the risk that a material weakness exists, testing and evaluating the design and operating effectiveness of internal control based on the assessed risk, 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, Southwest Airlines Co. maintained, in all material respects, effective internal control over financial reporting as of December 31, 2007, 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, 2007 and 2006, and the related consolidated statements of income, shareholders’ equity, and cash flows for each of the three years in the period ended December 31, 2007 of Southwest Airlines Co. and our report dated January 31, 2008 expressed an unqualified opinion thereon.

/s/ ERNST & YOUNG LLP

Dallas, Texas January 31, 2008

## QUARTERLY FINANCIAL DATA

**(Unaudited)**

**Three Months Ended**

## 2007

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

|  |  |  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- | --- | --- |
| Operating revenues ................................... .. | $2,198 |  | $2,583 |  | $2,588 |  | $2,492 |
| Operating income .................................... .. | 84 |  | 328 |  | 251 |  | 126 |
| Income before income taxes............................. .. | 149 |  | 447 |  | 277 |  | 183 |
| Net income ........................................ .. | 93 |  | 278 |  | 162 |  | 111 |
| Net income per share, basic ............................. .. | .12 |  | .36 |  | .22 |  | .15 |
| Net income per share, diluted ........................... .. | .12 |  | .36 |  | .22 |  | .15 |
|  | **March 31** |  | **June 30** |  | **Sept. 30** |  | **Dec. 31** |
| **2006**  Operating revenues ................................... .. | $2,019 | $2,449 | | $2,342 | | $2,276 | |
| Operating income .................................... .. | 98 | 402 | | 261 | | 174 | |
| Income before income taxes............................. .. | 96 | 515 | | 78 | | 101 | |
| Net income ........................................ .. | 61 | 333 | | 48 | | 57 | |
| Net income per share, basic ............................. .. | .08 | .42 | | .06 | | .07 | |
| Net income per share, diluted ........................... .. | .07 | .40 | | .06 | | .07 | |

### Item 9. *Changes in and Disagreements With* Accountants on Accounting and Financial Disclosure

None.

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

*Evaluation of Disclosure Controls and Procedures.* The Company maintains disclosure controls and procedures (as defined in Rule 13a-15(e) of the Securities Exchange Act) designed to provide reasonable assurance that the information required to be disclosed by the Company in the reports that it files or submits under the Exchange Act is recorded, pro- cessed, summarized, and reported within the time periods specified in the SEC’s rules and forms. These include controls and procedures designed to ensure that this information is accumulated and communicated to the Company’s manage- ment, including its Chief Executive Officer and Chief Finan- cial Officer, as appropriate to allow timely decisions regarding required disclosure. Management, with the participation of the Chief Executive and Chief Financial Officers, evaluated the effectiveness of the Company’s disclosure controls and procedures as of December 31, 2007. Based on this evalu- ation, the Company’s Chief Executive Officer and Chief Financial Officer have concluded that the Company’s disclo- sure controls and procedures were effective as of December 31, 2007 at the reasonable assurance level.

*Management’s Annual Report on Internal Control over Financial Reporting.* Management of the Com- pany is responsible for establishing and maintaining adequate internal control over financial reporting (as defined in Rule 13a-15(f) under the Exchange Act). The 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 of accounting principles generally accepted in the United States.

Because of its inherent limitations, internal control over financial reporting may not prevent or detect mis- statements. Therefore, even those systems determined to be effective can provide only reasonable assurance of achieving their control objectives.

Management, with the participation of the Chief Executive and Chief Financial Officers, evaluated the effectiveness of the Company’s internal control over financial reporting as of December 31, 2007. In making this assessment, management used the criteria set forth by the Committee of Sponsoring Organizations of the Treadway Commission (COSO) in Internal Con- trol — Integrated Framework. Based on this evaluation, management, with the participation of the Chief Exec- utive and Chief Financial Officers, concluded that, as of December 31, 2007, the Company’s internal control over financial reporting was effective.

Ernst & Young, LLP, the independent registered public accounting firm who audited the Company’s con- solidated financial statements included in this Form 10-K, has issued a report on the Company’s internal control over financial reporting, which is included herein.

*Changes in Internal Control over Financial Report- ing.* There were no changes in the Company’s internal control over financial reporting (as defined in Rule 13a-15(f) under the Exchange Act) during the quarter ended December 31, 2007, that have materially affected, or are reasonably likely to materially affect, the Company’s internal control over financial reporting.

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

None.

## PART III

### Item 10. *Directors, Executive Officers, and* Corporate Governance

**Directors and Executive Officers**

The information required by this Item 10 regarding the Company’s directors will be set forth under the heading “Election of Directors” in the Proxy Statement for the Company’s 2008 Annual Meeting of Shareholders and is incorporated herein by reference. The information required by this Item 10 regarding the Company’s exec- utive officers is set forth under the heading “Executive Officers of the Registrant” in Part I of this Form 10-K and is incorporated herein by reference.

## Section 16(a) Compliance

The information required by this Item 10 regarding compliance with Section 16(a) of the Exchange Act will be set forth under the heading “Section 16(a) Beneficial Ownership Reporting Compliance” in the Proxy State- ment for the Company’s 2008 Annual Meeting of Share- holders and is incorporated herein by reference.

## Corporate Governance

Except as set forth in the following paragraph, the remaining information required by this Item 10 will be set forth under the heading “Corporate Governance” in the Proxy Statement for the Company’s 2008 Annual Meeting of Shareholders and is incorporated herein by reference.

The Company has adopted a Code of Ethics that applies to the Company’s principal executive officer, prin- cipal financial officer, and principal accounting officer or controller. The Company’s Code of Ethics, as well as its Corporate Governance Guidelines and the charters of its Audit, Compensation, and Nominating and Corporate Governance Committees, are available on the Company’s website, [**www.southwest.com.**](http://www.southwest.com/)Copies of these documents are also available upon request to Investor Relations, Southwest Airlines Co., P.O. Box 36611, Dallas, TX 75235. The Company intends to disclose any amendments to or waivers of its Code of Ethics on behalf of the Company’s Chief Executive Officer, Chief Financial Offi- cer, Controller, and persons performing similar functions on the Company’s website, at **www.southwest.com**, under the “About Southwest” caption, promptly following the date of any such amendment or waiver.

**Item 11. *Executive Compensation***

The information required by this Item 11 will be set forth under the heading “Compensation of Executive Officers” in the Proxy Statement for the Company’s 2008 Annual Meeting of Shareholders and is incorpo- rated herein by reference.

### Item 12. *Security Ownership of Certain Beneficial* Owners and Management and Related Stockholder Matters

Except as set forth below regarding securities autho- rized for issuance under equity compensation plans, the information required by this Item 12 will be set forth under the heading “Voting Securities and Principal Shareholders” in the Proxy Statement for the Company’s 2008 Annual Meeting of Shareholders and is incorpo- rated herein by reference.

## Securities Authorized for Issuance under Equity Compensation Plans

The following table provides information as of December 31, 2007, 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**

**Plan Category**

**Number of Securities to be Issued Upon Exercise of Outstanding Options,**

**Warrants, and Rights (a)**

**Weighted-Average Exercise Price of Outstanding Options, Warrants, and Rights\* (b)**

**Available for Future Issuance Under Equity Compensation Plans (Excluding Securities**

**Reflected in Column (a)) (c)**

Equity Compensation Plans

**(In thousands) (In thousands)**

Approved by Security Holders . . 23,941 $12.76 5,707

Equity Compensation Plans not

|  |  |  |  |
| --- | --- | --- | --- |
| Approved by Security Holders . . | 68,517 | $15.16 | 20,011 |
| Total ................... | 92,459 | $14.54 | 25,718 |

\* As adjusted for stock splits.

See Note 13 to the Consolidated Financial State- ments 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 13. *Certain Relationships and Related Trans-* actions, and Director Independence

The information required by this Item 13 will be set forth under the heading “Certain Relationships and

Related Transactions, and Director Independence” in the Proxy Statement for the Company’s 2008 Annual Meeting of Shareholders and is incorporated herein by reference.

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

The information required by this Item 14 will be set forth under the heading “Relationship with Independent Auditors” in the Proxy Statement for the Company’s 2008 Annual Meeting of Shareholders and is incorpo- rated herein by reference.

## PART IV

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

* 1. 1. *Financial Statements:*

The financial statements included in Item 8. Financial Statements and Supplementary Data 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 circum- stances 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 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, 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)); Articles of Amendment to 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, 2007 (File No. 1-7279)).
   2. Amended and Restated Bylaws of Southwest, effective September 20, 2007 (incorporated by reference to Exhibit 3.1 to Southwest’s Current Report on Form 8-K dated September 20, 2007).
   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 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 percent 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)); Supplemental Agreement Nos. 46 and 47 (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. 48 (incorporated by reference to Exhibit 10.1 to Southwest’s Quarterly Report on Form 10-Q for the quarter ended June 30, 2006 (File No. 1-7259)); Supplemental Agreements No. 49 and 50 (incorporated by reference to Exhibit 10.1 to Southwest’s Quarterly Report on Form 10-Q for the quarter ended September 30, 2006 (File No. 1-7259)); Supplemental Agreement No. 51 (incorporated by reference to Exhibit 10.1 to Southwest’s Annual Report on Form 10-K for the year ended December 31, 2006 (File No. 1-7259)); Supplemental Agreement No. 52 (incorporated by reference to Exhibit 10.1 to Southwest’s Quarterly Report on Form 10-Q for the quarter ended March 31, 2007 (File No. 1-7259)); Supplemental Agreement No. 53 (incorporated by reference to Exhibit 10.1 to Southwest’s Quarterly Report on Form 10-Q for the quarter ended June 30, 2007 (File No. 1-7259)); Supplemental Agreement Nos. 54 and 55 (incorporated by reference to Exhibits 10.1 and 10.2, respectively, to Southwest’s Quarterly Report on Form 10-Q for the quarter ended September 30, 2007 (File No. 1-7259)); Supplemental Agreement No. 56.

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. 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)).
  3. 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)).
  4. 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)).
  5. 1991 Employee Stock Purchase Plan as amended March 16, 2006 (incorporated by reference to Exhibit 99.1 to Registration Statement on Form S-8 (File No. 333-139362)).
  6. Southwest Airlines Co. Profit Sharing Plan.
  7. Southwest Airlines Co. 401(k) Plan.
  8. 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)).
  9. 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)).
  10. 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)).
  11. Employment Contract dated as of July 15, 2007, 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, 2007 (File No. 1-7259)).
  12. Employment Contract dated as of July 15, 2007, 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, 2007 (File No. 1-7259)).
  13. Employment Contract dated as of July 15, 2007, 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, 2007 (File No. 1-7259)).
  14. Southwest Airlines Co. Severance Plan for Directors.
  15. Southwest Airlines Co. Outside Director Incentive Plan (incorporated by reference to Exhibit 10.2 to Southwest’s Quarterly Report on Form 10-Q for the quarter ended June 30, 2007 (as amended and restated effective May 16, 2007) (File No. 1-7259)).
  16. 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)).
  17. 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)).
  18. 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)).
  19. 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)).
  20. 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)).
  21. 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)).
  22. 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)).
  23. 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)).
  24. 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)).
  25. 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)).
  26. 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)).
  27. 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)).
  28. 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)).
  29. Southwest Airlines Co. 2007 Equity Incentive Plan (incorporated by reference to Exhibit 99.1 to Southwest’s Current Report on Form 8-K dated May 16, 2007 (File No. 1-7259)).
  30. 2007 Equity Incentive Plan Form of Notice of Grant and Terms and Conditions for Stock Option Grants.
  31. Southwest Airlines Co. 2005 Excess Benefit Plan (incorporated by reference to Exhibit 99.1 to Southwest’s Current Report on Form 8-K dated November 15, 2007 (File No. 1-7259)).

14 Code of Ethics (incorporated by reference to Exhibit 14.1 to Southwest’s Current Report on Form 8-K dated November 16, 2006 (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.

February 1, 2008

By: /s/ LAURA WRIGHT

Laura Wright

*Senior Vice President — 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 February 1, 2008 on behalf of the registrant and in the capacities indicated.

**Signature Capacity**

/s/ HERBERT D. KELLEHER

Herbert D. Kelleher

Executive Chairman of the Board of Directors

/s/ GARY C. KELLY

Gary C. Kelly

Chief Executive Officer and Director

/s/ COLLEEN C. BARRETT

Colleen C. Barrett

President and Director

/s/ LAURA WRIGHT

Laura Wright

Sr. Vice President — Finance and Chief Financial Officer (Chief Financial and Accounting Officer)

/s/ DAVID W. BIEGLER

David W. Biegler

Director

/s/ LOUIS CALDERA

Louis Caldera

Director

/s/ C. WEBB CROCKETT

C. Webb Crockett

Director

/s/ WILLIAM H. CUNNINGHAM

William H. Cunningham

Director

/s/ TRAVIS C. JOHNSON

Travis C. Johnson

Director

/s/ NANCY LOEFFLER

Nancy Loeffler

Director

/s/ JOHN T. MONTFORD

John T. Montford

Director