

SOUTHWEST AIRLINES CO

Form DEF 14A

April 16, 2004

**Table of Contents**

UNITED STATES  
SECURITIES AND EXCHANGE COMMISSION  
Washington, D.C. 20549

**SCHEDULE 14A**

Proxy Statement Pursuant to Section 14(a) of the Securities  
Exchange Act of 1934

Filed by the Registrant  **p**  
Filed by a Party other than the Registrant  **o**

Check the appropriate box:

- Preliminary Proxy Statement
- Confidential, for Use of the Commission Only (as permitted by Rule 14a-6(e)(2))**
- Definitive Proxy Statement
- Definitive Additional Materials
- Soliciting Material Pursuant to §240.14a-12

**Southwest Airlines Co.**

---

(Name of Registrant as Specified In Its Charter)

---

(Name of Person(s) Filing Proxy Statement, if other than the Registrant)

Payment of Filing Fee (Check the appropriate box):

- p** No fee required.
- o** Fee computed on table below per Exchange Act Rules 14a-6(i)(4) and 0-11.

1) Title of each class of securities to which transaction applies:

---

2) Aggregate number of securities to which transaction applies:

---

3) Per unit price or other underlying value of transaction computed pursuant to Exchange Act Rule 0-11 (set forth the amount on which the filing fee is calculated and state how it was determined):

---

4) Proposed maximum aggregate value of transaction:

---

5) Total fee paid:

---

- o** Fee paid previously with preliminary materials.
-

Edgar Filing: SOUTHWEST AIRLINES CO - Form DEF 14A

o Check box if any part of the fee is offset as provided by Exchange Act Rule 0-11(a)(2) and identify the filing for which the offsetting fee was paid previously. Identify the previous filing by registration statement number, or the Form or Schedule and the date of its filing.

1) Amount Previously Paid:

---

2) Form, Schedule or Registration Statement No.:

---

3) Filing Party:

---

4) Date Filed:

---

---

**Table of Contents**

**SOUTHWEST AIRLINES CO.**

**Proxy Statement and**

**2003 Report to Shareholders**

**Letter to Shareholders**

**Notice of 2004 Annual Meeting And Proxy Statement**

**2003 Report to Shareholders**

Management's Discussion and Analysis

Consolidated Financial Statements

TO OUR SHAREHOLDERS:

Just as promised in our 2002 Annual Report, in the year 2003 Southwest Airlines kept MOVING AHEAD.

While the airline industry, as a whole, reported more than \$5 billion (excluding special items) in 2003 losses:

1. Southwest produced its 31<sup>st</sup> consecutive year of profitability, an airline industry record that has also generated unprecedented airline industry job security and exceptional Profitsharing for our marvelous Employees, as well as exceptional investment returns for our Shareholders, including Employee-Shareholders.
  2. Southwest's annual profits increased from \$198 million in 2002, excluding special items (\$241 million, including special items), to \$298 million, excluding special items (\$442 million including special items, such as industrywide government war relief grants).
  3. Southwest expanded its fleet by a net of 13 new 737-700s and increased our Available Seat Miles by 4.2 percent.
  4. Southwest continued to equip our new aircraft deliveries, and to refurbish our existing fleet, with our fresh and most attractive Canyon Blue aircraft livery: all leather interiors in Canyon Blue and Saddle Tan; new design seats affording superb personal comfort; and aesthetic Blended Winglets, which improve aircraft performance by extending range, saving fuel, and reducing engine maintenance costs and takeoff noise.
-

**Table of Contents**

5. Southwest retained its leadership in Customer Satisfaction, again receiving the fewest Customer complaints per 100,000 Customers carried, as reflected in DOT statistics compiled from reports furnished to DOT by the largest domestic air carriers.

6. Southwest was selected:

In *FORTUNE* magazine, as one of our nation's Most Admired Companies

In *Business Ethics* magazine's listing of the 100 Best Corporate Citizens in America

In *HISPANIC* magazine's listing of the 2003 Hispanic Corporate 100

The Best Low Cost Airline at the 2003 *Official Airline Guide* Airline of the Year awards

By *Air Transport World* magazine as its Airline of the Year

By *Inside Flyer* magazine as having the Best Customer Service, Best Bonus Promotion, and Best Award Redemption of any frequent flyer program (Southwest's Rapid Rewards)

As featured airline in the A&E Network series *AIRLINE*

For *Global Finance* magazine's Experts List of the World's Most Socially Responsible Companies.

We intend to keep MOVING FURTHER AHEAD in 2004, expanding our fleet by a net of 29 new 737-700's and our Available Seat Miles by almost 8 percent, while utilizing our proportionally unsurpassed financial strength (\$1.87 billion in cash and an unsecured revolving credit line of \$575 million at yearend 2003), continued low costs per Available Seat Mile, leading Customer Satisfaction record, and superb Employee esprit de corps to prevail over the 2004 uncertainties with respect to: fuel price levels (we are over 80 percent hedged for the year with prices capped at approximately \$24 per barrel of crude oil); the rate of U.S. economic recovery and attendant expansion of Customer demand; a potential substantial expansion in capacity by competitive air carriers; and any exogenous events adversely affecting the domestic airline industry.

In May of 2004, we will commence air service to Philadelphia, the largest metropolitan area in the U.S. not now served, directly or indirectly, by Southwest. We have also announced that in light of Southwest's strong cash position, investment-grade balance sheet, and desire to maximize Employee-Shareholder and non-Employee-Shareholder value that Southwest intends to use the very significant present and anticipated proceeds from the exercise of our outstanding stock options for the repurchase, from time to time, of up to \$300 million of our common stock in the open market.

For more than three decades, the wisdom, farsightedness, goodwill, and camaraderie of our People have produced a remarkable airline providing remarkable psychic and financial rewards for all of our Employees. We thank them for their understanding and their goodness, which have produced greatness for Southwest and for them.

January 20, 2004

Most sincerely,

Herbert D. Kelleher

James F. Parker

Colleen C. Barrett

Chairman of the Board

Vice-Chairman and CEO

President and COO

---

**TABLE OF CONTENTS**

SOLICITATION AND REVOCABILITY OF PROXIES; VOTING

ELECTION OF DIRECTORS

CURRENT NOMINEES

DIRECTORS WHOSE TERM EXPIRES IN 2005

DIRECTORS WHOSE TERM EXPIRES IN 2006

VOTING SECURITIES AND PRINCIPAL SHAREHOLDERS

COMPENSATION OF EXECUTIVE OFFICERS

Option Grants in Last Fiscal Year

Aggregated Option Exercises In Last Fiscal Year and Fiscal Year-end Option Values

BOARD COMPENSATION COMMITTEE REPORT ON EXECUTIVE COMPENSATION

AUDIT COMMITTEE REPORT

PERFORMANCE GRAPH

RATIFICATION OF SELECTION OF AUDITOR

RELATIONSHIP WITH INDEPENDENT AUDITORS

OTHER MATTERS

APPENDIX A

APPENDIX B

Prohibited Non-Audit Services

PART I

Item 1. Business

Item 2. Properties

Item 3. Legal Proceedings

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

EXECUTIVE OFFICERS OF THE REGISTRANT

PART II

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

Item 6. Selected Financial Data

ITEM 7. MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATION

Item 7A. QUALITATIVE AND QUANTITATIVE DISCLOSURES ABOUT MARKET RISK

ITEM 8. FINANCIAL STATEMENTS AND SUPPLEMENTARY DATA

CONSOLIDATED BALANCE SHEET

CONSOLIDATED STATEMENT OF INCOME

CONSOLIDATED STATEMENT OF STOCKHOLDERS' EQUITY

CONSOLIDATED STATEMENT OF CASH FLOWS

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

REPORT OF INDEPENDENT AUDITORS

Quarterly Financial Data (Unaudited)

Item 9. Changes In and Disagreements With Accountants on Accounting and Financial Disclosure

Item 9A. Controls and Procedures

PART III

Item 10. Directors and Executive Officers of the Registrant

Item 11. Executive Compensation

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

Item 13. Certain Relationships and Related Transactions

Item 14. Principal Accountant Fees and Services

PART IV

Item 15. Exhibits, Financial Statement Schedules, and Reports on Form 8-K

SIGNATURES

---



**Table of Contents**

---

**Table of Contents**

**SOUTHWEST AIRLINES CO.**

**NOTICE OF ANNUAL MEETING OF SHAREHOLDERS**

Wednesday, May 19, 2004

To the Shareholders:

The Annual Meeting of the Shareholders of Southwest Airlines Co. (the Company or Southwest ) will be held at its corporate headquarters, 2702 Love Field Drive, Dallas, Texas on Wednesday, May 19, 2004, at 10:00 a.m., local time, for the following purposes:

- (1) to elect six Directors;
- (2) to ratify the selection of Ernst & Young LLP as the Company's independent auditors for the fiscal year ending December 31, 2004; and
- (3) to transact such other business as may properly come before such meeting.

March 23, 2004, is the date of record for determining Shareholders entitled to receive notice of and to vote at the Annual Meeting.

Our Annual Meeting will be broadcast live on the Internet. To listen to the broadcast, log on to [www.southwest.com](http://www.southwest.com) at 10:00 a.m., CDT, on May 19, 2004.

We have made the 2003 Annual Report available to you on the Internet at [www.southwest.com](http://www.southwest.com) (click on About SWA , Investor Relations , Annual Reports ).

If you do not have Internet access and you would like a copy of the 2003 Annual Report, you may request one from Investor Relations, Southwest Airlines Co., P.O. Box 36611, Dallas, Texas 75235. Additionally, the Company's Annual Report on Form 10-K (without exhibits), filed with the Securities and Exchange Commission, is attached to this Proxy Statement under the heading 2003 Annual Report to Shareholders.

By Order of the Board of Directors,

Colleen C. Barrett  
*President, Chief Operating Officer,  
and Secretary*

April 16, 2004

**YOUR VOTE IS IMPORTANT. PLEASE SIGN AND RETURN THE ENCLOSED PROXY IN THE ENCLOSED ENVELOPE TO ENSURE THAT YOUR SHARES ARE REPRESENTED AT THE MEETING. YOU MAY ALSO VOTE VIA TELEPHONE OR INTERNET AS DESCRIBED IN THE ENCLOSED PROXY.**

**Table of Contents**

**Southwest Airlines Co.  
P.O. Box 36611  
Dallas, Texas 75235-1611  
(214) 792-4000**

---

**PROXY STATEMENT**

**SOLICITATION AND REVOCABILITY OF PROXIES; VOTING**

The enclosed proxy is solicited by and on behalf of the Board of Directors of the Company for use at the Annual Meeting of Shareholders to be held on May 19, 2004, at the Company's corporate headquarters, 2702 Love Field Drive, Dallas, Texas, or any adjournment thereof. The Company will pay the cost of solicitation. In addition to solicitation by mail, solicitation of proxies may be made personally or by telephone by the Company's regular Employees, and arrangements will be made with brokerage houses or other custodian's nominees and fiduciaries to send proxies and proxy material to their principals. The proxy statement and form of proxy were first mailed to Shareholders of the Company on or about April 16, 2004.

The enclosed proxy, even though executed and returned, may be revoked at any time prior to the voting of the proxy by the subsequent execution and submission of a revised proxy, by written notice to the Secretary of the Company, or by voting in person at the meeting. All Shareholders can vote by written proxy card. All Shareholders of record can also vote by touch-tone telephone from the U. S., using the toll-free number on the proxy card, or by the Internet, using the instructions on the proxy card. Street name holders may vote by telephone or the Internet if their bank or broker makes these methods available, in which case the bank or broker will enclose the instructions with the proxy statement. Shares represented by proxy will be voted at the meeting. Cumulative voting is not permitted. An automated system administered by the Company's transfer agent tabulates the votes. Abstentions and broker non-votes are each included in the determination of the number of shares present and voting, for purposes of determining the presence or absence of a quorum for the transaction of business. Neither abstentions nor broker non-votes are counted as voted either for or against a proposal. Except as otherwise stated herein, provided a quorum is present, the affirmative vote of the holders of a majority of the shares entitled to vote on, and voted for or against, the matter is required to approve any matter.

In some cases, only one proxy statement is being delivered to multiple Shareholders sharing an address unless the Company has received contrary instructions from one or more of the Shareholders. Upon written or oral request, the Company will deliver a separate copy of the proxy statement to a Shareholder at a shared address to which a single copy of the proxy statement was delivered. A Shareholder can notify the Company at the above address that it wishes to receive a separate copy of the proxy statement in the future, or alternatively, that it wishes to receive a single copy of the materials instead of multiple copies.

**ELECTION OF DIRECTORS  
(Item 1)**

At the Annual Meeting of Shareholders, two Directors are to be elected for two-year terms expiring in 2006, and four Directors are to be elected for three-year terms expiring in 2007, each to serve with the six Directors whose terms have not expired. Provided a quorum is present at the Annual Meeting, a plurality of the votes cast in person or by proxy by the holders of shares entitled to vote is required to elect Directors.

The persons named in the enclosed proxy have been selected as a proxy committee by the Directors of the Company, and it is the intention of the proxy committee that, unless otherwise directed therein, proxies will be voted for the election of the nominees listed below. Although the Directors of the Company do not contemplate that any of the nominees will be unable to serve, if such a situation arises prior to the meeting, the proxy committee will act in accordance with its best judgment.

---

**Table of Contents**

The following table sets forth certain information for each nominee and present Director of the Company, as of January 1, 2004. Each of the nominees for Director named in the following table is now serving as a Director of the Company. There is no family relationship between any of the Directors or between any Director and any executive officer of the Company.

<u>Name</u>	<u>Director Since</u>	<u>Age</u>
Colleen C. Barrett.	2001	59
Louis E. Caldera.	2003	47
C. Webb Crockett*	1994	69
William H. Cunningham	2000	59
William P. Hobby*	1990	71
Travis C. Johnson*	1978	67
Herbert D. Kelleher*	1967	72
Nancy B. Loeffler	2003	57
Rollin W. King*	1967	72
John T. Montford	2002	60
June M. Morris*	1994	72
James F. Parker	2001	57

(\*) Current Nominee

**CURRENT NOMINEES**

Mr. King and Mrs. Morris are to be elected for terms expiring in 2006, and Mr. Kelleher, Mr. Crockett, Mr. Hobby, and Mr. Johnson for terms expiring in 2007.

Herbert D. Kelleher has been Chairman of the Board of the Company since March 29, 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 on June 19, 2001.

Rollin W. King engaged in executive education and consulting as the principal of Rollin King Associates from January 1, 1989 until his retirement on December 31, 1995, and subsequently he has been principally engaged in private investments.

June M. Morris was a founder of Morris Air Corporation ( Morris ). Mrs. Morris was Chief Executive Officer of Morris until its operations were absorbed by Southwest in October 1994, and subsequently she has been principally engaged in private investments. Morris was a domestic airline operating 21 Boeing 737 aircraft until its acquisition by Southwest in December 1993.

C. Webb Crockett has been an attorney and Shareholder in the Phoenix, Arizona law firm of Fennemore Craig for more than the past five years. Fennemore Craig performed services for the Company in 2003 and will do so in 2004.

William P. Hobby was lieutenant governor of the State of Texas for 18 years until January 1991. He was Chancellor of the University of Houston System from September 1995 until March 1997. He has been Chairman of Hobby Communications, L.L.C., Houston, Texas, a privately owned company, since January 1997, and was Chairman and CEO of H&C Communications, Inc. (a privately owned broadcasting company) from 1983 until December 1996. He was Executive Editor of the *Houston Post* for more than 20 years.



**Table of Contents**

Travis C. Johnson was a partner in the El Paso, Texas law firm of Johnson & Bowen for more than five years prior to 2001. Since January 2001, Mr. Johnson has practiced law as Travis Johnson, Attorney at Law. Mr. Johnson is a director of J. P. Morgan Chase Bank-El Paso.

**DIRECTORS WHOSE TERM EXPIRES IN 2005**

Colleen C. Barrett has been President and Chief Operating Officer of the Company since June 19, 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.

James F. Parker has been Vice Chairman of the Board of Directors and Chief Executive Officer of the Company since June 19, 2001. Prior to that time, Mr. Parker was Vice President - General Counsel since 1986.

John T. Montford has been President External Affairs, SBC Southwest and SNET, divisions of SBC Communications Inc., a global provider of telecommunications products and services, since July 2002. He was Senior Vice President Legislative and Political Affairs of SBC Communications Inc. from September 2001 until July 2002. Prior to September 2001, Mr. Montford served as Chancellor of the Texas Tech University System from 1996 to 2001. Mr. Montford served in the Texas Senate from 1983 to 1996. He served as both Chairman of the Senate Finance Committee and Chairman of the Senate State Affairs Committee. He is a Director of Fleetwood Enterprises, Inc. In 2002, he was named Chancellor Emeritus of the Texas Tech University System.

**DIRECTORS WHOSE TERM EXPIRES IN 2006**

William H. Cunningham, Ph.D., holds the James L. Bayless Chair for Free Enterprise at the University of Texas at Austin Red McCombs School of Business. Dr. Cunningham was the Chancellor of the University of Texas System from 1992 to June 2000. He is a Director of the following publicly traded companies: Jefferson-Pilot Corporation, Introgen Therapeutics, Inc., LIN TV Corp. and Hayes Lemmerz International, Inc. He is a disinterested Director of John Hancock Mutual Funds. Dr. Cunningham joined the Board of an e-learning privately held start-up company, IBT Technologies, in January 2000 as Chairman of the Board. He was named President and CEO in December 2000, resigning those positions in September 2001. He remained as Chairman until December 17, 2001, at which time the company filed for bankruptcy. The company has been liquidated.

Louis E. Caldera has been President of The University of New Mexico since August 2003. Prior to that time he was the Vice Chancellor for University Advancement and President, CSU Foundation, at California State University, since June 2001. He was the Secretary of the Army in the Clinton Administration from July 1998 until January 2001. Mr. Caldera previously served as the Managing Director and Chief Operating Officer for the Corporation for National and Community Service, a federal grant-making agency, from September 1997 to June 1998. He served as a member of the California State Legislature from 1992 to 1997 representing the 46<sup>th</sup> Assembly District (Los Angeles). Mr. Caldera is a Director of Belo Corp. and Indy Mac Bancorp, Inc.

Nancy B. Loeffler, a long-time advocate of volunteerism, currently serves as a Member of the University of Texas M.D. Anderson Cancer Center Board of Visitors and on the Board of Regents at St. Mary's University, The South Texas Community Foundation, the National Cowgirl Museum and Hall of Fame, the Vice President's Residence Foundation in Washington, D.C., and the Capitol Advisory Committee for Texas Lutheran University. She also serves as a member of the Blanton Museum of Art located on the University of Texas campus. The law firm of Loeffler, Jonas and Tuggey has performed services for the





## **Table of Contents**

Company in the past and may do so in 2004. Nancy Loeffler's husband is a member of the law firm of Loeffler, Jonas and Tuggey.

### **Board Committees**

**Audit Committee.** The Board of Directors has appointed an *Audit Committee* consisting of Messrs. Cunningham (Chairman), Caldera, Hobby, Johnson, Montford, and King and Mrs. Morris. The Audit Committee held five meetings during 2003. Pursuant to the Audit Committee Charter adopted by the Board of Directors, a copy of which is attached to this Proxy Statement as Appendix A, the Audit Committee is responsible for the appointment, compensation, retention, and oversight of the work of Southwest's independent auditors. Its principal functions are to give additional assurance that financial information is accurate and timely and that it includes all appropriate disclosures; to ascertain the existence of an effective accounting and internal control system; to pre-approve all services provided by the independent auditors; and to oversee the entire audit function, both independent and internal. The Board of Directors of the Company has determined that all of the members of the Audit Committee are independent, as that term is used under applicable rules of the New York Stock Exchange. The Board has also determined that at least one of the members of the Audit Committee, Dr. Cunningham, satisfies the criteria adopted by the Securities and Exchange Commission to serve as the audit committee financial expert on the Committee.

**Compensation Committee.** The Board of Directors has appointed a *Compensation Committee* consisting of Messrs. Hobby (Chairman) and Crockett and Mrs. Morris. The Board of Directors of the Company has determined that all of the members of the Compensation Committee are independent, as that term is used under applicable rules of the New York Stock Exchange; Mr. Crockett is an attorney and Shareholder in the Phoenix, Arizona law firm of Fennemore Craig, which performed services for the Company in 2003 and will do so in 2004. The Compensation Committee held one meeting during 2003, and otherwise acted by unanimous consent. Pursuant to the Compensation Committee Charter adopted by the Board of Directors, the Compensation Committee evaluates the Chief Executive Officer's performance in light of the Company's corporate objectives; studies, advises, and consults with management, and makes recommendations to the Board, respecting the compensation of the other officers of the Company; and administers the Company's stock-based compensation plans. It recommends for the Board's consideration any plan for additional compensation that it deems appropriate.

**Executive Committee.** The Board of Directors has appointed an *Executive Committee* consisting of Messrs. Kelleher (Chairman), Johnson, and King to assist the Board in carrying out its duties. The Executive Committee has authority to act for the Board on most matters during the intervals between Board meetings. The Executive Committee held two telephone meetings during 2003.

**Nominating and Corporate Governance Committee.** The Board of Directors has appointed a *Nominating and Corporate Governance Committee* consisting of Messrs. Caldera, Crockett, Cunningham, Hobby, Johnson, King, and Montford and Mrs. Morris. The Board of Directors of the Company has determined that all of the members of the Nominating and Corporate Governance Committee are independent, as that term is used under applicable rules of the New York Stock Exchange. The Nominating and Corporate Governance Committee held two meetings during 2003.

Pursuant to its Charter adopted by the Board of Directors, the Nominating and Corporate Governance Committee reviews and interviews possible candidates for Board membership and recommends a slate of nominees, and develops and recommends to the Board corporate governance principles applicable to the Company. The Committee will consider nominees submitted by Shareholders, provided nominations are submitted in accordance with the Company's Bylaws. See **Other Matters** **Notice Requirements** for details on the process for nominations for Directors.

The qualifications to be considered by the Committee in nominating Board members are set forth in the Company's Governance Guidelines. Members of the Board of Directors of Southwest Airlines Co. should possess the highest

personal and professional ethics, integrity, and values. They must possess

## **Table of Contents**

practical wisdom, mature judgment, and be committed to the best long-term interests of the Company's Employees, Customers, and Shareholders. Directors must be willing to devote sufficient time to fulfill their responsibilities and be willing to serve on the Board for an extended period of time. While there is no specific limitation on service on other Boards, the Committee will take into consideration the nature and time involved in a Director's service on other boards in evaluating the suitability of that Director. The Board will consider a number of factors in the nomination or appointment of new Board members, including finance, marketing, government, education, and other professional experience or knowledge relevant to the success of the Company in today's business environment. The Board will also take into consideration factors such as diversity and independence (for non-management Directors) in the appointment of future Board members. The Board evaluates each Director in the context of the Board as a whole, with the objective of recommending a group that can best serve the longterm interests of the Company's Employees, Customers, and Shareholders. In the case of current Directors being considered for renomination, the Committee considers the Director's past attendance at Board and Committee meetings and participation in and contributions to such meetings and Board activities.

In January 2004, at the recommendation of the Nominating and Corporate Governance Committee, the Board of Directors amended the Company's Bylaws to extend the mandatory retirement age from 72 to 75. The Chairman of the Board is exempted from the mandatory retirement provisions of the Bylaws. The Nominating Committee's recommendation was based on the need for the experience, leadership, and judgment provided by the Company's Directors.

## **Additional Information Concerning the Board of Directors**

During 2003, each Director attended at least 75 percent of the total of the Board and Committee meetings that he or she was obligated to attend. Additionally, it is the Board's policy that every Director and nominee for Director should make every effort to attend the Company's annual meeting of Shareholders. All of the Company's Directors attended the 2003 annual meeting.

The Board of Directors has adopted Governance Guidelines to set forth its policies concerning overall governance practices. In addition, the Board of Directors has adopted charters for each of its Compensation and Nominating and Corporate Governance Committees, and a revised charter for its Audit Committee. A copy of the guidelines and the charters, as well as the Company's Code of Ethics, are available on the Company's website, [www.southwest.com](http://www.southwest.com), and Shareholders can obtain copies upon written request to Investor Relations, P.O. Box 36611, Dallas, TX 75235.

The Company's Governance Guidelines require that a majority of the members of the Company's Board of Directors satisfy the independence requirements set forth in the rules of the New York Stock Exchange. The Company's Board has determined that each of its Directors, other than Messrs. Kelleher and Parker and Mrs. Barrett and Mrs. Loeffler, meets these independence requirements.

The Governance Guidelines require the Board's non-management Directors to meet at regularly scheduled executive sessions without management Directors. During 2003, they had five such meetings. Currently, Dr. Cunningham, Chairman of the Audit Committee, serves as the presiding Director for executive sessions of non-management Directors. Shareholders of the Company may contact the Board of Directors by mail addressed as follows: Board of Directors, c/o Southwest Airlines Co., Attn. William C. Cunningham, P.O. Box 36611, Dallas, Texas 75235.

## **Directors Fees**

Directors' fees are paid on an annual basis from May to May in each year. Each Director of the Company who is not an officer of the Company was paid \$11,800 for the 12-month period ending May 2003, increasing to \$12,250 for the

12-month period ending May 2004, for services as a Director. During 2003, the Board of Directors held six meetings and otherwise acted by unanimous consent. In addition, \$2,900 (increasing to \$3,000 for the 12-month period ending May 2004) was paid for attendance at each meeting of

**Table of Contents**

the Board of Directors, and \$1,200 (increasing to \$1,250 for the 12-month period ending May 2004) for attendance at each meeting of a Committee held on the same date as the Board meetings. Members of the Executive Committee receive an additional \$5,700 (increasing to \$5,900 for the 12-month period ending May 2004) per year for their services on such Committee. The Chairman of the Audit and Compensation Committees received annual fees of \$5,500 and \$3,200, respectively (increasing to \$5,900 and \$3,350, respectively for the 12-month period ending May 2004). Officers of the Company receive no additional remuneration for serving as Directors or on Committees of the Board.

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 awards are made under the 1996 Non-Qualified Stock Option Plan, which is administered by the Compensation Committee of the Board of Directors. These stock options become exercisable over a period of five 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 Shareholders and to provide the non-Employee Directors with retirement income. To accomplish this purpose, the plan compensates each non-Employee Director based on the 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 will grant 750 Performance Shares to each non-Employee Director who has served since the previous Annual Meeting. 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. On the 30<sup>th</sup> 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 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.

Upon retirement from the Board of Directors, a Director who has served at least five years as of the date of retirement will receive \$35,000 and a Director who has served at least ten years will receive \$75,000.

**Table of Contents****VOTING SECURITIES AND PRINCIPAL SHAREHOLDERS**

At the close of business on March 23, 2004, the record date of those entitled to notice of and to vote at the meeting, there were outstanding 790,181,982 shares of Common Stock, \$1.00 par value, each share of which is entitled to one vote.

**Certain Beneficial Owners**

The following table sets forth information with respect to persons who, to the Company's knowledge (based on information contained in Schedules 13G filed with the Securities and Exchange Commission with respect to beneficial ownership at December 31, 2003), beneficially own more than 5 percent of the Common Stock of the Company.

Name and Address of Beneficial Owner	Amount and Nature of Beneficial Ownership	Percent of Class
Capital Research and Management Company 333 South Hope Street Los Angeles, CA 90071	76,249,520 <sup>(1)</sup>	9.7%
State Street Bank and Trust Company 225 Franklin Street Boston, MA 02110	94,665,837 <sup>(2)</sup>	11.8% <sup>(3)</sup>
FMR Corp. 82 Devonshire Street Boston, MA 02109	41,816,409 <sup>(4)</sup>	5.3%

- <sup>(1)</sup> As of December 31, 2003, Capital Research and Management Company reported sole dispositive power with respect to 76,249,520 shares, but disclaimed beneficial ownership of any shares of Common Stock.
- <sup>(2)</sup> As of December 31, 2003, State Street Bank and Trust Company reported sole voting power with respect to 17,751,371 shares, shared voting power with respect to 75,246,672 shares, sole dispositive power with respect to 94,566,908 shares, and shared dispositive power with respect to 98,929 shares.
- <sup>(3)</sup> State Street Bank and Trust Company reported that it beneficially owned 9.6 percent of the shares outstanding at year-end in its capacity as trustee of the Southwest Airlines Co. ProfitSharing Plan.
- <sup>(4)</sup> As of December 31, 2003, of the 41,816,409 shares attributed to FMR Corp., it reported sole voting power over 4,593,271 shares and sole dispositive power over all 41,816,409 shares. Such voting and dispositive power is also attributable to Edward C. Johnson III and Abigail P. Johnson by virtue of their positions, Chairman and Director, respectively, and ownership interests in FMR Corp.

**Table of Contents**  
**Management**

The following table sets forth as of March 23, 2004, certain information regarding the beneficial ownership of Common Stock by the Directors, each of the executive officers of the Company named in the Summary Compensation Table and by all executive officers and Directors as a group.

Name of Director, Officer or Identity of Group	Number of Beneficially Owned Shares (1)(2)	Percent of Class (2)
Colleen C. Barrett <sup>(3)</sup>	539,114	*
Louis E. Caldera <sup>(14)</sup>	1,000	*
C. Webb Crockett <sup>(4)</sup>	25,975	*
William H. Cunningham <sup>(5)</sup>	14,750	*
William P. Hobby <sup>(6)</sup>	6,683	*
Travis C. Johnson	207,413	*
Herbert D. Kelleher <sup>(7)</sup>	7,347,898	*
Rollin W. King <sup>(8)</sup>	398,815	*
Nancy B. Loeffler <sup>(15)</sup>	1,500	*
John T. Montford <sup>(9)</sup>	4,050	*
June M. Morris <sup>(10)</sup>	870,831	*
James F. Parker <sup>(11)</sup>	726,600	*
Gary C. Kelly <sup>(12)</sup>	332,501	*
Jim Wimberly <sup>(13)</sup>	193,271	*
Executive Officers and Directors as a Group (18 persons) <sup>(16)</sup>	11,468,689	1.4%

\* Less than 1%

- (1) Unless otherwise indicated, beneficial owners have sole rather than shared voting and investment power respecting their shares, other than shared rights created under joint tenancy or marital property laws as between the Company's Directors and officers and their respective spouses, if any. Such persons also beneficially owned an equal number and percentage of non-exercisable Common Share Purchase Rights of the Company that trade in tandem with its Common Stock.
- (2) The number of shares beneficially owned includes shares that each beneficial owner and the group had the right to acquire within 60 days pursuant to stock options. The percentage for each beneficial owner and for the group is calculated based on the sum of the 790,181,982 shares of Common Stock outstanding on March 23, 2004 and any shares shown for such beneficial owner or group as subject to stock options and currently exercisable, as if any such stock options had been exercised.
- (3) Includes 1,492 shares held for her account under the ProfitSharing Plan with respect to which she has the right to direct the voting and 442,878 shares which Ms. Barrett had the right to acquire within 60 days pursuant to stock options.
- (4) Includes 7,500 shares held in a family trust.
- (5) Includes 6,750 shares, which Mr. Cunningham had the right to acquire within 60 days pursuant to stock options.

- (6) Held by a testamentary trust of which Governor Hobby is a co-trustee.
- (7) Includes 2,977,324 shares which Mr. Kelleher had the right to acquire within 60 days pursuant to stock options, 225,160 shares held in trust for unrelated individuals, and 304,380 shares held by a family limited liability company in which Mr. Kelleher's wife has a beneficial interest. Mr. Kelleher disclaims any beneficial interest in the limited liability company shares.

*(footnotes continue on next page)*



**Table of Contents**

- (8) Includes 3,563 shares held by a charitable remainder trust in which Mr. King has a beneficial interest. Mr. King disclaims any beneficial interest in the trust shares.
- (9) Includes 2,500 shares which Mr. Montford had the right to acquire within 60 days pursuant to stock options.
- (10) Includes 870,831 shares held by entities over which Ms. Morris has investment and voting power.
- (11) Includes 38,320 shares held for his account under the ProfitSharing Plan with respect to which he has the right to direct the voting and 443,654 shares which Mr. Parker had the right to acquire within 60 days pursuant to stock options.
- (12) Includes 1,900 shares held in a trust for Mr. Kelly's daughter, and 241,513 shares that Mr. Kelly had the right to acquire within 60 days pursuant to stock options.
- (13) Includes 30,448 shares held for his account under the ProfitSharing Plan with respect to which he has the right to direct the voting and 134,188 shares which Mr. Wimberly had the right to acquire within 60 days pursuant to stock options.
- (14) Based on 1,000 shares which Mr. Caldera had the right to acquire within 60 days pursuant to stock options.
- (15) Includes 1,000 shares which Ms. Loeffler had the right to acquire within 60 days pursuant to stock options.
- (16) Includes 60,750 shares held for the accounts of certain officers under the ProfitSharing Plan with respect to which such persons have the right to direct voting. All information with respect to the ProfitSharing Plan is based on a statement dated December 31, 2003.

**Table of Contents****COMPENSATION OF EXECUTIVE OFFICERS**

The following table discloses compensation for services rendered by the Company's Chief Executive Officer and the four remaining most highly paid executive officers during the three fiscal years ended December 31, 2003.

**Summary Compensation Table**

Name and Principal Position	Year	Annual Compensation <sup>(1)</sup>		Long Term Compensation Awards	All Other Compensation (\$) <sup>(2)</sup>
		Salary (\$)	Bonus (\$) <sup>(1)</sup>	Securities Underlying Options (#)	
Herbert D. Kelleher, Chairman of the Board	2003	\$450,000	\$170,000	8,570	\$ 73,016
	2002	431,396	170,000	8,570	50,898
	2001	356,250	196,000	555,844	86,272
James F. Parker, Chief Executive Officer and Vice Chairman of the Board	2003	\$330,773	\$187,000	13,087	\$ 60,769
	2002	305,241	187,000	12,024	43,819
	2001	198,335	345,000	195,000	77,127
Colleen C. Barrett, President, Chief Operating Officer, and Secretary	2003	\$327,593	\$270,000	8,336	\$ 64,568
	2002	302,308	270,000	7,663	44,052
	2001	219,790	400,000	172,050	86,608
Gary C. Kelly, Executive Vice President and Chief Financial Officer	2003	\$256,872	\$184,450	25,151	\$ 26,486
	2002	243,793	184,450	21,598	21,750
	2001	213,246	197,000	21,500	31,308
Jim Wimberly Executive Vice President, Operations	2003	\$249,110	\$161,500	19,631	\$ 30,961
	2002	238,864	161,500	17,981	22,209
	2001	213,013	176,000	15,000	38,915

<sup>(1)</sup> Officers' bonuses are paid in January of each year in respect of performance for the prior year. The numbers shown in this column reflect such payments made in January of the specified year.

<sup>(2)</sup> Consists of amounts contributed by the Company to the Southwest Airlines Co. ProfitSharing Plan, Excess Benefit Plan and 401(k) Plan in which all Employees of the Company are eligible to participate, as well as life insurance premiums. In addition to those amounts, All Other Compensation for Mr. Kelleher includes deferred compensation, bearing interest at an annual rate of 10 percent, in an amount equal to Company contributions which would otherwise have been made on behalf of Mr. Kelleher to the ProfitSharing Plan but which exceed the contributions permitted by Federal tax laws, totaling \$36,624, \$21,262, and \$53,090 for 2003, 2002, and 2001, respectively. All Other Compensation for Mr. Parker and Ms. Barrett includes deferred compensation, bearing interest at an annual rate of 10 percent, in an amount equal to Company contributions which would otherwise have been made on behalf of each of them to the ProfitSharing Plan but which exceed the contributions permitted by Federal tax laws, totaling \$25,946 and \$32,464, respectively, for 2003, and \$15,480 and \$19,721 respectively, for

2002.

10

---

**Table of Contents****Option Grants in Last Fiscal Year**

The following table provides information on option grants in 2003 to the named executive officers:

Name	Individual Grants			Expiration Date	Potential Realizable Value at Assumed Annual Rates of Stock Price Appreciation for Option Term <sup>(1)</sup>		
	Number of Securities Underlying Options Granted (#)	Percent of Total Options Granted to Employees in Fiscal Year	Exercise Price (\$/Share)		0% (\$)	5% (\$)	10% (\$)
Herbert D. Kelleher	8,570 <sup>(2)</sup>	.03%	\$ 14.03	01-02-2013	\$ 75,587	\$ 191,625	
James F. Parker	13,087 <sup>(2)</sup>	.04%	\$ 14.03	01-02-2013	\$ 115,427	\$ 292,625	
Colleen C. Barrett	8,336 <sup>(2)</sup>	.03%	\$ 14.03	01-02-2013	\$ 73,524	\$ 186,393	
Gary C. Kelly	4,151 <sup>(2)</sup>	.01%	\$ 14.03	01-02-2013	\$ 36,612	\$ 92,816	
	21,000 <sup>(3)</sup>	.07%	\$ 13.19	01-23-2013	\$ 174,300	\$ 441,420	
Jim Wimberly	1,481 <sup>(2)</sup>	.005%	\$ 14.03	01-02-2013	\$ 13,062	\$ 33,115	
	18,150 <sup>(3)</sup>	.06%	\$ 13.19	01-23-2013	\$ 150,645	\$ 381,513	

<sup>(1)</sup> These amounts represent assumed rates of appreciation in market value from the date of grant until the end of the option term, at the rates set by the Securities and Exchange Commission, and therefore are not intended to forecast possible future appreciation, if any, in Southwest's stock price. Southwest did not use an alternative formula for a grant date valuation, as it is not aware of any formula that will determine with reasonable accuracy a present value based on future unknown or volatile factors.

<sup>(2)</sup> These options were granted to the named individuals under the Company's 1996 Incentive and Non-Qualified Stock Option Plans at fair market value as of January 2, 2003, and were fully exercisable on the grant date.

<sup>(3)</sup> These options were granted to the named individuals under the Company's 1996 Incentive and Non-Qualified Stock Option Plans at fair market value on the date of the grants and are exercisable as follows: one-third on the grant date, one-third on the first anniversary of the grant date and one-third on the second anniversary of the grant date, subject to continued employment.

**Table of Contents****Aggregated Option Exercises In Last Fiscal Year and Fiscal Year-end Option Values**

The following table shows stock option exercises by the named executive officers during 2003. In addition, this table includes the number of shares covered by both exercisable and non-exercisable stock options as of December 31, 2003. Also reported are the values for in-the-money options that represent the positive spread between the exercise price of any such existing stock options and the year-end price of the Common Stock.

Name	Shares		Number of Securities Underlying Unexercised Options at Fiscal Year-End (#)		Value of Unexercised In-the-Money Options at Fiscal Year-End (\$) <sup>(2)</sup>	
	Acquired on Exercise (#)	Value Realized (\$) <sup>(1)</sup>	Exercisable (#)	Unexercisable (#)	Exercisable (\$)	Unexercisable (\$)
	Herbert D. Kelleher	1,020,000	\$ 14,646,809	2,968,754		\$ 30,097,372
James F. Parker	25,319	\$ 214,519	431,868		\$ 1,902,674	
Colleen C. Barrett	41,162	\$ 456,511	435,616		\$ 2,219,606	
Gary C. Kelly	26,015	\$ 159,898	216,454	25,350	\$ 1,451,246	\$ 41,300
Jim Wimberly			114,540	17,600	\$ 503,023	\$ 35,695

(1) Aggregate market value of the shares covered by the option less the aggregate price paid by the executive.

(2) The closing price of the Common Stock on December 31, 2003, the last trading day of Southwest's fiscal year, was \$16.14 per share.

**Employment and Other Contracts**

The Company employs James F. Parker, effective as of June 19, 2001, under a three-year Employment Contract as Vice Chairman of the Board and Chief Executive Officer. The Employment Contract provides for an annual base salary of \$312,000 for the year ending June 19, 2002, except that in 2001 the Company and Mr. Parker agreed that he would receive no salary for the period from October 1, 2001 through December 31, 2001 in light of the severe financial challenges facing the Company as a result of the terrorist attacks on the United States on September 11, 2001. Mr. Parker's annual base salary for the years ending June 19, 2003 and 2004 will be \$324,480 and \$337,460, respectively. The Employment Contract also provides for additional benefits including: (i) discretionary performance bonuses paid in cash at the times and in the amounts determined by the Board; (ii) long-term disability insurance providing for disability payments of \$10,000 per month to age 70; (iii) reimbursement for medical and dental expenses incurred by Mr. Parker and his spouse; (iv) deferred compensation bearing interest at 10 percent in an amount equal to any Company contributions which would otherwise have been made on behalf of Mr. Parker to the Company ProfitSharing Plan but which exceed maximum annual additions under the Plan on his behalf under federal tax laws; and (v) stock options that vest in equal annual installments during the term of the Employment Contract. The Employment Contract is terminable by Mr. Parker within 60 days after the occurrence of a change of control of the Company in which a third party acquires 20 percent or more of the Company's voting securities or a majority of the Directors of the Company are replaced as a result of a tender offer or merger, sale of assets or contested election. In the event Mr. Parker so terminates his employment, the Employment Contract provides for a lump sum severance payment equal to Mr. Parker's unpaid base salary for the remaining term of his Employment Contract plus \$750,000.

The Company employs Colleen C. Barrett, effective as of June 19, 2001, under a three-year Employment Contract as President and Chief Operating Officer of the Company. The Employment Contract provides for an annual base salary of \$309,000 for the year ending June 19, 2002, except that in 2001 the Company and Ms. Barrett agreed that she would receive no salary for the period from October 1, 2001 through December 31, 2001 in light of the severe financial challenges facing the Company as a result of the terrorist attacks on the United States on September 11, 2001. Ms. Barrett's annual base salary for the years

**Table of Contents**

ending June 19, 2003 and 2004 will be \$321,360 and \$334,215, respectively. The Employment Contract also provides for additional benefits including: (i) discretionary performance bonuses paid in cash at the times and in the amounts determined by the Board; (ii) long-term disability insurance providing for disability payments of \$10,000 per month to age 70; (iii) reimbursement for medical and dental expenses incurred by Ms. Barrett; (iv) deferred compensation bearing interest at 10 percent in an amount equal to any Company contributions which would otherwise have been made on behalf of Ms. Barrett to the Company ProfitSharing Plan but which exceed maximum annual additions under the Plan on her behalf under federal tax laws; and (v) stock options that vest in equal annual installments during the term of the Employment Contract. The Employment Contract is terminable by Ms. Barrett within 60 days after the occurrence of a change of control of the Company in which a third party acquires 20 percent or more of the Company's voting securities or a majority of the Directors of the Company are replaced as a result of a tender offer or merger, sale of assets or contested election. In the event Ms. Barrett so terminates her employment, the Employment Contract provides for a lump sum severance payment equal to Ms. Barrett's unpaid base salary for the remaining term of her Employment Contract plus \$750,000.

The Board of Directors of the Company established in 1987 an Executive Service Recognition Plan to permit the Company to continue to attract and retain well-qualified executive personnel and to assure both the Company of continuity of management and its executives of continued employment in the event of any actual or threatened change of control of the Company (defined substantially as described in the following paragraph). As contemplated by the Executive Service Recognition Plan, the Company has entered into employment agreements with each of its current executive officers named in the Summary Compensation Table and certain other executive personnel. The terms of these employment agreements would be invoked only in the event of a change of control. The executives must remain in the employment of the Company for one year after a change of control has occurred. If the executive's employment is terminated other than for cause (as defined), or if the executive terminates employment for good reason (as defined), during the one-year term of employment, then the executive would receive a severance payment equal to a full year's base salary and annual bonus plus a prorated annual bonus for the year of termination. In addition, the executive's welfare benefits would continue for the unexpired portion of his or her one-year term of employment.

The Board of Directors established in 1988 a Change of Control Severance Pay Plan (the Severance Pay Plan) to provide for severance payments to qualified Employees whose employment with the Company terminates due to certain conditions created by a change in control of the Company (as defined in the Severance Pay Plan). All Employees of the Company are participants in the Severance Pay Plan except any officer participating in the Executive Service Recognition Pay Plan and all other Employees who are beneficiaries of an enforceable contract with the Company providing for severance payments in the event of a reduction in force or furlough (collective bargaining agreements). Generally, the Severance Pay Plan provides for severance payments, based upon the Employee's salary and years of service with the Company, in the event the Employee is terminated, other than for cause (as defined in the Severance Pay Plan), death, voluntary retirement or total and permanent disability, within one year of a change in control. The Employee would also remain eligible for a 12-month extension of coverage under each welfare benefit plan of the Company, including medical, dental, etc., as in effect immediately prior to any change in control. For purposes of the Severance Pay Plan, a change in control is deemed to have occurred if 20 percent or more of the combined voting power of the Company's outstanding voting securities ordinarily having the right to vote for Directors shall have been acquired by a third person or a change in the makeup of the Board of Directors shall have occurred under certain circumstances described in the Severance Pay Plan.

**Table of Contents**

**BOARD COMPENSATION COMMITTEE REPORT ON EXECUTIVE COMPENSATION**

*The Salary Administration Program for Southwest's non-contract people will be administered in a manner that promotes the attainment by Southwest of reasonable profits on a consistent basis in order to preserve job protection and security for such non-contract people; that promotes and rewards productivity and dedication to the success of Southwest as the collective embodiment of all of its people; that accomplishes internal equity among its people; and that responds pragmatically to the actual influence of external market forces.*

Southwest Airlines Co.  
Salary Administration Manual

The above principles are applied to all Southwest non-contract Employees, including executive officers. The Compensation Committee of the Board of Directors reviews the compensation of Southwest's executive officers on an annual basis. The Committee considers the total compensation (both salary and incentives), as well as the recommendation of the Company's Chief Executive Officer, in establishing each element of compensation. Mr. Parker and Ms. Barrett have employment contracts with the Company. See Compensation of Executive Officers Employment and Other Contracts.

At current cash compensation levels, the Committee does not expect Internal Revenue Service regulations regarding maximum deductibility of executive compensation to have any application to the Company, except with respect to certain \$1 stock options granted to Mr. Kelleher under his 1996 and 2001 Employment Contracts. The Committee believes that it is in the best interest of all Shareholders to structure Mr. Kelleher's compensation in a manner consistent with past practices, in a way designed to ensure his continued service to Southwest.

The principal elements of compensation for Southwest's executive officers are the following:

**Base Salary.** As a general rule, base salary for the executive officers of Southwest falls below the salaries for comparable positions in comparably sized companies. The Committee bases this determination on comparative compensation studies for similarly situated businesses; its impression of the prevailing business climate; and the advice of the Company's Chief Executive Officer.

Annual salary increases, if any, for executive officers as a group are not more, on a percentage basis, than those received by other non-contract Employees.

**Annual Incentive Bonus.** Only officers of the Company are eligible for annual incentive bonuses. The Committee determines the amount of each bonus at the end of each year.

In fixing salary and bonus amounts since the terrorist attacks in September 2001, the Committee has considered the performance of each individual, his or her level of responsibility within the Company, the Company's profitability, the longevity in office of each officer, and each officer's performance as a team member. In addition, the Committee has considered the severe financial challenges faced by the Company as a result of the terrorist attacks. Many officers voluntarily reduced their salaries during November and December 2001. In 2002, no officer received a higher bonus than for the previous year, except new officers whose bonuses were annualized, and the bonus paid in 2002 for each of the five named executive officers was actually reduced from that paid in 2001. Bonuses paid in 2003 were flat with the year before. This resulted in the officer group for Southwest being the only group of Southwest Employees receiving a sustained reduction in compensation after 9/11, despite the fact that Southwest was the only profitable major airline during that time period. These decisions were made by the Committee, on the advice of the CEO and with the support of Southwest's officer group, in order to demonstrate their commitment to the long-term prosperity of the Company, and to set an example of frugality and prudence by the leaders of Southwest Airlines. In fixing the



salary and bonus amounts for 2003, the Committee considered the performance of the Company during the continuing difficult revenue environment faced by the Company and the industry during

**Table of Contents**

2003, the performance of each individual, his or her level of responsibility within the Company, the Company's continued profitability, the longevity in office of each officer, and each officer's performance as a team member. No mathematical weighing formulae were applied with respect to any of these factors. In evaluating an individual's performance, the Committee relied on the recommendation of the Chief Executive Officer, whose recommendation is based on his own perception of such officer's performance.

The Company does not utilize defined performance targets in establishing compensation, nor does it employ minimum, targeted or maximum amounts of bonuses or total compensation levels for the executive officers and the final determination of compensation is subjective.

**Stock Options.** In an effort to bridge the perceived gap between the lower level of cash compensation for Company officers as compared to their peers and to provide a long-term incentive for future performance that aligns officers' interests with Shareholders in general, the Company adopted its 1996 Incentive Stock Option Plan and 1996 Non-Qualified Stock Option Plan. The number of options initially granted to an officer, as compared to other Southwest Employees, is dependent on the length of service with the Company and individual levels of performance and responsibility. Subsequent grants are based on levels of individual performance. With respect to all options granted, the precise number of shares is determined on a subjective basis. All grants under the Stock Option Plans are at current market value and vest over a number of years, dependent on continued employment. Each grant is made based upon the individual's compensation package for that year, without reference to previous grants. Each of the Stock Option Plans limits the number of options that may be granted to any one individual in any calendar year to 253,125 shares.

Although it is not contractually obligated to do so, it has been the practice of the Committee on an annual basis to grant additional options to Employees (including the named executive officers) who exercise options under Stock Option Plans and hold the acquired stock. With respect to 2003, such grants were made on January 5, 2004 in an amount equal to five percent of the number of shares held by the Employee as of December 31, 2003 as a result of option exercises. The total options granted in January 2004 were 148,256, of which 33,401 were to named executive officers.

**CEO Employment Agreement.** Effective as of June 19, 2001, Southwest entered into a three-year employment agreement with Mr. Parker pursuant to which Mr. Parker serves as Chief Executive Officer of the Company, and so long as he is on the Board of Directors, Vice Chairman of the Board. See Compensation of Executive Officers - Employment and Other Contracts. Pursuant to his Employment Contract, Mr. Parker received an annual base salary of \$324,480 for the year ending June 19, 2003, and Mr. Parker's annual base salary for the year ending June 19, 2004 will be \$337,460. In addition, in June 2001, Mr. Parker was granted fair market value options to purchase 180,000 shares of Southwest Common Stock with one-third vested immediately and the balance vesting in increments of one-third on each of June 19, 2002 and June 19, 2003.

The Committee relied on information supplied by an independent consultant in determining that Mr. Parker's cash compensation for the three-year period covered by his Employment Contract was significantly below the median and the average for comparable positions. The options granted to Mr. Parker, in accordance with Company practice, were designed to make up at least a portion of the difference between his cash compensation and that received by others in comparable positions, dependent on successful performance by the Company as reflected in the price of its stock.

The number of options granted to Mr. Parker was based on the Committee's review of compensation for similarly situated individuals in the transportation industry and the Committee's perception of his expected future contributions to Southwest's performance over the three-year term of his contract. At Mr. Parker's recommendation, both his cash compensation and the number of options granted to him was significantly below the amounts recommended by the consultant as necessary to make his contract competitive. The Committee did not consider the amount and value of

other options granted to Mr. Parker in

**Table of Contents**

the past, as those options were granted in connection with earlier compensation packages. The Company has no target ownership levels for Company equity holdings by executives.

Pursuant to his employment agreement, Mr. Parker is entitled to a performance bonus at the discretion of the Board of Directors. The bonus paid to Mr. Parker in each of January 2003 and 2002 was \$187,000. In fixing Mr. Parker's bonus, the Committee considered the factors indicated above for bonuses for all officers of Southwest Airlines.

Executive officers participate in the Southwest Airlines ProfitSharing Plan, Deferred Compensation Plan, and 401(k) Plan, which are available to all Southwest Employees on the same basis. See Compensation of Executive Officers Summary Compensation Table. Southwest makes little use of perquisites for executive officers.

COMPENSATION COMMITTEE

William P. Hobby, Chair  
C. Webb Crockett  
June Morris

**Table of Contents**

**AUDIT COMMITTEE REPORT**

The Audit Committee has reviewed and discussed the audited financial statements of the Company for the year ended December 31, 2003 (the Audited Financial Statements ). In addition, we have discussed with Ernst & Young LLP, the independent auditing firm for the Company, the matters required by Codification of Statements on Auditing Standards No. 61, as amended by Statement on Auditing Standards No 90, Audit Committee Communications.

The Committee also has received the written disclosures and the letter from Ernst & Young required by Independence Standards Board Standard No. 1, and we have discussed with that firm its independence from the Company and the compatibility of its provision of services other than auditing services with such independence. We also have discussed with management of the Company and the auditing firm such other matters and received such assurances from them, as we deemed appropriate.

Based on the foregoing review and discussions and relying thereon, we have recommended to the Company's Board of Directors the inclusion of the Audited Financial Statements in the Company's Annual Report for the year ended December 31, 2003 in the Company's Annual Report on Form 10-K.

**AUDIT COMMITTEE**

William H. Cunningham, Chair  
Louis Caldera  
William P. Hobby  
Travis Johnson  
Rollin W. King  
John T. Montford  
June M. Morris

**Table of Contents****PERFORMANCE GRAPH**

The following table compares total Shareholder returns for the Company over the last five years to the Standard & Poor's 500 Stock Index and the Standard and Poor's Transportation Index assuming a \$100 investment made on December 31, 1998. Each of the three measures of cumulative total return assumes reinvestment of dividends. The stock performance shown on the graph below is not necessarily indicative of future price performance.

	<b>1998</b>	<b>1999</b>	<b>2000</b>	<b>2001</b>	<b>2002</b>	<b>2003</b>
<b>Southwest Airlines</b>	100	106.77	222.27	183.94	138.51	161.01
<b>S&amp;P 500</b>	100	121.02	110.02	96.89	75.45	96.96
<b>S&amp;P Transportation</b>	100	90.33	106.95	106.73	92.97	111.76

**Table of Contents****RATIFICATION OF SELECTION OF AUDITOR  
(Item 2)**

Shareholder ratification of the selection of Ernst & Young LLP as the Company's independent auditors is not required by our Bylaws or otherwise. However, the Board of Directors is submitting the selection of Ernst & Young to the Shareholders for ratification as a matter of good corporate practice. If the Shareholders fail to ratify the selection, the Audit Committee and Board of Directors will reconsider whether or not to retain that firm. Even if the selection is ratified, the Board of Directors, in its discretion, may direct the selection of a different independent accounting firm at any time during the year if the Board of Directors believes that this change would be in the best interests of the Company and its Shareholders.

**Your Directors recommend a vote FOR the ratification of the selection of Ernst & Young LLP as the independent auditor of the company. Proxies solicited by the Board of Directors will be so voted unless Shareholders specify a different choice.**

**RELATIONSHIP WITH INDEPENDENT AUDITORS**

The firm of Ernst & Young LLP, independent auditors, has been selected by the Board of Directors to serve as the Company's auditors for the fiscal year ending December 31, 2004. Ernst & Young LLP has served as the Company's auditors since the inception of the Company. A representative of Ernst & Young LLP is expected to be present at the Annual Meeting in order to make a statement if he so desires and to respond to appropriate questions.

The following table sets forth the various fees for services provided to the Company by Ernst & Young in 2003 and 2002:

<b>Year</b>	<b>Audit Fees<sup>(1)</sup></b>	<b>Audit-Related Fees<sup>(2)</sup></b>	<b>Tax Fees<sup>(3)</sup></b>	<b>All Other Fees<sup>(4)</sup></b>	<b>Total</b>
<b>2003</b>	\$626,351	\$ 121,500	\$56,062	\$ 4,500	\$808,413
<b>2002</b>	\$785,382	\$ 108,000	\$67,772	\$ 4,500	\$965,654

(1) Includes fees for the annual audit and quarterly reviews, SEC registration statements, accounting and financial reporting consultations and research work regarding Generally Accepted Accounting Principles, passenger facility charge audits, audits required by the Federal Government for security fee payments and government relief (2002), and consultations and research related to the Sarbanes-Oxley Act of 2002.

(2) Includes fees for audits of benefit plans and wholly owned captive insurance company.

(3) Includes services for tax compliance, tax advice and tax planning.

(4) Consists of fees for other products and services.

A copy of the Audit Committee's Audit and Non-Audit Services Preapproval Policy is attached to this Proxy Statement as Appendix B. All of the services rendered by the independent auditor during 2003 were pre-approved by the Audit Committee, or by its Chairman pursuant to his delegated authority.

**OTHER MATTERS**

**Notice Requirements**

To permit the Company and its Shareholders to deal with Shareholder proposals in an informed and orderly manner, the Bylaws establish an advance notice procedure with regard to the nomination (other than



**Table of Contents**

by or at the direction of the Board of Directors) of candidates for election to the Board of Directors and with regard to certain matters to be brought before an Annual Meeting of Shareholders. In general, under the Bylaws written notice must be received by the Secretary of the Company not less than 60 days nor more than 90 days prior to the meeting and must contain certain specified information concerning the person to be nominated or the matters to be brought before the meeting as well as the Shareholder submitting the proposal. Pursuant to the Company's Bylaws, a Shareholder may nominate a person or persons for election to the Board by providing written notice to the Secretary of the Company not less than 60 and not more than 90 days prior to the meeting. The notice must contain (i) as to each nominee, all information required to be disclosed in solicitations of proxies for election of Directors pursuant to Regulation 14A under the Securities Exchange Act of 1934, (ii) the name and address of the Shareholder giving the notice, and (iii) the number of shares of the Company beneficially owned by the Shareholder giving the notice. If we do not receive notice of your proposal before February 24, 2005, it will be considered untimely and we may properly use our discretionary authority to vote for or against the proposal. A copy of the applicable Bylaw provisions may be obtained, without charge, upon written request to the Secretary of the Company at the address set forth on page 1 of this Proxy Statement.

In addition, any Shareholder who wishes to submit a proposal for inclusion in the proxy material and presentation at the 2005 Annual Meeting of Shareholders must forward such proposal to the Secretary of the Company, at the address indicated on page 1 of this Proxy Statement, so that the Secretary receives it no later than December 6, 2004.

**Section 16(a) Beneficial Ownership Reporting Compliance**

Section 16(a) of the Securities and Exchange Act of 1934 requires the Company's officers and Directors to file reports of ownership and changes in ownership of Company Common Stock with the Securities and Exchange Commission and the New York Stock Exchange. Mrs. June Morris, a Director, filed a late report reporting seven transactions that occurred during the period from 1997-2001. The Company has recently implemented additional procedures to ensure that there is no recurrence of these events. During 2003, Mr. Gary Kelly, Executive Vice President and Chief Financial Officer, filed one report regarding one stock option exercise, one day past the filing deadline.

**Discretionary Authority**

In the event a quorum is present at the meeting but sufficient votes to approve any of the items proposed by the Board of Directors have not been received, the persons named as proxies may propose one or more adjournments of the meeting to permit further solicitation of proxies. A Shareholder vote may be taken on one or more of the proposals in this Proxy Statement prior to such adjournment if sufficient proxies have been received and it is otherwise appropriate. Any adjournment will require the affirmative vote of the holders of a majority of those shares of Common Stock represented at the meeting in person or by proxy. If a quorum is present, the persons named as proxies will vote these proxies which they have been authorized to vote on any other business properly before the meeting in favor of such an adjournment.

The Board of Directors does not know of any other matters that are to be presented for action at the meeting. However, if other matters properly come before the meeting, it is intended that the enclosed proxy will be voted in accordance with the judgment of the persons voting the proxy.

By Order of the Board of Directors,

Herbert D. Kelleher  
*Chairman of the Board*

April 16, 2004

**Table of Contents**

**TO: Participants in the Southwest Airlines Co. ProfitSharing Plan (the Plan )**

The accompanying Notice of Annual Meeting of Shareholders and Proxy Statement relate to shares of Common Stock of Southwest Airlines Co. held by the Trustee for your profit sharing account, as well as any shares you may own in your own name.

Under the Plan, each participant has the right to direct the voting of stock credited to his or her account. In addition, you and the other participants are entitled to direct the voting of stock credited to the accounts of participants who do not give voting instructions.

The Trustee is required to vote the shares held for your account in accordance with your instructions. If you wish to instruct the Trustee on the vote of shares held for your account, you should vote via telephone or the Internet, or complete and sign the form enclosed and return it in the addressed, postage-free envelope by May 17, 2004.

If you do not vote by May 17, 2004, the Trustee will vote your shares in the same proportions as the shares for which the Trustee receives voting instructions from other participants.

**Table of Contents**

**APPENDIX A**

**SOUTHWEST AIRLINES CO.  
AUDIT COMMITTEE CHARTER**

The Audit Committee of the Board of Directors of Southwest Airlines Co. is responsible for the appointment, compensation, retention, and oversight of the work of the Company's independent auditors. The Committee shall assist the Board of Directors in oversight of (1) the integrity of Southwest's financial statements, (2) Southwest's compliance with legal and regulatory requirements, (3) the independent auditor's qualification and independence, and (4) the performance of Southwest's internal audit function and independent auditors. The Committee shall perform the following functions:

1. Review with independent auditors the scope and results of their audits, the audit procedures utilized, including any restrictions on their work, cooperation received, and their findings and recommendations. Engage the independent auditors to review financial information included in the Company's Quarterly Reports on Form 10-Q, prior to the filing of such report with the Securities and Exchange Commission.
2. Review with the independent auditors and management the Company's financial reporting, and accounting and disclosure principles, policies and practices; alternative treatments within generally accepted accounting principles for material items discussed with management, including the ramifications of such alternatives and the treatment preferred by the auditors; and other written communications between the auditor and management that are material to the financial statements. The Committee shall discuss generally the Company's annual audited financial statements and quarterly financial statements with management and the independent auditor, including the Company's disclosures under Management's Discussion and Analysis of Financial Condition and Results of Operations, as well as the Company's earnings press releases and financial information and earnings guidance provided to analysts and rating agencies.
3. Discuss the Company's major financial risk exposures and its policies with respect to risk assessment and risk management;
4. Review with the independent auditors and the Company's internal auditor the adequacy of the Company's accounting, financial and internal operating controls, including those designed to insure that Company payments and other transactions are properly made and recorded in compliance with all applicable statutes and regulations, including the Foreign Corrupt Practices Act of 1977.
5. Review with the independent auditors and management the independent auditors' fees for audit services. Preapprove all services provided by the independent auditors in accordance with the policy attached as Exhibit A; from time to time delegate authority to one or more members of the Committee to preapprove services between committee meetings as set forth in the policy.
6. Determine appropriate funding by the Company for payment of:

**Table of Contents**

- (A) Compensation to any registered public accounting firm engaged for the purpose of preparing or issuing an audit report or performing other audit, review or attest services for the listed issuer;
  - (B) Compensation to any independent counsel or other advisers employed by the Committee, as the Committee determines necessary to carry out its duties as set forth in this Charter and by law or regulation of the NYSE;
  - (C) Ordinary administrative expenses of the Committee that are necessary or appropriate in carrying out its duties.
7. Establish and maintain procedures for the receipt, retention, and treatment of complaints regarding accounting, internal accounting controls, or auditing matters and the confidential, anonymous submission by Employees of concerns regarding questionable accounting or auditing matters. Set clear policies for the hiring of employees or former employees of the independent auditors.
8. Consider the possible effect of non-audit related services performed by the independent auditors, on the independence of said independent auditors. Receive an annual written report from the independent auditors regarding the following:
- (A) the firm's internal quality-control procedures;
  - (B) any material issues raised by the most recent internal quality-control review, or peer review, of the firm, or by any inquiry or investigation by governmental or professional authorities, within the preceding five years, respecting one or more independent audits carried out by the firm and any steps taken to deal with any such issues; and
  - (C) (to assess independence) all relationships between the independent auditor and Southwest.
- Upon receipt of this report, the Committee shall evaluate the auditor's qualifications, performance and independence, including a review and evaluation of the lead partner of the independent auditor. In making this evaluation, the Committee shall consider the opinions of management and the Director of Internal Audit. The Committee's findings shall be reported to the Board of Directors.
9. Meet five times a year in regular meetings, and additional meetings that may be deemed appropriate by the Chairman of the Audit Committee or the Board of Directors; meet separately, periodically, with management, with internal auditors, and with independent auditors.
10. Perform such additional functions as may from time to time be assigned to the Committee by the Board of Directors.
11. Review and reassess the performance of this Committee and the adequacy of this Charter annually and recommend any proposed changes to the Board for approval.

**Table of Contents**

12. Prepare the report required by the rules of the Securities and Exchange Commission to be included in the Company's annual proxy statement, in which the Committee will state whether:
- (A) the Audit Committee has reviewed and discussed the audited financial statements with management;
  - (B) the Audit Committee has discussed with the independent auditors the matters required to be discussed by SAS 61 (relating to the conduct of the audit);
  - (C) the Audit Committee has received the written disclosures and the letter from the independent auditors required by ISB Standard No.1 and has discussed with the auditors the auditors' independence; and
  - (D) based upon the review and discussions described above, it recommended to the Board of Directors that the financial statements be included in the Annual Report on Form 10-K.
- The members of the Audit Committee shall meet the independence and experience requirements of the New York Stock Exchange and applicable federal law.

As adopted by the Board of Directors on November 20, 2003.

**Table of Contents**

**APPENDIX B**

**Southwest Airlines Co.**

**Audit and Non-Audit Services Preapproval Policy  
Adopted March 20, 2003**

**I. Purpose**

Under the Sarbanes-Oxley Act of 2002 (the Act) and the rules of the Securities and Exchange Commission (the SEC), the Audit Committee of the Board of Directors is responsible for the appointment, compensation, and oversight of the work of the independent auditor. The Audit Committee is required to pre-approve the audit and non-audit services performed by the independent auditor in order to assure that they do not impair the auditor's independence from the Company. Accordingly, the Audit Committee has adopted, and the Board of Directors of Southwest Airlines Co. (the Company or Southwest) has ratified, this Audit and Non-Audit Services Preapproval Policy (the Policy), which sets forth the procedures and the conditions pursuant to which services proposed to be performed by the independent auditor may be preapproved.

The SEC's rules provide that proposed services may be preapproved without consideration of specific case-by-case services by the Audit Committee (general preapproval) or may require the specific preapproval of the Audit Committee (specific preapproval). The Audit Committee believes that the combination of these two approaches in this Policy will result in an effective and efficient procedure to pre-approve services performed by the independent auditor. Accordingly, unless a type of service has received general preapproval, it will require specific preapproval by the Audit Committee if it is to be provided by the independent auditor. Any proposed services exceeding preapproved cost levels or budgeted amounts will also require specific preapproval by the Audit Committee.

For each preapproval, the Audit Committee will consider whether the services are consistent with the SEC's rules on auditor independence. The Audit Committee will also consider whether the independent auditor is best positioned to provide the most effective and efficient service, for reasons such as its familiarity with the Company's business, people, culture, accounting systems, risk profile and other factors, and whether the service might enhance the Company's ability to manage or control risk or improve audit quality. All such factors will be considered as a whole, and no one factor will necessarily be determinative.

The independent auditor has reviewed this Policy and believes that implementation of the policy will not adversely affect the auditor's independence.

**II. Delegation**

The Act and the SEC's rules permit the Audit Committee to delegate preapproval authority to one or more of its members. The member to whom such authority is delegated must report, for informational purposes only, any preapproval decisions to the Audit Committee at its next scheduled meeting.

**Table of Contents**

**III. Audit Services**

The annual Audit services engagement terms and fees will be subject to the specific preapproval of the Audit Committee. The Audit Committee will monitor the Audit services engagement as necessary, but no less than on a quarterly basis, and will also approve, if necessary, any changes in terms, conditions and fees.

In addition to the annual Audit services engagement approved by the Audit Committee, the Audit Committee may grant preapproval to other Audit services, which are those services that only the independent auditor reasonably can provide. Other Audit services may include services associated with SEC registration statements or other documents issued in connection with securities offerings.

**IV. Audit-related Services**

Audit-related services are assurance and related services that are reasonably related to the performance of the audit or review of the Company's financial statements or that are traditionally performed by the independent auditor. Because the Audit Committee believes that the provision of Audit-related services does not impair the independence of the auditor and is consistent with the SEC's rules on auditor independence, the Audit Committee may grant general preapproval to Audit-related services. Audit-related services include, among others, due diligence services pertaining to potential business acquisitions/dispositions; accounting consultations related to accounting, financial reporting or disclosure matters not classified as Audit services; assistance with understanding and implementing new accounting and financial reporting guidance from rulemaking authorities; financial audits of Employee benefit plans; agreed-upon or expanded audit procedures related to accounting and/or billing records required to respond to or comply with financial, accounting or regulatory reporting matters; and assistance with internal control reporting requirements.

**V. Tax Services**

The Audit Committee believes that the independent auditor can provide Tax services to the Company such as tax compliance, tax planning and tax advice without impairing the auditor's independence, and the SEC has stated that the independent auditor may provide such services. The Audit Committee believes it may grant general preapproval to those Tax services that have historically been provided by the auditor, that the Audit Committee has reviewed and believes would not impair the independence of the auditor, and that are consistent with the SEC's rules on auditor independence. The Audit Committee will not permit the retention of the independent auditor in connection with a transaction initially recommended by the independent auditor, the sole business purpose of which may be tax avoidance and the tax treatment of which may not be supported in the Internal Revenue Code and related regulations. The Audit Committee will consult with the Chief Financial Officer or Vice President - Finance to determine that the tax planning and reporting positions are consistent with this policy.

The Audit Committee must preapprove tax services to be provided by the independent auditor to any Executive Officer or Director of the Company, in his or her individual capacity, where such services are paid for by the Company.

**VI. All Other Services**

The Audit Committee believes, based on the SEC's rules prohibiting the independent auditor from providing specific non-audit services, that other types of non-audit services are permitted. Accordingly, the Audit



**Table of Contents**

Committee believes it may grant general preapproval to those permissible non-audit services classified as All Other services that it believes are routine and recurring services, would not impair the independence of the auditor, and are consistent with the SEC's rules on auditor independence.

A list of the SEC's prohibited non-audit services is attached to this policy as Exhibit 1. The SEC's rules and relevant guidance should be consulted to determine the precise definitions of these services and the applicability of exceptions to certain of the prohibitions.

**VII. Preapproval Fee Levels or Budgeted Amounts**

Preapproval fee levels for all services to be provided by the independent auditor will be established by the Audit Committee. Any proposed services exceeding these levels or amounts will require specific preapproval by the Audit Committee. The Audit Committee is mindful of the overall relationship of fees for audit and non-audit services in determining whether to pre-approve any such services.

**VIII. Procedures**

All requests or applications for services to be provided by the independent auditor that do not require specific approval by the Audit Committee will be submitted to the Chief Financial Officer or Vice President - Finance and must include a detailed description of the services to be rendered. The Vice President - Finance will determine whether such services are included within the list of services that have received the general preapproval of the Audit Committee. The Audit Committee will be informed on a timely basis of any such services rendered by the independent auditor.

Requests or applications to provide services that require specific approval by the Audit Committee will be submitted to the Audit Committee by both the independent auditor and the Vice President - Finance and must include a joint statement as to whether, in their view, the request or application is consistent with the SEC's rules on auditor independence.

**Table of Contents**

**Exhibit 1**  
**Prohibited Non-Audit Services**

Bookkeeping or other services related to the accounting records or financial statements of the audit client

Financial information systems design and implementation

Appraisal or valuation services, fairness opinions or contribution-in-kind reports

Actuarial services

Internal audit outsourcing services

Management functions

Human resources

Broker-dealer, investment adviser or investment banking services

Legal services

Expert services unrelated to the audit

Page 4

---

**Table of Contents**

**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, 2003 or

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

For the transition period from \_\_\_\_\_ to \_\_\_\_\_  
Commission File No. 1-7259

**SOUTHWEST AIRLINES CO.**

(Exact name of registrant as specified in its charter)

**TEXAS**

(State or other jurisdiction of incorporation or organization)

**74-1563240**

(I.R.S. employer identification no.)

**P.O. Box 36611**

**Dallas, Texas**

(Address of principal executive offices)

**75235-1611**

(Zip Code)

Registrant's telephone number, including area code:

**(214) 792-4000**

**SECURITIES REGISTERED PURSUANT TO SECTION 12(b) OF THE ACT:**

<b>Title of Each Class</b>	<b>Name of Each Exchange on Which Registered</b>
Common Stock (\$1.00 par value)	New York Stock Exchange, Inc.
Common Share	New York Stock Exchange, Inc.
Purchase Rights	

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

None

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

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

Indicate by check mark whether the registrant is an accelerated filer (as defined in Rule 12b-2 of the Securities Exchange Act of 1934). Yes [X] No [ ]

The aggregate market value of the Common Stock held by non-affiliates of the registrant was approximately \$13,309,000,000, computed by reference to the closing sale price of the stock on the New York Stock Exchange on June 30, 2003, 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 December 31, 2003: 789,390,678 shares

### **DOCUMENTS INCORPORATED BY REFERENCE**

Proxy Statement for Annual Meeting of Shareholders, May 19, 2004:

**PART III**

---

**Table of Contents****PART I****Item 1. Business****Description of Business**

Southwest Airlines Co. ( Southwest ) is a major domestic airline that provides predominantly shorthaul, high-frequency, point-to-point, low-fare service. Southwest was incorporated in Texas in 1967 and commenced Customer Service on June 18, 1971 with three Boeing 737 aircraft serving three Texas cities - Dallas, Houston, and San Antonio.

At year-end 2003, Southwest operated 388 Boeing 737 aircraft and provided service to 59 airports in 58 cities in 30 states throughout the United States. Southwest Airlines topped the monthly domestic passenger traffic rankings for the first time in May 2003. Based on monthly data from May through August 2003 (the latest available data), Southwest Airlines is the largest carrier in the United States based on originating domestic passengers boarded and scheduled domestic departures. The Company recently announced that it intends to begin service to Philadelphia in May 2004.

One of Southwest's competitive strengths is its low operating costs. Southwest has the lowest costs, adjusted for stage length, on a per mile basis, of all of the major airlines. Among the factors that contribute to its low cost structure are a single aircraft type, an efficient, high-utilization, point-to-point route structure, and hardworking, innovative, and highly productive Employees.

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

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

**Fuel**

The cost of fuel is an item having significant impact on the Company's operating results. The Company's average cost of jet fuel, net of hedging gains, over the past five years was as follows:

<b>Year</b>	<b>Cost (Millions)</b>	<b>Average Cost per Gallon</b>	<b>Percent of Operating Expenses</b>
1999	\$492	\$.53	12.5%
2000	\$804	\$.79	17.4%
2001	\$771	\$.71	15.6%
2002	\$762	\$.68	14.9%
2003	\$830	\$.72	15.2%

From October 1, 2003 through December 31, 2003, the average cost per gallon was \$.74. See Management's Discussion and Analysis of Financial Condition and Results of Operations for a discussion of Southwest's fuel hedging activities.

**Regulation**

*Economic.* The Dallas Love Field section of the International Air Transportation Competition Act of 1979, as amended in 1997 (commonly known as the Wright Amendment ), as it affects Southwest s

A-2

---

**Table of Contents**

scheduled service, provides that no common carrier may provide scheduled passenger air transportation for compensation between Love Field and one or more points outside Texas, except that an air carrier may transport individuals by air on a flight between Love Field and one or more points within the states of Alabama, Arkansas, Kansas, Louisiana, Mississippi, New Mexico, Oklahoma, and Texas if (a) such air carrier does not offer or provide any through service or ticketing with another air carrier and (b) such air carrier does not offer for sale transportation to or from, and the flight or aircraft does not serve, any point which is outside any such states. The Wright Amendment does not restrict flights operated with aircraft having 56 or fewer passenger seats. The Wright Amendment does not restrict Southwest's intrastate Texas flights or its air service from points other than Love Field.

The Department of Transportation ( DOT ) has significant regulatory jurisdiction over passenger airlines. Unless exempted, no air carrier may furnish air transportation over any route without a DOT certificate of public convenience and necessity, which does not confer either exclusive or proprietary rights. The Company's certificates are unlimited in duration and permit the Company to operate among any points within the United States, its territories and possessions, except as limited by the Wright Amendment, as do the certificates of all other U.S. carriers. DOT may revoke such certificates, in whole or in part, for intentional failure to comply with certain provisions of the U.S. Transportation Code, or any order or regulation issued thereunder or any term of such certificate; provided that, with respect to revocation, the certificate holder has first been advised of the alleged violation and fails to comply after being given a reasonable time to do so.

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

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

The Company is subject to various other federal, state, and local laws and regulations relating to occupational safety and health, including Occupational Safety and Health Administration (OSHA) and Food and Drug Administration (FDA) regulations.

*Security.* On November 19, 2001, President Bush signed into law the Aviation and Transportation Security Act ( Security Act ). The Security Act generally provides for enhanced aviation security measures. The Security Act established a new Transportation Security Administration ( TSA ), which has recently been moved to the new Department of Homeland Security. The TSA assumed the aviation security functions previously residing in the FAA and assumed passenger screening contracts at U.S. airports on February 17, 2002. The TSA now provides for the screening of all passengers and property, which is performed by federal employees. Beginning February 1, 2002, a \$2.50 per enplanement security fee is imposed on passengers (maximum of \$5.00 per one-way trip). This fee was suspended by Congress from June 1 through September 30, 2003. Pursuant to authority granted to the TSA to impose additional fees on air carriers if necessary to cover additional federal aviation security costs, the TSA has imposed an annual Security Infrastructure Fee, which approximated \$23 million for Southwest in 2002 and \$18 million in 2003. This fee was also suspended by Congress from June 1 through September 30, 2003. Like the FAA, the TSA may impose and collect fines for violations of its regulations.





**Table of Contents**

Enhanced security measures have had, and will continue to have, a significant impact on the airport experience for passengers. While these security requirements have not impacted aircraft utilization, they have impacted our business. The Company has invested significantly in facilities, equipment, and technology to process Customers efficiently and restore the airport experience. The Company has implemented its Automated Boarding Passes and RAPID CHECK-IN self service kiosks in its 59 airports to reduce the number of lines in which a Customer must wait. During 2003, the Company also installed gate readers at all of its airports to improve the boarding reconciliation process. In 2004, Customers will be able to check baggage using RAPID CHECK-IN kiosks. Southwest also plans to introduce internet checkin and transfer boarding passes at the time of checkin.

*Environmental.* Certain airports, including San Diego and Orange County, have established airport restrictions to limit noise, including restrictions on aircraft types to be used, and limits on the number of hourly or daily operations or the time of such operations. In some instances, these restrictions have caused curtailments in service or increases in operating costs and such restrictions could limit the ability of Southwest to expand its operations at the affected airports. Local authorities at other airports may consider adopting similar noise regulations, but such regulations are subject to the provisions of the Airport Noise and Capacity Act of 1990 and regulations promulgated thereunder.

Operations at John Wayne Airport, Orange County, California, are governed by the Airport's Phase 2 Commercial Airline Access Plan and Regulation (the Plan). Pursuant to the Plan, each airline is allocated total annual seat capacity to be operated at the airport, subject to renewal/reallocation on an annual basis. Service at this airport may be adjusted annually to meet these requirements.

The Company is subject to various other federal, state, and local laws and regulations relating to the protection of the environment, including the discharge or disposal of materials such as chemicals, hazardous waste, and aircraft deicing fluid. Regulatory developments pertaining to such things as control of engine exhaust emissions from ground support equipment and prevention of leaks from underground aircraft fueling systems could increase operating costs in the airline industry. The Company does not believe, however, that such environmental regulatory developments will have a material impact on the Company's capital expenditures or otherwise adversely effect its operations, operating costs, or competitive position. Additionally, in conjunction with airport authorities, other airlines, and state and local environmental regulatory agencies, the Company is undertaking voluntary investigation or remediation of soil or groundwater contamination at several airport sites. The Company does not believe that any environmental liability associated with such sites will have a material adverse effect on the Company's operations, costs, or profitability.

*Customer Service Commitment.* From time to time, the airline transportation industry has been faced with possible legislation dealing with certain Customer service practices. As a compromise with Congress, the industry, working with the Air Transport Association, has responded by adopting and filing with the DOT written plans disclosing how it would commit to improving performance. Southwest Airlines formalized its dedication to Customer Satisfaction by adopting its Customer Service Commitment, a comprehensive plan which embodies the Mission Statement of Southwest Airlines: dedication to the highest quality of Customer Service delivered with a sense of warmth, friendliness, individual pride, and Company Spirit. The Customer Service Commitment can be reviewed by clicking on About SWA at Congress is expected to monitor the effects of the industry's plans, and there can be no assurance that legislation will not be proposed in the future to regulate airline Customer service practices.

**Table of Contents**

**Marketing and Competition**

Southwest focuses principally on point-to-point, rather than hub-and-spoke, service in markets with frequent, conveniently timed flights and low fares. At year-end, Southwest served 337 nonstop city pairs. Southwest's average aircraft trip stage length in 2003 was 558 miles with an average duration of approximately 1.5 hours. Examples of markets offering frequent daily flights are: Dallas to Houston, 35 weekday roundtrips; Phoenix to Las Vegas, 19 weekday roundtrips; and Los Angeles International to Oakland, 22 weekday roundtrips. Southwest complements these high-frequency shorthaul routes with longhaul nonstop service between markets such as Baltimore and Los Angeles, Phoenix and Tampa Bay, Seattle and Nashville, and Houston and Oakland.

Southwest's point-to-point route system, as compared to hub-and-spoke, provides for more direct nonstop routings for Customers and, therefore, minimizes connections, delays, and total trip time. Southwest focuses on nonstop, not connecting, traffic. As a result, approximately 79 percent of the Company's Customers fly nonstop. In addition, Southwest serves many conveniently located satellite or downtown airports such as Dallas Love Field, Houston Hobby, Chicago Midway, Baltimore-Washington International, Burbank, Manchester, Oakland, San Jose, Providence, Ft. Lauderdale/Hollywood and Long Island Islip airports, which are typically less congested than other airlines' hub airports and enhance the Company's ability to sustain high Employee productivity and reliable ontime performance. This operating strategy also permits the Company to achieve high asset utilization. Aircraft are scheduled to minimize the amount of time the aircraft are at the gate, currently approximately 25 minutes, thereby reducing the number of aircraft and gate facilities that would otherwise be required. The Company operates only one aircraft type, the Boeing 737, which simplifies scheduling, maintenance, flight operations, and training activities. Southwest does not interline or offer joint fares with other airlines, nor have any commuter feeder relationships.

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. The Company's highest oneway unrestricted walkup fare offered is \$299 for any flight. Even lower walkup fares are available on Southwest's short and medium haul flights.

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 home page on the Internet, [www.southwest.com](http://www.southwest.com). For the year ended December 31, 2003, more than 85 percent of Southwest's Customers chose the Ticketless travel option and approximately 54 percent of Southwest's passenger revenues came through its Internet site, which has become a vital part of the Company's distribution strategy. As part of Southwest's cost reduction measures and due to the success of its website, the Company has announced it will no longer pay commissions to travel agents for sales on or after December 15, 2003.

The airline industry is highly competitive as to fares, frequent flyer benefits, routes, and service, and some carriers competing with the Company have larger fleets and wider name recognition. Certain major United States airlines have established marketing or codesharing alliances with each other, including Northwest Airlines/Continental Airlines/Delta Air Lines; American Airlines/Alaska Airlines; and United Airlines/USAirways.

After the terrorist acts of September 11, 2001, and in the face of weak demand for air service, most major carriers (not including Southwest) significantly reduced service, grounded aircraft, and furloughed employees. UAL, the parent of United Airlines, and US Airways sought relief from financial obligations in bankruptcy and other, smaller carriers have ceased operation entirely. America West Airlines, USAirways, and others received federal loan guarantees authorized by federal law and additional airlines may do so in the future. Many carriers renegotiated collective bargaining agreements and vendor agreements, resulting in a reduction in their costs. More recently, many major carriers have announced plans for capacity increases in 2004; likewise, smaller low cost carriers have accelerated their growth plans. While Southwest's share of the



## **Table of Contents**

domestic market has continued to increase, it is not currently possible to assess the ultimate impact of all of these events on airline competition.

The Company is also subject to varying degrees of competition from surface transportation in its shorthaul markets, particularly the private automobile. In shorthaul air services that compete with surface transportation, price is a competitive factor, but frequency and convenience of scheduling, facilities, transportation safety and security procedures, and Customer Service are also of great importance to many passengers.

## **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, property 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. The federal government stepped in to provide supplemental third-party war-risk insurance coverage to commercial carriers for renewable 60-day periods, at substantially lower premiums than prevailing commercial rates and for levels of coverage not available in the commercial market. In November 2002, Congress passed the Homeland Security Act of 2002, which mandated the federal government to provide third party, passenger and hull war-risk insurance coverage to commercial carriers through August 31, 2003, and which permitted such coverage to be extended by the government through December 31, 2003. The Emergency Wartime Supplemental Appropriations Act (see Note 3 to the Consolidated Financial Statements) extends the government's mandate to provide war-risk insurance until August 31, 2004, and permits such coverage to be extended until December 31, 2004. The Company is unable to predict whether the government will extend this insurance coverage past August 31, 2004, whether alternative commercial insurance with comparable coverage will become available at reasonable premiums, and what impact this will have on the Company's ongoing operations or future financial performance.

## **Frequent Flyer Awards**

Southwest's frequent flyer program, Rapid Rewards, is based on trips flown rather than mileage. Rapid Rewards Customers earn a flight segment credit for each one-way trip flown or two credits for each round trip flown. Rapid Rewards Customers can also receive flight segment credits by using the services of non-airline partners, which include car rental agencies, hotels, and credit card partners, including the Southwest Airlines Bank One (formerly First USA<sup>(R)</sup>) Visa card. Rapid Rewards offers two types of travel awards. The Rapid Rewards Award Ticket ( Award Ticket ) offers one free roundtrip travel award to any Southwest destination after the accumulation of 16 flight segment credits within a consecutive twelve-month period. The Rapid Rewards Companion Pass ( Companion Pass ) is granted for flying 50 roundtrips (or 100 one-way trips) on Southwest within a consecutive twelve-month period. The Companion Pass offers unlimited free roundtrip travel to any Southwest destination for a designated companion of the qualifying Rapid Rewards member. In order 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.

Trips flown are valid for flight segment credits toward Award Tickets and Companion Passes for twelve months only; Award Tickets and Companion Passes are automatically generated when earned by the Customer rather than allowing the Customer to bank credits indefinitely; and Award Tickets and Companion Passes are valid for one year with an automatic expiration date. Black out dates apply during peak holiday



## **Table of Contents**

periods. Unlike most of its competitors, the Company does not limit the number of seats available to holders of Award Tickets and Companion Passes.

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

Customers redeemed approximately 2.5 million, 2.2 million, and 1.7 million Award Tickets and flights on Companion Passes during 2003, 2002, and 2001, respectively. The amount of free travel award usage as a percentage of total Southwest revenue passengers carried was 7.5 percent in 2003, 6.8 percent in 2002, and 5.4 percent in 2001. The number of Award Tickets outstanding at December 31, 2003 and 2002 was approximately 1.4 million. In addition, there were approximately 5.6 million partially earned Award Tickets as of December 31, 2003. However, due to the expected expiration of a portion of credits making up these partial awards, not all of them will eventually turn into useable Award Tickets. Also, not all Award Tickets will be redeemed for future travel. Since the inception of Rapid Rewards in 1987, approximately 14 percent of all Award Tickets have expired without being used. The number of Companion Passes for Southwest outstanding at December 31, 2003 and 2002 was approximately 53,000 and 55,000, respectively. The Company currently estimates that an average of 3 to 4 trips will be redeemed per outstanding Companion Pass.

The Company accounts for its frequent flyer program obligations by recording a liability for the estimated incremental cost of flight awards the Company expects to be redeemed (except for flight segment credits sold to business partners). This method recognizes an average incremental cost to provide roundtrip transportation to one additional passenger. 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 incremental cost is accrued at the time an award is earned and revenue is subsequently recognized, at the amount accrued, when the free travel award is used. Revenue from the sale of flight segment credits and associated with future travel is deferred and recognized when the ultimate free travel award is flown or the credits expire unused. Accordingly, Southwest does not accrue incremental cost for the expected redemption of free travel awards for credits sold to business partners. The liability for free travel awards earned but not used at December 31, 2003 and 2002 was not material.

## **Employees**

At December 31, 2003, Southwest had 32,847 active Employees, consisting of 10,854 flight, 1,956 maintenance, 15,949 ground Customer and fleet service and 4,088 management, accounting, marketing, and clerical personnel.

Southwest has ten collective bargaining agreements covering approximately 80.2 percent of its Employees. The following table sets forth the Company's Employee groups and collective bargaining status:

**Table of Contents**

<b>Employee Group</b>	<b>Represented by</b>	<b>Agreement amendable on</b>
Customer Service and Reservations	International Association of Machinists and Aerospace Workers, AFL-CIO	November 2008 (or 2006 at the Union's option under certain conditions)
Flight Attendants	Transportation Workers of America, AFL-CIO ( TWU )	In negotiations
Ramp, Operations and Provisioning	TWU	June 2008 (or 2006 at the Union's option under certain conditions)
Pilots	Southwest Airlines Pilots Association	September 2006
Flight Dispatchers	Southwest Airlines Employee Association	November 2009
Aircraft Appearance Technicians	Aircraft Mechanics Fraternal Association ( AMFA )	February 2009
Stock Clerks	International Brotherhood of Teamsters ( Teamsters )	August 2008
Mechanics	AMFA	August 2005
Flight Simulator Technicians	Teamsters	November 2008
Flight/Ground School Instructors and Flight Crew Training Instructors	Southwest Airlines Professional Instructors Association	December 2012

**Item 2. Properties****Aircraft**

Southwest operated a total of 388 Boeing 737 aircraft as of December 31, 2003, of which 89 and 7 were under operating and capital leases, respectively. The remaining 292 aircraft were owned.

Southwest was the launch Customer for the Boeing 737-700 aircraft, the newest generation of the Boeing 737 aircraft type. The first 737-700 aircraft was delivered in December 1997 and entered revenue service in January 1998. At December 31, 2003, Southwest had 146 Boeing 737-700 aircraft in service.

The following table details information on the 388 aircraft in the Company's fleet as of December 31, 2003:

<b>737 Type</b>	<b>Seats</b>	<b>Average Age (Yrs)</b>	<b>Number of Aircraft</b>	<b>Number Owned</b>	<b>Number Leased</b>
-200	122	21.2	23	21	2
-300	137	12.6	194	110	84

Edgar Filing: SOUTHWEST AIRLINES CO - Form DEF 14A

-500	122	12.7	25	16	9
-700	137	3.3	146	145	1
<b>Totals</b>		<b>9.6</b>	<b>388</b>	<b>292</b>	<b>96</b>

The Company currently intends to retire its fleet of 23 Boeing 737-200 aircraft by the end of first quarter 2005.

In total, at January 29, 2004, the Company had firm orders and options to purchase Boeing 737 aircraft as follows:

A-8

---



**Table of Contents****Firm Orders and Options to Purchase Boeing 737-700 Aircraft**

<b>Delivery Year</b>	<b>Firm Orders</b>	<b>Options</b>	<b>Purchase Rights</b>
2004	47*		
2005	28	6	
2006	22	12	
2007	25	9	20
2008	6	25	20
2009-2012			177
<b>Totals</b>	<b>128</b>	<b>52</b>	<b>217</b>

\*Includes one leased aircraft to be delivered new from a third party.

**Ground Facilities and Services**

Southwest leases terminal passenger service facilities at each of the airports it serves, to which it has added various leasehold improvements. The Company leases land on a long-term basis for its maintenance centers located at Dallas Love Field, Houston Hobby, Phoenix Sky Harbor, and Chicago Midway, its training center near Love Field, which houses six 737 simulators, and its corporate headquarters, also located near Love Field. The maintenance, training center, and corporate headquarters buildings on these sites were built and are owned by Southwest. At December 31, 2003, the Company operated nine reservation centers. The reservation centers located in Little Rock, Arkansas; Chicago, Illinois; Albuquerque, New Mexico; Oklahoma City, Oklahoma; and Salt Lake City, Utah occupy leased space. The Company owns its Dallas, Texas; Houston, Texas; Phoenix, Arizona; and San Antonio, Texas reservation centers. The Company recently announced that it intends to close its Dallas, Salt Lake City, and Little Rock reservations centers on February 28, 2004.

Southwest has entered into a concession agreement with the Town of Islip, New York which gives the Company the right to construct, furnish, occupy, and maintain a new concourse at the airport. Once all phases of the project are completed, the concourse could have up to a total of eight gates. Phase I of this project, which is expected to be ready for operations in mid-2004, includes four gates. Phase II construction, which includes an additional 4 gates, could, at the Company's election, begin immediately upon the completion of Phase I and could be completed in 2005. When all phases of construction are complete, the entire new concourse will become the property of the Town of Islip. In return for constructing the new concourse, Southwest will receive fixed-rent abatements for a total of 25 years; however, the Company will still be required to pay variable rents for common use areas and manage the new concourse.

The Company performs substantially all line maintenance on its aircraft and provides ground support services at most of the airports it serves. However, the Company has arrangements with certain aircraft maintenance firms for major component inspections and repairs for its airframes and engines, which comprise the majority of the annual aircraft maintenance 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 Internal 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 of merit. The Company's management does not expect that the outcome in any of its currently ongoing legal proceedings or the outcome of any proposed adjustments presented to date by the IRS, individually or collectively, will have a material adverse effect on the Company's financial condition, results of operations or cash flows.

A-9

---

**Table of Contents**

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

None to be reported.

A-10

---

**Table of Contents****EXECUTIVE OFFICERS OF THE REGISTRANT**

The executive officers of Southwest, their positions, and their respective ages (as of January 1, 2004) are as follows:

<b>Name</b>	<b>Position</b>	<b>Age</b>
Herbert D. Kelleher	Chairman of the Board	72
James F. Parker	Vice Chairman of the Board and Chief Executive Officer	57
Colleen C. Barrett	Director, President and Chief Operating Officer	59
Donna D. Conover	Executive Vice President- Customer Service	50
Gary C. Kelly	Executive Vice President and Chief Financial Officer	48
James C. Wimberly	Executive Vice President- Chief Operations Officer	50
Joyce C. Rogge	Senior Vice President - Marketing	46
Ron Ricks	Vice President-Governmental Affairs	54
Dave Ridley	Vice President-Ground Operations	50

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

**Table of Contents****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 high and low sales prices of the common stock on the Composite Tape and the quarterly dividends per share paid on the common stock were:

<b>Period</b>	<b>Dividend</b>	<b>High</b>	<b>Low</b>
<b>2003</b>			
1st Quarter	\$0.00450	\$15.33	\$11.72
2nd Quarter	0.00450	17.70	14.09
3rd Quarter	0.00450	18.99	15.86
4th Quarter	0.00450	19.69	15.30
<b>2002</b>			
1st Quarter	\$0.00450	\$22.00	\$17.17
2nd Quarter	0.00450	19.35	14.85
3rd Quarter	0.00450	16.08	10.90
4th Quarter	0.00450	16.70	11.23

As of December 31, 2003, there were 12,114 holders of record of the Company's common stock.

**Recent Sales of Unregistered Securities**

During 2003, Herbert D. Kelleher, Chairman of the Board, exercised unregistered options to purchase Southwest Common Stock as follows:

<b>Number of Shares</b>			<b>Date of Option Grant</b>
<b>Purchased</b>	<b>Exercise Price</b>	<b>Date of Exercise</b>	
51,947	\$1.00	6/16/03	1/1/92
287,173	1.00	6/16/03	1/1/96
506,250	4.64	6/16/03	1/1/96
54,630	2.24	6/16/03	1/1/92
120,000	1.00	11/19/03	1/1/96

The issuances of the above options and shares to Mr. Kelleher were deemed exempt from the registration provisions of the Securities Act of 1933, as amended (the Securities Act), by reason of the provision of Section 4(2) of the Securities Act because, among other things, of the limited number of participants in such transactions and the agreement and representation of Mr. Kelleher that he was acquiring such securities for investment and not with a view to distribution thereof. The certificates representing the shares issued to Mr. Kelleher contain a legend to the effect that such shares are not registered under the Securities Act and may not be transferred except pursuant to a registration statement which has become effective under the Securities Act or to an exemption from such registration. The issuance of such shares was not underwritten.



**Table of Contents****Securities Authorized for Issuance under Equity Compensation Plans**

The following table provides information as of December 31, 2003 regarding compensation plans (including individual compensation arrangements) under which equity securities of Southwest are authorized for issuance.

**Equity Compensation Plan Information**

<b>Plan Category</b>	<b>Number of Securities to be Issued Upon Exercise of Outstanding Options, Warrants and Rights (in thousands)</b>	<b>Weighted-Average Exercise Price of Outstanding Options, Warrants and Rights*</b>	<b>Number of Securities Remaining Available for Future Issuance Under Equity Compensation Plans (Excluding Securities Reflected in Column (a)) (in thousands)</b>
<b>(a)</b>	<b>(b)</b>	<b>(c)</b>	
Equity Compensation Plans Approved by Security Holders	29,821	\$ 10.77	18,317
Equity Compensation Plans not Approved by Security Holders	127,694	\$ 10.77	36,616
Total	157,515	\$ 10.77	54,933

\*As adjusted for stock splits.

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

**Table of Contents****Item 6. Selected Financial Data**

The following financial information for the five years ended December 31, 2003 has been derived from the Company's Consolidated Financial Statements. This information should be read in conjunction with the Consolidated Financial Statements and related notes thereto included elsewhere herein.

**Years ended December 31,**

	<b>2003</b>	<b>2002</b>	<b>2001</b>	<b>2000</b>	<b>1999</b>
<b>Financial Data:</b>					
(In millions, except per share amounts)					
Operating revenues	\$ 5,937	\$ 5,522	\$ 5,555	\$ 5,650	\$ 4,736
Operating expenses	5,454	5,104	4,924	4,628	3,954
Operating income	483	418	631	1,022	782
Other expenses(income), net	(225)	25	(197)	4	8
Income before income taxes	708	393	828	1,018	774
Provision for income taxes	266	152	317	392	299
Net income <sup>(3)</sup>	\$ 442	\$ 241	\$ 511	\$ 626	\$ 475
Net income per share, basic	\$ .56	\$ .31	\$ .67	\$ .84	\$ .63
Net income per share, diluted	\$ .54	\$ .30	\$ .63	\$ .79	\$ .59
Cash dividends per common share	\$ .0180	\$ .0180	\$ .0180	\$ .0148	\$ .0143
Total assets at period-end	\$ 9,878	\$ 8,954	\$ 8,997	\$ 6,670	\$ 5,654
Long-term obligations at period-end	\$ 1,332	\$ 1,553	\$ 1,327	\$ 761	\$ 872
Stockholders' equity at period-end	\$ 5,052	\$ 4,422	\$ 4,014	\$ 3,451	\$ 2,836
<b>Operating Data:</b>					
Revenue passengers carried	65,673,945	63,045,988	64,446,773	63,678,261	57,500,213
Revenue passenger miles (RPMs) (000s)	47,943,066	45,391,903	44,493,916	42,215,162	36,479,322
Available seat miles (ASMs) (000s)	71,790,425	68,886,546	65,295,290	59,909,965	52,855,467
Load factor <sup>(1)</sup>	66.8%	65.9%	68.1%	70.5%	69.0%
Average length of passenger haul (miles)	730	720	690	663	634



Edgar Filing: SOUTHWEST AIRLINES CO - Form DEF 14A

Trips flown	949,882	947,331	940,426	903,754	846,823
Average passenger fare	\$ 87.42	\$ 84.72	\$ 83.46	\$ 85.87	\$ 79.35
Passenger revenue yield per RPM	11.97¢	11.77¢	12.09¢	12.95¢	12.51¢
Operating revenue yield per ASM	8.27¢	8.02¢	8.51¢	9.43¢	8.96¢
Operating expenses per ASM	7.60¢	7.41¢	7.54¢	7.73¢	7.48¢
Operating expenses per ASM, excluding fuel	6.44¢	6.30¢	6.36¢	6.38¢	6.55¢
Fuel cost per gallon (average)	72.3¢	68.0¢	70.9¢	78.7¢	52.7¢
Number of Employees at year-end	32,847	33,705	31,580	29,274	27,653
Size of fleet at year-end <sup>(2)</sup>	388	375	355	344	312

(1) Revenue passenger miles divided by available seat miles.

(2) Includes leased aircraft.

(3) Before cumulative effect of change in accounting principle.

A-14

**Table of Contents**

**ITEM 7. MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATION**

**Year In Review**

In 2003, Southwest posted a profit for the 31st consecutive year. The Company also extended its streak of consecutive quarterly profits to 51 periods in fourth quarter 2003. Both of these achievements are unsurpassed in the airline industry. For the third consecutive year, the airline industry as a whole suffered a net loss and many of the larger airlines underwent or continued massive efforts to restructure their business, gain wage concessions from their employees, and slash costs in efforts to avoid bankruptcy or emerge from bankruptcy. For the Company, although profitability levels have not returned to those achieved prior to the September 11, 2001, terrorist attacks, profits increased considerably versus 2002, even excluding the impact of government grants received in both years.

Although the process has been gradual, revenue trends had shown improvement prior to the Iraq war, and have steadily improved since major hostilities in Iraq ended in May 2003. However, air traffic remains depressed compared to pre-September 11, 2001, levels, particularly business demand. Unit revenues continue to run below pre-September 11, 2001, levels by more than 10 percent and the percentage of Customers traveling on full-fares remains down from historical levels. The Company does not anticipate a complete recovery in revenues until the economy fully recovers and there is an upturn in business travel.

The Company's business strategy did not waver in 2003. Southwest remained committed to providing predominantly shorthaul flights, high frequency service, low fares, point-to-point flying, and high-quality Customer Service, all while keeping costs low. The Company also continued to complement this strategy by adding longer haul flights, including transcontinental service.

The Company continued to respond to the many security changes imposed since the terrorist attacks and find ways to improve Customer convenience and the airport experience. The Company has automated and significantly streamlined the ticketing and boarding process with computer generated bag tags, automated boarding passes, self-service boarding pass kiosks, and electronic boarding pass readers at the gate. The Company also has made technological advancements, including the addition of functionality to its website at [www.southwest.com](http://www.southwest.com), and has continued to enhance its fleet interiors with a new look, including comfortable leather seats.

The Company did not open any new cities in 2003, although it continued to improve its quality of service between cities already served. The Company recently announced that it would begin new service to Philadelphia, Pennsylvania in May 2004, which will represent the Company's 60th airport and 31st state to which it flies. During 2003, the Company added 17 new 737-700 aircraft to its fleet and retired four older 737-200 aircraft, resulting in a net capacity increase of 4.2 percent. This brought the Company's all-737 fleet to 388 aircraft at the end of 2003.

During 2003, the Company made announcements that are expected to benefit the Company's overall cost structure in 2004 and beyond. The Company announced it would add blended winglets to its fleet of 737-700 aircraft. The addition of these wing enhancements, which began to be retrofitted on existing aircraft in fourth quarter 2003 and are expected to take place through early 2005, will extend the range of these aircraft, save fuel, lower engine maintenance costs, and reduce takeoff noise. New aircraft are expected to arrive with winglets already installed beginning in August 2004. In October 2003, the Company announced it would no longer pay commissions on travel agency sales effective December 15, 2003, consistent with virtually all other U.S. airlines. This change in policy is expected to save the Company approximately \$40 million in 2004. In November 2003, the Company also announced the consolidation of its nine Reservations Centers into six, effective February 28, 2004. This decision was made in response to the established shift to the internet as a preferred way of booking travel. The Company's website, [www.southwest.com](http://www.southwest.com), is now accountable for more than half of passenger revenues, and, as a consequence, demand for phone contact has

dramatically decreased. The Company estimates the costs associated with this decision, approximately \$20

A-15

---

**Table of Contents**

million, will be recognized primarily in first quarter 2004. These costs are primarily related to Employee relocation expenses and severance packages. The Company estimates that future annual operating cost savings related to this decision will exceed the costs incurred. See Note 9 to the Consolidated Financial Statements for further information. The Company also expects to benefit from efficiencies achieved at airports through our effort to improve the Customer experience in ticketing and boarding.

Available seat mile (ASM) capacity currently is expected to grow in the 7 to 8 percent range in 2004 with the planned net addition of 29 aircraft. The Company currently has 47 new Boeing 737 700s scheduled for delivery during the year and plans to retire 18 of the Company's older 737-200s.

**Results of Operation**

**2003 Compared With 2002.** The Company's consolidated net income for 2003 was \$442 million (\$.54 per share, diluted), as compared to 2002 net income of \$241 million (\$.30 per share, diluted), an increase of \$201 million or 83.4 percent. Operating income for 2003 was \$483 million, an increase of \$66 million, or 15.8 percent compared to 2002.

As disclosed in Note 3 to the consolidated financial statements, results for 2003 included \$271 million as Other gains from the Emergency Wartime Supplemental Appropriations Act (Wartime Act) and results for 2002 included \$48 million as Other gains from grants under the Air Transportation Safety and System Stabilization Act (Stabilization Act). The Company believes that excluding the impact of these special items will enhance comparative analysis of results. The grants were made to stabilize and support the airline industry as a result of the devastating effects of the September 11, 2001 terrorist attacks and the 2003 war with Iraq. Neither of these grants was indicative of the Company's operating performance for these respective periods, nor should they be considered in developing trend analysis for future periods. The following table reconciles results reported in accordance with Generally Accepted Accounting Principles (GAAP) for 2003 and 2002 with results excluding the impact of the government grants received:

(in millions, except per share amounts)	2003	2002
Operating expenses, as reported	\$5,454	\$5,105
Profitsharing impact of Stabilization Act grant		(7)
Profitsharing impact of Wartime Act grant	(40)	
Operating expenses, excluding impact of government grants	<u>\$5,414</u>	<u>\$5,098</u>
Operating income, as reported	\$ 483	\$ 417
Profitsharing impact of Stabilization Act grant		7
Profitsharing impact of Wartime Act grant	40	
Operating income, excluding impact of government grants	<u>\$ 523</u>	<u>\$ 424</u>
Net income, as reported	\$ 442	\$ 241

Edgar Filing: SOUTHWEST AIRLINES CO - Form DEF 14A

Stabilization Act grant, net of income taxes and profitsharing		(25)
Wartime Act grant, net of income taxes and profitsharing	(144)	
	<u>          </u>	<u>          </u>
Net income, excluding government grants	\$ 298	\$ 216
	<u>          </u>	<u>          </u>
Net income per share, diluted, as reported	\$ .54	\$ .30
Stabilization Act grant, net of income taxes and profitsharing		(.03)
Wartime Act grant, net of income taxes and profitsharing	(.18)	
	<u>          </u>	<u>          </u>
Net income per share, diluted, excluding government grants	\$ .36	\$ .27
	<u>          </u>	<u>          </u>

Excluding the governments grants received in both years, consolidated net income for 2003 was \$298 million

**Table of Contents**

(\$.36 per share, diluted), as compared to 2002 net income of \$216 million (\$.27 per share, diluted), an increase of \$82 million, or 38.0 percent. The increase was primarily due to overall higher demand for air travel in 2003, vacation travel in particular. Operating income for 2003 was \$523 million, an increase of \$99 million, or 23.3 percent compared to 2002.

**OPERATING REVENUES.** Consolidated operating revenues increased \$415 million, or 7.5 percent, primarily due to a \$400 million, or 7.5 percent, increase in passenger revenues. The increase in passenger revenues was primarily due to a 5.6 percent increase in revenue passenger miles (RPMs) flown. Although the Company saw a disruption in revenue and bookings due to the threat of war and from the subsequent conflict between the United States and Iraq during the first half of 2003, demand improved following the war.

The increase in revenue passenger miles primarily was due to a 4.2 percent increase in added capacity, as measured by available seat miles or ASMs. This was achieved through the Company's net addition of 13 aircraft during 2003 (net of four aircraft retirements). The Company's improved load factor for 2003 (RPMs divided by ASMs) was 66.8 percent, compared to 65.9 percent for 2002. The improved 2003 load factor is still well below pre-September 11, 2001, annual levels. Passenger yields for 2003 (passenger revenue divided by RPMs) were \$.1197 compared to \$.1177 in 2002, an increase of 1.7 percent, due to less heavy fare discounting in 2003 by the Company and the airline industry in general.

As the economy recovers and demand for business travel increases, the Company's operating revenue yields per ASM (unit revenues) gradually continue to improve. Although the first half of January 2004 showed modest unit revenue growth, bookings suggest that January's load factor could fall below January 2003's load factor of 58.0 percent.

Consolidated freight revenues increased \$9 million, or 10.6 percent, primarily due to an increase in freight and cargo units shipped. Other revenues increased \$6 million, or 6.3 percent, primarily due to an increase in commissions earned from programs the Company sponsors with certain business partners, such as the Company-sponsored Bank One® (formerly First USA) Visa card.

**OPERATING EXPENSES.** Consolidated operating expenses for 2003 increased \$349 million, or 6.8 percent, compared to the 4.2 percent increase in capacity. To a large extent, changes in operating expenses for airlines are driven by changes in capacity, or ASMs. The following presents Southwest's operating expenses per ASM for 2003 and 2002 followed by explanations of these changes on a per-ASM basis:

	<b>2003</b>	<b>2002</b>	<b>Increase (decrease)</b>	<b>Percent change</b>
Salaries, wages, and benefits	<b>3.10¢</b>	2.89¢	.21¢	7.3%
Fuel and oil	<b>1.16</b>	1.11	.05	4.5
Maintenance materials and repairs	<b>.60</b>	.57	.03	5.3
Agency commissions	<b>.07</b>	.08	(.01)	(12.5)
Aircraft rentals	<b>.25</b>	.27	(.02)	(7.4)
Landing fees and other rentals	<b>.52</b>	.50	.02	4.0
Depreciation	<b>.53</b>	.52	.01	1.9
Other	<b>1.37</b>	1.47	(.10)	(6.8)
	<b>_____</b>	<b>_____</b>	<b>_____</b>	<b>_____</b>
Total	<b>7.60¢</b>	7.41¢	.19¢	2.6%
	<b>_____</b>	<b>_____</b>	<b>_____</b>	<b>_____</b>

Operating expenses per ASM increased 2.6 percent to \$.0760, primarily due to increases in salaries, profitsharing, and jet fuel prices, after hedging gains. For first quarter 2004, excluding costs associated with the Company's reservations center consolidation, the Company currently expects an increase in operating expenses per ASM compared to first quarter 2003 primarily due to higher salaries, jet fuel prices, and airport costs. Based on the Company's aggressive efforts to mitigate these cost pressures, unit costs should begin to decline in the

A-17

---

**Table of Contents**

second half of 2004. For the year 2004, the Company's goal is to, at least, keep unit costs flat with 2003.

Salaries, wages, and benefits expense per ASM increased 7.3 percent. Approximately 60 percent of the increase was due to an increase in salaries and wages per ASM, primarily from increases in average wage rates. The majority of the remainder of the increase was due to an increase in Employee retirement plans expense per ASM, primarily from the increase in 2003 earnings and resulting profitsharing. The Company also expects to experience an increase in salaries, wages, and benefits per ASM in 2004 due, in part, to restructuring charges related to the consolidation of the Company's reservations centers. See Note 9 to the Consolidated Financial Statements.

The Company's Flight Attendants are subject to an agreement with the TWU that became amendable in June 2002. In September 2003, the Company and the TWU requested the assistance of the National Mediation Board in the negotiations for a new contract; however, as of the end of 2003, a mutual agreement had not been reached.

Fuel and oil expense per ASM increased 4.5 percent, primarily due to a 6.3 percent increase in the average jet fuel cost per gallon. The average cost per gallon of jet fuel in 2003 was 72.3 cents compared to 68.0 cents in 2002, excluding fuel related taxes but including the effects of hedging activities. The Company's 2003 and 2002 average jet fuel costs are net of approximately \$171 million and \$45 million in gains from hedging activities, respectively. See Note 2 and Note 10 to the Consolidated Financial Statements. As detailed in Note 10 to the Consolidated Financial Statements, the Company has hedges in place for over 80 percent of its anticipated fuel consumption in 2004 with a combination of derivative instruments that effectively cap prices at about \$24 per barrel, including approximately 82 percent of its anticipated requirements for first quarter 2004. Considering current market prices and the continued effectiveness of the Company's fuel hedges, the Company is forecasting first quarter 2004 average fuel cost per gallon to be in the 75 to 80 cent range. The majority of the Company's near term hedge positions are in the form of option contracts, which protect the Company in the event of rising jet fuel prices and allow the Company to benefit in the event of declining prices.

Maintenance materials and repairs per ASM increased 5.3 percent primarily due to an increase in engine maintenance. The Company outsources all of its engine maintenance work. Approximately half of the increase in engine maintenance expense was for 737-300 and -500 aircraft subject to a long-term maintenance contract, which is based on a contract rate charged per hour flown. The majority of the increase in engine expense for these aircraft in 2003 was due to an increase in the contract rate per hour flown, predicated on increased engine maintenance events. The other half of the increase in engine maintenance expense was for 737-700 aircraft, which is based on a time and materials basis. Expense for these aircraft engines increased because of an increase in repairs for these aircraft engines. Currently, the Company expects an increase in maintenance materials and repairs expense per ASM in first quarter 2004, versus 2003, due to the number of engine repairs scheduled.

Agency commissions per ASM decreased 12.5 percent, primarily due to a decline in commissionable revenues. The percentage of commissionable revenues decreased from approximately 20 percent in 2002 to approximately 16 percent in 2003. Approximately 54 percent of passenger revenues in 2003 were derived through the Company's web site at [www.southwest.com](http://www.southwest.com) versus 49 percent in 2002. In October 2003, the Company announced it would no longer pay commissions on travel agency sales effective December 15, 2003. This change in policy is expected to save the Company approximately \$40 million in 2004.

Aircraft rentals per ASM and depreciation expense per ASM were both impacted by a higher percentage of the aircraft fleet being owned. Aircraft rentals per ASM decreased 7.4 percent while depreciation expense per ASM increased 1.9 percent. The Company owns all 17 of the aircraft it put into service during 2003. This, along with the retirement of three owned and one leased aircraft, has increased the Company's percentage of aircraft owned or on capital lease to 77 percent at December 31, 2003, from 76 percent at December 31, 2002. Based on the Company's scheduled 2004 capacity increases and aircraft financing plans, the Company expects a decline in aircraft rental expense per ASM in



2004.

A-18

---

**Table of Contents**

Landing fees and other rentals per ASM increased 4.0 percent primarily as a result of higher space rental rates throughout the Company's system. During 2003, many other major airlines reduced their flight capacity at airports served by the Company. Since Southwest did not reduce its flights, the Company incurred higher airport costs based on a greater relative share of total flights and passengers.

Other operating expenses per ASM decreased 6.8 percent. Approximately 70 percent of the decrease was due to lower aviation insurance costs. Following the September 2001 terrorist attacks, commercial aviation insurers significantly increased the premiums and reduced the amount of war-risk coverage available to commercial carriers. The federal government stepped in to provide supplemental third-party war-risk insurance coverage to commercial carriers for renewable 60-days periods, at substantially lower premiums than then-prevailing commercial rates and for levels of coverage not available in the commercial market. In November 2002, Congress passed the Homeland Security Act of 2002, which mandated the federal government provide third party, passenger, and hull war-risk insurance coverage to commercial carriers through August 31, 2003, and which permitted such coverage to be extended by the government through December 31, 2003. The Emergency Wartime Supplemental Appropriations Act (see Note 3 to the Consolidated Financial Statements) extended the government's mandate to provide war-risk insurance until August 31, 2004, and permits extensions until December 31, 2004. As a result of more coverage from government insurance programs and a more stable aviation insurance market, the Company was able to negotiate lower 2003 aviation insurance premiums than 2002. However, aviation insurance remains substantially higher than before September 11, 2001. The majority of the remaining decrease in other operating expenses per ASM was due to reductions in security costs from the transition of airport security to the federal government, and decreases in advertising and personnel-related expenses. As a result of recently concluded negotiations for 2004 commercial insurance coverage and the additional coverage provided by the government, the Company currently expects other operating expenses per ASM to decrease again, in 2004.

**OTHER.** Other expenses (income) included interest expense, capitalized interest, interest income, and other gains and losses. Interest expense decreased \$15 million, or 14.2 percent, compared to the prior year, primarily due to lower effective interest rates. The Company executed two interest-rate swaps in second quarter 2003 to convert a portion of its fixed-rate debt to a lower floating rate. The Company entered into interest rate swap agreements relating to its \$385 million 6.5% senior unsecured notes due March 1, 2012 and \$375 million 5.496% Class A-2 pass-through certificates due November 1, 2006. See Note 10 to the Consolidated Financial Statements for more information on the Company's hedging activities. Excluding the effect of any new debt offerings the Company may execute during 2004, the Company expects a decrease in interest expense compared to 2003, due to the full year effect of the 2003 interest rate swaps, the October 2003 redemption of its \$100 million senior unsecured 8 3/4% Notes, and the scheduled redemption of the Company's \$175 million Aircraft Secured Notes on its due date in fourth quarter 2004. Capitalized interest increased \$16 million, or 94.1 percent, primarily as a result of higher 2003 progress payment balances for scheduled future aircraft deliveries, compared to 2002. Based on the Company's current schedule of progress payments and aircraft deliveries, the Company expects progress payment balances, and corresponding capitalized interest, to increase in 2004 compared to 2003. Interest income decreased \$13 million, or 35.1 percent, primarily due to a decrease in rates earned on short-term investments. Other gains in 2003 and 2002 primarily resulted from government grants of \$271 million and \$48 million, respectively, received pursuant to the Wartime and the Stabilization Acts. See Note 3 to the Company's Consolidated Financial Statements for further discussion of these Acts.

**INCOME TAXES.** The provision for income taxes, as a percentage of income before taxes, decreased to 37.60 percent in 2003 from 38.64 percent in 2002 due to higher Company earnings in 2003 and lower effective state income tax rates.

**2002 Compared with 2001.** The Company's consolidated net income for 2002 was \$241 million (\$.30 per share, diluted), as compared to 2001 net income of \$511 million (\$.63 per share, diluted), a decrease of \$270 million or 52.8 percent. Approximately 43 percent of this decrease was due to the decrease in government grants that the

Company recognized under the Stabilization Act. In 2002 and 2001, the Company recognized \$48 million (pretax) and \$235 million (pretax) in government grants under the Stabilization Act. See Note 3

A-19

---

**Table of Contents**

to the Consolidated Financial Statements. The remainder of the decrease primarily was due to the full-year impact of the September 11, 2001 terrorist attacks on the Company and the airline industry.

Following the September 11, 2001 terrorist attacks, all U.S. commercial flight operations were suspended for approximately three days. However, the Company continued to incur nearly all of its normal operating expenses (with the exception of certain direct trip-related expenditures such as fuel, landing fees, etc.). The Company canceled approximately 9,000 flights before resuming flight operations on September 14. After operations were fully resumed, load factors and passenger yields were severely depressed, and ticket refund activity increased. In addition, operating expenses in areas such as aviation insurance and security-related expenses were much higher than before. From January 2001 through the end of August 2001, the Company had earned approximately \$707 million in operating income. However, for September 2001, it incurred operating losses of \$113 million, and for fourth quarter 2001, operating income was \$37 million. For the full year 2002, operating income was \$417 million, a decrease of \$214 million, or 33.9 percent compared to 2001 due to the full year impact the terrorist attacks had on airline industry revenue performance.

**OPERATING REVENUES.** Consolidated 2002 operating revenues decreased \$33 million from 2001, or .6 percent, primarily due to a \$38 million, or .7 percent, decrease in passenger revenues. The decrease in passenger revenues was primarily due to lower load factors attributable to the post-September 11, 2001 reduction in demand for air travel. The Company's load factor for 2002 was 65.9 percent, compared to 68.1 percent for 2001, resulting from a capacity (ASM) increase of 5.5 percent versus a traffic (RPM) increase of only 2.0 percent. The increase in ASMs was due to the net addition of 20 aircraft during 2002 (net of three aircraft retirements).

Consolidated freight revenues decreased \$6 million, or 6.6 percent, primarily due to a 40.3 percent decrease in mail revenues. Following the terrorist attacks, the United States Postal Service shifted a significant portion of the mail that commercial carriers had previously carried to freight carriers. The mail decrease more than offset an 11.4 percent increase in other freight revenues. Other revenues increased \$11 million, or 12.9 percent, primarily due to an increase in commissions earned from programs the Company sponsors with certain business partners, such as the Company-sponsored Bank One® Visa card.

**OPERATING EXPENSES.** Consolidated operating expenses for 2002 increased \$181 million, or 3.7 percent, compared to the 5.5 percent increase in capacity. To a large extent, changes in operating expenses for airlines are driven by changes in capacity, or ASMs. The following presents Southwest's operating expenses per ASM for 2002 and 2001 followed by explanations of these changes on a per ASM basis:

	<b>2002</b>	<b>2001</b>	<b>Increase (decrease)</b>	<b>Percent change</b>
Salaries, wages, and benefits	<b>2.89¢</b>	2.84¢	.05¢	1.8%
Fuel and oil	<b>1.11</b>	1.18	(.07)	(5.9)
Maintenance materials and repairs	<b>.57</b>	.61	(.04)	(6.6)
Agency commissions	<b>.08</b>	.16	(.08)	(50.0)
Aircraft rentals	<b>.27</b>	.29	(.02)	(6.9)
Landing fees and other rentals	<b>.50</b>	.48	.02	4.2
Depreciation	<b>.52</b>	.49	.03	6.1
Other	<b>1.47</b>	1.49	(.02)	(1.3)
	<hr/>	<hr/>	<hr/>	<hr/>
Total	<b>7.41¢</b>	7.54¢	(.13)¢	(1.7)%



Salaries, wages, and benefits expense per ASM increased 1.8 percent due to a 5.7 percent increase in salaries and wages per ASM and a 7.6 percent increase in benefits expense per ASM, mostly offset by a 30.3 percent decrease in Employee retirement plans expense per ASM. The majority of the increase in salaries and wages was due to headcount additions outpacing the Company's capacity growth in several operational areas, due in

A-20

---

**Table of Contents**

part to additional security requirements at airports. The remaining portion of the increase in salaries and wages per ASM primarily was due to higher average wage rates.

The increase in benefits expense per ASM primarily was due to higher health care costs. Employee retirement plans expense per ASM decreased due to lower Company earnings available for profitsharing. In 2002 and 2001, earnings available for profitsharing included \$48 million and \$235 million, respectively, from grants recognized under the Stabilization Act. See Note 3 to the Consolidated Financial Statements.

Fuel and oil expense per ASM decreased 5.9 percent, primarily due to a 4.0 percent decrease in the average jet fuel cost per gallon. The average cost per gallon of jet fuel in 2002 was 68.0 cents compared to 70.9 cents in 2001, excluding fuel related taxes but including the effects of hedging activities. The Company's 2002 and 2001 average jet fuel costs are net of approximately \$45 million and \$80 million in gains from hedging activities, respectively. See Notes 2 and 10 to the Consolidated Financial Statements.

Maintenance materials and repairs per ASM decreased 6.6 percent. This decrease primarily was due to a decrease in airframe expense resulting from fewer outsourced heavy maintenance events versus 2001. More heavy maintenance events were performed internally in 2002, resulting in the labor costs associated with those events being reflected in salaries and wages.

Agency commissions per ASM decreased 50.0 percent, primarily due to a change in the Company's commission rate policy. Effective October 15, 2001, the Company reduced the commission paid to travel agents from eight percent for Ticketless bookings and five percent for paper ticket bookings, to five percent, regardless of the type of ticket sold. In addition, the mix of tickets sold through travel agents declined from 25 percent of total revenues in 2001 to 20 percent in 2002, thereby reducing commissionable revenues and commission expense.

Aircraft rentals per ASM and depreciation expense per ASM were both impacted by a higher percentage of the aircraft fleet being owned. Aircraft rentals per ASM decreased 6.9 percent while depreciation expense per ASM increased 6.1 percent. The Company owns all 23 of the aircraft it put into service during 2002. This, along with the retirement of one owned and two leased aircraft in 2002, increased the Company's percentage of aircraft owned or on capital lease to 76 percent at December 31, 2002, from 74 percent at December 31, 2001.

Landing fees and other rentals per ASM increased 4.2 percent primarily as a result of airport rate increases throughout the Company's system. Moreover, following the terrorist attacks, most other major airlines reduced their flight schedules due to the drop in air travel. Since Southwest did not reduce its flights, the Company incurred higher airport costs based on a greater relative share of total flights and passengers.

Other operating expenses per ASM decreased 1.3 percent despite a per-ASM increase of more than 175 percent in aviation insurance costs. The insurance cost increases were more than offset through various cost control measures implemented immediately following the prior year terrorist attacks, including reductions in personnel related expenses and office expenses. Excluding insurance expense, other operating expenses per ASM decreased 8.5 percent. Following the terrorist attacks, commercial aviation insurers significantly increased the premiums and reduced the amount of war-risk coverage available to commercial carriers. The federal government then stepped in to provide supplemental third-party war-risk insurance coverage to commercial airlines, for renewable 60-days periods, at substantially lower premiums than prevailing commercial rates during 2002 and for levels of coverage not available at that time in the commercial market.

OTHER. Other expenses (income) included interest expense, capitalized interest, interest income, and other gains and losses. Interest expense increased \$36 million, or 51.4 percent, compared to the prior year, due to higher debt levels. In fourth quarter 2001, the Company issued \$614 million in long-term debt in the form of Pass Through Certificates.

In first quarter 2002, the Company issued \$385 million in unsecured notes. See Note 7 to the Consolidated Financial Statements for more information on these two borrowings. The increase in expense caused by these borrowings was partially offset by a decrease in interest rates on the Company's floating rate debt and the July 2001 redemption of \$100 million of unsecured notes. Capitalized interest decreased \$4 million, or 19.0 percent, primarily as a result of lower 2002 progress payment balances for scheduled future aircraft deliveries, compared to 2001. Interest income decreased \$6

A-21

---

**Table of Contents**

million, or 14.0 percent, as higher invested cash balances for the year were more than offset by lower rates. Other gains in 2002 and 2001 primarily resulted from \$48 million and \$235 million, respectively, received as the Company's share of government grants under the Stabilization Act. See Note 3 to the Company's Consolidated Financial Statements for further discussion of the Stabilization Act.

**INCOME TAXES.** The provision for income taxes, as a percentage of income before taxes, increased to 38.64 percent in 2002 from 38.24 percent in 2001, primarily due to the Company's lower earnings in 2002.

**LIQUIDITY AND CAPITAL RESOURCES**

Net cash provided by operating activities was \$1.3 billion in 2003 compared to \$520 million in 2002. For the Company, operating cash inflows are primarily derived from providing air transportation for Customers. The vast majority of tickets are purchased prior to the day in which travel is provided and, in some cases, several months before the anticipated travel date. Operating cash outflows are primarily related to the recurring expenses of operating the airline. For 2003, the increase in operating cash flows primarily was due to higher net income, largely attributable to the \$271 million government grant from the Wartime Act. Also contributing to the increase in operating cash flows was an increase in accrued liabilities and a decrease in accounts and other receivables. The increase in accrued liabilities primarily was due to an increase in accrued profitsharing from higher 2003 earnings available for profitsharing. The decrease in accounts and other receivables was primarily due to the 2003 collection of a \$51 million tax refund related to the 2002 tax year. Cash generated in 2003 and in 2002 was primarily used to finance aircraft-related capital expenditures and provide working capital.

Cash flows used in investing activities in 2003 totaled \$1.2 billion compared to \$603 million in 2002. Investing activities in both years primarily consisted of payments for new 737-700 aircraft delivered to the Company and progress payments for future aircraft deliveries. Although the Company received fewer new aircraft in 2003 (17 new 737-700s) versus 2002 (23 new 737-700s), there was a substantial increase in progress payments for future deliveries compared to the prior year. The increase in progress payments primarily was related to aircraft to be delivered in 2004 and 2005. During 2003, the Company accelerated the delivery for several aircraft from future years into 2004, and exercised options for several 2004 and 2005 deliveries. These decisions resulted in an acceleration of progress payments to the manufacturer related to the aircraft. See Note 4 to the Consolidated Financial Statements.

Net cash used in financing activities was \$48 million in 2003 compared to \$382 million in 2002. Cash used in financing activities during 2003 was primarily for the redemption of its \$100 million senior unsecured 8 3/4% Notes originally issued in 1991. This was mostly offset by proceeds of \$93 million from the exercise of Employee stock options. Cash used in financing activities in 2002 was primarily for the repayment of the Company's \$475 million revolving credit facility that the Company drew down in September 2001 and for the repayment of a special purpose trust (Trust) created in 2001. See Note 4 to the Consolidated Financial Statements for more information on the Trust. These uses were partially offset by cash generated from the issuance of \$385 million in unsecured notes in March 2002. See Note 6 and Note 7 to the Consolidated Financial Statements for more information on these financing activities.

The Company has various options available to meet its capital and operating commitments, including cash on hand at December 31, 2003, of \$1.9 billion, internally generated funds, and a \$575 million bank revolving line of credit. In addition, the Company will also consider various borrowing 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 has two fully available unsecured revolving credit facilities from which it can borrow up to \$575 million from a group of banks. One of the facilities, for half of the total amount, was renewed for an additional



year during April 2003. This facility now expires in April 2004. The other facility, for half of the amount, expires in April 2005. The Company expects that it will be able to renew the expiring 364-day facility

A-22

---

**Table of Contents**

for an additional 364-day period at reasonable terms. If the Company is unable to renew, the Company's available credit facility will be reduced.

The Company currently has outstanding shelf registrations for the issuance of up to \$1.0 billion in public debt securities and pass through certificates, which it may utilize for aircraft financings in the future. The Company currently expects that a portion of these securities will be issued in 2004.

**OFF-BALANCE SHEET ARRANGEMENTS, CONTRACTUAL OBLIGATIONS, AND CONTINGENT LIABILITIES AND COMMITMENTS**

Southwest has contractual obligations and commitments primarily with regards to future purchases of aircraft, payment of debt, and lease arrangements. Along with the receipt of 17 new 737-700 aircraft from Boeing in 2003, the Company exercised several options for delivery in 2004 and 2005 and accelerated the delivery dates for several aircraft into 2004 from future years. The Company also entered into an agreement to lease a new Boeing 737-700 from a third party beginning in 2004. The following table details the Company's current firm orders, options, and purchase rights for 737-700 aircraft:

	<b>As of December 31, 2003</b>	
	<b>Firm</b>	<b>Options*</b>
2004**	47	
2005	28	6
2006	22	12
2007	25	29
2008	6	45
2009-2012		177
	—	—
Total	128	269

\* Includes purchase rights

\*\* Includes one leased aircraft

The Company has the option to substitute 737-600s or -800s for the -700s. This option is applicable to aircraft ordered from the manufacturer and must be exercised two years prior to the contractual delivery date.

The following table details information on the 388 aircraft in the Company's fleet as of December 31, 2003:

<b>737 Type</b>	<b>Seats</b>	<b>Average Age (Yrs)</b>	<b>Number of Aircraft</b>	<b>Number Owned</b>	<b>Number Leased</b>
-----------------	--------------	--------------------------	---------------------------	---------------------	----------------------

Edgar Filing: SOUTHWEST AIRLINES CO - Form DEF 14A

-200	122	21.2	23	21	2
-300	137	12.6	194	110	84
-500	122	12.7	25	16	9
-700	137	3.3	146	145	1
		<u>          </u>	<u>          </u>	<u>          </u>	<u>          </u>
TOTALS		9.6	388	292	96

The Company has engaged in off-balance sheet arrangements in the leasing of aircraft. The leasing of aircraft provides flexibility to the Company by allowing for capacity and fleet growth, without the substantial cash outlay necessary to purchase new aircraft. 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.

As shown above and as disclosed in Note 8 to the Consolidated Financial Statements, the Company operates 96 aircraft that it has leased from third parties, of which 89 are operating leases. As prescribed by GAAP, assets

A-23

---

**Table of Contents**

and obligations under operating lease are not included in the Company's Consolidated Balance Sheet. Disclosure of the contractual obligations associated with the Company's leased aircraft are shown below as well as in Note 8 to the Consolidated Financial Statements.

The following table aggregates the Company's material expected contractual obligations and commitments as of December 31, 2003:

<b>Contractual obligations</b>	<b>Obligations by period (in millions)</b>				<b>Total</b>
	<b>2004</b>	<b>2005 -2006</b>	<b>2007 -2008</b>	<b>Beyond 2008</b>	
Long-term debt (1)	\$ 196	\$ 658	\$ 110	\$ 511	\$1,475
Capital lease commitments (2)	18	38	29	39	124
Operating lease commitments	283	492	392	1,328	2,495
Aircraft purchase commitments (3)	1,177	1,421	619		3,217
Other purchase commitments	90	133	5		228
<b>Total contractual obligations</b>	<b>\$1,764</b>	<b>\$2,742</b>	<b>\$1,155</b>	<b>\$1,878</b>	<b>\$7,539</b>

(1) Includes current maturities, but excludes amounts associated with interest rate swap agreements

(2) Includes amounts classified as interest

(3) Firm orders from the manufacturer

The Company currently expects that it will issue a portion of its \$1.0 billion in public debt securities and pass through certificates from its outstanding shelf registrations during 2004, in order to fulfill some of its obligations as noted above.

There were no outstanding borrowings under the revolving credit facility at December 31, 2003. See Note 6 to the consolidated financial statements for more information.

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 anticipated proceeds from the exercise of Employee stock options. 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 United States GAAP. The Company'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 experiences and changes in the business

environment. However, actual results may differ from estimates under different conditions, sometimes materially. Critical accounting policies and estimates are defined as those that are both most important to the portrayal of the Company's financial condition and results and require management's most subjective judgments. The Company's most critical accounting policies and estimates are described below.

#### Revenue Recognition

As described in Note 1 to the Consolidated Financial Statements, tickets sold for passenger air travel are initially deferred as Air traffic liability. Passenger revenue is recognized and air traffic liability is reduced when the service is provided (i.e., when the flight takes place). Air traffic liability represents tickets sold for future travel dates and estimated future refunds and exchanges of tickets sold for past travel dates. The Company's air traffic liability balance at December 31, 2003 was \$462 million.

A-24

---

**Table of Contents**

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

Events and circumstances outside of historical fare sale activity or historical Customer travel patterns, as noted above, 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 experience results in an amount outside of this range, estimates 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 promotional fare 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 estimated amounts. Furthermore, the Company believes it is unlikely that materially different estimates for future refunds, exchanges, and forfeited tickets would be reported based on other reasonable assumptions or conditions suggested by actual historical experience and other data available at the time estimates were made.

Following September 2001 and through 2002, the Company experienced fluctuations in estimated refunds and exchanges, and correspondingly, forfeited tickets, due to many of the factors described above. Following the terrorist events of September 11, 2001, and the subsequent temporary shutdown of U.S. air space, Southwest temporarily suspended its normal refund policy in order to provide the highest Service to the Company's Customers, including the refunding of nonrefundable tickets upon Customer request. As a result, the Company experienced refunds during September 2001 and through December 2001 far above historical refund levels and in excess of the Company's contractual obligations. In evaluating passenger revenue through third quarter 2001, based on these unusually high refund levels, the Company estimated that approximately \$30 million of these refunds related to revenue previously recognized for estimated forfeited tickets. As a result, the Company reduced third quarter 2001 Passenger revenue by \$30 million and restored Air traffic liability, accordingly.

Subsequent to third quarter 2001 and through second quarter 2002, the Company experienced a higher than historical mix of discount, nonrefundable ticket sales. The Company also experienced changes in Customer travel patterns resulting from various factors, including new airport security measures, concerns about further terrorist attacks, and an uncertain economy. Consequently, the Company recorded \$36 million in additional passenger revenue in second quarter 2002 as Customers required fewer refunds and exchanges, resulting in more forfeited tickets. During 2003, refund, exchange, and forfeiture activity returned to more historic, pre-September 11, 2001, patterns.

**Accounting for Long-Lived Assets**

As of December 31, 2003, the Company had approximately \$10.6 billion of long-lived assets, including \$8.6 billion in flight equipment and related assets. 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.



**Table of Contents**

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

	<b>Estimated Useful Life</b>	<b>Estimated Residual value</b>
Aircraft and engines	20 to 25 years	15%*
Aircraft parts	Fleet life	4%
Ground property and equipment	5 to 30 years 5 years or lease term	0% - 10%
Leasehold improvements		0%

\* The Company's remaining 737-200s, due to be retired by first quarter 2005, have residual values of 2%

In estimating the lives and expected residual values of its aircraft, the Company has primarily relied upon actual experience with the same or similar aircraft types and recommendations from Boeing, the manufacturer of the Company's aircraft. Aircraft estimated useful lives are based on the number of cycles flown (a cycle is 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. 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 aircraft (actual cycles during a given period of time), governmental 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 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 and continues to experience positive cash flow. 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.

**Financial Derivative Instruments**

The Company utilizes financial derivative instruments to manage its risk associated with changing jet fuel prices, and accounts for them under Statement of Financial Accounting Standards No. 133, *Accounting for Derivative Instruments and Hedging Activities* (SFAS 133). See *Qualitative and Quantitative Disclosures about Market Risk* for more information on these risk management activities and see Notes 2 and 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 marked to market (fair value) and recorded on the Consolidated Balance Sheet. The fair value of the Company's financial derivative instruments recorded on the Company's Consolidated Balance Sheet as of December 31, 2003, was \$251 million. The financial derivative instruments utilized by the Company primarily were 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 market exchange, the Company estimates their fair values. Depending on the type of instrument, the values are

A-26

---

**Table of Contents**

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 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 and heating oil) and adjusted based on historical variations to those like commodities.

Fair values for financial derivative instruments and forward jet fuel prices are both estimated prior to the time that the financial derivative instruments settle, and the time that jet fuel is purchased and consumed, respectively. However, once settlement of the financial derivative instruments occurs and the hedged jet fuel is purchased and consumed, all values and prices are known and are recognized in the financial statements. Based on these actual results once all values and prices become known, the Company's estimates have proved to be materially accurate. Furthermore, since the majority of the Company's hedges settle within 12 to 24 months from the time the Company enters into the contract for the derivative financial instrument, the estimates being made are relatively short-term.

Estimating the fair value of these fuel hedging derivatives 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 period to period change in the estimated fair value of a fuel hedging instrument differs from a period to period change in the estimated price of the associated jet fuel to be purchased, ineffectiveness of the fuel hedge will result, as defined by SFAS 133. This could result in the immediate recording of charges or income, even though the derivative instrument may not expire until a future period. Historically, the Company has not experienced significant ineffectiveness in its fuel hedges accounted for under SFAS 133.

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 documentation that is required at the time each hedge is executed by the Company. As required by SFAS 133, the Company assesses the effectiveness of each of its individual hedges on a quarterly basis. The Company also examines the effectiveness of its entire hedging program on a quarterly basis utilizing statistical analysis. This analysis involves utilizing regression and other statistical analyses that compare changes in the price of jet fuel to changes in the prices of the commodities used for hedging purposes (crude oil and heating oil).

The Company also utilizes financial derivative instruments in the form of interest rate swap agreements. During second quarter 2003, the Company entered into interest rate swap agreements relating to its \$385 million 6.5% senior unsecured notes due March 1, 2012, and \$375 million 5.496% Class A-2 pass-through certificates due November 1, 2006. Under the first interest rate swap agreement, the Company pays the London InterBank Offered Rate (LIBOR) plus a margin every six months and receives 6.5% every six months on a notional amount of \$385 million until March 1, 2012. Under the second agreement, the Company pays LIBOR plus a margin every six months and receives 5.496% every six months on a notional amount of \$375 million until November 1, 2006.

The Company's interest rate swap agreements qualify as fair value hedges, as defined by SFAS 133. In addition, these interest rate swap agreements qualify for the "shortcut" method of accounting for hedges, as defined by SFAS 133. Under the "shortcut" method, the hedges are assumed to be perfectly effective, and thus, there is no ineffectiveness to be recorded in earnings. The fair value of the interest rate swap 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, 2003, was a liability of approximately \$18 million. This amount is recorded in "Other deferred liabilities" in the Consolidated Balance Sheet. 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.



**Table of Contents**

**FORWARD LOOKING STATEMENTS**

Some statements in this Form 10-K (or otherwise made by the Company or on the Company's behalf from time to time in other reports, filings with the Securities and Exchange Commission, news releases, conferences, World Wide Web postings or otherwise) which are not historical facts, may be forward-looking statements within the meaning of Section 21E of the Securities Exchange Act of 1934 and the Private Securities Litigation Reform Act of 1995. Forward-looking statements include statements about Southwest's estimates, expectations, beliefs, intentions or strategies for the future, and the assumptions underlying these forward-looking statements. Southwest uses the words anticipates, believes, estimates, expects, intends, forecasts, may, will, should, and similar expressions in forward-looking statements. Forward-looking statements involve risks and uncertainties that could cause actual results to differ materially from historical experience or the Company's present expectations. Factors that could cause these differences include, but are not limited to:

Items directly linked to the September 11, 2001 terrorist attacks, such as the adverse impact of new airline and airport security directives on the Company's costs and Customer demand for travel, changes in the Transportation Security Administration's scope for managing U.S. airport security, the availability and cost of war-risk and other aviation insurance, including the federal government's provision of third party war-risk coverage, and the possibility of additional incidents that could cause the public to question the safety and/or efficiency of air travel.

War or other military actions by the U.S. or others.

Competitive factors, such as fare sales and capacity decisions by the Company and its competitors, changes in competitors' flight schedules, mergers and acquisitions, codesharing programs, and airline bankruptcies.

General economic conditions, which could adversely affect the demand for travel in general and consumer ticket purchasing habits, as well as decisions by major freight Customers on how they allocate freight deliveries among different types of carriers.

Factors that could affect the Company's ability to control its costs, such as the results of Employee labor contract negotiations, Employee hiring and retention rates, costs for health care, the largely unpredictable prices of jet fuel, crude oil, and heating oil, the continued effectiveness of the Company's fuel hedges, changes in the Company's overall fuel hedging strategy, capacity decisions by the Company and its competitors, unscheduled required aircraft airframe or engine repairs and regulatory requirements, changes in commission policy, availability of capital markets, future financing decisions made by the Company, and reliance on single suppliers for both the Company's aircraft and its aircraft engines.

Disruptions to operations due to adverse weather conditions and air traffic control-related constraints.

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 7A. QUALITATIVE AND QUANTITATIVE DISCLOSURES ABOUT MARKET RISK**

Southwest has interest rate risk in its floating rate debt obligations and interest rate swaps, and has commodity price risk in jet fuel required to operate its aircraft fleet. The Company purchases jet fuel at prevailing market 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 96 aircraft under operating and capital leases. However, leases are not considered market sensitive financial



**Table of Contents**

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 instruments for trading purposes. See Note 2 to the Consolidated Financial Statements for information on the Company's accounting for its hedging program and Note 10 to the Consolidated Financial Statements for further details on the Company's financial derivative instruments.

**Fuel hedging.** The Company utilizes its fuel hedges 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 1.2 billion gallons of jet fuel in 2004. 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 \$12 million per year.

The fair values of outstanding financial derivative instruments related to the Company's jet fuel market price risk at December 31, 2003, were net assets of \$251 million. The current portion of these financial derivative instruments, or \$164 million, is classified as Fuel hedge contracts in the Consolidated Balance Sheet. The long-term portion of these financial derivative instruments, or \$87 million, is included in Other assets. 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 percent increase or decrease in underlying fuel-related commodity prices from the December 31, 2003, prices would correspondingly change the fair value of the commodity derivative instruments in place by approximately \$125 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, 2003, levels, except underlying futures prices.

**Financial market risk.** Airline operators are inherently capital intensive as the vast majority of the Company's assets are expensive aircraft, which are long-lived. The Company's strategy is to capitalize conservatively 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. The Company's Aircraft Secured Notes and French Credit Agreements do not give rise to significant fair value risk but do give rise to interest rate risk because these borrowings are floating-rate debt. In addition, as disclosed in Note 10 to the Consolidated Financial Statements, during 2003, the Company entered into interest rate swap agreements relating to its \$385 million 6.5% senior unsecured notes due March 1, 2012, and \$375 million 5.496% Class A-2 pass-through certificates due November 1, 2006. Due to these transactions, the Company considers these debts to also be at floating rates. Although there is interest rate risk associated with these floating rate borrowings, the risk for the Aircraft Secured Notes and French Credit Agreements is somewhat mitigated by the fact that the Company may prepay this debt on any of the semi-annual principal and interest payment dates. See Notes 6 and 7 to the Consolidated Financial Statements for more information on the material terms of the Company's short-term and long-term debt.

Excluding the \$385 million 6.5% senior unsecured notes that were converted to a floating rate as previously noted, the Company had outstanding senior unsecured notes totaling \$300 million at December 31, 2003. These senior unsecured notes currently have a weighted-average maturity of 9.3 years at fixed rates averaging 7.75 percent at December 31, 2003, which is comparable to average rates prevailing for similar debt instruments over the last ten years. The fixed-rate portion of the Company's pass-through certificates consists of its Class A certificates and Class B certificates, which totaled \$193 million at December 31, 2003. These Class A and Class B certificates had a weighted-average maturity of 2.3 years at fixed rates averaging 5.58 percent at December 31, 2003. The carrying value of the Company's floating rate debt totaled \$964 million, and this debt had a weighted-average maturity of 4.6 years at floating rates averaging 1.47 percent at December 31, 2003. In total, the Company's fixed rate debt and floating rate debt represented 6.5 percent and 13.0 percent, respectively, of total noncurrent assets at December 31,

2003.

A-29

---

**Table of Contents**

The Company also has some risk associated with changing interest rates due to the short-term nature of its invested cash, which totaled \$1.9 billion at December 31, 2003. The Company invests available cash in certificates of deposit, highly rated money markets, investment grade commercial paper, 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 management activities.

A hypothetical ten percent change in market interest rates as of December 31, 2003, would not have a material effect on the fair value of the Company's fixed rate debt instruments. See Note 10 to the Consolidated Financial Statements for further information on the fair value of the Company's financial instruments. A change in market interest rates could, however, have a corresponding effect on the Company's earnings and cash flows associated with its floating rate debt, invested cash, and short-term investments because of the floating-rate nature of these items. Assuming floating market rates in effect as of December 31, 2003, 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 \$1 million. Utilizing these assumptions and considering the Company's cash balance, short-term investments, and floating-rate debt outstanding at December 31, 2003, 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 processing agreement, the revolving credit facility, and outstanding debt agreements. Covenants included the maintenance of minimum credit ratings and minimum asset fair values. The Company met or exceeded the minimum standards set forth in these agreements as of December 31, 2003. However, if conditions change and the Company failed 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.



**Table of Contents****ITEM 8. FINANCIAL STATEMENTS AND SUPPLEMENTARY DATA****SOUTHWEST AIRLINES CO.****CONSOLIDATED BALANCE SHEET**

(In millions, except share data)	DECEMBER 31,	
	2003	2002
<b>ASSETS</b>		
Current assets:		
Cash and cash equivalents	\$ 1,865	\$1,815
Accounts and other receivables	132	175
Inventories of parts and supplies, at cost	93	86
Fuel hedge contracts	164	113
Prepaid expenses and other current assets	59	43
	2,313	2,232
Total current assets		
Property and equipment, at cost:		
Flight equipment	8,646	8,025
Ground property and equipment	1,117	1,042
Deposits on flight equipment purchase contracts	787	389
	10,550	9,456
Less allowance for depreciation and amortization	3,107	2,810
	7,443	6,646
Other assets	122	76
	\$ 9,878	\$8,954
	\$ 9,878	\$8,954
<b>LIABILITIES AND STOCKHOLDERS EQUITY</b>		
Current liabilities:		
Accounts payable	\$ 405	\$ 362
Accrued liabilities	650	529
Air traffic liability	462	412
Current maturities of long-term debt	206	131
	1,723	1,434
Total current liabilities		

Long-term debt less current maturities	<b>1,332</b>	1,553
Deferred income taxes	<b>1,420</b>	1,227
Deferred gains from sale and leaseback of aircraft	<b>168</b>	184
Other deferred liabilities	<b>183</b>	134
Commitments and contingencies		
Stockholders' equity:		
Common stock, \$1.00 par value: 2,000,000,000 shares authorized; 789,390,678 and 776,662,894 shares issued in 2003 and 2002, respectively	<b>789</b>	777
Capital in excess of par value	<b>258</b>	136
Retained earnings	<b>3,883</b>	3,455
Accumulated other comprehensive income	<b>122</b>	54
	<u>          </u>	<u>          </u>
Total stockholders' equity	<b>5,052</b>	4,422
	<u>          </u>	<u>          </u>
	<b>\$ 9,878</b>	\$8,954
	<u>          </u>	<u>          </u>

See accompanying notes.

**Table of Contents****SOUTHWEST AIRLINES CO.****CONSOLIDATED STATEMENT OF INCOME**

(In millions, except per share amounts)	YEARS ENDED DECEMBER 31,		
	2003	2002	2001
<b>OPERATING REVENUES:</b>			
Passenger	\$5,741	\$5,341	\$5,379
Freight	94	85	91
Other	102	96	85
Total operating revenues	<u>5,937</u>	<u>5,522</u>	<u>5,555</u>
<b>OPERATING EXPENSES:</b>			
Salaries, wages, and benefits	2,224	1,993	1,856
Fuel and oil	830	762	771
Maintenance materials and repairs	430	390	398
Agency commissions	48	55	103
Aircraft rentals	183	187	192
Landing fees and other rentals	372	345	311
Depreciation and amortization	384	356	318
Other operating expenses	983	1,017	976
Total operating expenses	<u>5,454</u>	<u>5,105</u>	<u>4,924</u>
<b>OPERATING INCOME</b>	<b>483</b>	417	631
<b>OTHER EXPENSES (INCOME):</b>			
Interest expense	91	106	70
Capitalized interest	(33)	(17)	(21)
Interest income	(24)	(37)	(43)
Other (gains) losses, net	(259)	(28)	(203)
Total other expenses (income)	<u>(225)</u>	<u>24</u>	<u>(197)</u>
<b>INCOME BEFORE INCOME TAXES</b>	<b>708</b>	393	828
<b>PROVISION FOR INCOME TAXES</b>	<b>266</b>	152	317
<b>NET INCOME</b>	<b>\$ 442</b>	<b>\$ 241</b>	<b>\$ 511</b>

<b>NET INCOME PER SHARE, BASIC</b>	<b>\$ .56</b>	<b>\$ .31</b>	<b>\$ .67</b>
	<b>_____</b>	<b>_____</b>	<b>_____</b>
<b>NET INCOME PER SHARE, DILUTED</b>	<b>\$ .54</b>	<b>\$ .30</b>	<b>\$ .63</b>
	<b>_____</b>	<b>_____</b>	<b>_____</b>

See accompanying notes.

A-32

---

Table of Contents**SOUTHWEST AIRLINES CO.****CONSOLIDATED STATEMENT OF STOCKHOLDERS EQUITY****YEARS ENDED DECEMBER 31, 2003, 2002, AND 2001**

(In millions, except per share amounts)	Common Stock	Capital in excess of par value	Accumulated			Total
			Retained earnings	comprehensive income (loss)	Treasury stock	
Balance at December 31, 2000	\$508	\$ 104	\$2,902	\$	\$ (63)	\$3,451
Three-for-two stock split	254	(136)	(118)			
Issuance of common and treasury stock pursuant to Employee stock plans	5	29	(53)		63	44
Tax benefit of options exercised		54				54
Cash dividends, \$.018 per share			(14)			(14)
Comprehensive income (loss)						
Net income			511			511
Unrealized loss on derivative instruments				(31)		(31)
Other				(1)		(1)
Total comprehensive income						479
Balance at December 31, 2001	767	51	3,228	(32)		4,014
Issuance of common stock pursuant to Employee stock plans	10	47				57
Tax benefit of options exercised		38				38
Cash dividends, \$.018 per share			(14)			(14)
Comprehensive income (loss)						
Net income			241			241
Unrealized gain on derivative instruments				88		88
Other				(2)		(2)
Total comprehensive income						327
Balance at December 31, 2002	777	136	3,455	54		4,422
<b>Issuance of common stock pursuant to Employee stock plans</b>	<b>12</b>	<b>81</b>				<b>93</b>

<b>Tax benefit of options exercised</b>		<b>41</b>				<b>41</b>
<b>Cash dividends, \$.018 per share</b>			<b>(14)</b>			<b>(14)</b>
<b>Comprehensive income (loss)</b>						
<b>Net income</b>			<b>442</b>			<b>442</b>
<b>Unrealized gain on derivative instruments</b>				<b>66</b>		<b>66</b>
<b>Other</b>				<b>2</b>		<b>2</b>
						<u>          </u>
<b>Total comprehensive income</b>						<b>510</b>
	<u>          </u>	<u>          </u>	<u>          </u>	<u>          </u>	<u>          </u>	<u>          </u>
<b>Balance at December 31, 2003</b>	<b>\$789</b>	<b>\$ 258</b>	<b>\$3,883</b>	<b>\$ 122</b>	<b>\$</b>	<b>\$5,052</b>
	<u>          </u>	<u>          </u>	<u>          </u>	<u>          </u>	<u>          </u>	<u>          </u>

See accompanying notes.

**Table of Contents****SOUTHWEST AIRLINES CO.****CONSOLIDATED STATEMENT OF CASH FLOWS**

(In millions)	YEARS ENDED DECEMBER 31,		
	2003	2002	2001
<b>CASH FLOWS FROM OPERATING ACTIVITIES:</b>			
Net income	\$ 442	\$ 241	\$ 511
Adjustments to reconcile net income to net cash provided by operating activities:			
Depreciation and amortization	384	356	318
Deferred income taxes	183	170	208
Amortization of deferred gains on sale and leaseback of aircraft	(16)	(15)	(15)
Amortization of scheduled airframe inspections and repairs	49	46	43
Income tax benefit from Employee stock option exercises	41	38	54
Changes in certain assets and liabilities:			
Accounts and other receivables	43	(103)	67
Other current assets	(19)	(10)	(9)
Accounts payable and accrued liabilities	129	(149)	203
Air traffic liability	50	(38)	73
Other	50	(16)	32
	1,336	520	1,485
<b>CASH FLOWS FROM INVESTING ACTIVITIES:</b>			
Purchases of property and equipment, net	(1,238)	(603)	(998)
<b>CASH FLOWS FROM FINANCING ACTIVITIES:</b>			
Issuance of long-term debt		385	614
Proceeds from revolving credit facility			475
Proceeds from trust arrangement		119	266
Proceeds from Employee stock plans	93	57	44
Payments of long-term debt and capital lease obligations	(130)	(65)	(111)
Payments of trust arrangement		(385)	
Payment of revolving credit facility		(475)	
Payments of cash dividends	(14)	(14)	(13)
Other, net	3	(4)	(5)
	(48)	(382)	1,270
<b>NET INCREASE (DECREASE) IN CASH AND CASH EQUIVALENTS</b>	<b>50</b>	<b>(465)</b>	<b>1,757</b>
<b>CASH AND CASH EQUIVALENTS AT BEGINNING OF PERIOD</b>	<b>1,815</b>	<b>2,280</b>	<b>523</b>

<b>CASH AND CASH EQUIVALENTS AT END OF PERIOD</b>	<b>\$ 1,865</b>	\$1,815	\$2,280
	<u>          </u>	<u>          </u>	<u>          </u>
<b>CASH PAYMENTS FOR:</b>			
Interest, net of amount capitalized	\$ 62	\$ 80	\$ 48
Income taxes	\$ 51	\$ 3	\$ 66

See accompanying notes.



**Table of Contents**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

DECEMBER 31, 2003

**1. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES**

**BASIS OF PRESENTATION** Southwest Airlines Co. (Southwest) is a major domestic airline that provides predominantly shorthaul, high-frequency, point-to-point, low-fare service. The Consolidated Financial Statements include the accounts of Southwest and its wholly owned subsidiaries (the Company). All significant intercompany balances and transactions have been eliminated. The preparation of financial statements in conformity with accounting principles 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 maturities 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.

**INVENTORIES** Inventories of flight equipment expendable parts, materials, and supplies are carried at average cost. These items are generally charged to expense when issued for use.

**PROPERTY AND EQUIPMENT** Depreciation is provided by the straight-line method to estimated residual values over periods generally ranging from 20 to 25 years for flight equipment and 5 to 30 years for ground property and equipment once the asset is placed in service. Residual values estimated for aircraft are 15 percent, except for 737-200 aircraft, which will be retired from the Company's fleet by the end of first quarter 2005. The estimated residual value for these aircraft is two percent, based on current market values. Residual value percentages for ground property and equipment range from zero to 10 percent. Property under capital leases and related obligations are recorded at an amount equal to the present value of future minimum lease payments computed on the basis of the Company's incremental borrowing rate or, when known, the interest rate implicit in 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 has primarily relied upon actual experience with the same or similar aircraft types and recommendations from Boeing, the manufacturer of the Company's aircraft. Subsequent revisions to these estimates, which can be significant, could be caused by changes to the Company's maintenance program, 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 expense, as required by GAAP.

When appropriate, the Company evaluates its long-lived assets used in operations for impairment. Impairment losses would be recorded when events and circumstances 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. While the airline industry as a whole has experienced many of these indicators, Southwest has continued to operate all of its aircraft and continues to experience positive cash flow.



**Table of Contents**

**AIRCRAFT AND ENGINE MAINTENANCE** The cost of scheduled engine inspections and repairs and routine maintenance costs for aircraft and engines are charged to maintenance expense as incurred. Scheduled airframe inspections and repairs, known as D checks, are generally performed every ten years. Costs related to D checks are capitalized and amortized over the estimated period benefited, presently the least of ten years, the time until the next D check, or the remaining life of the aircraft. Modifications that significantly enhance the operating performance or extend the useful lives of aircraft or engines are capitalized and amortized over the remaining life of the asset.

In 2003, the Accounting Standards Executive Committee of the American Institute of Certified Public Accountants issued a Draft Statement of Position entitled "Accounting for Certain Costs and Activities Related to Property, Plant, and Equipment" (Draft SOP). Among other items, the Draft SOP, as written, would require that all D checks be expensed as incurred beginning in 2005. See Recent Accounting Developments for further information.

**REVENUE RECOGNITION** Tickets sold are initially deferred as "Air traffic liability". Passenger revenue is recognized when transportation is provided. "Air traffic liability" primarily represents tickets sold for future travel dates and estimated 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 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 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 subsequent 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 Company'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 estimated amounts.

Subsequent to third quarter 2001 and through second quarter 2002, the Company experienced a higher than historical mix of discount, nonrefundable ticket sales. The Company also experienced changes in Customer travel patterns resulting from various factors, including new airport security measures, concerns about further terrorist attacks, and an uncertain economy. Consequently, the Company recorded \$36 million in additional passenger revenue in second quarter 2002 as Customers required fewer refunds and exchanges, resulting in more forfeited tickets. During 2003, refund, exchange, and forfeiture activity returned to more historic, pre-September 11, 2001, patterns.

**FREQUENT FLYER PROGRAM** The Company accrues the estimated incremental cost of providing free travel for awards earned under its Rapid Rewards frequent flyer program. The Company also sells frequent flyer credits and related services to companies participating in its Rapid Rewards frequent flyer program. Funds received from the sale of flight segment credits and associated with future travel are deferred and recognized as "Passenger revenue" when the ultimate free travel awards are flown or the credits expire unused.

**ADVERTISING** The Company expenses the costs of advertising as incurred. Advertising expense for the years ended December 31, 2003, 2002, and 2001 was \$155 million, \$156 million, and \$148 million, respectively.

**Table of Contents**

**STOCK-BASED EMPLOYEE COMPENSATION** The Company has stock-based compensation plans covering the majority of its Employee groups, including a plan covering the Company's Board of Directors and plans related to employment contracts with certain Executive Officers of the Company. The Company accounts 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 is recognized for fixed option plans because the exercise prices of Employee stock options equal or exceed the market prices of the underlying stock on the dates of grant. Compensation expense for other stock options is not material.

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

<b>(In millions, except per share amounts)</b>	<b>2003</b>	<b>2002</b>	<b>2001</b>
Net income, as reported	\$442	\$241	\$511
Add: Stock-based Employee compensation expense included in reported income, net of related tax effects			
Deduct: Total stock-based Employee compensation expense determined under fair value based methods for all awards, net of related tax effects	(57)	(53)	(25)
Pro forma net income	\$385	\$188	\$486
Net income per share			
Basic, as reported	\$ .56	\$ .31	\$ .67
Basic, pro forma	\$ .49	\$ .24	\$ .64
Diluted, as reported	\$ .54	\$ .30	\$ .63
Diluted, pro forma	\$ .48	\$ .23	\$ .61

As required, the pro forma disclosures above include options granted since January 1, 1995. Consequently, the effects of applying SFAS 123 for providing pro forma disclosures may not be representative of the effects on reported net income for future years until all options outstanding are included in the pro forma disclosures. For purposes of pro forma disclosures, the estimated fair value of stock-based compensation plans and other options is amortized to expense primarily over the vesting period. See Note 13 for further discussion of the Company's stock-based Employee compensation.

In December 2002, the FASB issued SFAS No. 148, Accounting for Stock-Based Compensation-Transition and Disclosure. SFAS No. 148 amends the transition and disclosure provisions of SFAS No. 123. Among other items, SFAS 148 allows companies adopting SFAS 123 to utilize one of three alternative transition methods, one of which was a prospective method, as defined, that was only available if adopted during 2003. To date, the Company has not adopted SFAS 123 utilizing any of the transition methods of SFAS 148. The FASB currently is working on a project to develop a new standard for accounting for stock-based compensation. Tentative decisions by the FASB indicate that expensing of stock options will be required beginning January 1, 2005. The FASB expects to issue an exposure draft, which will be subject to public comment, in first quarter 2004 and issue its final standard in the second half of 2004. See Note 13 for further information on the Company's stock-based compensation plans.



**Table of Contents**

**FINANCIAL DERIVATIVE INSTRUMENTS** On January 1, 2001, the Company adopted Statement of Financial Accounting Standards No. 133 (SFAS 133), *Accounting for Derivative Instruments and Hedging Activities*, as amended, which governs the way it accounts for financial derivative instruments. The Company utilizes various derivative instruments, including both crude oil and heating oil-based derivatives, to hedge a portion of its exposure to jet fuel price increases. These instruments consist primarily of purchased call options, collar structures, and fixed price swap agreements. The Company has also entered into interest rate swap agreements to convert a portion of its fixed-rate debt to floating rates.

Since the majority of the Company's financial derivative 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 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 and heating oil) and adjusted based on historical variations to those like commodities. See Notes 2 and 10 for further information on SFAS 133 and financial derivative instruments.

**RECENT ACCOUNTING DEVELOPMENTS** In fourth quarter 2003, the Accounting Standards Executive Committee of the American Institute of Certified Public Accountants released a Draft Statement of Position entitled *Accounting for Certain Costs and Activities Related to Property, Plant, and Equipment* (Draft SOP). The Draft SOP, which is expected to be issued in its final form in first quarter 2004, would become effective for the Company January 1, 2005. The primary areas of applicability of the Draft SOP to the Company are in the areas of planned major maintenance activities (D checks) and component accounting.

As discussed in *Aircraft and Engine Maintenance*, the Company currently capitalizes costs related to D checks and amortizes those costs over the estimated period benefited, presently the least of ten years, the time until the next D check, or the remaining life of the aircraft. In the Draft SOP, D checks would be considered a planned major maintenance activity and, as such, would be expensed as incurred. During 2003, the Company recorded \$49 million in *Depreciation expense* related to previously capitalized D checks, compared to the \$47 million in D check costs that were capitalized during 2003. These amounts are not necessarily indicative of those experienced in previous periods or to be expected in future periods, however, as maintenance schedules can vary significantly from year to year. As of December 31, 2003, the Company has \$185 million, net of related accumulated depreciation, in capitalized D checks classified as *Flight equipment* in the Consolidated Balance Sheet. Upon the expected adoption of the Draft SOP in 2005, any remaining unamortized costs of planned major maintenance activities (D checks) would be expensed as a cumulative effect of accounting change adjustment (charge) in the first quarter of that year.

The Draft SOP also requires, among other things, management to establish a level of *component accounting*, as defined, for property and equipment. The Draft SOP defines a component as a tangible part of property or equipment that is accounted for separately and is expected to provide benefit for more than one year. Each component of property and equipment shall be depreciated over its own separate useful life, and once it is replaced with a new component, any remaining value would be written off to expense in the period of replacement. Although the Company is still studying the Draft SOP as it relates to component accounting, Southwest does not expect its future results of operation or financial position to be materially affected by the application of component accounting.

In January 2003, FASB issued Interpretation No. 46, *Consolidation of Variable Interest Entities* (FIN 46) which requires the consolidation of variable interest entities, as defined. FIN 46, as revised, is applicable to financial statements of companies that have interests in *special purpose entities*, as defined, during 2003. FIN 46 is applicable to financial statements of companies that have interests in all other types of entities, in first quarter 2004. However, disclosures are required currently if the Company expects to consolidate any variable interest entities. The Company

does not currently believe that any material entities will be consolidated with Southwest as a result of FIN 46.

A-38

---

**Table of Contents****2. ACCOUNTING CHANGES**

Effective January 1, 2001, the Company adopted SFAS 133. SFAS 133 requires the Company to record all financial derivative instruments on its balance sheet at fair value. Derivatives that are not designated as hedges must be adjusted to fair value through income. If a derivative is designated as a hedge, depending on the nature of the hedge, changes in its fair value that are considered to be effective, as defined, either offset the change in fair value of the hedged assets, liabilities, or firm commitments through earnings or are recorded in Accumulated other comprehensive income (loss) until the hedged item is recorded in earnings. Any portion of a change in a derivative's fair value that is considered to be ineffective, as defined, is recorded immediately in Other (gains) losses, net in the Consolidated Statement of Income. Any portion of a change in a derivative's fair value that the Company elects to exclude from its measurement of effectiveness is required to be recorded immediately in earnings.

Under the rules established by SFAS 133, the Company has alternatives in accounting for its financial derivative instruments. The Company primarily uses financial derivative instruments to hedge its exposure to jet fuel price increases and accounts for these derivatives as cash flow hedges, as defined. In accordance with SFAS 133, the Company must comply with detailed rules and strict documentation requirements prior to beginning hedge accounting. 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 (crude oil and heating oil).

Upon adoption of SFAS 133, the Company recorded the fair value of its fuel derivative instruments in the Consolidated Balance Sheet and a deferred gain of \$46 million, net of tax, in Accumulated other comprehensive income (loss). See Note 11 for further information on Accumulated other comprehensive income (loss). During 2003, 2002, and 2001, the Company recognized \$16 million in additional income, \$5 million in additional income, and \$8 million in expense, respectively, in Other (gains) losses, net, related to the ineffectiveness of its hedges. During 2003, 2002, and 2001, the Company recognized approximately \$29 million, \$26 million, and \$18 million, respectively, of net expense, related to amounts excluded from the Company's measurements of hedge effectiveness, in Other (gains) losses, net. The 2001 adoption of SFAS 133 has resulted in more volatility in the Company's financial statements than in the past due to the changes in market values of its derivative instruments and some ineffectiveness that has been experienced in its fuel hedges. See Note 10 for further information on the Company's derivative instruments.

**3. FEDERAL GRANTS AND SPECIAL CHARGES RELATED TO TERRORIST ATTACKS**

On September 11, 2001, terrorists hijacked and used two American Airlines, Inc. aircraft and two United Air Lines, Inc. aircraft in terrorist attacks on the United States (terrorist attacks). As a result of these terrorist attacks, the Federal Aviation Administration (FAA) immediately suspended all commercial airline flights. From September 11 until the Company resumed flight operations on September 14, Southwest cancelled approximately 9,000 flights.

On September 22, 2001, President Bush signed into law the Air Transportation Safety and System Stabilization Act (Stabilization Act). The Stabilization Act provided for up to \$5 billion in cash grants to qualifying U.S. airlines and freight carriers to compensate for direct and incremental losses, as defined in the Stabilization Act, from September 11, 2001, through December 31, 2001, associated with the terrorist attacks. Each airline's total eligible grant was determined based on that airline's percentage of available seat miles (ASMs) during August 2001 to total eligible carriers' ASMs for August 2001, less an amount set aside for eligible carriers for whom the use of an ASM formula would result in an insufficient representation of their share of direct and incremental losses.



In 2001, the Department of Transportation (DOT) made a determination of the amount of eligible direct and incremental losses incurred by Southwest, and the Company was allotted 100 percent of its eligible grants,

A-39

---

**Table of Contents**

totaling \$283 million. The Company recognized \$235 million in Other gains from grants under the Stabilization Act during the second half of 2001 and recognized an additional \$48 million as Other gains from grants under the Stabilization Act in third quarter 2002 coincident with the receipt of its final payment. Representatives of the DOT or other governmental agencies may perform additional audit and/or review(s) of the Company's previously submitted final application. While the Stabilization Act is subject to significant interpretation as to what constitutes direct and incremental losses, management believes the Company's eligible direct and incremental losses are sufficient to retain 100 percent of its eligible grant following additional audits or reviews, should they occur.

The Company recorded total special charges of \$48 million in 2001 arising from the terrorist attacks, which included a \$30 million reduction in Passenger revenue. Following the terrorist events of September 11, 2001, and the subsequent temporary shutdown of U.S. air space, Southwest temporarily suspended its normal refund policy in order to provide the highest Service to the Company's Customers, including refunding nonrefundable tickets upon Customer request. As a result, the Company's refunds during September 2001 and through December 2001 were far above historical refund levels and in excess of the Company's contractual obligations. Refunds are recorded as a reduction in Air traffic liability. Based on these unusually high refunds, the Company estimated that approximately \$30 million of these refunds related to revenue previously recognized for estimated forfeited tickets. As a result, the Company reduced third quarter 2001 Passenger revenue by \$30 million and restored Air traffic liability accordingly. Total special charges also included \$13 million in Other operating expenses, primarily related to write-downs of various assets due to impairment. Other miscellaneous charges totaling approximately \$5 million were also included in Other (gains) losses, net.

On April 16, 2003, as a result of the United States war with Iraq, the Emergency Wartime Supplemental Appropriations Act (Wartime Act) was signed into law. Among other items, the legislation included a \$2.3 billion government grant for airlines. Southwest received \$271 million as its proportional share of the grant during second quarter 2003. This amount is included in Other (gains) losses in the accompanying Consolidated Income Statement for 2003. Also as part of the Wartime Act, the Company received approximately \$5 million as a reimbursement for the direct cost of reinforcing cockpit doors on all of the Company's aircraft. The Company accounted for this reimbursement as a reduction of capitalized property and equipment.

**4. COMMITMENTS**

The Company's contractual purchase commitments consist primarily of scheduled aircraft acquisitions from Boeing. The Company has contractual purchase commitments with Boeing for 46 737-700 aircraft deliveries in 2004 (plus one leased aircraft to be delivered new from a third party), 28 scheduled for delivery in 2005, 22 in 2006, 25 in 2007, and 6 in 2008. In addition, the Company has options to purchase up to 52 737-700s during 2005-2008 and purchase rights for an additional 217 737-700s during 2007-2012. The Company has the option, which must be exercised two years prior to the contractual delivery date, to substitute 737-600s or 737-800s for the 737-700s. As of December 31, 2003, aggregate funding needed for firm commitments is approximately \$3.2 billion, subject to adjustments for inflation, due as follows: \$1.2 billion in 2004, \$776 million in 2005, \$645 million in 2006, \$524 million in 2007, and \$95 million in 2008.

In November 2001, in response to decreased demand for air travel following the terrorist attacks, the Company modified its schedule for future aircraft deliveries to defer the acquisition of 19 new 737-700 aircraft that were either already in production at Boeing or were scheduled to be built through April 2002. The Company accomplished this by entering into a trust arrangement with a special purpose entity (the Trust) and assigned its purchase agreement with Boeing to the Trust with respect to the 19 aircraft originally scheduled for delivery between September 2001 and April 2002. Southwest subsequently entered into a purchase agreement with the Trust to purchase the aircraft at new delivery dates from January 2002 to April 2003. The Trust was formed to facilitate the financing of the Company's near-term aircraft purchase obligations with Boeing. The Trust purchased 11 of the aircraft in 2001 and eight aircraft

in 2002. For these 19 Trust aircraft, the Company recorded the associated assets ( Flight equipment ) and liabilities ( Aircraft purchase obligations ) in its financial

A-40

---

**Table of Contents**

statements as the aircraft were completed by Boeing and delivered to the Trust. In the Consolidated Statement of Cash Flows, the Trust's receipt of these aircraft was recorded as Purchases of property and equipment and Proceeds from trust arrangement. During 2002, the Company accelerated the deliveries from the Trust and accepted delivery of all 19 aircraft, thereby terminating the Trust. The receipt of the aircraft from the Trust was reflected in the Consolidated Statement of Cash Flows as Payments of trust arrangement. The cost of financing these aircraft obligations, approximately \$5 million, was expensed.

**5. ACCRUED LIABILITIES**

(In millions)	2003	2002
Retirement plans (Note 14)	<b>\$126</b>	\$ 71
Aircraft rentals	<b>114</b>	121
Vacation pay	<b>109</b>	96
Advances and deposits	<b>121</b>	80
Other	<b>180</b>	161
	<b>—</b>	<b>—</b>
	<b>\$650</b>	\$529
	<b>—</b>	<b>—</b>

**6. SHORT-TERM BORROWINGS**

Following the terrorist attacks in September 2001, the Company borrowed the full \$475 million available under its unsecured revolving credit line with a group of banks. Borrowings under the credit line bore interest at six-month LIBOR plus 15.5 basis points. The Company repaid this unsecured revolving credit line in full, plus accrued interest, in March 2002. This credit facility was replaced in April 2002.

In April 2002, the Company entered into two unsecured revolving credit facilities from which it can borrow up to \$575 million from a group of banks. One of the facilities, for half of the total amount, was renewed for an additional year during April 2003. This facility now expires in April 2004. The other facility, for half of the amount, expires in April 2005. At the Company's option, interest on the facilities can be calculated on one of several different bases. For most borrowings, Southwest would anticipate choosing a floating rate based upon LIBOR. If fully drawn, the spread over LIBOR would be 75 basis points for both facilities given Southwest's credit ratings at December 31, 2003. The Company expects that it will be able to renew the expiring 364-day facility for an additional 364-day period at reasonable terms. If the Company is unable to renew, the Company's available credit facility will be reduced. As of December 31, 2003 and December 31, 2002, there were no outstanding amounts borrowed under either facility.

**7. LONG-TERM DEBT**

(In millions)	2003	2002
8 3/4% Notes due 2003	\$	\$ 100
Aircraft Secured Notes due 2004	<b>175</b>	175
8% Notes due 2005	<b>100</b>	100

Pass through Certificates	<b>564</b>	586
7 7/8% Notes due 2007	<b>100</b>	100
French Credit Agreements	<b>47</b>	50
6 1/2% Notes due 2012	<b>371</b>	385
7 3/8% Debentures due 2027	<b>100</b>	100
Capital leases (Note 8)	<b>91</b>	100
	<b>1,548</b>	1,696
Less current maturities	<b>206</b>	131
Less debt discount and issue costs	<b>10</b>	12
	<b>\$1,332</b>	<b>\$1,553</b>

**Table of Contents**

In October 2003, the Company redeemed \$100 million of senior unsecured 8 3/4% Notes originally issued in 1991.

On March 1, 2002, the Company issued \$385 million senior unsecured Notes (Notes) due March 1, 2012. The Notes bear interest at 6.5 percent, payable semi-annually beginning on September 1, 2002. Southwest used the net proceeds from the issuance of the Notes, approximately \$380 million, for general corporate purposes, including the repayment of the Company's credit facility in March 2002. See Note 6. During 2003, the Company entered into an interest rate swap agreement relating to these Notes. See Note 10 for further information.

On October 30, 2001, the Company issued \$614 million Pass Through Certificates consisting of \$150 million 5.1% Class A-1 certificates, \$375 million 5.5% Class A-2 certificates, and \$89 million 6.1% Class B certificates. A separate trust was established for each class of certificates. The trusts used the proceeds from the sale of certificates to acquire equipment notes, which were issued by Southwest on a full recourse basis. Payments on the equipment notes held in each trust will be passed through to the holders of certificates of such trust. The equipment notes were issued for each of 29 Boeing 737-700 aircraft owned by Southwest and are secured by a mortgage on such aircraft. Interest on the equipment notes held for the certificates is payable semiannually, beginning May 1, 2002. Beginning May 1, 2002, principal payments on the equipment notes held for the Class A-1 certificates are due semiannually until the balance of the certificates mature on May 1, 2006. The entire principal of the equipment notes for the Class A-2 and Class B certificates are scheduled for payment on November 1, 2006. During 2003, the Company entered into an interest rate swap agreement relating to the \$375 million 5.5% Class A-2 certificates. See Note 10 for further information.

In fourth quarter 1999, the Company issued \$200 million of floating rate Aircraft Secured Notes (the Notes), due November 2004. The Notes are funded by a bank through a commercial paper conduit program and are secured by eight aircraft. Interest rates on the Notes are based on the conduit's actual commercial paper rate, plus fees, for each period and are expected to average approximately LIBOR plus 36 basis points over the term of the Notes. Interest is payable monthly and the Company can prepay the Notes in whole or in part prior to maturity. The Company prepaid \$25 million of the Notes during 2002.

Also in fourth quarter 1999, the Company entered into two identical 13-year floating rate financing arrangements, whereby it effectively borrowed a total of \$56 million from French banking partnerships. For presentation purposes, the Company has classified these identical borrowings as one \$56 million transaction. The effective rate of interest over the 13-year term of the loans is LIBOR plus 32 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 has pledged two aircraft as collateral for the transactions.

On February 28, 1997, the Company issued \$100 million of senior unsecured 7 3/8% 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 scheduled payments of principal and interest thereon, discounted to the date of redemption at the comparable treasury rate plus 20 basis points, plus accrued interest at the date of redemption.

During 1995, the Company issued \$100 million of senior unsecured 8% Notes due March 1, 2005. Interest is payable semi-annually on March 1 and September 1. The Notes are not redeemable prior to maturity.

During 1992, the Company issued \$100 million of senior unsecured 7 7/8% Notes due September 1, 2007. Interest is payable semi-annually on March 1 and September 1. The Notes are not redeemable prior to maturity.

The net book value of the assets pledged as collateral for the Company's secured borrowings, primarily aircraft and engines, was \$893 million at December 31, 2003.



**Table of Contents**

As of December 31, 2003, aggregate annual principal maturities (not including interest on capital leases) for the five-year period ending December 31, 2008 were \$206 million in 2004, \$143 million in 2005, \$542 million in 2006, \$114 million in 2007, \$5 million in 2008, and \$556 million thereafter.

**8. LEASES**

The Company had seven aircraft classified as capital leases at December 31, 2003. The amounts applicable to these aircraft included in property and equipment were:

(In millions)	2003	2002
Flight equipment	\$171	\$165
Less accumulated depreciation	114	106
	<u>\$ 57</u>	<u>\$ 59</u>

Total rental expense for operating leases charged to operations in 2003, 2002, and 2001 was \$386 million, \$371 million, and \$359 million, respectively. The majority of the Company's terminal operations space, as well as 89 aircraft, were under operating leases at December 31, 2003. Future minimum lease payments under capital leases and noncancelable operating leases with initial or remaining terms in excess of one year at December 31, 2003, were:

(In millions)	Capital leases	Operating leases
2004	\$ 18	\$ 283
2005	24	273
2006	14	219
2007	16	202
2008	13	190
After 2008	39	1,328
	<u>124</u>	<u>\$2,495</u>
Total minimum lease payments		
	33	
	<u>91</u>	
Present value of minimum lease payments		
Less current portion	10	
	<u>81</u>	



Long-term portion \$ 81

---

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.

## **9. CONSOLIDATION OF RESERVATIONS CENTERS**

In November 2003, the Company announced the consolidation of its nine Reservations Centers into six, effective February 28, 2004. This decision was made in response to the established shift by Customers to the internet as a preferred way of booking travel. The Company's website, [www.southwest.com](http://www.southwest.com), is now responsible for more than half of ticket bookings and, as a consequence, demand for phone contact has dramatically decreased. The Company will close its Reservations Centers located in Dallas, Texas, Salt Lake City, Utah, and Little Rock, Arkansas. The Company is giving the 1,900 affected Employees at these

A-43

---

**Table of Contents**

locations the opportunity to relocate to another of the Company's remaining six centers. As of mid-January 2004, approximately 55 percent of these Employees had notified the Company that they would not relocate. Employees choosing to not relocate have been offered support packages, which include severance pay, flight benefits, medical coverage, and job-search assistance, depending on length of service with the Company. The costs associated with this decision, primarily related to Employee severance packages and relocation expenses, will be recognized primarily in first quarter 2004, in accordance with SFAS 146.

**10. 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 in 2003, 2002, and 2001 represented approximately 15.2, 14.9 percent, and 15.6 percent of Southwest's operating expenses, respectively. The Company endeavors to acquire jet fuel at the lowest possible cost. Because jet fuel is not traded on an organized futures exchange, liquidity for hedging is limited. However, the Company has found that both crude oil and heating oil contracts are effective commodities for hedging jet fuel. The Company has financial derivative instruments in the form of the types of hedges it utilizes to decrease its exposure to jet fuel price increases. The Company does not purchase or hold any derivative financial instruments for trading purposes.

The Company utilizes financial derivative instruments for both short-term and long-term time frames when it appears the Company can take advantage of market conditions. As of December 31, 2003, the Company had a mixture of purchased call options, collar structures, and fixed price swap agreements in place to hedge approximately 82 percent of its 2004 total anticipated jet fuel requirements, approximately 60 percent of its 2005 total anticipated jet fuel requirements, and portions of its 2006-2007 total anticipated jet fuel requirements. As of December 31, 2003, the majority of the Company's first quarter 2004 hedges are effectively heating oil-based positions in the form of option contracts. The majority of the remaining hedge positions are crude oil-based positions.

During 2003, 2002, and 2001, the Company recognized gains in Fuel and oil expense of \$171 million, \$45 million, and \$80 million, respectively, from hedging activities. At December 31, 2003 and 2002, approximately \$19 million and \$13 million, respectively, due from third parties from expired derivative contracts, is included in Accounts and other receivables in the accompanying Consolidated Balance Sheet. The Company accounts for its fuel hedge derivative instruments as cash flow hedges, as defined. Therefore, all changes in fair value that are considered to be effective are recorded in Accumulated other comprehensive income (loss) until the underlying jet fuel is consumed. The fair value of the Company's financial derivative instruments at December 31, 2003, was a net asset of approximately \$251 million. The current portion of these financial derivative instruments is classified as Fuel hedge contracts and the long-term portion is classified as Other assets in the Consolidated Balance Sheet. The fair value of the derivative instruments, depending 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.

As of December 31, 2003, the Company had approximately \$123 million in unrealized gains, net of tax, in Accumulated other comprehensive income (loss) related to fuel hedges. Included in this total are approximately \$83 million in net unrealized gains that are expected to be realized in earnings during 2004.

Interest Rate Swaps - During second quarter 2003, the Company entered into interest rate swap agreements relating to its \$385 million 6.5% senior unsecured notes due March 1, 2012, and \$375 million 5.496% Class A-2 pass-through certificates due November 1, 2006. Under the first interest rate swap agreement, the Company pays the London InterBank Offered Rate (LIBOR) plus a margin every six months and receives 6.5% every six months on a notional amount of \$385 million until March 1, 2012. Under the second agreement, the Company pays LIBOR plus a margin every six months and receives 5.496% every six months on a notional amount of \$375 million until November 1,

2006.

A-44

---

**Table of Contents**

The Company's interest rate swap agreements qualify as fair value hedges, as defined by SFAS 133. The fair value 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, 2003, was a liability of approximately \$18 million. This amount is recorded in Other deferred liabilities in the Consolidated Balance Sheet. In accordance with fair value hedging, the offsetting entry is an adjustment to decrease the carrying value of long-term debt. See Note 7.

Outstanding financial derivative instruments expose the Company to credit loss in the event of nonperformance by the counterparties to the agreements. However, the Company does not expect any of the counterparties to fail to meet their 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 periodically 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, 2003, the Company had agreements with seven counterparties containing early termination rights and/or bilateral collateral provisions whereby security is required if market risk exposure exceeds a specified threshold amount or credit ratings fall below certain levels. The Company is in the process of negotiating similar agreements with other counterparties.

The carrying amounts and estimated fair values of the Company's long-term debt at December 31, 2003 were as follows:

(In millions)	Carrying value	Estimated fair value
Aircraft Secured Notes due 2004	\$ 175	\$ 175
8% Notes due 2005	100	107
Pass Through Certificates	564	604
7 7/8% Notes due 2007	100	116
French Credit Agreements	47	47
6 1/2% Notes due 2012	371	409
7 3/8% Debentures due 2027	100	112

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

**11. COMPREHENSIVE INCOME**

Comprehensive income includes changes in the fair value of certain financial derivative instruments, which qualify for hedge accounting, and unrealized gains and losses on certain investments. Comprehensive income totaled \$510 million, \$327 million, and \$479 million for 2003, 2002, and 2001, respectively. The differences between Net income and Comprehensive income for these years are as follows:

**Table of Contents**

(In millions)	2003	2002	2001
<b>Net income</b>	<b>\$442</b>	\$241	\$511
Unrealized gain (loss) on derivative instruments, net of deferred taxes of \$43, \$56 and (\$21)	<b>66</b>	88	(31)
Other, net of deferred taxes of \$1, (\$1) and \$0	<b>2</b>	(2)	(1)
Total other comprehensive income	<b>68</b>	86	(32)
<b>Comprehensive income</b>	<b>\$510</b>	\$327	\$479

A rollforward of the amounts included in Accumulated other comprehensive income (loss), net of taxes for 2003, 2002, and 2001, is shown below:

(In millions)	Fuel hedge derivatives	Other	Accumulated other comprehensive income (loss)
Balance at December 31, 2001	\$ (31)	\$(1)	\$ (32)
2002 changes in fair value	110	(2)	108
Reclassification to earnings	(22)	—	(22)
Balance at December 31, 2002	57	(3)	54
<b>2003 changes in fair value</b>	<b>157</b>	<b>2</b>	<b>159</b>
<b>Reclassification to earnings</b>	<b>(91)</b>	—	<b>(91)</b>
<b>Balance at December 31, 2003</b>	<b>\$ 123</b>	<b>\$(1)</b>	<b>\$ 122</b>

**12. COMMON STOCK**

The Company has one class of 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, 2003, the Company had common stock reserved for issuance pursuant to Employee stock benefit plans (242 million shares authorized of which 55 million shares have not yet been granted) and upon exercise of rights (408 million shares) pursuant to the Common Share Purchase Rights Agreement, as amended (Agreement).

Pursuant to the Agreement, each outstanding share of the Company's common stock is accompanied by one common share purchase right (Right). Each Right is exercisable only in the event of a proposed takeover, as defined by the Agreement. The Company may redeem the Rights at \$.0022 per Right prior to the time that 15 percent of the common stock has been acquired by a person or group. The Agreement is not applicable to a fully-financed or cash tender offer for all of the Company's shares of common stock, which remains open for at least 60 calendar days, is at a price equal to the higher of (a) 65% over the average closing price of the common stock during the 90 days preceding the offer and (b) the highest closing price during the 52 weeks preceding the offer, and is accompanied by a written fairness opinion of a nationally recognized investment banking firm. If the Company is acquired, as defined in the Agreement, each Right will entitle its holder to purchase for \$3.29 that number of the acquiring company's or the Company's common shares, as provided in the Agreement, having a market value of two times the exercise price of the Right. The Rights will expire no later than July 30, 2005.

A-46

---

**Table of Contents**

On January 18, 2001, the Company's Board of Directors declared a three-for-two stock split, distributing 254 million shares on February 15, 2001. Unless otherwise stated, all share and per share data presented in the accompanying consolidated financial statements and notes thereto have been restated to give effect to this stock split.

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 anticipated proceeds from the exercise of Employee stock options. 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.

**13. 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 granted at or above the fair market value of the Company's common stock on the date of grant, generally have terms ranging from six to twelve years, and vest primarily in accordance with the period covered by the respective collective bargaining agreement. 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 granted at the fair market value of the Company's common stock on the date of grant, have ten-year terms, and vest and become fully exercisable over three, five, or ten years of continued employment, depending upon the grant type. All of these other Employee plans have been approved by shareholders except the plan covering non-management, non-contract Employees, which had 7.6 million options outstanding to purchase the Company's common stock as of December 31, 2003, and an additional plan which is not available to Officers or Board members, reserving 15 million shares for future grants.

Aggregated information regarding the Company's fixed stock option plans, as adjusted for stock splits, is summarized below:

(In thousands, except exercise prices)	COLLECTIVE BARGAINING PLANS		OTHER EMPLOYEE PLANS	
	Options	Average exercise price	Options	Average exercise price
Outstanding December 31, 2000	63,400	\$ 5.59	36,358	\$ 8.66
Granted	1,665	19.05	4,022	18.75
Exercised	(4,166)	4.48	(4,135)	4.77
Surrendered	(349)	8.71	(1,394)	10.87
Outstanding December 31, 2001	60,550	6.05	34,851	10.20
Granted	48,414	13.37	4,423	16.90
Exercised	(4,211)	4.48	(3,805)	5.75
Surrendered	(733)	8.69	(1,317)	12.48
Outstanding December 31, 2002	104,020	9.51	34,152	11.47

<b>Granted</b>	<b>26,674</b>	<b>13.53</b>	<b>4,770</b>	<b>14.63</b>
<b>Exercised</b>	<b>(7,422)</b>	<b>6.78</b>	<b>(3,318)</b>	<b>7.95</b>
<b>Surrendered</b>	<b>(3,214)</b>	<b>12.69</b>	<b>(1,052)</b>	<b>13.57</b>
	<hr/>		<hr/>	
<b>Outstanding December 31, 2003</b>	<b>120,058</b>	<b>\$ 10.47</b>	<b>34,552</b>	<b>\$ 12.21</b>
	<hr/>		<hr/>	
<b>Exercisable December 31, 2003</b>	<b>60,430</b>	<b>\$ 7.46</b>	<b>16,031</b>	<b>\$ 12.37</b>
<b>Available for grant in future periods</b>	<b>20,919</b>		<b>28,981</b>	

A-47



**Table of Contents**

The following table summarizes information about stock options outstanding under the fixed option plans at December 31, 2003:

<b>Range of exercise prices</b>	<b>OPTIONS OUTSTANDING</b>			<b>OPTIONS EXERCISABLE</b>	
	<b>Options outstanding at 12/31/03 (000s)</b>	<b>Wtd-average remaining contractual life</b>	<b>Wtd-average exercise price</b>	<b>Options exercisable at 12/31/03 (000s)</b>	<b>Wtd-average exercise price</b>
\$3.33 to \$4.99	43,779	2.9 yrs	\$ 4.05	40,295	\$ 4.01
\$5.11 to \$7.41	2,411	2.5 yrs	5.77	2,411	5.77
\$7.86 to \$11.73	12,762	4.9 yrs	9.86	6,978	9.97
\$12.11 to \$18.07	87,167	7.8 yrs	13.76	22,328	14.12
\$18.26 to \$23.94	8,491	6.3 yrs	19.61	4,449	19.84
	<b>154,610</b>	<b>6.0 yrs</b>	<b>\$10.86</b>	<b>76,461</b>	<b>\$ 8.49</b>

Under the amended 1991 Employee Stock Purchase Plan (ESPP), which has been approved by stockholders, as of December 31, 2003, the Company is authorized to issue up to a remaining balance of 5.0 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 purchase period. Common stock purchases are paid for through periodic payroll deductions. Participants under the plan received 1.4 million shares in 2003, 1.4 million shares in 2002, and 1.0 million shares in 2001, at average prices of \$14.04, \$14.70, and \$16.42, respectively. The weighted-average fair value of each purchase right under the ESPP granted in 2003, 2002, and 2001, which is equal to the ten percent discount from the market value of the common stock at the end of each purchase period, was \$1.56, \$1.63, and \$1.82, respectively.

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

	<b>2003</b>	<b>2002</b>	<b>2001</b>
Wtd-average risk-free interest rate	2.6%	3.4%	4.5%
Expected life of option (years)	4.2	5.0	5.9
Expected stock volatility	34.0%	34.0%	34.8%
Expected dividend yield	0.13%	0.13%	0.07%

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 highly subjective assumptions including expected stock price volatility. Because the Company's Employee stock options have characteristics significantly different from those of traded options and because changes in the subjective input assumptions can materially affect the fair value estimate, in management's opinion the existing models do not necessarily provide a reliable single measure of the fair value of its Employee stock options.

The fair value of options granted under the fixed option plans during 2003 ranged from \$3.33 to \$8.17. The fair value of options granted under the fixed option plans during 2002 ranged from \$3.54 to \$8.52. The fair value of options granted under the fixed option plans during 2001 ranged from \$5.69 to \$9.11.

#### **14. EMPLOYEE RETIREMENT PLANS**

The Company has defined contribution plans covering substantially all of Southwest's Employees. The Southwest Airlines Co. Profitsharing Plan is a money purchase defined contribution plan and Employee stock

**Table of Contents**

purchase plan. 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. Contributions under all defined contribution plans are based primarily on Employee compensation and performance of the Company.

Company contributions to all retirement plans expensed in 2003, 2002, and 2001 were \$219 million, \$156 million, and \$215 million, respectively.

**15. 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, 2003 and 2002, are as follows:

(In millions)	2003	2002
<b>DEFERRED TAX LIABILITIES:</b>		
Accelerated depreciation	\$1,640	\$1,440
Scheduled airframe maintenance	77	71
Fuel hedges	79	35
Other	19	26
	<hr/>	<hr/>
Total deferred tax liabilities	1,815	1,572
<b>DEFERRED TAX ASSETS:</b>		
Deferred gains from sale and leaseback of aircraft	89	96
Capital and operating leases	73	77
Accrued employee benefits	108	86
State taxes	47	43
Other	40	37
	<hr/>	<hr/>
Total deferred tax assets	357	339
	<hr/>	<hr/>
Net deferred tax liability	\$1,458	\$1,233
	<hr/>	<hr/>

The provision for income taxes is composed of the following:

(In millions)	2003	2002	2001
<b>CURRENT:</b>			
Federal	\$ 73	\$ (19)	\$ 99
State	10	1	10

	—	—	—
Total current	<b>83</b>	(18)	109
<b>DEFERRED:</b>			
Federal	<b>170</b>	157	187
State	<b>13</b>	13	21
	—	—	—
Total deferred	<b>183</b>	170	208
	—	—	—
	<b>\$266</b>	\$152	\$317
	—	—	—

For the year 2002, Southwest Airlines Co. had a tax net operating loss of \$163 million for federal income tax purposes. This resulted in a federal tax refund due to utilization of this net operating loss as a carryback to prior taxable years. This refund, estimated at \$51 million at December 31, 2002, was included in Accounts and other receivables in the Consolidated Balance Sheet at December 31, 2002 and was collected in 2003.

**Table of Contents**

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

(In millions)	2003	2002	2001
Tax at statutory U.S. tax rates	\$247	\$138	\$290
Non deductible items	7	6	7
State income taxes, net of federal benefit	15	9	20
Other, net	(3)	(1)	—
	—	—	—
Total income tax provision	<b>\$266</b>	<b>\$152</b>	<b>\$317</b>

The Internal Revenue Service (IRS) regularly examines the Company's federal income tax returns and, in the course of which, may propose 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 of merit. The Company's management does not expect that the outcome of any proposed adjustments presented to date by the IRS, individually or collectively, will have a material adverse effect on the Company's financial condition, results of operations, or cash flows.

**16. NET INCOME PER SHARE**

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

(In millions, except per share amounts)	2003	2002	2001
Net income	\$442	\$241	\$511
Weighted-average shares outstanding, basic	783	773	763
Dilutive effect of Employee stock options	39	36	44
	—	—	—
Adjusted weighted-average shares outstanding, diluted	<b>822</b>	<b>809</b>	<b>807</b>
	—	—	—
Net income per share, basic	<b>\$ .56</b>	<b>\$ .31</b>	<b>\$ .67</b>
	—	—	—
Net income per share, diluted	<b>\$ .54</b>	<b>\$ .30</b>	<b>\$ .63</b>

The Company has excluded 10 million, 11 million, and 6 million shares from its calculations of net income per share, diluted, in 2003, 2002, and 2001, respectively, as they represent antidilutive stock options for the respective periods presented.

A-50

---

**Table of Contents**

**REPORT OF INDEPENDENT AUDITORS**

**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, 2003 and 2002, and the related consolidated statements of income, stockholders' equity, and cash flows for each of the three years in the period ended December 31, 2003. 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 auditing standards generally accepted in the 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, 2003 and 2002, and the consolidated results of its operations and its cash flows for each of the three years in the period ended December 31, 2003, in conformity with accounting principles generally accepted in the United States.

As discussed in Note 2 to the financial statements, in 2001 the Company changed its method of accounting for derivative financial instruments.

ERNST & YOUNG LLP

Dallas, Texas  
January 21, 2004

A-51

---

**Table of Contents****Quarterly Financial Data (Unaudited)**  
**(in millions except per share amounts)**

<b>2003</b>	<b>Three months ended</b>			
	<b>March 31</b>	<b>June 30</b>	<b>Sept. 30</b>	<b>Dec. 31</b>
Operating revenues	\$1,351	\$1,515	\$1,553	\$1,517
Operating income	46	140	185	111
Income before income taxes	39	397	171	101
Net income	24	246	106	66
Net income per share, basic	.03	.32	.14	.08
Net income per share, diluted	.03	.30	.13	.08
<b>2002</b>	<b>March 31</b>	<b>June 30</b>	<b>Sept. 30</b>	<b>Dec. 31</b>
Operating revenues	\$1,257	\$1,473	\$1,391	\$1,401
Operating income	49	189	91	88
Income before income taxes	35	169	124	64
Net income	21	102	75	42
Net income per share, basic	.03	.13	.10	.05
Net income per share, diluted	.03	.13	.09	.05

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

None.



**Table of Contents**

**Item 9A. Controls and Procedures**

**Disclosure Controls and Procedures.**

The Company maintains controls and procedures designed to ensure that it is able to collect the information it is required to disclose in the reports it files with the SEC, and to process, summarize and disclose this information within the time periods specified in the rules of the SEC. Based on an evaluation of the Company's disclosure controls and procedures as of the end of the period covered by this report conducted by the Company's management, with the participation of the Chief Executive and Chief Financial Officers, the Chief Executive and Chief Financial Officers believe that these controls and procedures are effective to ensure that the Company is able to collect, process and disclose the information it is required to disclose in the reports it files with the SEC within the required time periods.

**Internal Control over Financial Reporting.**

During the period covered by this report, there have been no changes in the Company's internal control over financial reporting that have materially affected or are reasonably likely to materially affect the Company's internal control over financial reporting.

**PART III**

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

The information required by Item 401 of Regulation S-K regarding directors is included under "Election of Directors" in the definitive Proxy Statement for Southwest's Annual Meeting of Shareholders to be held May 19, 2004 and is incorporated herein by reference. The information required by Item 401 of Regulation S-K regarding executive officers is included under "Executive Officers of the Registrant" in Part I following Item 4 of this Report. The information required by Item 405 of Regulation S-K is included under "Section 16(a) Beneficial Ownership Reporting Compliance" in the definitive Proxy Statement for Southwest's Annual Meeting of Shareholders to be held May 19, 2004 and is incorporated herein by reference.

In the wake of well-publicized corporate scandals, the Securities and Exchange Commission and the New York Stock Exchange have issued multiple new regulations, requiring the implementation of policies and procedures in the corporate governance area. Since beginning business in 1971, Southwest has thrived on a culture, which encourages an entrepreneurial spirit in its Employees, and has emphasized personal responsibility, initiative, and the use of independent, good judgment. The Golden Rule is one of the core values, and there is a top-down insistence on the highest ethical standards at all times.

In complying with new regulations requiring the institution of policies and procedures, it has been the goal of Southwest's Board of Directors and senior leadership to do so in a way which does not inhibit or constrain Southwest's unique culture, and which does not unduly impose a bureaucracy of forms and checklists. Accordingly, formal, written policies and procedures have been adopted in the simplest possible way, consistent with legal requirements. The Company's Corporate Governance Guidelines, its charters for each of its Compensation and Nominating and Corporate Governance Committees, and a revised charter for its Audit Committee and its Code of Ethics covering all Employees are available on the Company's website, [www.southwest.com](http://www.southwest.com), and a copy will be mailed upon request to Sr. Director - Investor Relations, Southwest Airlines Co., P.O. Box 36611, Dallas, TX 75235. The Company intends to disclose any amendments to or waivers of the Code of Ethics on behalf of the Company's Chief Executive Officer, Chief Financial Officer, Controller, and persons performing similar functions on the



**Table of Contents**

Company's website, at [www.southwest.com](http://www.southwest.com) under the "About SWA" caption, promptly following the date of such amendment or waiver.

**Item 11. *Executive Compensation***

See "Compensation of Executive Officers," incorporated herein by reference from the definitive Proxy Statement for Southwest's Annual Meeting of Shareholders to be held May 19, 2004.

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

See "Voting Securities and Principal Shareholders," incorporated herein by reference from the definitive Proxy Statement for Southwest's Annual Meeting of Shareholders to be held May 19, 2004.

**Item 13. *Certain Relationships and Related Transactions***

See "Election of Directors" incorporated herein by reference from the definitive Proxy Statement for Southwest's Annual Meeting of Shareholders to be held May 19, 2004.

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

See "Relationship with Independent Auditors" incorporated herein by reference from the definitive Proxy Statement for Southwest's Annual Meeting of Shareholders to be held May 19, 2004.

**PART IV**

**Item 15. Exhibits, Financial Statement Schedules, and Reports on Form 8-K**

(a) 1. Financial Statements:

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

2. Financial Statement Schedules:

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

3. Exhibits:

3.1 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)).

A-54

---

**Table of Contents**

3.2 Bylaws of Southwest, as amended through January 2004.

4.1 364-Day Competitive Advance and Revolving Credit Facility Agreement dated as of April 23, 2002 and 3-Year Competitive Advance and Revolving Credit Facility Agreement dated as of April 23, 2002 (incorporated by reference to Exhibits 10.2 and 10.1, respectively, to Southwest's Quarterly Report on Form 10-Q for the quarter ended September 30, 2002 (File No. 1-7259)); First Amendment to 364-Day Competitive Advance and Revolving Credit Facility Agreement among Southwest Airlines Co., the banks party thereto, and JPMorgan Chase Bank, as Administrative Agent, dated as of April 22, 2003 (incorporated by reference to Exhibit 10.7 to Southwest's Quarterly Report on Form 10-Q for the quarter ended June 30, 2003 (File No. 1-7259)).

4.2 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)).

4.3 Amended and Restated Rights Agreement dated July 18, 1996 between Southwest and Continental Stock Transfer & Trust Company, as Rights Agent (incorporated by reference to Exhibit 1, Southwest's Registration Statement on Form 8-A/A dated August 12, 1996 (File No. 1-7259)); Amendment No. 1 to Rights Agreement dated March 15, 2001 (incorporated by reference to Exhibit 1 to Form 8-A Amendment No. 3 dated April 25, 2001 (File No. 1-7529)).

4.4 Indenture dated as of June 20, 1991 between Southwest Airlines Co. and Bank of New York, successor to NationsBank of Texas, N.A. (formerly NCNB Texas National Bank), Trustee (incorporated by reference to Exhibit 4.1 to Southwest's Current Report on Form 8-K dated June 24, 1991 (File No. 1-7259)).

4.5 Indenture dated as of February 25, 1997 between the Company and U.S. Trust Company of Texas, N.A. (incorporated by reference to Exhibit 4.2 to Southwest's Annual Report on Form 10-K for the year ended December 31, 1996 (File No. 1-7259)).

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

10.1 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,

**Table of Contents**

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.

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.

- 10.2 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)).
- 10.3 1996 stock option agreements between Southwest and Herbert D. Kelleher (incorporated by reference to Exhibit 10.8 to Southwest's Annual Report on Form 10-K for the year ended December 31, 1996 (File No. 1-7259)).
- 10.4 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)).
- 10.5 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)).
- 10.6 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)).
- 10.7 1991 Employee Stock Purchase Plan as amended September 21, 2000 (incorporated by reference to Exhibit 4 to Amendment No. 1 to Registration Statement on Form S-8 (file No. 33-40653)).
- 10.8 Southwest Airlines Co. Profit Sharing Plan (incorporated by reference to Exhibit 10.8 to Southwest's Annual Report on Form 10-K for the year ended December 31, 2000 (File No. 1-729)); Amendment No. 1 to Southwest Airlines Co. Profit Sharing Plan (incorporated by reference to Exhibit 10.11 to Southwest's Annual Report on Form 10-K for the year ended December 31, 2001 (File No. 1-7259)); Amendment No. 2 to Southwest Airlines Co. Profit Sharing Plan (incorporated by reference to Exhibit 10.9 to Southwest's Annual Report on Form 10-K for the year ended December 31, 2002 (File No. 1-7259)); Amendment No. 3 to Southwest Airlines Co. Profit Sharing Plan (incorporated by reference to Exhibit 10.1 to Southwest's Quarterly Report on

**Table of Contents**

Form 10-Q for the quarter ended June 30, 2003 (File No. 1-7259)); Amendment No. 4 to Southwest Airlines Co. Profit Sharing Plan.

- 10.9 Southwest Airlines Co. 401(k) Plan (incorporated by reference to Exhibit 10.12 to Southwest's Annual Report on Form 10-K for the year ended December 31, 2001 (File No. 1-7259)); Amendment No. 1 to Southwest Airlines Co. 401(k) Plan (incorporated by reference to Exhibit 10.10 to Southwest's Annual Report on Form 10-K for the year ended December 31, 2002 (File No. 1-7259)); Amendment No. 2 to Southwest Airlines Co. 401(k) Plan (incorporated by reference to Exhibit 10.10 to Southwest's Annual Report on Form 10-K for the year ended December 31, 2002 (File No. 1-7259)); Amendment No. 3 to Southwest Airlines Co. 401(k) Plan (incorporated by reference to Exhibit 10.2 to Southwest's Quarterly Report on Form 10-Q for the quarter ended June 30, 2003 (File No. 1-7259)); Amendment No. 4 to Southwest Airlines Co. 401(k) Plan.
- 10.10 Southwest Airlines Co. 1995 SWAPA Non-Qualified Stock Option Plan (incorporated by reference to Exhibit 10.14 to Southwest's Annual Report on Form 10-K for the year ended December 31, 1994 (File No. 1-7259)).
- 10.11 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)).
- 10.12 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)).
- 10.13 Employment Agreement dated as of June 19, 2002 between Southwest and James F. Parker (incorporated by reference to Exhibit 10.16 to Southwest's Annual Report on Form 10-K for the year ended December 31, 2001 (File No. 1-7259)).
- 10.14 Employment Agreement dated as of June 19, 2002 between Southwest and Colleen C. Barrett (incorporated by reference to Exhibit 10.17 to Southwest's Annual Report on Form 10-K for the year ended December 31, 2000 (File No. 1-7259)).
- 10.15 Southwest Airlines Co. Outside Director Incentive Plan (incorporated by reference to Exhibit 10.1 to Southwest's Quarterly Report on Form 10-Q for the quarter ended March 31, 2002 (File No. 1-7259)).
- 10.16 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)).
- 10.17 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)).
- 10.18 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)).

**Table of Contents**

- 10.19 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)).
- 10.20 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)).
- 10.21 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)).
- 10.22 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)).
- 10.23 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)).
- 10.24 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)).
- 10.25 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)).
- 10.26 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)).
- 10.27 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)).
- 10.28 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)).

14 Code of Ethics

A-58

---



**Table of Contents**

22 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 Auditors.

31.1 Rule 13a-14(a) Certification of Chief Executive Officer.

31.2 Rule 13a-14(a) Certification of Chief Financial Officer.

32.1 Section 1350 Certification of Chief Executive Officer.

32.2 Section 1350 Certification of 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: Sr. Director of Investor Relations, Southwest Airlines Co., P.O. Box 36611, Dallas, Texas 75235-1611.

(b) On October 20, 2003, Southwest filed a current report on Form 8-K to furnish the Company's public announcement of its third quarter 2003 earnings and an announcement regarding the payment of commissions to travel agencies.

A-59

---

**Table of Contents**

**SIGNATURES**

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

SOUTHWEST AIRLINES CO.

January 28, 2004

By /s/ Gary C. Kelly

---

Gary C. Kelly  
*Executive Vice President,  
 Chief Financial Officer*

Pursuant to the requirements of the Securities Exchange Act of 1934, this report has been signed below by the following persons on January 28, 2004 on behalf of the registrant and in the capacities indicated.

<b><u>Signature</u></b>	<b><u>Capacity</u></b>
<u>/s/ Herbert D. Kelleher</u> Herbert D. Kelleher	Chairman of the Board of Directors
<u>/s/ James F. Parker</u> James F. Parker	Chief Executive Officer and Director
<u>/s/ Colleen C. Barrett</u> Colleen C. Barrett	President, Chief Operating Officer and Director
<u>/s/ Gary C. Kelly</u> Gary C. Kelly	Executive Vice President and Chief Financial Officer (Chief Financial and Accounting Officer)
<u>/s/ C. Webb Crockett</u> C. Webb Crockett	Director
<u>/s/ William H. Cunningham</u> William H. Cunningham	Director
<u>/s/ William P. Hobby</u> William P. Hobby	Director

/s/ Travis C. Johnson Director

Travis C. Johnson

/s/ R.W. King Director

R. W. King

/s/ John T. Montford Director

John T. Montford

/s/ June M. Morris Director

June M. Morris

Director

Louis Caldera

/s/ Nancy Loeffler Director

Nancy Loeffler

A-60

---

**Table of Contents**

**DIRECTIONS TO THE ANNUAL MEETING**

Southwest Airlines Co. corporate headquarters is located at 2702 Love Field Drive, Dallas, Texas. From Dallas Love Field, take Cedar Springs Road south to the airport exit. Turn right onto West Mockingbird Lane. Turn right onto Denton Drive and travel approximately two miles to Seelcco Street. Turn right at Seelcco Street. Go past the security booth and the headquarters building will be to your left. Please park near the main entrance to the building.

---

**Table of Contents**

**6 FOLD AND DETACH HERE AND READ THE REVERSE SIDE 6**

**PROXY**

**SOLICITED BY THE BOARD OF DIRECTORS OF SOUTHWEST AIRLINES CO.**

The undersigned hereby appoints Colleen C. Barrett, James F. Parker, and Gary C. Kelly proxies (to act by majority decision if more than one shall act), and each of them with full power of substitution, to vote all shares of Common Stock of Southwest Airlines Co. that the undersigned is entitled to vote at the annual meeting of Shareholders thereof to be held on May 19, 2004, or at any adjournments thereof, as follows:

**ALL SHARES WILL BE VOTED AS DIRECTED HEREIN AND, UNLESS OTHERWISE DIRECTED, WILL BE VOTED FOR ALL NOMINEES IN ITEM 1 AND FOR THE RATIFICATION OF SELECTION OF AUDITOR IN ITEM 2 AND IN ACCORDANCE WITH THE DISCRETION OF THE PERSON VOTING THE PROXY WITH RESPECT TO ANY OTHER BUSINESS PROPERLY BEFORE THE MEETING.**

(Please Date and Sign on Reverse Side)

---

**Table of Contents**

**SOUTHWEST AIRLINES CO.**

*Voting by telephone or Internet is quick, easy and immediate.* As a Southwest Airlines Co. Shareholder, voting your shares electronically through the Internet or by telephone eliminates the need to return the proxy card. An electronic or telephonic vote authorizes the named proxies to vote your shares in the same manner as if you marked, signed, dated and returned the proxy card. Votes submitted electronically over the Internet or by telephone must be received by 6:00 p.m., Eastern Time, on May 18, 2004.

**Your vote is important. Please vote immediately.**

Vote-by-Internet

---

**LOG ON TO THE INTERNET AND GO TO**

**[www.continentalstock.com](http://www.continentalstock.com)**

**CLICK ON PROXY VOTING LOG IN UNDER THE HEADING CONTINENTALINK . HAVE THIS PROXY CARD AVAILABLE WHEN ACCESSING THE ABOVE WEBSITE. YOU WILL BE PROMPTED TO ENTER THE COMPANY NUMBER, PROXY NUMBER AND ACCOUNT NUMBER FROM YOUR PROXY CARD BELOW TO COMPLETE AN ELECTRONIC BALLOT.**

Vote-by-Telephone

---

**ON A TOUCH-TONE TELEPHONE, DIAL 1-800-293-8533**

**USE ANY TOUCH-TONE TELEPHONE TO VOTE. HAVE YOUR PROXY CARD AVAILABLE AND FOLLOW THE INSTRUCTIONS PROVIDED.**

**PLEASE DO NOT RETURN THE CARD BELOW IF YOU ARE VOTING ELECTRONICALLY OR BY THE TELEPHONE.**

Vote-by-Mail

---

**MARK, SIGN AND DATE THE PROXY CARD BELOW, DETACH IT AND RETURN IT IN THE POSTAGE-PAID ENVELOPE PROVIDED.**

6 FOLD AND DETACH HERE AND READ THE REVERSE SIDE 6

**PROXY**

Please  
mark **X**  
your votes  
like this

**The Board of Directors recommends a vote FOR all nominees.**

- |   |  |   |
|---|--|---|
| 1. ELECTION OF DIRECTORS:   | FOR all nominees<br>listed (except those<br>indicated to the<br>contrary below, see<br>instructions) | WITHHOLD<br>AUTHORITY<br>to vote for all<br>nominees listed |
| Herbert D. Kelleher, Rollin W. King,<br>June M. Morris, C. Webb Crockett,<br>William P. Hobby and Travis C. Johnson | <input type="radio"/>  | <input type="radio"/>                                       |

INSTRUCTION: to withhold authority to vote for any individual nominee, write that nominee's name in the space provided here.

**The Board of Directors recommends a vote APPROVE the Ratification of Selection of Auditor:**

- |  |                       |                       |                       |
|--|-----------------------|-----------------------|-----------------------|
| 2. Ratification of Selection of Auditor (Item 2) on page 19 of<br>the Proxy Statement. | APPROVE               | DISAPPROVE            | ABSTAIN               |
|  | <input type="radio"/> | <input type="radio"/> | <input type="radio"/> |

**COMPANY ID:**

**PROXY NUMBER:**

**ACCOUNT NUMBER:**

**Signature** \_\_\_\_\_ **Signature** \_\_\_\_\_ **Date** \_\_\_\_\_

Please sign exactly as name appears on this card. Joint owners should each sign. Executors, administrators, trustees, etc., should give their full titles.