

Southwest Airlines Co.  
1977 Annual Report







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## Highlights

	1977	1976	Percent Change
<b>INCOME DATA</b>			
Operating revenues .....	<b>\$49,113,000</b>	\$30,966,000	58.6%
Operating expenses .....	<b>37,824,000</b>	22,332,000	69.4
Net Income —			
Amount .....	<b>\$ 7,545,000</b>	\$ 4,939,000	52.8
Per share* .....	<b>\$ 2.52</b>	\$ 2.10	20.0
Average shares outstanding* .....	<b>2,991,230</b>	2,354,016	27.1
Shares outstanding at end of period* .....	<b>3,000,000</b>	2,970,000	1.0%
<b>FINANCIAL DATA</b>			
Working capital .....	<b>\$ 5,052,000</b>	\$ 8,026,000	—37.1%
Flight and ground equipment — net .....	<b>69,853,000</b>	32,699,000	113.6
Stockholders' equity .....	<b>26,606,000</b>	19,345,000	37.5
Book value per share* .....	<b>\$ 8.87</b>	\$ 6.51	36.3%
<b>OPERATING DATA</b>			
Trips operated .....	<b>35,415</b>	22,311	58.7%
Passengers carried .....	<b>2,339,524</b>	1,539,113	52.0
Passenger miles flown (000) .....	<b>675,668</b>	406,269	66.3
Available seat miles flown (000) .....	<b>1,011,048</b>	618,732	63.4
Passenger load factor .....	<b>66.8%</b>	65.7%	1.8
Average revenue per passenger mile .....	<b>6.95¢</b>	7.26¢	—4.3
No. of employees at year end .....	<b>892</b>	517	72.5%

\*Adjusted to reflect effect of 5-for-4 stock split on March 16, 1977 and 3-for-2 stock split on March 24, 1978.



## President's Letter

Don't you sometimes get bored reading year after year about the successes of Southwest Airlines? It's happened again in 1977 and, frankly, I have difficulty in finding something original to say.

I really think what happened in 1977 might best be summed up in one very long sentence. Hang on, because it's packed full of information: With an average 27% more shares outstanding, by year-end we leveraged with debt the purchase of 114% more flight and ground equipment and were able to pay good wages to, on average, 64% more employees, with which we produced 63% more available seat miles and managed to have 66.8% of all those seats occupied, thus flying 66% more passenger miles which, with our 4% lower average yield per passenger mile, produced 59% more operating revenues, which resulted in 53% higher net income and 20% higher income per average share of common stock outstanding. Now read that last sentence one more time.

Incidentally, in the process, we opened up five new stations — at Corpus Christi on March 1, Midland/Odessa and Lubbock on May 20, El Paso on June 30, and the State Capital, Austin, on September 15. We took delivery of four more Boeing 737 jet aircraft and got ready to operate two additional such aircraft for a fleet of 12 effective February 13, 1978, doubling our fleet in just ten months. Also, we virtually got out of

the courthouse during 1977 when the U. S. Supreme Court refused to review our second Love Field victory, and the appeal of our latest route award was dismissed.

This month, Southwest's Maintenance and Engineering Department moved into a new 78,000 square-foot Maintenance Operations Center located on an eight-acre tract of land at Love Field, leased from the City of Dallas for a 20-year term. This new facility, constructed by Southwest at a cost of approximately \$1.8 million, will provide substantially expanded capabilities for in-house aircraft maintenance functions. The new facility can house under roof four Boeing 737-200 aircraft at one time and gives Southwest much larger parts storage, shop, and office facilities.


To give each of our shareholders a better understanding of the economics of our business, we are reprinting a filing we are concurrently making with the Texas Aeronautics Commission entitled "Justification for a 1978 Fare Increase". This document tells it like it is, and we think those of you who are truly interested in Southwest Airlines, and the industry of which we are a part, will find it most interesting reading.



Our long-standing route application to provide our brand of short-haul service in 14 major Chicago markets through Midway Airport, filed with the Civil Aeronautics Board during 1976 and stripped down to the six largest markets by the CAB, is now proceeding expeditiously through the administrative procedures of the Board. A two-week hearing for the various applicants before an Administrative Law Judge was completed on February 10, 1978; briefs were filed directly with the Board itself on March 20, 1978; and the Board has promised an initial decision in the matter before August 1, 1978. In anticipation of a favorable award, Southwest has three additional Boeing 737 aircraft on firm order for delivery in the latter part of December 1978 and the first half of 1979, plus six additional such aircraft for delivery in the final quarter of 1979, which may be cancelled on or before August 1, 1978.

We have had the same goals for the last three years and are not going to change them now. If you want to know what they are, refer to previous annual reports. Thank you, customers, employees, and shareholders, for your continued support.

Cordially yours,



M. Lamar Muse  
President and Chief Executive Officer

March 31, 1978





## Six Year Summary of Operations

	Compound Annual Growth Rate 1972-77	Year ended December 31,					
		1977	1976	1975	1974	1973	1972
TRAFFIC							
Passengers carried .....	49.9%	2,339,524	1,539,113	1,136,318	759,721	543,407	308,999
Passenger miles flown (000) ..	56.0	675,668	406,269	298,458	183,596	130,533	73,079
Passenger load factor .....	19.3	66.8%	65.7%	62.5%	58.4%	50.1%	27.7%
Average revenue per —							
Passenger .....	2.0	\$ 20.07	\$ 19.18	\$ 19.07	\$ 18.50	\$ 16.14	\$ 18.17
Passenger mile .....	(2.0)	6.95¢	7.26¢	7.26¢	7.66¢	6.72¢	7.68¢
Trip flown .....	19.6%	\$ 1,387	\$ 1,388	\$ 1,301	\$ 1,199	\$ 867	\$ 567
OPERATIONS							
Trips flown .....	27.3%	35,415	22,311	17,552	12,382	10,619	10,576
Revenue plane miles .....	29.7	9,027,213	5,524,395	4,309,478	2,957,255	2,505,926	2,463,114
Available seat miles(000) .....	30.8	1,011,048	618,732	477,166	314,407	260,616	263,808
Operating expenses per trip flown .....	9.3%	\$ 1,068	\$ 1,000	\$ 992	\$ 903	\$ 749	\$ 685
FINANCIAL(000)							
Revenues							
Passenger .....	52.4%	\$47,645	\$29,998	\$22,031	\$14,313	\$ 8,996	\$ 5,804
Other .....	50.5	1,468	968	797	539	213	190
Total .....	52.3	49,113	30,966	22,828	14,852	9,209	5,994
Expenses							
Personnel .....	45.3	10,980	6,708	4,559	3,042	2,136	1,694
Fuel & oil .....	61.9	10,152	5,302	4,007	2,054	963	914
Services purchased and materials utilized net of changes in A/W reserve ..	39.5	7,781	5,139	4,278	2,767	1,878	1,471
Landing fees and rentals ...	40.8	2,040	1,292	946	343	333	369
Insurance, taxes, advertising and other .....	22.0	3,951	2,443	1,959	1,580	1,304	1,462
Cost of borrowed funds .....	26.2	2,784	1,220	1,297	1,357	1,076	871
Depreciation and amortization .....	23.7	3,880	2,352	2,111	1,569	1,344	1,337
Total .....	38.6%	41,568	24,456	19,157	12,712	9,034	8,118
Income (loss) before federal income tax .....		7,545	6,510	3,671	2,140	175	(2,124)
Provision for federal income tax .....		—	1,571	1,507	1,095	122	—
Income (loss) before extraordinary item .....		7,545	4,939	2,164	1,045	53	(2,124)
Gain on sale of flight equipment		—	—	—	—	—	533
Reduction of federal income tax arising from carryforward of prior years' losses .....		—	—	1,236	1,095	122	—
Net income (loss) .....		\$ 7,545	\$ 4,939	\$ 3,400	\$ 2,140	\$ 175	\$ (1,591)
Earnings (loss) per share adjusted for 5-for-4 stock split on March 16, 1977							
Before extraordinary item .		\$ 3.78	\$ 3.15	\$ 1.62	\$ .76	\$ .04	\$ (1.60)
Net income(loss) .....		3.78	3.15	2.54	1.55	.13	(1.20)
Earnings (loss) per share adjusted for 3-for-2 stock split on March 24, 1978							
Before extraordinary item .		2.52	2.10	1.08	.50	.03	(1.07)
Net income(loss) .....		\$ 2.52	\$ 2.10	\$ 1.69	\$ 1.03	\$ .08	\$ (.80)



# Management's Discussion and Analysis of the Summary of Operations

## Net Income

Net income increased, as compared to the prior corresponding period, 59% in 1975, 45% in 1976 and 53% in 1977, due primarily to higher operating profits generated by increased revenues in each period from greater utilization of Boeing 737-200 aircraft and due to the utilization of net operating loss carryforwards in 1975 and the utilization of investment tax credits in 1976 and 1977. Net income for 1975 was favorably impacted by the utilization of prior year net operating loss tax carryforwards (recorded as extraordinary credits) resulting in only \$271,000 of net federal income taxes being accrued for 1975. Due to the fact that sufficient investment tax credits were available from current year 1977 additions and prior year carryforwards, net income for 1976 and 1977 was favorably impacted by accrual of federal income taxes at the minimum allowable effective tax rates of 24% in 1976 and 0% in 1977. For financial statement purposes, all prior year net operating loss carryforwards were utilized in 1975, and at December 31, 1977, the Company had unused investment tax credit carryovers of approximately \$157,230. During 1978, investment tax credits will be supplemented by approximately \$3,750,000 in new investment tax credits, resulting from the delivery of six Boeing 737-200 aircraft, plus additional support equipment, now on order. It is anticipated that all such credits will be utilized during 1978.

## Revenues

The Company has experienced substantial increases in revenues in each year of operation. Passenger revenues increased, as compared to the prior corresponding period, 54% in 1975, 36% in 1976 and 59% in 1977, due primarily to increases in passenger miles flown of 63% in 1975, 36% in 1976 and 66% in 1977. The increases in passengers carried were due in part to the addition of a fifth Boeing 737-200 in July

1975, a sixth Boeing 737-200 in September 1976 and four Boeing 737-200 aircraft in 1977. These additional aircraft permitted the Company to offer additional service and capture an increasing share of expanding markets, and to extend service to the Lower Rio Grande Valley in February 1975 and to Austin, Corpus Christi, El Paso, Lubbock and Midland/Odessa during 1977. Contributing to increased revenues were increases, as compared to the prior corresponding period, in other revenues of 48% in 1975, 21% in 1976 and 52% in 1977.

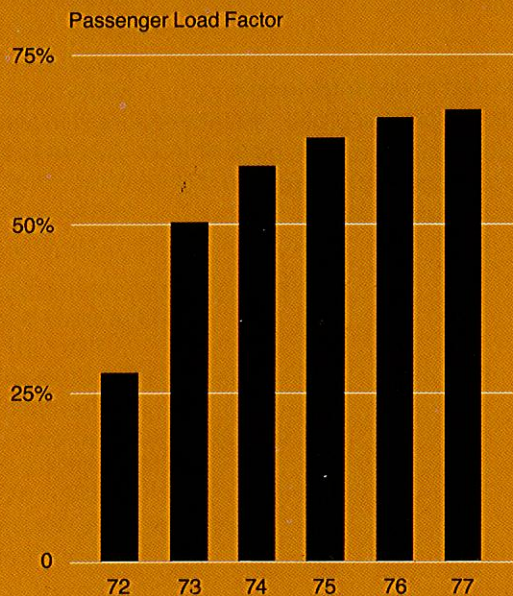
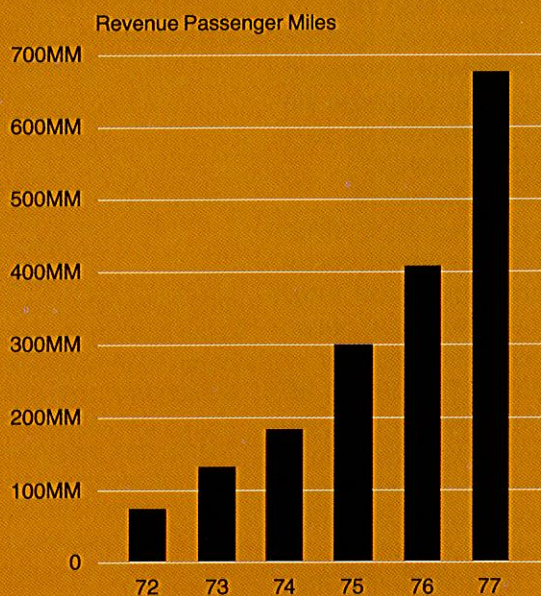
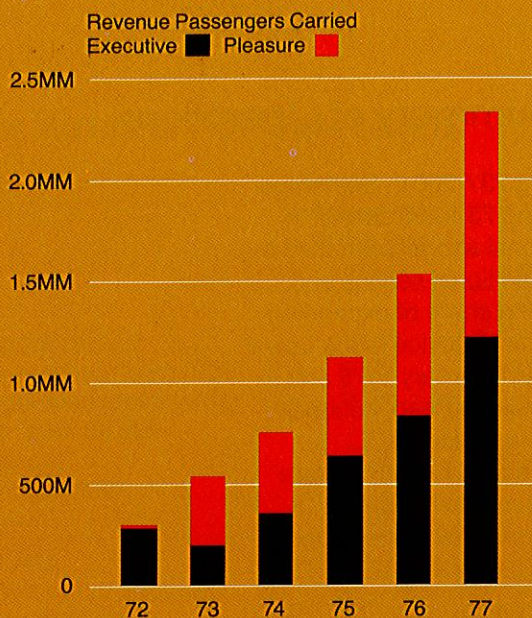
## Expenses

The percentage increase in total expenses in 1975 and 1976 was lower than the percentage increase in revenues for the same period. The percentage increase in expenses in 1977, however, outpaced the percentage increase in revenues for 1977. Total expenses (including interest) increased, as compared to the prior corresponding period, 51% in 1975, 28% in 1976 and 70% in 1977. The primary factor contributing to increased expenses, which was not offset by productivity gains, was principally the increase in the price per gallon of jet fuel of 35% in 1975, 2% in 1976 and 19% in 1977. Additionally, in 1977, the average cost of borrowed funds rose to 8.3% versus 7.4% in 1976, while long-term debt outstanding rose from \$20,000,000 at December 31, 1976 to \$47,000,000 at December 31, 1977. The net effect of the increases in costs in 1977 was to lower the Company's pre-tax profit margin from 21% in 1976 to 15% in 1977.

## Conclusion

While costs are expected to continue to rise in 1978, the decline in the pre-tax profit margin in 1977 should, to some extent, be offset in 1978 by the proposed 1978 fare increases discussed elsewhere in this annual report.





## Description of Business

Southwest Airlines Co. (a Texas corporation) operates frequent, commuter-type, low-fare schedules between the Texas cities of Dallas, Houston, San Antonio, the Lower Rio Grande Valley (through the Harlingen Airport), Austin, Corpus Christi, El Paso, Lubbock and Midland/Odessa utilizing a current fleet of twelve 112-seat Boeing 737-200 aircraft. Service to the last five cities listed above was inaugurated at varying times during 1977. The Company operates under route authority granted by the Texas Aeronautics Commission and does not carry United States mail, nor solicit or carry interstate passengers.

The Company's wholly-owned subsidiary, Midway (Southwest) Airway Co., (a Texas corporation) was organized in 1976 for the purpose of prosecuting a route application through the United States Civil Aeronautics Board (CAB) for interstate route authority radiating out of Chicago, Illinois' close-in Midway Airport. Such application is now pending a decision from the CAB. Should the CAB's decision be favorable for the Company's subsidiary, it is planned that air service under such certificate authority would commence in 1979.

Throughout the balance of 1978 the Company will receive an additional four new Boeing 737-200 aircraft. Three of these aircraft will replace the Company's three oldest Boeing 737-200 aircraft (to be traded in to the manufacturer) and the other one will increase the Company's fleet to thirteen aircraft by December, 1978. Additionally, the Company has on firm order two Boeing 737-200 aircraft for delivery in May and June of 1979 and conditional purchase agreements on an additional six Boeing 737-200 aircraft to be delivered in the fourth quarter of 1979, if not cancelled on or before August 1, 1978.

The Company currently employs approximately 1,000 employees.



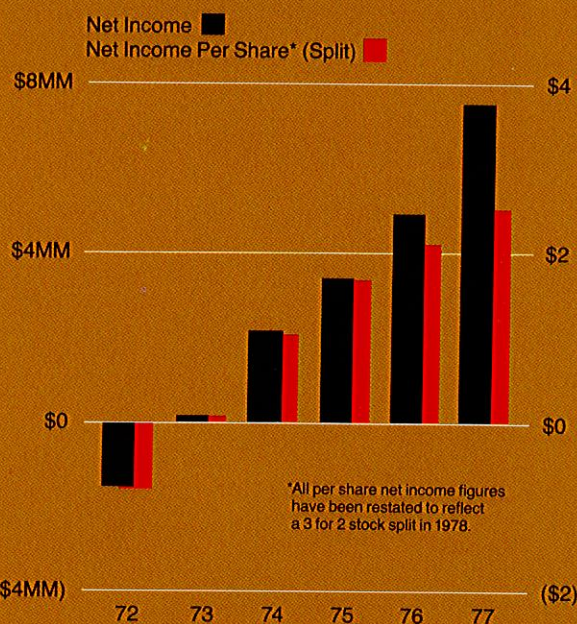
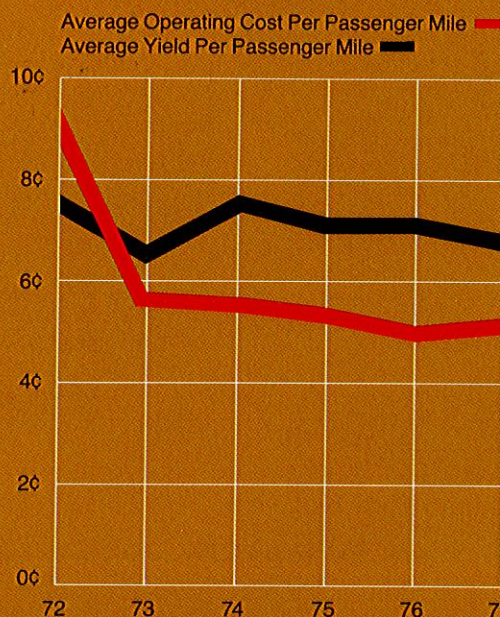
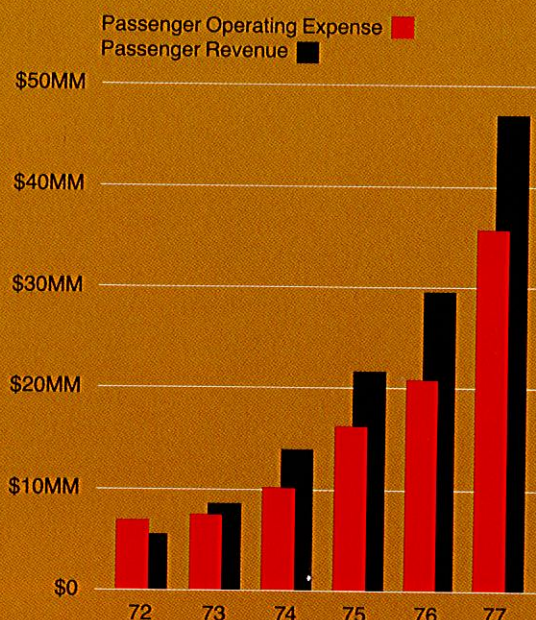
## Common Stock Price Ranges, Dividends and Stock-Splits

During 1976 and 1977 the Common Stock of the Company was listed for trading on the American Stock Exchange (AMEX) and the New York Stock Exchange (commencing June 27, 1977). Recently the Company's Common Stock was delisted from trading on the AMEX, at the request of the Company, because of extremely low trading volume on the AMEX since trading in the Company's Common Stock commenced on the New York Stock Exchange. The Company's Common Stock continues to trade on the New York Stock Exchange under the symbol "LUV". The reported high and low sale prices and the quarterly cash dividends paid on each share of Common Stock (both adjusted for a 5-for-4 stock split distributed March 16, 1977 and a 3-for-2 stock split distributed March 24, 1978) for each quarterly period during the last two years were as follows:

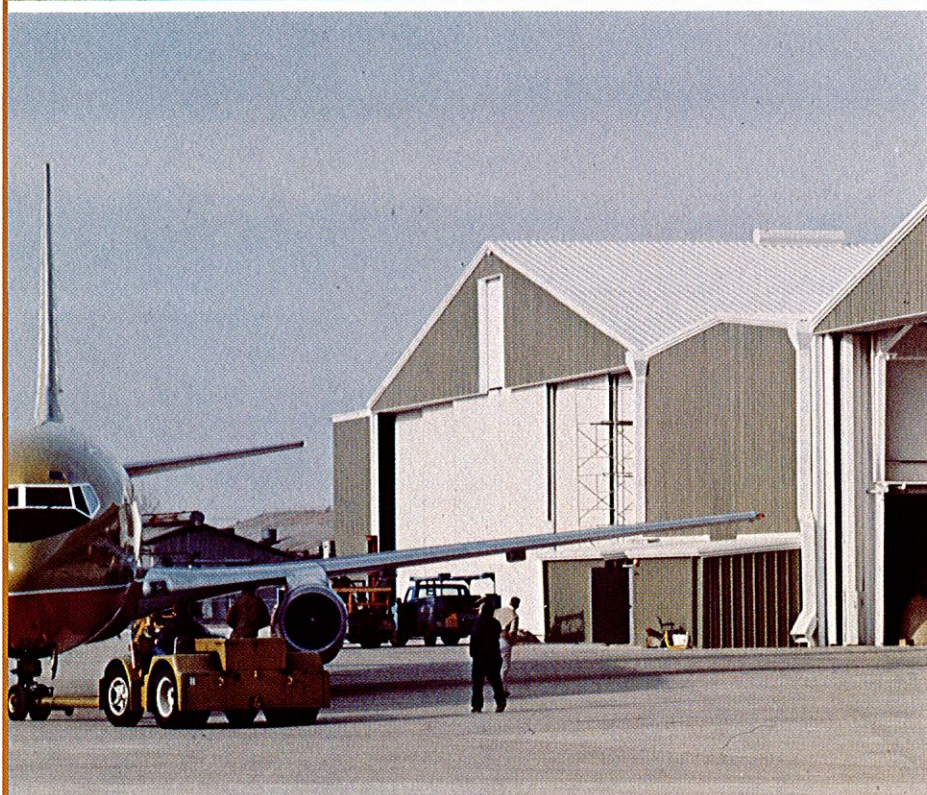
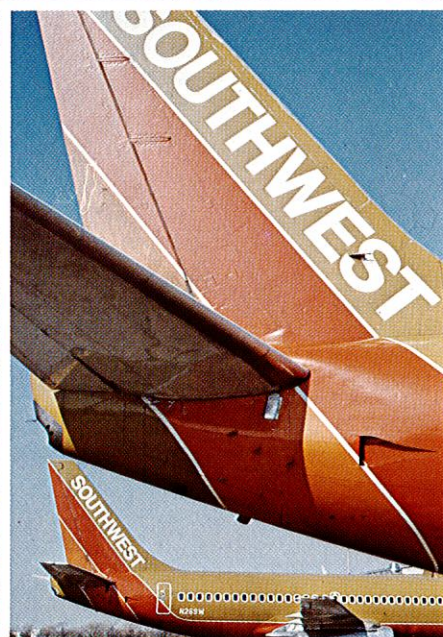
QUARTER		1977		1976	
		Stock Price	Dividend	Stock Price	Dividend
1st	High	\$15.73		\$ 8.40	
	Low	11.93		4.80	
2nd	High	17.00	.0333	9.00	—0—
	Low	12.50	.0467	6.74	—0—
3rd	High	17.09	.0467	10.67	—0—
	Low	14.58	.0467	8.34	—0—
4th	High	16.17	.0467	12.13	.0333
	Low	13.08		8.40	

During the first two months of 1978, the high and low sale prices of a share of the Company's Common Stock, as reported on the New York Stock Exchange, and as adjusted for the 3-for-2 stock split distributed March 24, 1978 were \$18.67 and \$15.67 respectively. Also during the first quarter of 1978 the Company paid a cash dividend of \$.0467 per share, again adjusted for the 3-for-2 stock split. The Company's Board of Directors has stated its intention to pay a quarterly cash dividend of \$.07 per share, commencing the second quarter of 1978, on the post-split shares of Common Stock now outstanding, representing a 50% increase in the quarterly cash dividend rate.

Note: See footnote 8 of the Notes to Consolidated Financial Statements for a summary of quarterly financial data.







## Justification for a 1978 Fare Increase

### Introduction

When Southwest Airlines commenced operations on June 18, 1971, the CAB carrier coach fares were \$28.00 between Dallas and San Antonio and \$27.00 between Dallas and Houston. Today, the comparable CAB carrier fares are \$43.00 and \$41.00, respectively. Southwest's Executive Class fare in both city pair markets is \$25.00 and its Pleasure Class fare \$15.00, producing an average fare of \$20.00, which is the fare with which Southwest began service almost seven years ago.

Over the period during which Southwest Airlines has enjoyed the privilege of providing Texans with the bulk of their short-haul air transportation, the continuing goal of management has been to provide such service at the lowest possible cost to the consumer. We are extremely proud of our accomplishments in this regard and are grateful to the Texas Aeronautics Commission for granting us new route opportunities which have enabled us to maintain fare stability, through increased productivity, despite soaring costs.

We are also extremely grateful to the Texas Aeronautics Commission for allowing us to experiment freely with different fare levels, combinations, and structures, which has produced the two-tier, peak and off-peak, pricing system now being emulated in the form of "discount" fares by the CAB carriers. This pricing flexibility is probably the most important manifestation of the latitude which the Texas Aeronautics Commission has

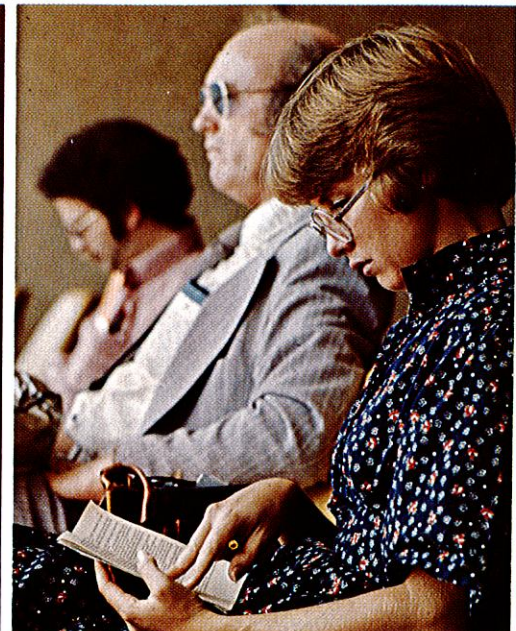
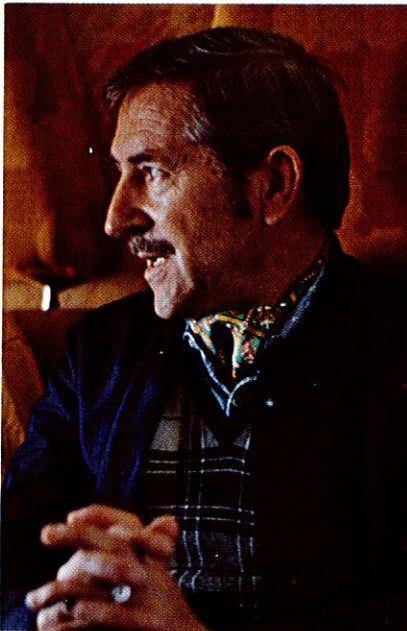


allowed carrier management, a latitude which has distinguished the TAC's activities from those of the CAB and the California Public Utilities Commission. Primarily because Southwest has flourished under the Texas Aeronautics Commission's "restrained regulation," while the CAB and California intrastate air carriers have languished under their "intense regulation," the United States Congress is on the verge of enacting a "regulatory reform" bill, citing the Texas Aeronautics Commission and Southwest Airlines as the principal examples of why less Federal regulation will produce both healthier air carriers and greater public benefits. Thanks to the Texas Aeronautics Commission, the naturally competitive airline industry is about to emerge from the Federal regulatory cocoon and be reborn as "free enterprise," where market forces, rather than regulatory theories and whims, will determine the success or failure of pricing policies.

With these facts and background in mind, a discussion of (1) the tremendous increase in input costs with which we have been faced, (2) the improvements we have made in various types of productivity, and finally (3) the net effect of these contravening forces on unit costs per passenger carried will be helpful in explaining why, after seven years of operations, it is finally necessary and desirable to place into effect later this year the passenger fares for which new tariffs will be filed with the Commission in due course.

#### **Increase in Input Costs**

Between the years 1973 (our first profitable year) and 1977 (our most recent calendar year), input costs for Southwest Airlines have increased dramatically. Some





representative examples of these increases are set forth in the following table:

Description	1973	1977	% Increase
Representative payroll costs (29% of total costs)			
Captain . . . . .	\$26,808	<b>\$51,426</b>	92%
Mechanic . . . . .	13,776	<b>26,425</b>	92
Station Agent . . . . .	6,327	<b>13,717</b>	117
Flight Attendant . . . . .	7,229	<b>11,779</b>	63
Aircraft fuel per gallon (24% of total costs) . . . . .	11.24¢	<b>36.44¢</b>	224
Landing fees per flight (4% of total costs) . . . . .	\$ 11.49	<b>\$ 41.81</b>	264
Aircraft costs, affecting depreciation, property insurance, property taxes, interest, and spare parts (23% of total costs) . . . . .	\$ 4 MM	<b>\$7.5 MM</b>	88%

The above four examples represent 80% of the total costs of doing business. It can be assumed that the remaining 20% of our costs increased approximately the same as the increase in the consumer price index of 34.7% between 1973 and 1977. Overall, this means that during the four-year period between 1973 and 1977, the input costs of Southwest Airlines have increased on average 121%. Had there been no improvements in productivity during the same period, this would have necessitated fare increases during this period of a comparable amount.

## Improvements in Productivity

In the following table, we present the four measurements of productivity which we consider to be the most important measurements for our operations from a cost control standpoint. The actual productivity measures for the years 1973 and 1977 are shown, together with our forecasts of productivity for the year 1978 with the applicable percentage increases reflected:

Productivity Index	CY 1973	CY 1977	% Change 1973-77	Forecast CY 1978	% Change 1977-78
Passengers per Employee . . . . .	2,527	3,119	23%	3,336	+7%
Passengers per Gate Position . .	181,136	233,952	29	225,448	-4
Avg. Daily Block hrs. per aircraft . . . . .	8:13	10:06	23	10:17	+2
Passenger Load Factor . . . . .	50.1%	66.8%	33%	65.2%	-2%

As the above table indicates, substantial productivity increases have been experienced during the four-year period from 1973 through 1977. Concerning employees, they were 23% more productive in 1977 than they were in 1973. Our extensive ground facilities, as expressed in gate positions at the various terminals we serve, were 29% more productive in 1977 as opposed to 1973. We have been able to increase the productivity of each aircraft we own by 23%, and most important, overall we have increased the utilization of seats flown on such aircraft by 33% to one of the highest load factors (66.8%) ever experienced by any scheduled carrier.

At the present stage of technological improvements, however, we anticipate that further productivity increases beyond those attained in 1977 are virtually impossible, as indicated by the forecast percentage change between 1977 and 1978. The learning curve of our many new employees added during the year 1977 represents the primary reason for the additional 7% improvement in employee productivity. Annualization, however, of our new stations which, quite obviously, have less frequencies operating



through them than our major terminal stations of Dallas and Houston, will cause a 4% decrease systemwide in ground facility utilization. While we feel that we can satisfactorily accomplish the small additional increase in daily aircraft utilization of some 11 minutes per day per aircraft, this is offset by the slightly lower load factor which we hope to attain during 1978. In this regard, we feel that any long-term system-wide load factor in excess of 65% represents a disservice to our customers in that the percent of time that they are unable to utilize the flight of their choice increases geometrically at system load factors above 65%.

### Resulting Unit Costs Per Passenger Handled

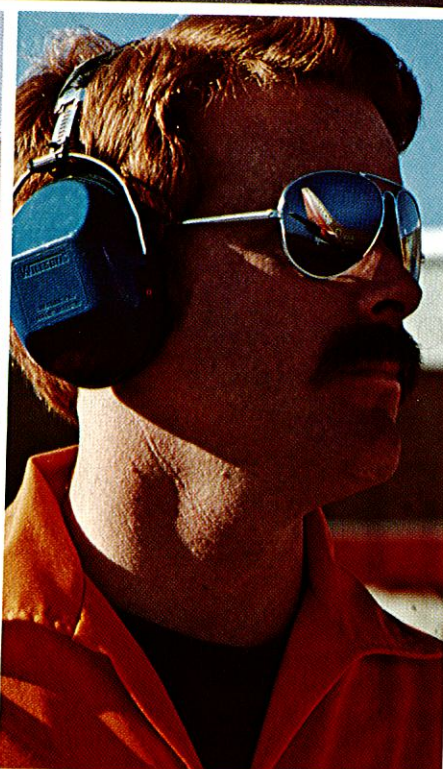
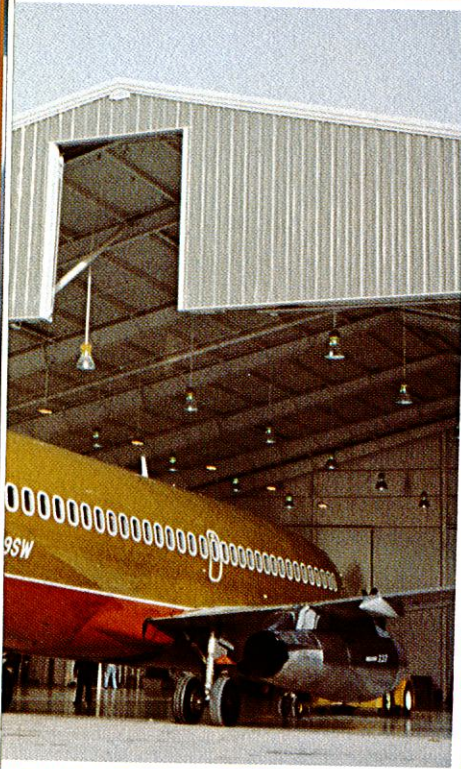
In spite of the 121% average increase in input costs experienced during the 1973-1977 period, the impressive productivity increases also experienced had the effect of limiting substantially the increase in unit cost per passenger carried through 1977. Since it is anticipated that input costs will continue to climb during 1978 and they will not be offset by further productivity increases, we forecast a rather substantial overall 10% increase in the unit costs per passenger carried in 1978, as the following table indicates:

Category of Costs	Unit Cost Per Passenger Carried		
	1973 Actual	1977 Actual	1978 Forecast
Payroll & related . . . .	\$ 4.43	\$ 5.24	\$ 5.54
Aircraft fuel and oil . .	1.77	4.34	5.20
Landing fees . . . . .	.22	.63	.69
Aircraft costs . . . . .	5.74	4.03	4.71
All other . . . . .	4.47	3.53	3.43
Total costs . . . . .	\$16.63	\$17.77	\$19.57

As shown in the above table, the bottom line is that costs will have increased almost exactly \$3 per passenger (\$2.94) between the year 1973 when Southwest turned its first profit and 1978 when Southwest will have to institute its first overall fare increase.







### Passenger Fare Increase

The multiplicity of new fares (64) to be included in Southwest's new 1978 tariff are derived from our basic pricing formula for flight segments of less than one hour's duration. The present and new basic fare structure is summarized in the following table:

No. of Segments	Service Class / 1	Psgs. Using Fare	Passenger Fares (Incl. tax)/2				
			Present		New		% Inc. RT
			OW	RT	OW	RT	
1	P	38%	\$15	\$ 30	\$18	\$ 35	16.7%
1	E	46	25	50	28	55	10.0
2	P	8	25	50	28	55	10.0
2	E	6	40	80	43	85	6.2
3	P	1	30	60	35	70	16.7
3	E	1	50	100	55	110	10.0
4	P	—	35	70	40	80	14.3
4	E	—	\$60	\$120	\$65	\$130	8.3%

100%

<sup>1</sup>P = Pleasure Class; E = Executive Class

<sup>2</sup>O.W. = One-way; R.T. = Round-trip

As indicated, 98% of our passengers who purchase round-trip tickets for one or two-segment flights will be faced with an additional fare charge of \$5.00, including tax, per round-trip (\$4.63, excluding tax, or \$2.31 per one-way trip). This is 63¢ less than the anticipated cost increase per passenger between 1973 and 1978. Since this fare increase will not be effective at least during the first half of 1978, the average additional fare that each passenger will pay, excluding tax, during 1978 will be only a few cents over \$1. Not until 1979 will Southwest realize during the full year the scheduled fare increase of some \$2.31 per one-way passenger before dilution. Since the typical 1978 Southwest passenger will fly 296 miles with Southwest, or 23.3% further than the 240 miles flown in 1973, on average, his cost of travel per mile will still be considerably less after the fare increase than it was in the earlier years before the route expansions authorized by the Texas Aeronautics Commission.



### Conclusion

During the past year, Southwest has acquired six new Boeing 737-200 aircraft at a total capital cost of \$44 million. It will shortly be exchanging its three oldest aircraft for three new ones at an additional capital cost of \$12 million, giving it the youngest fleet in the airline industry. Southwest also desires to expand its services to additional cities in Texas and to increase schedules on segments experiencing high load factors.

These steps will necessitate further acquisitions of aircraft, which have increased in price from \$4 million in 1973 to \$8.1 million in 1978, and will go even higher. The CAB carriers are now facing the greatest re-equipment challenge in their history, which the financial analysts have declared insurmountable for some of them. Southwest wants to continue providing the finest service in the finest aircraft available and will continue to do so with an adequate return on investment.

In this connection, from the beginning of operations on June 18, 1971 through December 31, 1977, Southwest has experienced an average return on investment of 12.5%. From the turnaround year of 1973 through 1977 the average return on total investment has averaged 16.5%. Without any fare increase during 1978, we estimate our return on average invested capital will be 12.4%. If the fare increase is assumed effective during the final half of 1978, the average return for 1978 will be an estimated 15.5%. Such a return is well below the returns enjoyed by numerous local service and trunk carriers regulated by the Civil Aeronautics Board.

With the 1978 fare increase being in effect during the entire year of 1979, we anticipate that it will take care of all of our financial requirements throughout the current decade and, hopefully, into the decade of the 80's. This assumption is based on there not being any abnormal or catastrophic further increases in the price of jet fuel. Finally, the single increase for which Southwest will be filing is less than a fourth of the cumulative increases instituted by the CAB carriers during the decade of the 70's.





# Southwest Airlines Co. Consolidated Statement of Income

	Year Ended December 31,	
	1977	1976
<b>REVENUES</b>		
Passenger .....	\$47,645,159	\$29,998,050
Package express .....	1,318,146	864,443
Interest .....	54,017	41,241
Other .....	95,492	61,971
	<u>49,112,814</u>	<u>30,965,705</u>
<b>EXPENSES</b>		
Operations and maintenance .....	27,521,493	15,692,860
Marketing and promotion .....	2,587,884	1,594,286
Insurance, taxes and administrative .....	4,794,988	3,597,007
Depreciation and amortization .....	3,880,304	2,351,898
Cost of borrowed funds (Note 3) .....	2,783,512	1,219,930
	<u>41,568,181</u>	<u>24,455,981</u>
Income before federal income tax .....	7,544,633	6,509,724
Provision for federal income tax (Note 7) .....	—	1,571,000
<b>NET INCOME</b> .....	<u><b>\$ 7,544,633</b></u>	<u><b>\$ 4,938,724</b></u>

## Income per common and common equivalent share (Note 4):

### Before 1978 stock split:

Weighted average common and common equivalent shares outstanding (1976 adjusted for 1977 stock split) .....	<u>1,994,153</u>	<u>1,569,344</u>
Net income .....	<u>\$ 3.78</u>	<u>\$ 3.15</u>

### After 1978 stock split:

Weighted average common and common equivalent shares outstanding .....	<u>2,991,230</u>	<u>2,354,016</u>
Net income .....	<u>\$ 2.52</u>	<u>\$ 2.10</u>

See accompanying notes.



# Consolidated Statement of Financial Position

	December 31,	
	1977	1976
<b>CURRENT ASSETS</b>		
Cash .....	\$ 4,847,418	\$ 4,412,578
Certificate of deposit .....	—	4,500,000
Accounts receivable .....	2,258,856	1,502,866
Inventories of parts and supplies, at cost .....	484,992	303,276
Other .....	238,532	146,946
<b>TOTAL CURRENT ASSETS</b> .....	<b>7,829,798</b>	<b>10,865,666</b>
<b>CURRENT LIABILITIES</b>		
Accounts payable .....	1,422,882	1,257,223
Federal income taxes .....	—	545,000
Accrued liabilities .....	1,355,196	1,037,624
<b>TOTAL CURRENT LIABILITIES</b> .....	<b>2,778,078</b>	<b>2,839,847</b>
<b>WORKING CAPITAL</b> .....	<b>5,051,720</b>	<b>8,025,819</b>
Flight and ground equipment, at cost, less reserves (Notes 2 and 3) .....	69,853,149	32,698,884
Other assets .....	284,230	138,102
<b>TOTAL ASSETS LESS CURRENT LIABILITIES</b> .....	<b>75,189,099</b>	<b>40,862,805</b>
Less:		
Long-term debt (Notes 2 and 3) .....	47,000,000	20,000,000
Deferred federal income tax (Note 7) .....	1,297,000	1,297,000
Deferred compensation — officer (Note 5) .....	285,751	220,327
<b>NET ASSETS</b> .....	<b>\$26,606,348</b>	<b>\$19,345,478</b>
<b>STOCKHOLDERS' EQUITY (Notes 3 and 4):</b>		
Common stock, \$1.00 par value, 5,000,000 shares authorized, (2,000,000 in 1976), 2,000,000 shares issued (1,590,000 in 1976) .....	\$ 2,000,000	\$ 1,590,000
Capital in excess of par value .....	12,366,698	12,568,432
Retained earnings .....	12,239,650	5,212,996
	<b>26,606,348</b>	<b>19,371,428</b>
Less 6,000 shares of treasury stock, at cost, in 1976 .....	—	25,950
<b>TOTAL STOCKHOLDERS' EQUITY</b> .....	<b>\$26,606,348</b>	<b>\$19,345,478</b>

See accompanying notes.



## Consolidated Statement of Changes in Financial Position

	Year Ended December 31,	
	1977	1976
<b>FINANCIAL RESOURCES WERE PROVIDED BY:</b>		
Net income .....	\$ 7,544,633	\$ 4,938,724
Items not affecting working capital in the current period:		
Depreciation and reserve for maintenance .....	4,288,171	1,818,588
Amortization of certification and Love Field costs .....	—	53,013
Deferred compensation — officer .....	65,424	62,124
Noncurrent deferred federal income tax .....	—	1,026,000
Working capital provided from operations for the period .....	11,898,228	7,898,449
Proceeds from issuance of common stock in public offering and exercise of warrants .....	40,000	6,442,494
Issuance of long-term debt .....	27,000,000	10,500,000
Contribution of treasury stock to profit- sharing trust (Note 6) .....	628,499	646,443
	<u>39,566,727</u>	<u>25,487,386</u>
<b>FINANCIAL RESOURCES WERE USED FOR:</b>		
Net additions to flight and ground equipment .....	41,442,436	13,730,042
Reduction of long-term debt .....	—	5,000,000
Cash dividends .....	517,979	97,124
Purchase of treasury stock .....	433,731	—
Increase in other assets .....	146,128	25,920
Other .....	552	—
	<u>42,540,826</u>	<u>18,853,086</u>
Increase (decrease) in working capital (Note 10) .....	<u>\$ (2,974,099)</u>	<u>\$ 6,634,300</u>

See accompanying notes.



# Consolidated Statement of Stockholders' Equity

	Years ended December 31, 1977 and 1976				
	Common stock	Capital in excess of par value	Retained earnings	Treasury stock	Total
Balance at December 31, 1975 .....	\$ 1,108,758	\$ 6,103,812	\$ 371,396	\$ (169,025)	\$ 7,414,941
Issuance of 115,000 shares of common stock upon exercise of warrants .....	115,000	580,750			695,750
Issuance of 366,242 shares of common stock in public offering .....	366,242	5,380,502			5,746,744
Contribution of 30,067 shares of treasury stock to profit-sharing trust ....		503,368		143,075	646,443
Cash dividends, \$.0333 per share .....			(97,124)		(97,124)
Net income — 1976 .....			4,938,724		4,938,724
Balance at December 31, 1976 .....	1,590,000	12,568,432	5,212,996	(25,950)	19,345,478
Issuance of 10,000 shares of common stock upon exercise of warrants .....	10,000	30,000			40,000
Purchase of 20,000 shares of treasury stock .....				(433,731)	(433,731)
Contribution of 26,000 shares of treasury stock to profit-sharing trust ....		168,818		459,681	628,499
Five-for-four stock split .....	400,000	(400,552)			(552)
Cash dividends, \$.1733 per share .....			(517,979)		(517,979)
Net income — 1977 .....			7,544,633		7,544,633
Balance at December 31, 1977 .....	<u>\$ 2,000,000</u>	<u>\$12,366,698</u>	<u>\$12,239,650</u>	<u>\$ —</u>	<u>\$26,606,348</u>

See accompanying notes



# Notes to Consolidated Financial Statements

December 31, 1977 and 1976

## 1. Basis of presentation and summary of significant accounting policies:

**Basis of presentation** — The consolidated financial statements include the accounts of the Company and its wholly-owned subsidiary, Midway (Southwest) Airway Co. All significant intercompany accounts or transactions have been eliminated in consolidation.

Certain reclassifications of amounts previously reported in the financial statements at December 31, 1976 have been made to conform to the presentation at December 31, 1977.

**Depreciation and overhaul allowances** — Depreciation is computed by the straight-line method over the estimated useful lives of the various classes of depreciable assets after allowing for residual values. The estimated useful lives are 12 to 15 years for the Boeing 737-200 aircraft, related spare engines and support flight equipment, and 3 to 10 years for ground equipment and other. Upon sale or retirement of equipment, the cost and related accumulated depreciation are removed from the accounts and the resulting gain or loss is included in income for the period, with the exception of equipment depreciated on a group basis.

The Company provides an airworthiness reserve for major aircraft maintenance and overhaul costs. These costs are accrued to the reserve at the rate of \$100 per flight hour (\$2,477,000 in 1977 and \$1,536,500 in 1976). Actual expenditures for certain aircraft maintenance materials and outside repair costs are relieved from the reserve as incurred. Routine aircraft maintenance inspections are charged to expense as incurred.

**Per share amounts** — Income per share computations are based upon the weighted average number of shares outstanding during the respective periods as adjusted for outstanding warrants which were considered as common stock equivalents in periods where their inclusion had a material effect.

## 2. Flight and ground equipment

The Company's investment in flight and ground equipment is summarized as follows:

	1977	1976
Boeing 737-200 jet aircraft	\$57,641,921	\$28,725,821
Progress payments on additional aircraft . . . . .	10,825,532	5,910,382
Support flight equipment . . . . .	7,051,294	3,800,750
Ground equipment . . . . .	3,527,791	1,657,990
Leasehold improvements . . . . .	1,303,333	488,086
Construction in progress . . . . .	1,598,432	118,332
	<u>81,948,303</u>	<u>40,701,361</u>
Less reserve for depreciation (including reserve for major maintenance and overhaul costs of \$1,122,971 in 1977 and \$715,104 in 1976)	<u>12,095,154</u>	<u>8,002,477</u>
	<u>\$69,853,149</u>	<u>\$32,698,884</u>

At December 31, 1977 the Company had contractual commitments of approximately \$113,400,000 for the purchase of fourteen Boeing 737-200 aircraft to be delivered in 1978 and 1979 (see Note 3). The purchase commitments of approximately \$51,000,000 for six of these aircraft can be cancelled on or before August 1, 1978 with the forfeiture of \$150,000 in total deposits made on these six aircraft to date. The Company's decision to cancel the purchase commitment on these six aircraft will be influenced by the ruling of the Civil Aeronautics Board dealing with the Company's proposed service out of Chicago's Midway Airport. In compliance with the terms of the commitments, the Company had made progress payments totalling \$10,825,532 through December 31, 1977.



## Notes (Cont. )

### 3. Long-term debt

Under the terms of a loan agreement with various banks dated December 22, 1976, as amended May 31, 1977, the Company may borrow up to \$60,000,000 through January 31, 1979. Pursuant to this agreement the Company has borrowed \$47,000,000 through December 31, 1977. The borrowings bear interest at  $1\frac{1}{2}\%$  over the lender's prime rate payable quarterly. Interest on one-half of total borrowings is limited to a maximum of  $9\frac{1}{2}\%$ . The principal is to be repaid in thirty-two quarterly instalments beginning March 31, 1979 through December 31, 1986; and if the full \$60,000,000 is borrowed, such instalments will be in the following respective amounts: during 1979, \$1,250,000 each; during 1980, \$1,500,000 each; during 1981, \$1,750,000 each; during 1982, \$2,000,000 each; during 1983, 1984 and 1985, \$2,250,000 each; during 1986, \$1,750,000 each. The borrowings are secured by the Company's aircraft including the aircraft to be delivered in 1978 and 1979 (see Note 2).

The loan agreement provides, among other things, for the maintenance of certain minimums for net worth and working capital ratio, and for certain restrictions as to additional borrowings, capital expenditures and cash dividend payments. At December 31, 1977 the Company had retained earnings in the amount of \$1,508,926 available for payment of cash dividends during 1978.

The Company and the various banks have an informal understanding that the Company will endeavor to maintain average cash balances approximating 6% of the unpaid balance existing from time to time under the loan agreement. It is understood between the parties that no such funds are restricted from withdrawal by the Company at any time.

### 4. Stockholders' equity

A five-for-four common stock split was effected on March 16, 1977 to shareholders of record as of February 23, 1977 pursuant to authorization by the

Board of Directors. The stock split resulted in the issuance of an additional 400,000 shares of the Company's common stock.

Also during 1977, 10,000 shares of \$4.00 common stock warrants were exercised. There are no warrants outstanding at December 31, 1977.

On January 24, 1978 the Company's Board of Directors authorized a three-for-two common stock split to be distributed on March 24, 1978 to shareholders of record as of February 28, 1978. The stock split will result in the issuance of an additional 1,000,000 shares of the Company's common stock. An amount equal to the par value of additional shares issued will be transferred from capital in excess of par value to the common stock account and the effect of fractional shares will be reflected in the capital in excess of par value account. Per share information has been restated to reflect the common stock split.

### 5. Deferred compensation

A deferred compensation agreement with the President of the Company adopted by the Board of Directors on October 29, 1974, obligates the Company to accrue for the benefit of the President, in addition to his regular salary, deferred compensation of \$250,000 over the five-year term of his current agreement ending September 30, 1979, or five percent of the net pretax earnings of the Company (as defined by the agreement) whichever is lower, for the period October 1, 1974 through September 30, 1979. During 1977, \$50,000 was accrued and charged to operations in connection with this agreement.

Total deferred compensation, including amounts pursuant to a prior agreement, will be paid at a rate not to exceed \$50,000 per year, commencing in the year following termination of the President's employment with the Company. Until such time as this deferred compensation is paid, the Company is accruing interest at the rate of 7% compounded annually on the unpaid balance beginning October 1, 1974 on the prior agreement and October 1, 1975 on the current agreement. During 1977 the Company accrued \$15,424 of interest pursuant to the agreements.



## Notes (Cont.)

### 6. Employee profit-sharing and cash bonus plans

The Company is accruing costs under a non-contributory profit-sharing plan established January 1, 1973 and amended on December 2, 1974, January 15, 1975 and January 1, 1976. All regular employees are eligible to become members as of January 1 following their date of employment. The plan provides that the Company may contribute, as determined by the Board of Directors, up to 15 percent of its adjusted pretax income (as defined by the plan) in excess of \$2,100,000 (\$1,150,000 for periods prior to October 1, 1976) for the year except that the Company's contribution in any year shall not exceed the maximum amount deductible for federal income tax purposes.

Effective January 1, 1975 the plan as amended permits the Company to pay currently a portion of each eligible employee's profit-sharing amount in the form of a cash bonus based on a bonus formula. The remaining profit-sharing amount is contributed to the employees' profit-sharing trust to be invested in the common stock of the Company. The plan may be terminated at any time at the discretion of the Company's Board of Directors.

Charges to income under the provisions of the plan amounted to \$960,818 in 1977 and \$903,922 in 1976.

### 7. Federal income tax

Deferred federal income taxes arise from timing differences between financial and tax reporting, principally for depreciation and provisions made for future maintenance and overhaul costs which are not deductible for income tax purposes until actually incurred. There is no provision for federal income tax in 1977 due to the utilization (flow-through method) of \$3,611,878 of current year investment tax credit. The provision for federal income tax was reduced by \$1,596,000 of investment tax credit in 1976.

The Company has unused investment tax credit carryovers for financial statement purposes of approximately \$157,230 at December 31, 1977, which expire in 1984, if not previously utilized.

### 8. Quarterly financial data (unaudited)

Summarized quarterly financial data (in thousands of dollars except for per share amounts) for 1977 and 1976 is as follows:

	Three months ended			
	March 31	June 30	Sept. 30	Dec. 31
<b>1977:</b>				
Revenues . . . .	\$8,655	\$10,936	\$14,253	\$15,269
Income before tax . . . . .	\$1,433	\$ 1,925	\$ 2,132	\$ 2,055
Net income . . .	\$1,433	\$ 1,925	\$ 2,132	\$ 2,055
Earnings per share (Note 4):				
Before 1978 stock split	\$ .72	\$ .96	\$1.07	\$1.03
After 1978 stock split .	\$ .48	\$ .64	\$ .71	\$ .69
<b>1976:</b>				
Revenues . . . .	\$6,591	\$ 7,769	\$ 8,322	\$ 8,284
Income before tax . . . . .	\$1,343	\$ 1,883	\$ 1,895	\$ 1,389
Net income . . .	\$1,014	\$ 1,431	\$ 1,434	\$ 1,060
Earnings per share (Note 4):				
Before 1978 stock split (adjusted for 1977 stock split) . . .	\$ .71	\$1.00	\$ .98	\$ .54
After 1978 stock split .	\$ .47	\$ .67	\$ .65	\$ .36

### 9. Commitments and contingencies

In 1973 the United States District Court for the Northern District of Texas declared that the cities of Dallas and Fort Worth and the Dallas-Fort Worth Regional Airport Board could not prevent the Company from serving Dallas Love Field as long as Love Field remained open as an airport. This decision was affirmed by the Fifth Circuit Court of Appeals, and the United States Supreme Court declined to grant review.



## Notes (Cont.)

Subsequently, in December 1974 a CAB carrier (the Carrier) filed an action in the Travis County, Texas District Court seeking to exclude the Company from Love Field or, as one of the alternatives, to close Love Field as an airport. Certain other airlines serving DFW Airport joined the Carrier in requesting this relief. The United States District Court for the Northern District of Texas entered a temporary injunction prohibiting the Carrier and certain other CAB air carriers serving DFW from proceeding with that portion of the State Court suit which sought to relitigate the right of the Company to remain at Love Field. Those carriers appealed the entry of the temporary injunction to the Fifth Circuit Court of Appeals which Court ruled in favor of the Company. Some of the defendants petitioned the United States Supreme Court to review the Fifth Circuit Court's decision, which petition was denied by the Supreme Court. Since such denial, no action has been taken by any party on the merits of the case.

The management of the Company and its legal counsel expect to prosecute and defend successfully both the Federal and State Court actions, but, in the event of an adverse decision, no financial liability is indicated, although the effect on future operations is not predictable at this time.

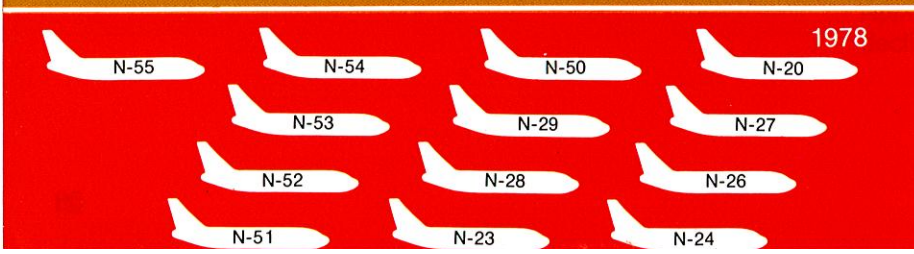
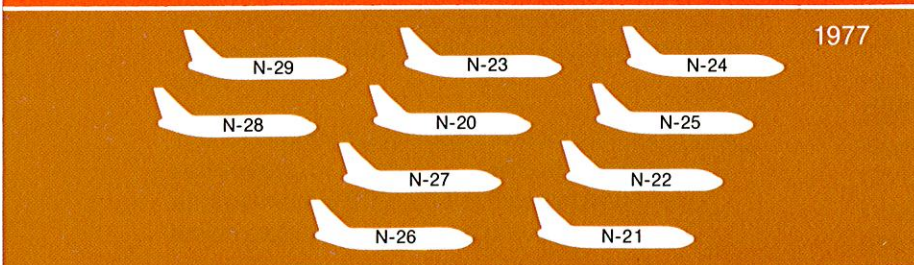
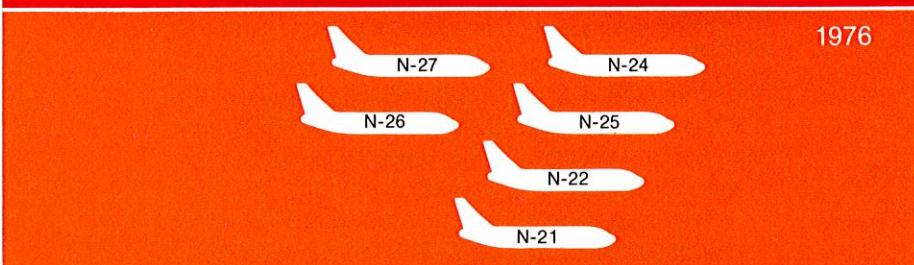
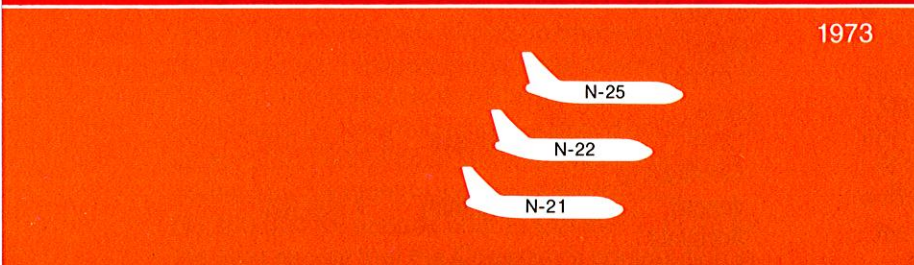
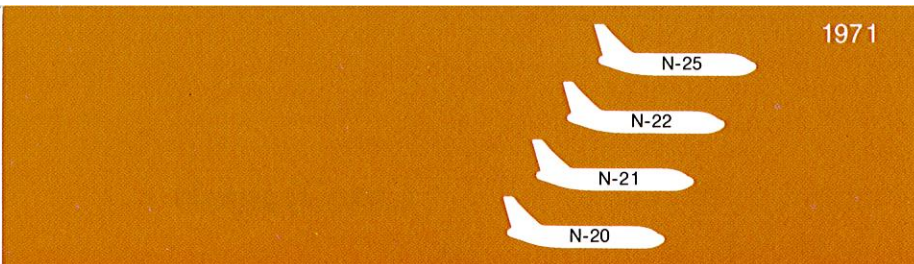
In connection with authority granted the Company in December 1976 by the Texas Aeronautics Commission (TAC) to provide expanded service in Texas, the City of Fort Worth and the Fort Worth Area Chamber of Commerce appealed the TAC's decision to the State District Court. The plaintiffs withdrew their appeal during 1977.

Total rental expense charged to operations in 1977 and 1976 were \$559,105 and \$359,720, exclusive of landing fees of \$1,480,746 and \$928,509, respectively. Landing fees are set by the governing bodies of the airports served by the Company and are based upon usage of airport runways. Lease commitments relating to noncancellable long-term leases are not material.

### 10. Changes in components of working capital

	<u>1977</u>	<u>1976</u>
Changes in components of working capital:		
Increase (decrease) in current assets:		
Cash .....	\$ 434,840	\$ 3,102,012
Certificate of deposit .....	(4,500,000)	4,500,000
Accounts receivable .....	755,990	390,141
Inventories ...	181,716	58,142
Other .....	91,586	75,782
	<u>(3,035,868)</u>	<u>8,126,077</u>
Increase (decrease) in current liabilities:		
Accounts payable .....	165,659	561,513
Federal income taxes .....	(545,000)	545,000
Accrued liabilities .....	317,572	385,264
	<u>(61,769)</u>	<u>1,491,777</u>
(Decrease) increase in working capital .....	<u>\$ (2,974,099)</u>	<u>\$ 6,634,300</u>





## Auditor's Report

The Board of Directors and Stockholders  
Southwest Airlines Co.

We have examined the accompanying consolidated statement of financial position of Southwest Airlines Co. at December 31, 1977 and 1976, and the related consolidated statements of income, stockholders' equity and changes in financial position for the years then ended. Our examinations were made in accordance with generally accepted auditing standards and, accordingly, included such tests of the accounting records and such other auditing procedures as we considered necessary in the circumstances.

In our opinion, the statements mentioned above present fairly the consolidated financial position of Southwest Airlines Co. at December 31, 1977 and 1976, and the consolidated results of operations and consolidated changes in financial position for the years then ended, in conformity with generally accepted accounting principles applied on a consistent basis during the period.

*Arthur J. Gung* : *Copy*

February 3, 1978



## Corporate Data

### Transfer Agent and Registrar

First National Bank in Dallas  
Dallas, Texas

### Stock Exchange Listing

New York Stock Exchange  
Ticker Symbol: LUV

### Auditors

Arthur Young & Company  
Houston, Texas

### General Offices

1820 Regal Row  
Dallas, Texas 75235

### Annual Meeting

The Annual Meeting of Shareholders of Southwest Airlines Co. will be held at 10:00 a.m. on Tuesday, April 25, 1978 in the Auditorium of the Mercantile National Bank Building located on its fourth floor at 1704 Main Street, Dallas, Texas.

### SEC Form 10-K

For additional information, see Statement of Operations covering the five year period 1973/1977 filed with the Securities and Exchange Commission as part of the Company's Annual Report on Form 10-K. A copy of this report is available upon written request to the Treasurer of the Company.





## Directors

**Sidney A. Adger**  
*Senior Vice President  
Milchem, Inc.  
Houston, Texas*

**Samuel E. Barshop**  
*President and Chairman  
of the Board of Directors  
LaQuinta Motor Inns, Inc.  
San Antonio, Texas*

**Gene H. Bishop**  
*Chairman of the Board  
of Directors and Chief  
Executive Officer  
Mercantile Texas Corporation  
Dallas, Texas*

**A. A. Bradford\***  
*Investor  
Midland, Texas*

**Herbert D. Kelleher**  
*Attorney  
Oppenheimer, Rosenberg,  
Kelleher & Wheatley, Inc.  
San Antonio, Texas*

**Rollin W. King**  
*Captain  
Southwest Airlines Co.  
Dallas, Texas*

**John D. Murchison**  
*Partner  
Murchison Brothers Investments  
Dallas, Texas*

**M. Lamar Muse**  
*President and Chief Executive Officer  
Southwest Airlines Co.  
Dallas, Texas*

*\*Mr. Bradford resigned as a director in early  
1978 due to health reasons.*

## Officers

### Corporate

**M. Lamar Muse**  
*President and Chief Executive Officer*

**Herbert D. Kelleher**  
*Secretary and General  
Counsel*

**Michael L. Muse**  
*Vice President — Finance  
and Administration*

**Herman H. Farr**  
*Treasurer*

**W. James Thomson**  
*Assistant Treasurer*

**Sherry Phelps**  
*Assistant Secretary*

### Administrative

**William W. Franklin**  
*Vice President — Ground Operations*

**J. L. Herring**  
*Vice President — Inflight Service*

**Edward W. Lang**  
*Vice President — Marketing*

**Donald G. Ogden**  
*Vice President — Flight Operations*

**John A. Vidal**  
*Vice President — Maintenance and  
Engineering*

**Tom Hoff**  
*Asst. Vice President — Ground Operations*

**Camille Keith**  
*Assistant Vice President — Public Relations*

**Dennis Lardon**  
*Assistant Vice President — San Antonio*

**Jack Mercer**  
*Assistant Vice President — Dallas*

**Harold Reilly**  
*Assistant Vice President — Flight Control*

**Carl Warrell**  
*Assistant Vice President — Houston*



Top row: Seligson,  
Phelps and Farr  
Bottom Row:  
Kelleher and Muse



Left: Keith.  
Right: Thomson,  
Lang and M. Muse.



Reilly,  
Herring,  
Ogden and Vidal.



Mercer, Warrell,  
Hoff, Lardon  
and Franklin







1820 Regal Row  
Dallas, Texas 75235