

Southwest Airlines Co.
1981 Annual Report

*Beginning Our Second
Decade of Progress*



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Highlights

	1981	1980	Percent Change
OPERATING DATA			
Trips operated	110,301	91,143	21.0%
<u>Passengers carried</u>	<u>6,792,927</u>	5,976,621	13.7
Revenue passenger miles (000)	2,310,181	2,024,097	14.1
Available seat miles (000)	3,633,351	2,969,448	22.4
Passenger load factor	63.6%	68.2%	(6.7)
Average revenue per passenger mile	11.19¢	10.09¢	10.9
Number of employees at year-end	2,129	1,839	15.8
INCOME DATA			
<u>Operating revenues</u>	<u>\$270,358,000</u>	\$213,048,000	26.9%
Operating expenses	221,854,000	164,219,000	35.1
Operating income	48,504,000	48,829,000	(0.7)
Net Income —			
Amount	\$ 34,165,000	\$ 28,447,000	20.1
Per share	\$ 3.38	\$ 3.25	4.0
Average shares outstanding	10,120,000	8,757,000	15.6
FINANCIAL DATA			
Working capital	\$ 5,999,000	\$ 9,979,000	(39.9%)
Property and equipment-net	258,982,000	194,908,000	32.9
Capital expenditures	79,377,000	56,504,000	40.5
Stockholders' equity	176,503,000	106,964,000	65.0
Return on stockholders' equity	23.5%	36.0%	N/A
Long-term debt as a % of total invested capital	25.0%	42.1%	N/A
Book value per share	\$ 16.96	\$ 11.29	50.2

Cover:

The cover of last year's annual report focused on Southwest Airlines' 10th anniversary. In a sense it was a look back at the proud history and record of a fledgling company that grew to become the standard setter for the American airline industry. This year's cover features the Boeing 737-300, the airplane chosen by Southwest to provide lift into the 21st century. This report then is a look forward into a future that the management and employees of Southwest intend to make as illustrious as its past.

Letter to Stockholders



Highlight of 1981

Despite a second half afflicted by the PATCO strike; an economy in rapid decline; intensified nationwide competition for a dwindling pool of passengers; and an airline industry increasingly focused on market share and cash flow rather than profitability, Southwest achieved a record net income of \$34,165,000, an increase of 20% over 1980.

Profitability

Operating revenues increased 27% in 1981. Operating expenses increased 35%. Operating profit was virtually unchanged from 1980. Our program to lower interest expense contributed to a

reduction in net non-operating expense of \$7,300,000, and record net income of \$34,165,000. Earnings per share, adjusted for stock splits, were \$3.38 on an average of 1,363,000 more shares outstanding than in 1980, when earnings were \$3.25 per share.

Traffic

A record 6,793,000 passengers were boarded, despite the impact of the threatened PATCO strike in June and the actual strike in August, accompanied by a stabilizing of the availability and price of gasoline, which together made automobile travel more competitive with shorthaul air transportation. Revenue passenger miles increased by 14%, but load factor fell from 68.16% to 63.58% as we increased frequencies to better serve our existing markets. The average yield per revenue passenger mile increased 10.9% to 11.19¢, while total operating cost per available seat mile increased 10.5% to 6.11¢. As in previous years, Southwest's cost structure and fare structure were the lowest among shorthaul carriers.

Routes

During 1981, we concentrated on improving service in our

existing markets. On January 31, 1982, we began serving the new cities of Phoenix, San Diego and Las Vegas from Houston, Albuquerque and El Paso, with single plane and connecting service to most of the other cities on our existing system. In addition, we provide twelve flights per day between Phoenix and San Diego and eight flights per day between Phoenix and Las Vegas. On February 18, 1982, we will also commence service in Kansas City where we will provide three non-stop trips per day to Houston and to Oklahoma City and three one-stop trips per day to Houston.

We announced our entry into the Phoenix, San Diego and Las Vegas markets with the lowest, generally available, non-introductory fares offered to and from our destinations. Prior to inauguration of our service and subsequently, most competing carriers matched our fares, on either a generally available or restricted seat basis. Although at this writing we have been serving these markets for less than two weeks, the initial traffic results are encouraging and we are hopeful that our high frequencies and low fares will produce substantial market stimulation in keeping with our past experience.



Fleet

During 1981, Southwest added three new and one leased Boeing ("B") 737-200 advanced series aircraft to its fleet, bringing the total of such aircraft to 26 owned and one leased. The first new aircraft was delivered in January; the leased aircraft entered service in March; and the remaining two new aircraft were delivered in December but did not augment capacity until the opening of our new cities on January 31, 1982, having served prior to that time as fleet substitutes for other aircraft undergoing passenger compartment refitting.

At present, six more B 737-200s are scheduled for delivery through June, 1982; another three in the fall of 1982 or the first quarter of 1983, as the Company may elect; and three more in the second quarter of 1983. Also on firm order are ten B 737-300s for delivery beginning late in 1984 and continuing throughout 1985, with options to purchase an additional 30 through 1989. This splendid aircraft, which we anticipate will at first largely supplement and later succeed our B 737-200's, is more thoroughly discussed in a separate section of this Annual Report.

Passenger Service

During the first half of 1981, we assiduously pursued the goal of increasing our operational efficiency and reliability. This program culminated in an on-time performance record of 92.4% and a flight completion record of 99.4% in July, immediately prior to the PATCO strike. These achievements are especially notable for a tightly scheduled, shorthaul carrier, and we plan to resume such excellence when the Air Traffic Control system returns to normal. In the meantime, our high level of frequencies in most markets enables us to afford service superior to competitive carriers when encountering Air Traffic Control delays.

Our new San Antonio Reservations Center serves as a model for the industry and has reduced our average waiting time on incoming calls to less than twenty seconds, while providing an ideal working environment for our people employed there.

On January 4, 1982, we joined the Area Settlement Plan, a clearing house for travel agency transactions, which has facilitated passengers in obtaining our tickets and made us more competitive with other carriers by substantially increasing our travel agency

population and sales. Under the Area Settlement Plan, travel agents receive our tickets on consignment, rather than paying for them in advance of resale, and account to us on standard industry documents cleared through the Plan mechanism.

Prior to commencement of service to our new cities, large overhead bins were installed in the passenger compartments of all of our aircraft then containing the older, smaller bins, which adds greatly to passenger convenience in storing carry-on items, standardizes our fleet and eases and speeds the enplaning and deplaning of passengers.

Financial Strategy

In 1981, we successfully continued our strategy of strengthening our capital structure and reducing our exposure to volatile money markets by issuing 750,000 shares of common stock, producing net proceeds to the Company of \$38,069,000. As a consequence of this and earlier measures, we were able to discharge all of our prime related debt; reduce long-term indebtedness as a percentage of invested capital to 25%; and acquire new aircraft free of any liens.



Our financial flexibility and access to funds were further improved by the negotiation of a \$100,000,000 domestic revolving credit convertible into a term loan; a \$50,000,000 Euro-dollar revolving credit available in early 1982; and the recent completion of a \$5,400,000 Industrial Revenue Bond financing on our San Antonio Reservations Center at a very favorable interest rate.

Stock Split

On August 25, 1981, your Board of Directors declared a 5-for-4 stock split, resulting in the distribution to shareholders of 2,081,500 additional shares on October 23, 1981. The Board also reaffirmed its intention to continue the eight cent quarterly dividend, which, coupled with the split, would produce a dividend increase of 25%.

Love Field

On December 16, 1981, the Dallas City Council voted against the imposition of noise related restrictions on operations at Love Field. We will cooperate fully with the voluntary noise abatement program adopted by the Council, which is designed to reduce noise without

constricting operational capacity.

Outlook 1982

1982 looms as a year of uncertainty, challenge and testing for the American airline industry. It now appears that the year will be dominated by the continuation of high interest rates, a depressed economy, intensified competition and Air Traffic Control restrictions on service.

By virtue of its strengthened balance sheet, enhanced credit facilities, young and efficient fleet and historic and continued emphasis on cost controls and high productivity, as well as its proven philosophy of service set forth on page 32, Southwest is probably as well prepared to cope with such a year as any carrier in the industry. Moreover, in my opinion, we are also superbly poised to take immediate advantage of any improvement in the economy and attendant increases in passenger traffic and expansion opportunities.

As we embark upon a difficult and trying year for the industry and the nation, perhaps my greatest optimism resides in our employees, who have striven with pride, dedication, good

humor and devotion to overcome all trials and tribulations in the course of making our airline a pleasure for its passengers and a success for its shareholders. One of our airplanes is dedicated to our original employees. It's called "The Winning Spirit." I feel confident that spirit will continue to manifest itself in 1982 and that Southwest will remain a "winner."

Most sincerely,

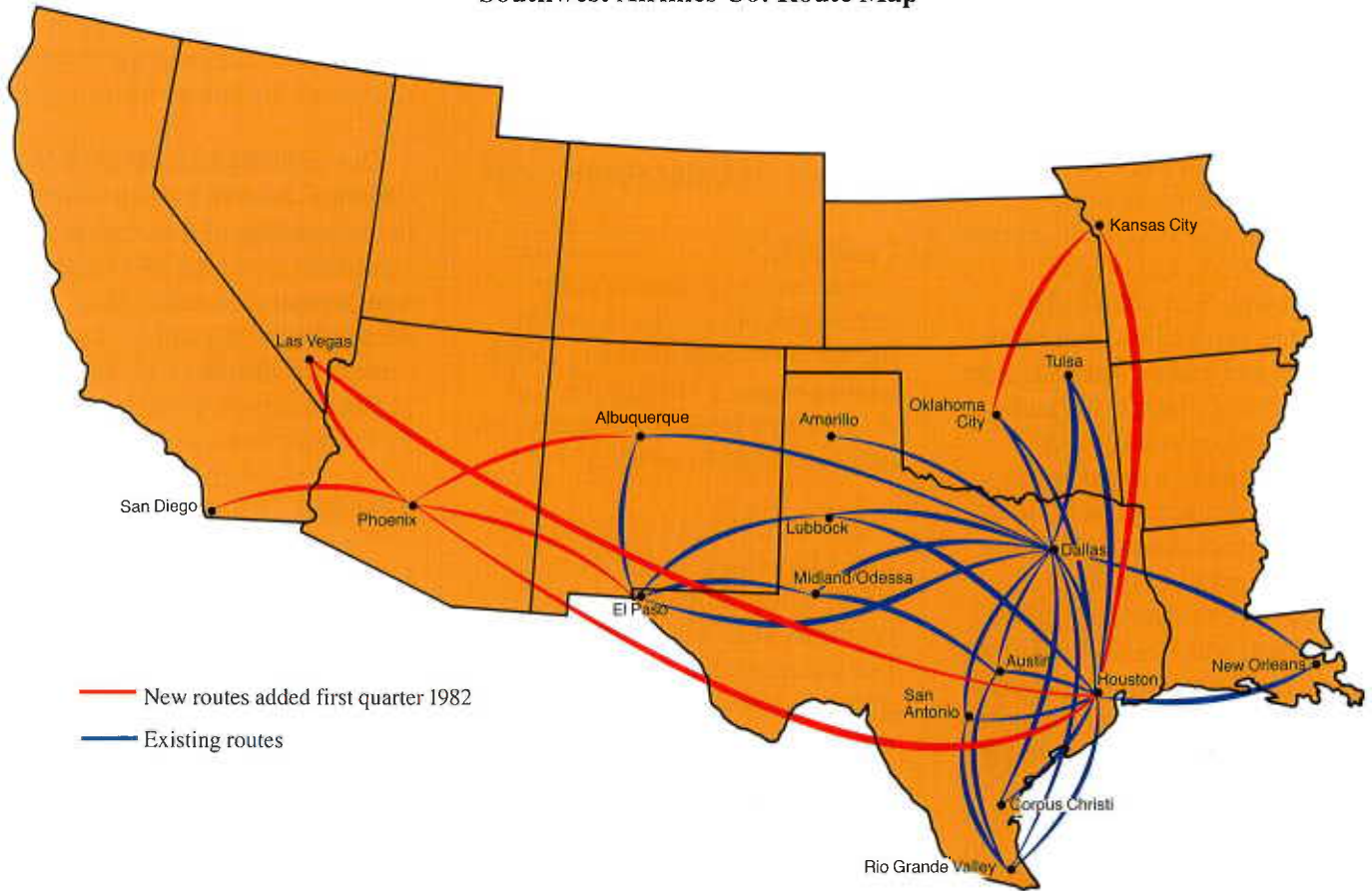
Herbert D. Kelleher

Herbert D. Kelleher
Chairman of the Board,
President and
Chief Executive Officer

February 11, 1982



Southwest Airlines Co. Route Map



Description of Business

During 1981, Southwest Airlines provided single-class, high frequency air service to cities in Texas and to New Orleans, Oklahoma City, Tulsa and Albuquerque. In early 1982, it inaugurated such service to Kansas City, Las Vegas, Phoenix and San Diego. The Company primarily concentrates on shorthaul markets and stresses high levels of aircraft utilization and employee productivity. In the Company's opinion its service is characterized by low fares and convenient schedules. The principal hub airports in Southwest's system are Dallas Love Field and Houston's Hobby Airport, satellite airports located substantially closer to downtown business centers than the major airports serving these cities.

Southwest's two tier fare structure is designed to provide "Executive Class" travelers with low cost air transportation and "Pleasure Class" travelers with an economically competitive alternative to various forms of ground transportation. Southwest

does not carry the United States mail, interline passengers, or engage in carrying air freight (other than small packages).

Review of Operations

CAPACITY

Aircraft acquisitions and commitments are discussed in the Letter to Stockholders and in Management's Discussion and Analysis of Results of Operations and Financial Condition.

During 1981, available seat miles increased by 22% over 1980. This compares to the previous year's increase of 28%. For the most part, the 1981 increase was attributable to a greater average number of seats in our fleet combined with an advance in block hour utilization from 11 hours and 16 minutes per aircraft per day in 1980 to 11 hours and 36 minutes in 1981. The fact that our leased aircraft has six more seats than our owned airplanes and that our average trip length experienced a slight increase also made minor contributions.

ROUTES

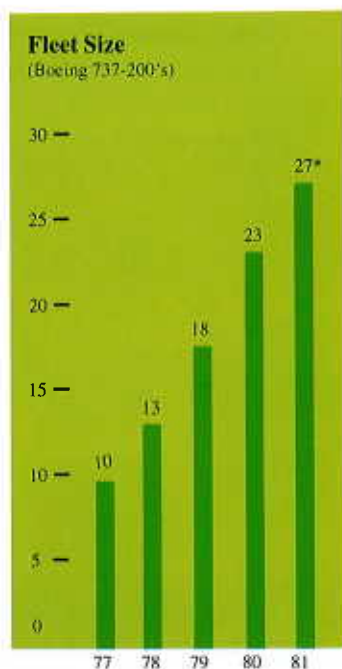
Our routes are discussed in the Letter to Stockholders and are shown on the Route Map.

Our additional capacity in 1981 was used to enhance service to our existing cities through increased frequencies, more nonstop service and better connections, as well as improved ontime and flight completion performance prior to the PATCO strike.

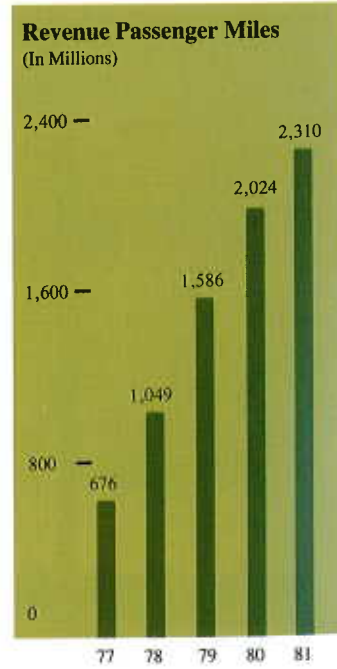
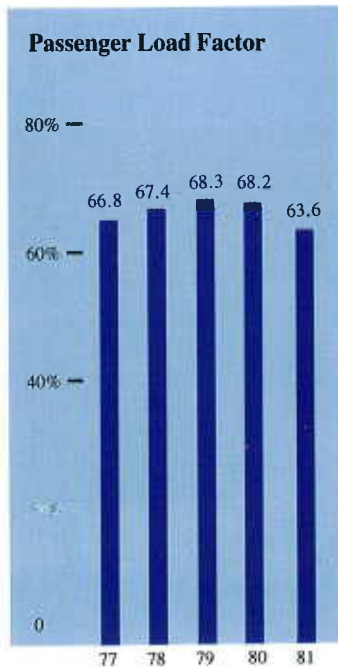
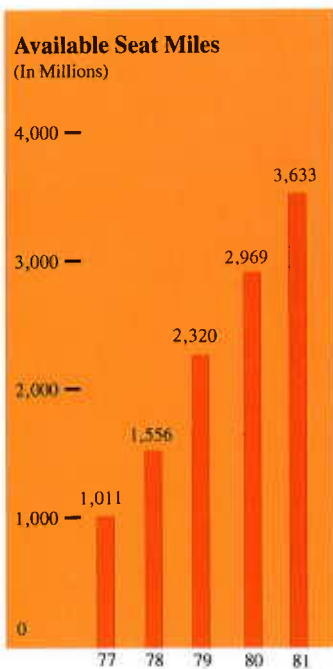
TRAFFIC

Traffic is discussed in the Letter to Stockholders and in Management's Discussion and Analysis of Results of Operations and Financial Condition.

Passenger boardings were up 14% in 1981 over 1980, and Southwest experienced record passenger traffic levels in every month of operation during 1981, although the magnitude of such increases declined in the second half of the year. Since average stage length and average length of passenger haul varied little between 1980 and 1981, the



*Includes one leased B737-200 aircraft.



increase of 14% in revenue passenger miles paralleled the 14% increase in passengers boarded.

Review of Financial Performance and Changes in Financial Condition

REVENUES

A 27% increase in operating revenues, from \$213,048,000 in 1980 to \$270,358,000 in 1981, was occasioned chiefly by the 14% increase in passenger traffic; 11% increase in average passenger fare; and \$2,246,000 increase (37%) in package express revenues between the two years. Southwest's yield per revenue passenger mile rose from 10.09¢ in 1980 to 11.19¢ in 1981.

OPERATING EXPENSES

The timing of Southwest's only 1980 and 1981 fare increases, in January of each year, coincided to a large degree with the pattern of fuel costs observed in the following table, which shows a 14% to 15% increase in the first quarters of 1980 and 1981, as

compared to the previous quarter, followed by moderation of prices in the succeeding three quarters.

	Average Price Per Gallon	Percent Increase
1979		
First Quarter	39.45¢	3.1%
Second Quarter	55.25¢	40.0%
Third Quarter	66.90¢	21.1%
Fourth Quarter	70.98¢	6.1%
Year	59.35¢	55.3%
1980		
First Quarter	81.31¢	14.6%
Second Quarter	83.89¢	3.2%
Third Quarter	86.00¢	2.5%
Fourth Quarter	87.97¢	2.3%
Year	84.96¢	43.2%
1981		
First Quarter	100.34¢	14.1%
Second Quarter	104.85¢	4.5%
Third Quarter	100.60¢	(4.1%)
Fourth Quarter	100.69¢	0.1%
Year	101.67¢	19.7%

Fuel costs as a percent of total operating costs increased from 37.7% in 1980 to 40.5% in 1981.

Total operating expenses in 1981 increased by 35% to \$221,854,000 from \$164,219,000 in 1980. This increase is attributable to the increase in the number of trips flown of 21%

and the associated increase in available seat miles flown of 22%, combined with a 10.5% increase in operating cost per available seat mile to 6.11¢ in 1981 from 5.53¢ in 1980. The following table shows the components of these unit costs on a year to year basis.



	Per Available Seat Mile	Increase (Decrease)	Per Available Seat Mile	Increase (Decrease)	Per Available Seat Mile
	1981		1980		1979
Category of Costs					
Aircraft fuel and oil	2.47¢	18.8%	2.08¢	28.4%	1.62¢
Payroll and related	1.75	8.0%	1.62	15.7%	1.40
Landing fees .....	.13	8.3%	.12	(14.3%)	.14
Aircraft costs .....	.73	4.3%	.70	27.3%	.55
All other	1.03	2.0%	1.01	11.0%	.91
Total operating costs	6.11¢	10.5%	5.53¢	19.7%	4.62¢

The 10.5% overall increase in unit cost compares with the 19.7% increase experienced in 1980. Excluding fuel, operating expenses per available seat mile rose 5.5% in 1981 compared to 15% in 1980.

OPERATING INCOME

Operating income of \$48,504,000 in 1981 was down slightly (0.7%) from 1980's level of \$48,829,000. The primary reason is the lower load factor experienced in 1981, which averaged 63.6% for the year compared to 68.2% in 1980.

CAPITALIZATION AND FINANCING

In 1981, Southwest further pursued its strategy of reducing its exposure to volatile money markets and strengthening its

capital structure, continuing a program which began in 1979 and was partially accomplished in 1980. This strategy has accomplished the following:

... The repayment of all prime-related debt from a peak in 1979 of \$72,000,000.

... Placement in late 1979 and early 1980 of fifteen year maturity equipment trust certificates at a 10.3% fixed rate of interest, covering ten of our aircraft.

... Capital availability of up to \$100,000,000 from a domestic bank credit line.

... A \$50,000,000 revolving credit available from European sources in early 1982.

... Expansion of the equity base in September, 1980 and April, 1981 through public offerings of common stock.

... Purchase of seven new aircraft (including two in February, 1982) free of any mortgage liens or claims.

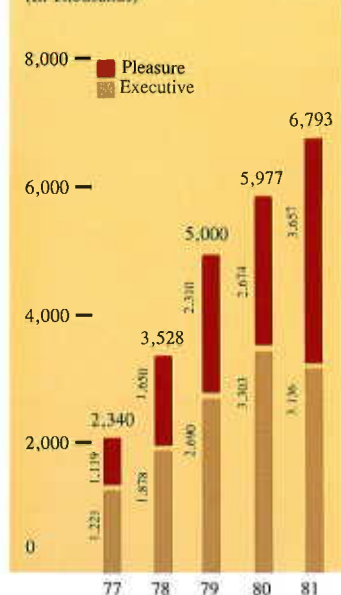
... Reduction of long-term debt as a percentage of total invested capital from 60% at December 31, 1979 to 42% at December 31, 1980 and to 25% at December 31, 1981.

The strengthening and diversification of Southwest Airlines' financial position not only provides the base for substantial fleet and route additions, but also furnishes flexibility in choosing the most advantageous timing and means of further financing in order to reduce costs of capital and provide part of the competitive edge necessary to be successful in a deregulated environment.

PUBLIC OFFERING OF COMMON STOCK

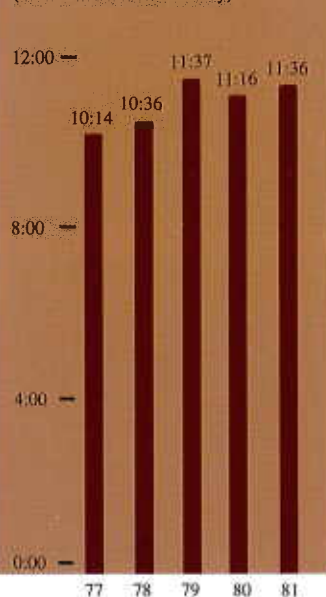
The April, 1981 public offering of 750,000 shares of Company

Revenue Passengers Carried
(In Thousands)

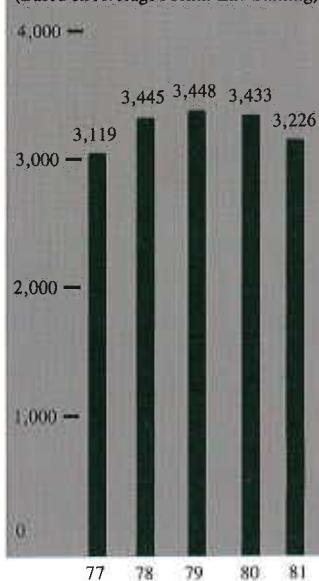


Executive: Monday through Friday, 6:30 AM to 6:59 PM
Pleasure: All weekends and after 6:59 PM weekdays.

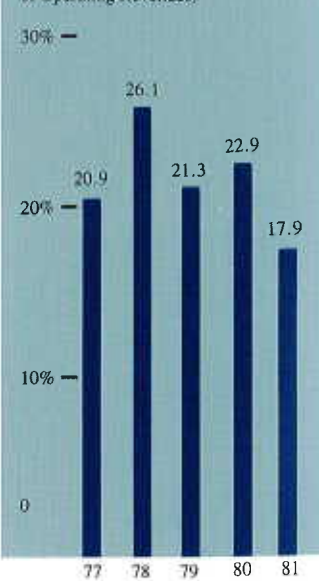
Aircraft Utilization
(Hours and Minutes Per Day)



Passengers Boarded Per Employee
(Based on Average Month-End Staffing)



Net Operating Margin
(Operating Income as a Percentage of Operating Revenues)



common stock generated net proceeds of \$38,069,000, which were applied toward the acquisition of six new Boeing 737-200 aircraft, the last of which is scheduled for delivery in May, 1982. These aircraft, including buyer-furnished equipment, are estimated, with price escalation, to cost approximately \$70,000,000 in the aggregate. By year end 1981 the offering proceeds had been used to pay the \$13,666,000 remainder of the progress payments due on all six aircraft, \$1,765,000 for buyer-furnished equipment and \$17,162,000 for delivery payments on two of the six aircraft.

Prior to the delivery dates of the aircraft, the net proceeds were added to general working capital and used to reduce bank indebtedness or invested in short-term obligations.

NON-OPERATING INCOME AND EXPENSE

The interest income generated from the interim use of the net proceeds from the stock offering made a significant contribution to the Company's cash flow and aided in offsetting Southwest's interest expense on its long term debt. Also, as interim working capital, \$12,000,000 was initially used to repay all but \$1,000,000 of the Company's outstanding debt under its prior revolving credit agreement, which significantly reduced the Company's interest expense for 1981. Further reducing interest expense was the capitalization of interest of \$3,200,000 on new aircraft progress payments and projects under construction.

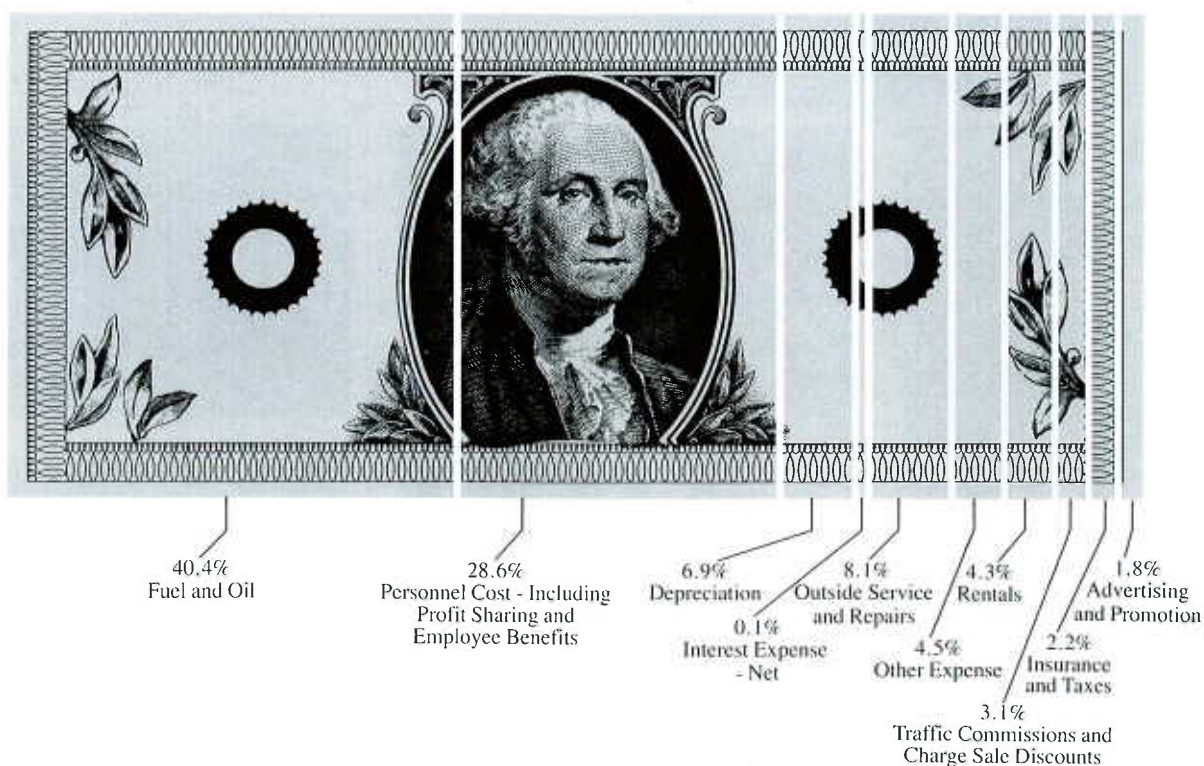
INCOME TAXES

Federal income taxes provided for financial reporting purposes in 1981 were \$14,100,000,

resulting in an effective tax rate of 29% compared to the 1980 effective rate of 31%. The difference between such rate for 1981 and the 46% statutory rate is primarily due to the \$7,328,000 of current year investment tax credits generated from the acquisition of three new aircraft which were placed in service during 1981, along with other qualified capital additions. Also lowering the 1981 effective rate was \$733,000 of additional investment tax credit for the Company's contribution to its Employee Stock Ownership Plan.

Deferred income taxes at December 31, 1981 were \$29,598,000, arising from the accumulation of timing differences between financial and taxable income. These differences are principally due to the use of accelerated depreciation methods for tax

Distribution of Total Expenses



reporting and the deferral of taxes due to the nonrecognition of gain on disposition of aircraft for federal income tax purposes.

For additional analysis of the tax provision and deferred taxes see Note 7 to the consolidated financial statements.

NET INCOME AND EARNINGS PER SHARE

Net income for 1981 increased by 20% to \$34,165,000, as compared to the prior year's \$28,447,000, while earnings per share increased by 4% to \$3.38 from \$3.25. An average of 1,363,000 more shares were outstanding in 1981 than 1980, which represents a 16% increase.

STOCKHOLDERS' EQUITY

Total stockholders' equity increased 65% in 1981, from \$106,964,000 to \$176,503,000. Of this increase, \$38,069,000, or 55%, was attributable to the issuance of new shares, with the remainder attributable to increases in retained earnings.

Return on stockholders' equity for 1981 was 23.5% as compared to 36.0% in 1980. Book value per share at year-end was \$16.96, up 50% over 1980.

PROFIT SHARING CONTRIBUTIONS

Virtually all of Southwest's employees are members of the Company's Profit Sharing Plan. This Plan creates a visible linkage for each employee between his own job performance and the overall financial performance of Southwest. The Plan thus provides a significant financial incentive for employee productivity, one of the keys to Southwest's financial success. During 1981, the Profit Sharing Plan added an average of 19% to the compensation of each employee in the Plan. Total 1981 contributions, paid in quarterly cash bonuses and contributions to the Profit Sharing Trust, were \$7,650,000, up 5% from 1980. In addition to its Profit Sharing Plan, Southwest maintains an Employee Stock Ownership Plan which allows it to generate an

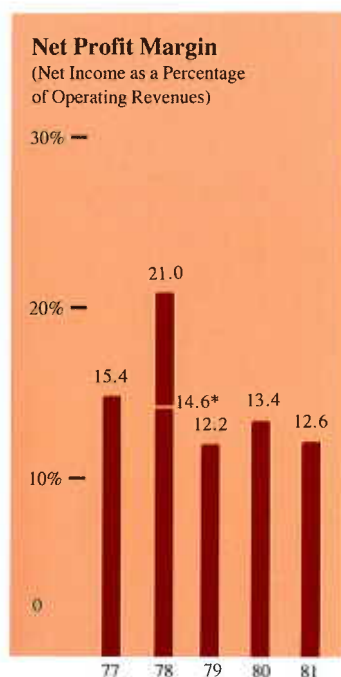
additional one percent investment tax credit if this amount is invested in Southwest stock on behalf of the employees. In 1981, \$733,000 in additional employee compensation resulted from this Plan.

CASH FLOW AND CAPITAL EXPENDITURES

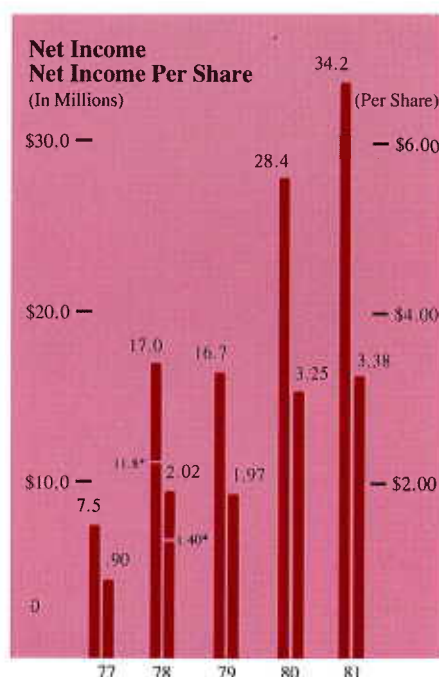
Total working capital from operations increased by 23% to \$59,032,000 in 1981. Proceeds of \$38,069,000 from issuance of common stock and of \$712,000 from issuance of long-term debt provided a total source of funds of \$97,813,000. Additions to flight and ground equipment, cash dividends and reduction of long-term debt required an outlay of \$101,793,000.

In 1980, \$48,100,000 was generated internally and \$44,087,000 externally, equally divided between long-term debt and equity. Total financial resources utilized were \$90,403,000.

Capital expenditures in 1981 were \$79,377,000 and in 1980 \$56,504,000, in each instance predominantly for aircraft progress and delivery payments.



*Excluding non-recurring items.



*Excluding non-recurring items.



QUARTERLY EARNINGS

Unaudited quarterly financial results are summarized as follows (Dollars in thousands, except per share amounts):

	Three months ended			
	March 31	June 30	Sept. 30	Dec. 31
1981				
Revenues	\$62,237	\$72,207	\$70,020	\$65,894
Operating income . .	12,473	14,833	12,089	9,109
Income before tax . .	10,890	14,604	12,885	9,886*
Net income	7,027	9,970	9,024	8,144
Income per share . .	.74	.98	.87	.79

	Three months ended			
	March 31	June 30	Sept. 30	Dec. 31
1980				
Revenues	\$40,186	\$56,566	\$58,795	\$57,501
Operating income . .	7,532	14,233	14,678	12,386
Income before tax . .	6,093	11,359	12,661	11,177
Net income	4,309	7,764	8,423	7,951
Income per share . .	.50	.91	.98	.86

*An additional \$600,000 of investment tax credits were generated in the fourth quarter of 1981 from the discretionary acceleration of progress payments. The effect of this acceleration was the primary reason for the fourth quarter, 1981 effective tax rate of 17% as compared to the 1981 annual effective tax rate of 29%.

COMMON STOCK PRICE RANGES AND DIVIDENDS

Southwest's Common Stock is listed on the New York Stock Exchange and trades 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, in each case as adjusted for stock splits in September, 1980 and October, 1981, were:

Period	Dividend	High	Low
1980			
1st Qtr.	\$.0426	\$12.54	\$ 9.34
2nd Qtr. . . . .	.0426	16.46	9.46
3rd Qtr. . . . .	.0640	23.60	15.46
4th Qtr. . . . .	.0640	29.60	20.80
1981			
1st Qtr. . . . .	.0640	41.60	26.50
2nd Qtr. . . . .	.0640	48.20	37.60
3rd Qtr. . . . .	.0640	42.70	24.40
4th Qtr. . . . .	.0800	32.13	25.40

At February 28, 1982, there were approximately 3,500 holders of record of Southwest's Common Stock.



The 737-300

In March, 1981, Southwest Airlines announced the largest equipment decision in its history. The Company placed the launching order for ten Boeing 737-300 new technology jetliners and it obtained options on thirty additional aircraft. Should all options be exercised, Southwest would make a financial commitment approaching one billion dollars. Given the importance of this decision and its impact on the future of Southwest, we would like to share with our stockholders the reasons why the Company decided on the 737-300.

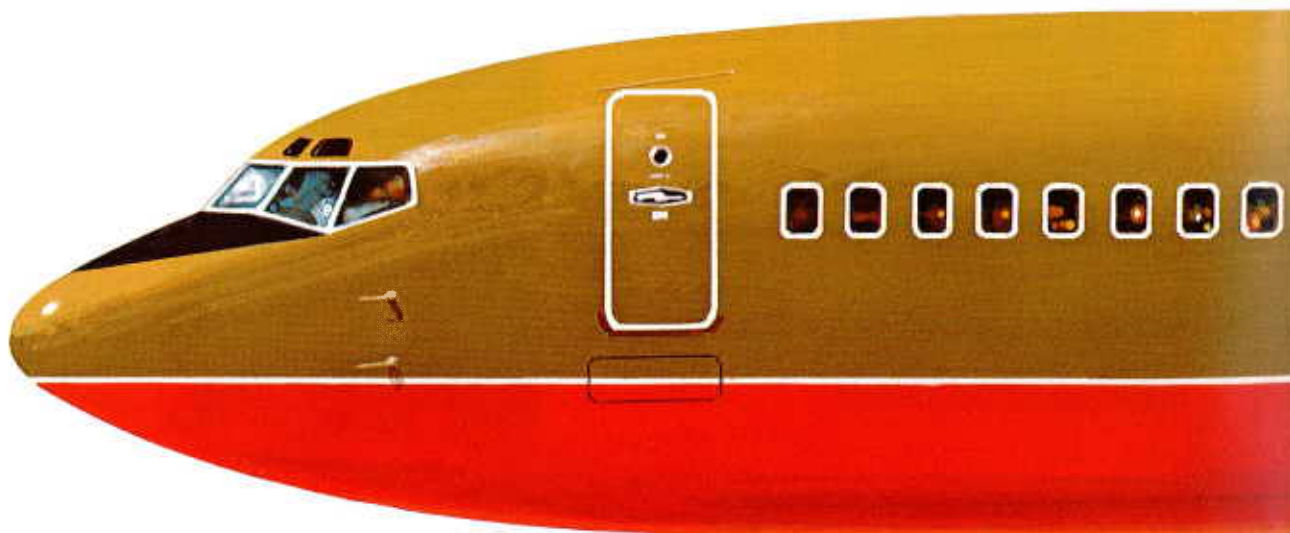
In reaching its decision, Southwest concentrated on three major areas:

- aircraft economics
- environmental acceptability
- system compatability

In each of these areas, the Boeing 737-300 promises benefits superior to any aircraft being built or proposed.

Aircraft Economics

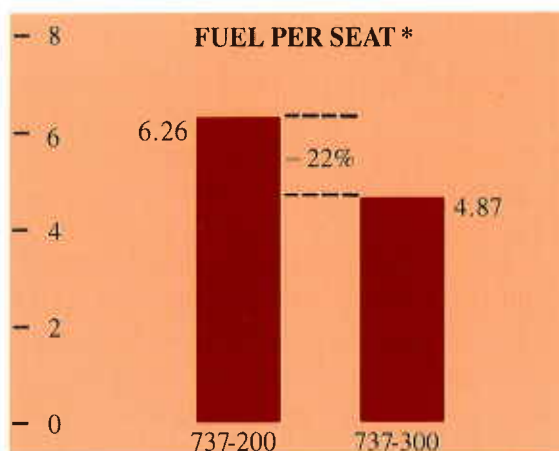
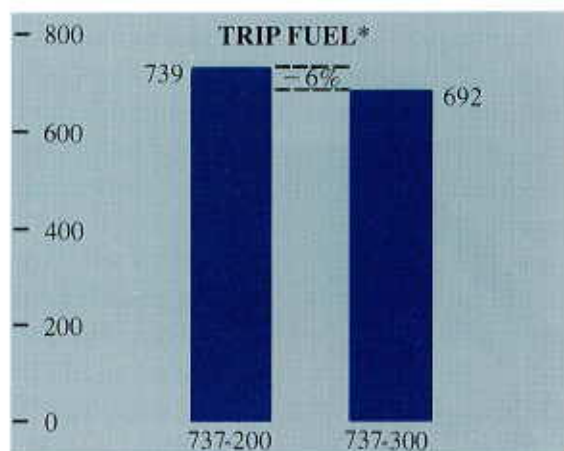
The 737-300 will have a fuselage that is 8'8" longer than the 737-200. It will accomodate 142 passengers in the Southwest configuration as compared to the current 118 passengers. The airframe will incorporate the newest advances in materials technology and design, which will produce marked weight savings and thus greater fuel efficiency.



Power is supplied by GE-SNECMA CFM 56-3 high bypass engines, which will be a well tested powerplant, incorporating the latest in fuel savings technology.

The net result of these changes is an aircraft which not only produces a lower seat mile fuel cost than Southwest's current fleet, but also produces a lower plane mile or trip cost.

The 737-300 will save over 210,000 gallons of fuel per year per airplane, compared to the current 737-200. This savings reflects the more than 6% advantage in fuel per trip that the 737-300 provides. This fuel efficiency, combined with the increase in seats, will result in our 737-300's using 22 % less fuel per seat than today's 737-200.



Environmental Acceptability

The CFM 56-3 engine contributes as much to the environmental acceptability of the 737-300 as it does to the aircraft's economics. In fact, the 737-300 will have the lowest operational noise of any twin jet airplane in its class. Noise around airports will be reduced in all phases of the aircraft's terminal area flight profile.

The noise reduction offered by the 737-300 results largely from the design of the CFM 56-3 engine, which incorporates the latest technology in noise attenuation in the engine and nacelle. Nacelle, fan and jet noises are reduced through the use of advanced acoustic liners, fan design and the inherently lower jet noise features of the high by-pass ratio engine.

The 737-300 will exceed the requirements of Federal Aviation Regulation (FAR) Part 36 for new type aircraft, commonly referred to as "Stage 3," which specifies maximum levels for takeoff, sideline and approach noise.



System Compatibility

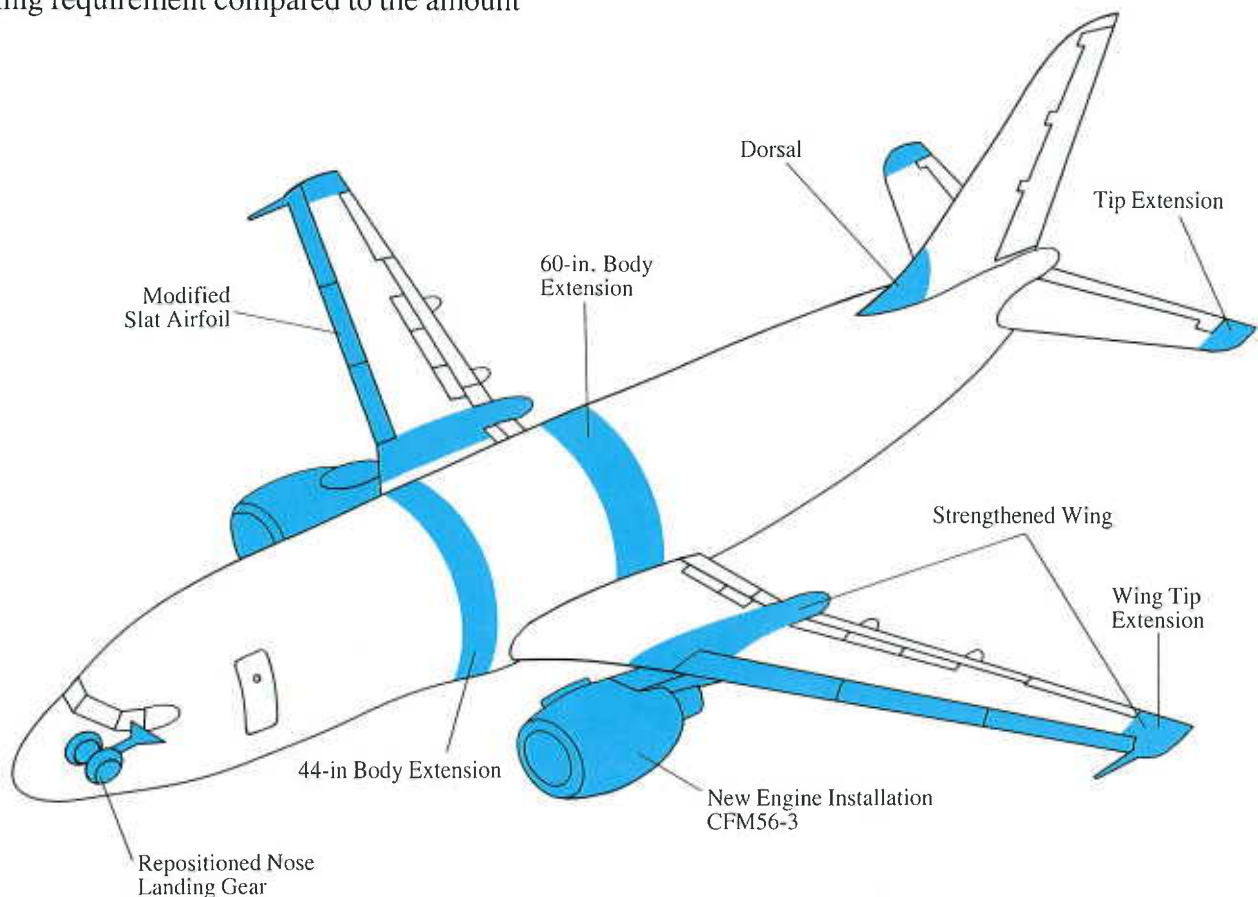
One of Southwest Airlines' major cost advantages has been its reliance on a single aircraft type, the Boeing 737-200. A single airplane type enhances simplicity and efficiency of operations by markedly reducing costs for maintenance personnel and parts, crew training and different types of ground equipment and passenger handling facilities. Moreover, it allows for complete interchange of aircraft and crews, thus lessening the amount of expensive capital and human resources needed to operate at Southwest's high level of aircraft utilization. In evaluating aircraft alternatives Southwest paid close attention to the compatibility of the next generation of aircraft with its current fleet. By every measure the 737-300 proved to be the most compatible aircraft with the lowest costs both for introduction and continued operation within the Southwest system.

Flight crews will be certified on both the 737-300 and the 737-200. Existing 737-200 crews require only a short ground school course, plus minimum hours of simulator and/or flight time. This minimum crew training requirement compared to the amount

required to introduce a totally different aircraft type results in significant cost avoidance. In addition, and most importantly, the Company can continue to use flight crews interchangeably on any aircraft in its system, thus ensuring a continued high degree of productivity. Southwest's flight attendants will similarly require only a brief familiarization course on the 737-300.

Maintenance and ground personnel already familiar with the 737-200 will need only minimum training to be able to handle the 737-300. In addition to a high degree of spare parts commonality, the 737-300 will be able to use, without modifications, Southwest's current ground equipment and facilities including jetways, aircraft handling equipment and passenger service facilities.

In evaluating its future aircraft alternatives therefore, Southwest Airlines was searching for a difficult combination of economic efficiency, environmental acceptability and system compatibility. We are confident that in deciding upon the 737-300, we have achieved each of these goals.



Financial Performance

Southwest Airlines Co. Consolidated Balance Sheet

(in thousands except shares)
December 31, 1981 and 1980

	1981	1980
Assets		
CURRENT ASSETS:		
Cash, including short-term investments of \$16,349 (\$17,094 in 1980) (Note 4)	\$ 16,983	\$ 18,079
Accounts receivable	9,348	8,703
Inventories of parts and supplies, at cost	1,888	1,351
Prepaid federal income tax	2,481	—
Prepaid other	1,634	814
TOTAL CURRENT ASSETS	32,334	28,947
Property and equipment, at cost (Note 2):		
Flight equipment—aircraft (Notes 4 and 5)	225,845	188,353
Other flight and ground equipment	73,784	37,477
Land and building	5,285	—
	304,914	225,830
Less allowance for depreciation	45,932	30,922
	258,982	194,908
Deferred charges and other assets	507	587
	\$291,823	\$224,442
Liabilities and Stockholders' Equity		
CURRENT LIABILITIES:		
Current maturities of long-term debt	\$ 5,075	\$ 2,385
Accounts payable	8,937	6,254
Unearned revenues	2,390	2,358
Accrued liabilities (Note 3)	9,933	7,971
TOTAL CURRENT LIABILITIES	26,335	18,968
Long-term debt less current maturities (Note 4)	58,934	77,892
Deferred federal income tax	29,598	20,222
Deferred compensation	453	396
Total liabilities	115,320	117,478
Commitments and contingencies (Notes 2, 8 and 9)		
STOCKHOLDERS' EQUITY:		
Common stock, \$1.00 par value; 15,000,000 shares authorized; 10,407,500 shares issued and outstanding in 1981 (7,576,000 in 1980)	10,408	7,576
Capital in excess of par value	64,313	28,999
Retained earnings	101,782	70,389
Total Stockholders' Equity	176,503	106,964
	\$291,823	\$224,442

See accompanying notes.

Southwest Airlines Co.
Consolidated Statement of Income
(in thousands except for share and per share information)

	Years Ended December 31,		
	1981	1980	1979
OPERATING REVENUES:			
Passenger	\$ 260,236	\$ 205,764	\$ 131,573
Package express	8,326	6,080	4,057
Other	1,796	1,204	484
Total operating revenues	270,358	213,048	136,114
OPERATING EXPENSES:			
Fuel and oil	89,820	61,887	37,598
Flight operations	23,824	16,101	12,689
Maintenance	18,779	14,319	7,675
Passenger services	11,776	7,992	5,868
Terminal operations	27,058	22,170	15,321
Promotion and sales	12,146	10,061	6,749
Insurance, taxes, and administrative	14,750	12,224	8,444
Depreciation	15,303	12,172	8,482
Employee profit sharing (Note 6)	8,398	7,293	4,302
Total operating expenses	221,854	164,219	107,128
OPERATING INCOME	48,504	48,829	28,986
NON-OPERATING EXPENSE (INCOME):			
Interest and other income	(4,383)	(1,697)	(441)
Interest expense (less interest capitalized of \$3,222 in 1981; \$1,216 in 1980) (Note 4)	4,622	9,236	8,713
Net non-operating expense	239	7,539	8,272
Income before federal income tax	48,265	41,290	20,714
Provision for federal income tax (Note 7)	14,100	12,843	4,062
NET INCOME	\$ 34,165	\$ 28,447	\$ 16,652
INCOME PER COMMON SHARE:			
Weighted average common shares outstanding (adjusted for stock splits in each year)	10,120,000	8,757,000	8,438,000
Net income	\$3.38	\$3.25	\$1.97

See accompanying notes.

Financial Performance

Southwest Airlines Co. Consolidated Statement of Stockholders' Equity (in thousands except for per share information)

Three Years Ended December 31, 1981				
	Common stock	Capital in excess of par value	Retained earnings	Total
BALANCE AT DECEMBER 31, 1978	\$ 3,000	\$11,415	\$ 28,474	\$ 42,889
Three-for-two stock split	1,500	(1,500)	—	—
Cash dividends, \$.15 per share	—	—	(1,260)	(1,260)
Compensation element of executive stock options	—	131	—	131
Net income—1979	—	—	16,652	16,652
BALANCE AT DECEMBER 31, 1979	4,500	10,046	43,866	58,412
Three-for-two stock split	2,287	(2,287)	—	—
Proceeds from issuance of common stock	615	15,836	—	16,451
Contribution of common stock to profit sharing trust	174	5,275	—	5,449
Cash dividends, \$.21 per share	—	—	(1,924)	(1,924)
Compensation element of executive stock options	—	129	—	129
Net income—1980	—	—	28,447	28,447
BALANCE AT DECEMBER 31, 1980	7,576	28,999	70,389	106,964
Five-for-four stock split	2,082	(2,086)	—	(4)
Proceeds from issuance of common stock	750	37,319	—	38,069
Cash dividends, \$.27 per share	—	—	(2,772)	(2,772)
Compensation element of executive stock options	—	81	—	81
Net income—1981	—	—	34,165	34,165
BALANCE AT DECEMBER 31, 1981	<u>\$10,408</u>	<u>\$64,313</u>	<u>\$101,782</u>	<u>\$176,503</u>

See accompanying notes.

Southwest Airlines Co.
Consolidated Statement of Changes in Financial Position
(in thousands)

	Years Ended December 31,		
	1981	1980	1979
FINANCIAL RESOURCES WERE PROVIDED BY:			
Working capital provided from operations:			
Net income	\$ 34,165	\$28,447	\$16,652
Items not affecting working capital during the current period:			
Depreciation	15,303	12,172	8,482
Deferred compensation and compensation element of executive stock options	188	178	215
Deferred federal income tax	9,376	7,303	3,460
Deferred profit sharing	—	—	499
Other	—	—	49
Total from operations	59,032	48,100	29,357
Issuance of common stock	38,069	21,900	—
Issuance of long-term debt	712	22,187	57,865
Total source of funds	97,813	92,187	87,222
FINANCIAL RESOURCES WERE UTILIZED FOR:			
Net additions to property and equipment	79,377	56,504	54,314
Cash dividends	2,772	1,924	1,260
Reduction of long-term debt	19,670	31,669	32,541
Other	(26)	306	579
Total application of funds	101,793	90,403	88,694
INCREASE (DECREASE) IN WORKING CAPITAL	\$ (3,980)	\$ 1,784	\$ (1,472)
CHANGES IN COMPONENTS OF WORKING CAPITAL:			
Increase (decrease) in current assets:			
Cash including short-term investments	\$ (1,096)	\$ 7,672	\$ 1,742
Accounts receivable	645	(454)	5,170
Inventories	537	115	650
Prepaid federal income tax and other	3,301	525	(184)
	3,387	7,858	7,378
Increase (decrease) in current liabilities:			
Current maturities of long-term debt	2,690	(156)	2,541
Accounts payable	2,683	721	2,286
Unearned revenues	32	2,358	—
Accrued liabilities	1,962	3,151	4,023
	7,367	6,074	8,850
Increase (decrease) in working capital	\$ (3,980)	\$ 1,784	\$ (1,472)

See accompanying notes.

Southwest Airlines Co.

Notes to Consolidated Financial Statements

December 31, 1981

1. Summary of significant accounting policies

Property and equipment—

Depreciation is provided by the straight-line method to residual values over a fifteen-year period for aircraft, over periods ranging from three to twenty years on other flight and ground equipment and over thirty years for buildings. The Company charges major aircraft maintenance and overhaul costs to operations as incurred.

Investment tax credits—

Investment tax credits are accounted for by the flow-through method.

Unearned revenues—

Unearned revenues represent the sale of tickets for which transportation has not yet been provided under a program for preselling tickets to travel agencies.

Per share amounts—

Income per share computations are based upon the weighted average number of shares outstanding during the respective periods. Per share information has been restated to reflect common stock splits.

2. Flight and ground equipment

At December 31, 1981, the Company had contractual commitments of approximately \$347,419,000, including escalation and net of progress payments, for the purchase of twelve Boeing 737-200 and ten Boeing 737-300 aircraft to be delivered in 1982 through 1985. In addition, the Company has options to purchase an additional thirty 737-300 aircraft. Deposits of \$750,000 have been made to secure delivery positions in years 1986 through 1989 in case the Company exercises its purchase options.

Other flight and ground equipment is (in thousands):

	1981	1980
Progress payments on aircraft	\$30,867	\$ 5,770
Support flight equipment	18,958	13,878
Ground equipment	13,975	10,088
Leasehold improvements	4,645	3,914
Construction in progress	5,339	3,827
	<u>\$73,784</u>	<u>\$37,477</u>

3. Accrued liabilities

Accrued liabilities consist of (in thousands):

	1981	1980
Profit sharing	\$2,466	\$1,683
Interest	3,251	—
Federal income tax	—	4,861
Vacation pay	1,700	600
Ad valorem taxes	2,146	581
Other	370	246
	<u>\$9,933</u>	<u>\$7,971</u>

4. Long-term debt

Long-term debt less current maturities consists of (in thousands):

	1981	1980
10.40% Equipment Trust Certificates due July 1, 1994	\$21,493	\$23,284
10.30% Equipment Trust Certificates due January 1, 1995	17,500	18,900
10.30% Equipment Trust Certificates due July 1, 1995	19,229	20,708
Revolving Credit Agreement	—	15,000
10% note due August 28, 1984 with quarterly interest and annual principal payments starting April 1, 1982 and August 28, 1982, respectively	712	—
Long-term debt less current maturities	<u>\$58,934</u>	<u>\$77,892</u>

The equipment trust certificates require semiannual principal and interest payments and are secured by ten Boeing 737-200 advanced series aircraft with a net book value of \$76,413,000 at December 31, 1981.

Long-term debt principal repayments due in each of the next five years are (in thousands):

1982	\$5,075
1983	5,076
1984	5,076
1985	4,720
1986	4,720

The Credit Agreement permits the Company to borrow amounts up to the lesser of the Primary Commitment, 80% of the net book value of collateral pledged under the Agreement, or 70% of the market value of such collateral. Currently, the Primary Commitment is \$25,000,000, and with six months advance notice the Company can increase the amount of the Primary Commitment up to \$100,000,000. Currently, the Agreement is secured by eleven aircraft with a net book value of \$56,533,000.

The commitment fee for the Credit Agreement is $\frac{3}{8}\%$ per annum on the unused portion of the Primary Commitment and $\frac{1}{8}\%$ per annum on the difference between \$100,000,000 and the amount of the Primary Commitment.

Interest rates on borrowings under the Credit Agreement can be, at the option of the Company: the agent bank's prime commercial rate; a rate derived from a formula based on the Domestic Fixed Rate (computed from available secondary Certificate of Deposit market rates); or, a rate derived from a formula based on the London Interbank Offered Rate (LIBOR); and interest is payable quarterly or at the end of the interest period selected. If the Company elects the Domestic Fixed Rate option or the LIBOR rate option, the effective interest rate would remain unchanged for periods of up to six months or, with the banks' agreement, up to two years under the LIBOR rate option.

During the commitment period but not later than October 30, 1985, the outstanding balance is convertible into a seven-year term loan repayable in 28 quarterly installments beginning the first day of the calendar quarter following conversion to the term loan. The interest rates available on the term loan are $\frac{1}{4}\%$ over the agent bank's prime commercial rate for the first

three years and 1/2% thereafter, or the previously mentioned formula rate based on LIBOR with the rate remaining unchanged for periods of up to six months.

The Company will maintain cash balances equal to 5% of borrowings under the Credit Agreement or will pay the banks a quarterly fee equal to the unmaintained balance multiplied by one quarter of the agent bank's prime commercial interest rate. These cash balances are not legally restricted as to withdrawals.

5. European banks credit agreement

On January 22, 1982, the Company entered into a Letter Agreement with a group of European banks which permits the Company to borrow on a revolving credit basis up to \$50,000,000 through January 22, 1985. Borrowings will bear interest at 1/2% over the London Interbank Offered Rate and the interest rate will remain unchanged for either one, three, or six months, at the Company's option. The Company will pay a commitment fee of 3/8% per annum on the daily unused portion of the Available Amount, as defined, and 1/16% per annum on the difference between the amount of the loan commitment and the Available Amount, as defined. The loans will be secured by aircraft.

6. Employee profit sharing and stock ownership plans

Substantially all of the Company's employees are members of a profit sharing plan. The plan provides that the Company may contribute, as determined by the Board of Directors, the lesser of 15% of its adjusted pretax income (as defined by the plan) or the maximum amount deductible for federal income tax purposes.

During 1979, the Company adopted an Employee Stock Ownership Plan which, under Internal Revenue Service regulations, allows the Company to claim an additional 1% investment tax credit if this amount is invested in Company stock on behalf of its employees.

7. Federal income tax

Provisions for federal income tax are as follows (in thousands):

	1981	1980	1979
Current	\$ 4,724	\$ 5,540	\$ 602
Deferred	9,376	7,303	3,460
	<u>\$14,100</u>	<u>\$12,843</u>	<u>\$4,062</u>

The provision for federal income tax reconciles to the statutory rate as follows (in thousands):

	1981		1980		1979	
	Amount	%	Amount	%	Amount	%
Income tax provision at statutory rate . .	\$22,202	46	\$18,993	46	\$9,528	46
Investment tax credit	(7,328)	(15)	(5,576)	(14)	(4,915)	(24)
ESOP tax credit	(733)	(2)	(557)	(1)	(873)	(4)
Other	(41)	—	(17)	—	322	2
	<u>\$14,100</u>	<u>29</u>	<u>\$12,843</u>	<u>31</u>	<u>\$4,062</u>	<u>20</u>

Deferred federal income tax results from (in thousands):

	1981	1980	1979
Timing differences in flight and ground equipment	\$8,726	\$5,813	\$3,967
Application of investment tax credits	—	884	(409)
Other	650	606	(98)
	<u>\$9,376</u>	<u>\$7,303</u>	<u>\$3,460</u>

Timing differences in flight and ground equipment result principally from the use of accelerated depreciation methods for federal income tax reporting.

8. Commitments

Total rental expense charged to operations in 1981, 1980 and 1979, were \$4,802,000, \$2,281,000 and \$3,127,000, exclusive of landing fees of \$4,832,000, \$3,532,000 and \$2,557,000, respectively. Landing fees are set by the governing bodies of the airports served by the Company and are based upon usage of airport runways.

The majority of the Company's corporate office and terminal operations space and one aircraft are leased through non-cancelable operating leases. Minimum future obligations on such leases are as follows (in thousands):

1982	\$ 4,461
1983	2,500
1984	1,385
1985	1,255
1986	1,243
After 1986	12,399
	<u>\$23,243</u>

9. 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 DFW 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.

Subsequently, in December, 1974, Texas International Airlines (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 preliminary injunction prohibiting the Carrier and certain other CAB air carriers serving DFW from proceeding with that portion of the State Court suit which seeks to relitigate the right of the Company to remain at Love Field. Those carriers appealed the entry of the preliminary injunction to the Fifth Circuit Court of Appeals which Court ruled in favor of the Company. Some of those carriers 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, other than the Company's filing a motion for partial summary judgment. Ruling on this motion has been deferred

pending the outcome of negotiations between the parties to dismiss both the Company's federal case and the above-described state court case to which it relates.

In December, 1978, the Company became subject to the jurisdiction of the CAB by obtaining authority to commence interstate air service between Houston, Texas and New Orleans, Louisiana. The CAB thereafter issued a certificate to the Company confirming its right to use Love Field in conjunction with its intra-Texas service over routes originally granted by the Texas Aeronautics Commission.

Subsequently, the CAB granted the Company authority to fly between Love Field and New Orleans, Louisiana. This determination was appealed to the District of Columbia Circuit Court of Appeals by certain of the DFW airport parties and certain homeowner organizations. This appeal was dismissed by stipulation of the parties subsequent to enactment of the federal legislation described below.

In February, 1980, federal legislation was enacted which authorizes, under certain conditions met by the Company, air service between Love Field and any points in Texas, and the four adjacent states of Arkansas, Louisiana, New Mexico, and Oklahoma. Such legislation also validates the Company's right to continue its Love Field-New Orleans air service pursuant to the earlier grant of such authority by the CAB. Since enactment of such legislation, the CAB has granted the Company authority to provide air service between Love Field and Albuquerque, New Mexico; Oklahoma City, Oklahoma; and Tulsa, Oklahoma, which service the Company has been providing since April, 1980.

Based on opinion of counsel, the Company believes that its becoming subject to CAB jurisdiction and receiving a final CAB certificate authorizing use of Love Field in connection with intra-Texas air service, plus the enactment of the described legislation, establishes, as a matter of federal law, the Company's right to continue to use Love Field for such intra-Texas service. Further, based on opinion of counsel, the Company believes that it may continue to operate flights between Love Field and points within Texas and the four adjacent states while furnishing air service from points other than Love Field to points beyond Texas and the four adjacent states.

On September 2, 1980, pursuant to CAB authorization granted over the Company's objection, an interlining CAB air carrier (the Carrier) introduced air service between Love Field, Houston's Intercontinental Airport, and points in Louisiana. The Company, the Cities of Dallas and Fort Worth, and the DFW Regional Airport Board appealed the CAB's determination to the District of Columbia Circuit Court of Appeals, insofar as such determination permitted an interlining air carrier to provide interstate air service between Love Field and points in the four states adjoining Texas. The Company, which does not interline, and the DFW Airport parties contended that the federal legislation described above prohibits any interstate air service to or from Love Field by an interlining air carrier. The Carrier terminated all air service at Love Field on January 31, 1981. Thereafter, because of such termination, the District of Columbia Circuit Court of Appeals dismissed the appeal as moot and directed the CAB to expunge its order granting the Carrier the right to serve Love Field.

Insofar as the Love Field lawsuits involve controversy over the continued use and operation of Love Field as an airport, the management of the Company and its legal counsel expect to prosecute and defend successfully both the federal and state court actions. In the event of an adverse decision, no financial liability is indicated, although the effect on future operations is not predictable at this time.

The Company is involved in several other legal proceedings, the outcome of which in the opinion of management and counsel will not have a material effect on the financial statements.

Groups and organizations of homeowners in the vicinity of Love Field proposed that the Dallas City Council adopt restrictions on aircraft operations at Love Field, including a flight curfew. Any such mandatory restrictions were rejected by vote of the Dallas City Council on December 16, 1981.

Supplementary Information On Effects of Changing Prices (Unaudited)

Financial reporting and changing prices

Statement of Financial Accounting Standards No. 33, "Financial Reporting and Changing Prices," requires providing certain information about the effects of general inflation (constant dollar) and the effects of changes in specific prices (current cost). It is hoped that measuring certain assets and expenses in constant dollars and at current costs will provide better information to investors, creditors and others to assess prospective cash flow and current economic resources. The information provided should be viewed as an estimate of the approximate effect of inflation, rather than as a precise measure.

FASB 33 endeavors to measure the effects of inflation in two different ways:

- 1) Constant dollar — in inflationary periods, the amount of goods and services that a dollar will buy declines. Since financial data involves dollars expended in different years, all dollars are adjusted to a common index level by application of the Consumer Price Index for All Urban Consumers (CPI-U).
- 2) Current cost — in inflationary periods, prices of goods and services will not all necessarily increase at the same rate. The impact of inflation on a specific company may also be measured by estimates of the change in prices of specific goods and services that the company uses. Current cost amounts reflect changes in specific prices of goods and services and differ from constant dollar amounts to the extent that specific prices have increased more or less rapidly than prices in general. Neither method purports to represent the amount at which assets could be sold.

Methods of computation

Constant dollar — values were determined by applying the CPI-U to specified data.

Current cost —

a) Property and equipment — current cost was determined by the following methods:

- 1) Direct pricing — the Company's aircraft fleet is comprised of B737-200 aircraft, which were priced using current new purchase prices and deducting an allowance for the age of each aircraft. Spare rotatable equipment was valued by applying the ratio of the historical cost of the aircraft fleet to its current cost to historical cost of rotatable equipment.
- 2) Indexing — all ground equipment, building and facilities were valued by applying the CPI-U to the appropriate asset account.

b) Depreciation was computed utilizing the same depreciable life assumption as used for the historical cost basis financial statements.

Table I "Statement of Income from Continuing Operations Adjusted for Changing Prices" restates net income for the year based upon the restatement of property and equipment adjusted for general inflation and for changes in specific prices.

Since the depreciable value of the Company's property and equipment was higher when adjusted for the effect of general inflation than when adjusted for its average 1981 current costs, the depreciation expense computed on these higher values was therefore greater as reflected in the disclosures of adjusted depreciation expense and adjusted net income in Table I.

Table I "Effect on Relevant Balance Sheet Accounts at December 31, 1981 of Adjustment for Changing Prices" also presents the changes in values of our "net monetary assets" which occurred during 1981. The first item is a gain due to inflation, applicable to both methods, based on the decline in purchasing power of net monetary amounts owed. The Company's current assets (except flight equipment parts, fuel inventories and prepaid expense) and most of its liabilities (except unearned revenue and accrued vacation pay) are monetary items. Since monetary liabilities during 1981 were greater than monetary assets, an unrealized gain of \$5,929,000 resulted. It must be noted, however, that the gain may only be realized when such liabilities are paid in the future with then cheaper dollars.

The next three items in Table I show that the value of the Company's net property and equipment has, as valued in current cost 1981 dollars, increased during the year by \$6,039,000. For the same period, the increase in net property and equipment as adjusted for the effects of general inflation was \$20,904,000. The difference between the two adjusted amounts reflects the extent to which the general rate of inflation exceeded increases in current costs. The final item in Table I shows the effect of restating net assets at year-end for the effects of changing prices.

Table II is a five-year summary of certain selected supplementary financial data as adjusted for general inflation (CPI-U) as required by FASB 33. Certain data is not required for years 1977 through 1979.

Current tax laws do not recognize deductions for current cost of depreciation and amortization expense; therefore, income taxes provided are reported in historical dollars as required by FASB 33.

The information presented in response to FASB 33 will continue to be examined by the Financial Accounting Standards

Board in order to determine whether or not both the effect of consumer price index fluctuations and changes in current valuation of certain assets should continue to be shown or whether another method of calculation would be more useful.

TABLE I

**STATEMENT OF INCOME FROM CONTINUING OPERATIONS
ADJUSTED FOR CHANGING PRICES FOR THE YEAR ENDED**

DECEMBER 31, 1981

(000's)

	As Reported in the Primary Statements	Adjusted for General Inflation (Constant Dollar)	Adjusted for Changes in Specific Prices (Current Costs)
Operating revenues	\$270,358	\$270,358	\$270,358
Depreciation expense	15,303	20,682	19,419
Other expenses	206,790	206,790	206,790
Provision for income taxes	14,100	14,100	14,100
Total expense	236,193	241,572	240,309
Net Income	\$ 34,165	\$ 28,786	\$ 30,049
Net Income per Common Share	\$ 3.38	\$ 2.84	\$ 2.97

**EFFECT ON RELEVANT BALANCE SHEET ACCOUNTS AT
DECEMBER 31, 1981 OF ADJUSTMENT FOR CHANGING PRICES**

(000's)

Gain from decline in purchasing power of net amounts owed		<u>\$ 5,929</u>	<u>\$ 5,929</u>
Increase in specific prices (current cost) of property and equipment*			\$ 6,039
Increase in general price level (inflation component) of property and equipment.			<u>20,904</u>
Excess of increase in general price level over increases in specific prices			<u>\$14,865</u>
Net assets at year-end	\$176,503	\$227,538	\$229,463

*At December 31, 1981, current cost of property and equipment net of accumulated depreciation was \$284,950,000.

TABLE II

FIVE-YEAR COMPARISON OF SELECTED SUPPLEMENTARY FINANCIAL DATA (000's)

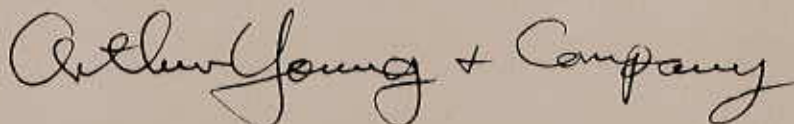
	Years Ended December 31,				
	1981	1980	1979	1978	1977
Operating revenues	\$270,358	\$235,061	\$170,487	\$112,968	\$73,584
Historical cost information adjusted for general inflation—					
Net income	28,786	25,354	—	—	—
Net income per share	2.84	2.90	—	—	—
Net assets	227,538	145,618	—	—	—
Historical cost information adjusted for specific prices—					
Net income	30,049	26,456	—	—	—
Net income per share	2.97	3.02	—	—	—
Excess of increase in specific prices over increase in the general price level	(14,865)	2,004	—	—	—
Net assets	229,463	134,368	—	—	—
Depreciation and amortization	19,419	14,163	—	—	—
Gain from decline in purchasing power of net amounts owed	5,929	9,906	—	—	—
Cash dividends paid per common share . . . . .	.27	.24	.19	.13	.09
Market price per common share at year-end	28.88	31.78	14.95	9.72	8.58
Average consumer price index (1967 = 100)	272.3	246.8	217.4	195.4	181.5

Auditor's Report

The Board of Directors
Southwest Airlines Co.

We have examined the accompanying consolidated balance sheet of Southwest Airlines Co. at December 31, 1981 and 1980, and the related consolidated statements of income, stockholders' equity and changes in financial position for each of the three years in the period ended December 31, 1981. 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, 1981 and 1980, and the consolidated results of operations and changes in financial position for each of the three years in the period ended December 31, 1981, in conformity with generally accepted accounting principles applied on a consistent basis during the period.



Dallas, Texas

January 20, 1982, except as to Note 5, as to which the date is January 22, 1982

Management's Discussion and Analysis of Results of Operations and Financial Condition

Operating Revenues. 1981 operating revenues increased 27% over 1980. 1980's revenues increased 57% over 1979.

The lower rate of growth in 1981 operating revenues reflected the fact that both traffic and yields grew more slowly in 1981 than they had in 1980. Revenue passenger miles increased by 14% in 1981 as compared to 28% in 1980. Yield per revenue passenger mile increased by 10.9% in 1981 compared to 22.6% in 1980.

These slower growth rates in turn were the result of several different factors. Capacity increased by 22% in 1981, compared to 28% in 1980. No new cities were added to Southwest's route system in 1981, while three were added in 1980. The threat of a PATCO strike in June and the actual strike in August caused noticeable downturns in traffic growth in those months. In addition, the second half of 1981 witnessed the effect of the nationwide economic slowdown in Southwest's service area. Finally, competitive pressures in our region increased substantially as several carriers added service and reduced fares in an effort to increase or defend their market shares.

Operating Expenses. From 1979 to 1980 the operating cost per available seat mile increased by 19.7% as compared to an increase of 10.5% between 1980 and 1981. Excluding fuel, the increases were 15% and 5.5%, respectively. Load factor remained constant between 1979 and 1980, however, and declined by 4.58 points between 1980 and 1981.

Recently, the cost of jet fuel has softened, and it is expected that other operating costs will remain well under control during 1982. The Company, is, however, undertaking a major expan-

sion of its fleet and routes which will substantially increase the volume of its operating costs during 1982.

The Company's operating margins for 1981, 1980 and 1979 were 18.0%, 22.9% and 21.3%, respectively.

Capital Resources and Liquidity. The Company's principal capital expenditures are for aircraft and related items. Capital expenditures in 1981 were \$79,377,000; in 1980 \$56,504,000; and in 1979 \$54,314,000.

Capital expenditure estimates for 1982 range from \$80,000,000 to \$112,000,000, depending on whether three 1983 B 737-200 aircraft deliveries are moved to the fall of 1982. Beyond these requirements, the Company is committed to the delivery of three additional B 737-200's in 1983 at an estimated cost of approximately \$34,000,000 and additional progress and, ultimately, delivery payments on ten B 737-300 aircraft to be delivered one in 1984 and nine in 1985 at an estimated cost of approximately \$24,000,000 each.

The Company anticipates that its cash flow from operations, which totalled \$29,357,000 in 1979, \$48,100,000 in 1980 and \$59,032,000 in 1981, plus its \$150,000,000 combined lines of credit, will be sufficient to pay for all of the B 737-200's and related items which it is now committed to purchase, as well as progress payments on the B 737-300's, but additional external financing, which has not yet been arranged, will be required for the delivery payments on the B 737-300's. The Company is not presently aware of any particular restrictions on its ability to raise funds externally.



Financial Performance

Ten Year Summary of Operations and Financial Results

	1981	Years Ended December 31,		1978
	1980	1979		
OPERATIONS AND TRAFFIC				
Available seat miles (ASM's) (000)	3,633,351	2,969,448	2,320,371	1,556,173
Trips flown	110,301	91,143	75,837	54,816
Average length of flight segment	279	276	264	253
Size of B-737 fleet at year-end	27***	23	18	13
Passengers carried	6,792,927	5,976,621	5,000,086	3,528,105
Revenue passenger miles (RPM's) (000) . .	2,310,181	2,024,097	1,585,539	1,048,624
Average passenger fare	\$ 38.07	\$ 34.18	\$ 26.10	\$ 21.99
Average length of passenger haul	340	339	317	297
Yield per passenger mile	11.19¢	10.09¢	8.23¢	7.40¢
Actual load factor	63.6%	68.2%	68.3%	67.4%
Break-even load factor**	48.3%	50.2%	53.6%	49.9%
FINANCIAL (000)				
Operating revenues	\$ 270,358	\$ 213,048	\$ 136,114	\$ 81,065
Operating expenses	221,854	164,219	107,128	59,943
Operating income (loss)	48,504	48,829	28,986	21,122
Income (loss) before FIT	48,265	41,290	20,714	23,956
Net income (loss)	34,165	28,447	16,652	17,004
INVESTOR STATISTICS				
Avg. no. of common shares outstanding . .	10,120,000	8,757,000	8,437,500	8,437,500
Common shares outstanding	10,407,500	9,470,000	8,437,500	8,437,500
Earnings per share	\$ 3.38	\$ 3.25	\$ 1.97	\$ 2.02*
Dividends per share	\$.27	\$.21	\$.15	\$.09
Book Value per share	\$ 16.96	\$ 11.29	\$ 6.92	\$ 5.08
Stockholders' equity (000)	\$ 176,503	\$ 106,964	\$ 58,412	\$ 42,889
Return on Stockholders' equity	23.5%	36.0%	33.1%	50.3%*
CAPITAL STRUCTURE (000)				
Total assets	\$ 291,823	\$ 224,442	\$ 172,495	\$ 118,706
Aftertax return on total assets	13.0%	14.1%	11.7%	17.2%*
Working capital	\$ 5,999	\$ 9,979	\$ 8,195	\$ 9,667
Current ratio	1.23:1	1.53:1	1.64:1	3.39:1
Flight and ground equipment-net	\$ 258,982	\$ 194,908	\$ 150,576	\$ 104,744
Capital expenditures	\$ 79,377	\$ 56,504	\$ 54,314	\$ 40,204
Long-term debt (L-T D)	\$ 58,934	\$ 77,892	\$ 87,374	\$ 62,000
L-T D as a % of total invested capital . . .	25.0%	42.1%	59.9%	59.1%
PRODUCTIVITY AND UNIT COSTS				
Number of employees at year-end	2,129	1,839	1,630	1,119
Average number of employees	2,106	1,741	1,450	1,024
Passengers boarded per employee	3,226	3,433	3,448	3,445
RPM's per employee (000)	1,097	1,163	1,093	1,024
Revenue per employee	\$ 128,375	\$ 122,371	\$ 93,872	\$ 79,165
Fuel costs per available seat mile	2.5¢	2.1¢	1.6¢	1.1¢
All other operating costs per ASM	3.6¢	3.4¢	3.0¢	2.8¢
Total operating cost per ASM	6.1¢	5.5¢	4.6¢	3.9¢
Fuel cost per gallon-average	101.67¢	85.0¢	59.3¢	38.2¢
Fuel cost per gallon-year-end	100.73¢	89.7¢	71.3¢	37.5¢
Fuel as a % of operating costs	40.5%	37.7%	35.1%	27.5%
Daily block hours per aircraft	11:36	11:16	11:37	10:36

*Includes a net of tax gain on disposition of aircraft of \$4,456,000 and net cumulative effect of an accounting change of \$735,000 for a total per share amount of \$.62.

**Based on operating revenues per passenger needed to cover total expenses excluding profit sharing and federal income taxes.

***Includes one leased aircraft.

Certain items previously reported have been reclassified to conform to the presentation at December 31, 1981.

1977	1976	Years Ended December 31,		1973	1972
		1975	1974		
1,011,048	618,732	477,166	314,407	260,616	263,808
35,415	22,311	17,552	12,382	10,619	10,576
255	248	246	239	236	233
10	6	5	4	3	3
2,339,524	1,539,113	1,136,318	759,721	543,407	308,999
675,668	406,269	298,458	183,596	130,533	73,079
\$ 20.07	\$ 19.18	\$ 19.07	\$ 18.50	\$ 16.14	\$ 18.17
289	264	263	242	240	237
6.95¢	7.26¢	7.26¢	7.66¢	6.72¢	7.68¢
66.8%	65.7%	62.5%	58.4%	50.1%	27.7%
52.9%	47.0%	49.2%	47.6%	49.0%	39.6%
\$ 49,047	\$ 30,920	\$ 22,817	\$ 14,813	\$ 9,195	\$ 5,912
38,785	23,236	17,860	11,354	7,957	7,248
10,262	7,684	4,957	3,459	1,238	(1,336)
7,545	6,510	3,671	2,141	175	(1,591)
7,545	4,939	3,400	2,141	175	(1,591)
8,412,835	6,620,670	5,643,280	5,836,380	5,846,969	5,605,266
8,437,500	8,353,125	5,656,769	5,771,029	5,846,966	5,846,966
\$.90	\$.75	\$.60	\$.37	\$.03	\$ (.28)
\$.06	\$.01	—	—	—	—
\$ 3.15	\$ 2.32	\$ 1.31	\$.71	\$.34	\$.31
\$ 26,606	\$ 19,345	\$ 7,415	\$ 4,072	\$ 2,002	\$ 1,827
33.0%	39.4%	60.1%	67.1%	9.5%	N/A
\$ 77,967	\$ 43,703	\$ 23,692	\$ 18,566	\$ 14,027	\$ 14,086
12.4%	15.4%	16.2%	13.1%	1.3%	N/A
\$ 5,052	\$ 8,026	\$ 1,392	\$ 802	\$ 1,042	\$ 709
2.82:1	3.83:1	2.03:1	1.64:1	2.96:1	3.24:1
\$ 69,853	\$ 32,699	\$ 20,787	\$ 16,173	\$ 11,979	\$ 12,658
\$ 41,442	\$ 13,730	\$ 6,294	\$ 6,579	\$ 832	\$ 79
\$ 47,000	\$ 20,000	\$ 14,500	\$ 12,197	\$ 11,455	\$ 11,942
63.8%	50.8%	66.2%	75.0%	85.1%	86.7%
892	517	392	323	238	183
750	457	368	284	215	187
3,119	3,368	3,088	2,675	2,527	1,652
901	889	811	646	607	391
\$ 65,395	\$ 67,657	\$ 62,003	\$ 52,158	\$ 42,767	\$ 31,615
1.0¢	.9¢	.8¢	.7¢	.4¢	.3¢
2.8¢	2.9¢	2.9¢	2.9¢	2.7¢	2.4¢
3.8¢	3.8¢	3.7¢	3.6¢	3.1¢	2.7¢
36.4¢	30.7¢	30.1¢	22.3¢	11.3¢	11.2¢
37.2¢	33.1¢	31.1¢	28.3¢	11.3¢	11.2¢
26.2%	22.8%	22.4%	18.1%	12.1%	12.6%
10:14	9:22	8:35	8:16	8:13	7:02

Officers



Kelleher



King



Doolin



Barron



Franklin



Gottsacker



Herring



Hoff



Keith



Reilly



ter Kuile



Vidal



Volz



Barrett



Phelps

	Age	Officer Since		Age	Officer Since
Herbert D. Kelleher <i>Chairman of the Board, President & Chief Executive Officer</i>	50	1967	Thomas J. Hoff <i>Vice President—Properties & Facilities</i>	42	1981
Rollin W. King <i>Advisor—Special Projects</i>	50	1967	Camille T. Keith <i>Vice President—Public Relations</i>	36	1978
Earl L. Doolin <i>Treasurer—Controller</i>	34	1981	Harold F. Reilly <i>Vice President—Schedule Planning</i>	37	1980
Gary A. Barron <i>Vice President—Inflight Service</i>	37	1978	Roger C. ter Kuile <i>Vice President—Flight Operations</i>	42	1981
William W. Franklin <i>Vice President—Ground Operations & Chairman of the Operating Committee</i>	54	1971	John A. Vidal <i>Vice President—Maintenance</i>	63	1971
Peggy R. Gottsacker <i>Vice President—Personnel</i>	35	1981	Thomas J. Volz <i>Vice President—Marketing</i>	38	1979
J. L. Herring <i>Vice President—Energy & Provisioning</i>	58	1973	Colleen C. Barrett <i>Secretary</i>	37	1978
			Sherry L. Phelps <i>Assistant Secretary</i>	32	1976

Directors



Adger



Barshop



Bishop



Johnson



Kelleher



King

Sidney A. Adger, *Senior Vice President, Milchem, Inc., Houston, Texas*
Audit and Compensation Committees

Samuel E. Barshop, *Chairman of the Board and President, La Quinta Motor Inns, Inc. San Antonio, Texas*
Audit and Compensation Committees

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

Travis C. Johnson, *Johnson & Bowen, El Paso, Texas*
Audit Committee

Herbert D. Kelleher, *Chairman of the Board and President of Southwest Airlines Co., Dallas, Texas*
Executive and Compensation Committees

Rollin W. King, *Advisor-Special Projects, Southwest Airlines Co., and Private Investments, Dallas, Texas*
Executive Committee

Information for Southwest Airlines Investors

Transfer Agent and Registrar

Mercantile National Bank
P. O. Box 225415
Dallas, Texas 75265

Stock Exchange Listing

New York Stock Exchange
Ticker Symbol: LUV

Auditors

Arthur Young & Company
Dallas, Texas

General Offices

P. O. Box 37611
Love Field
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 27, 1982 in the Auditorium of the Mercantile Bank Building, located on its fourth floor at 1704 Main Street, Dallas, Texas.

SEC Form 10-K

Stockholders may obtain free of charge a copy of the Company's Annual Report on Form 10-K as filed with the Securities and Exchange Commission by writing to the Chief Financial Officer, P.O. Box 37611, Love Field, Dallas, Texas 75235.

Notice to Stockholders

This notice is published in accordance with regulations of the Civil Aeronautics Board (Economic Regulations, Part 245).

Any person acquiring ownership, either beneficially or as trustee, of more than 5 percent, in the aggregate, of any class of the capital stock or capital of Southwest Airlines Co. must file with the Civil Aeronautics Board within 10 days after such acquisition the report required by Civil Aeronautics Board Economic Regulations, Subpart B, Section 245.13. Any person who owns, either beneficially or as trustee, more than 5 percent, in the aggregate, of any class of the capital stock or capital of Southwest Airlines Co. must file with the Civil Aeronautics Board a report containing the information required by Section 245.12 of such regulations on or before April 1 as to such shares or other interest owned as of December 31 of the preceding year. Any bank or broker holding such an interest as trustee on the last day of any quarter of a calendar year must file a report under Section 245.14 of such regulations within 30 days after the end of the quarter. Any person who grants a security interest in more than 5 percent of any class of the capital stock or capital of Southwest Airlines Co. must file a report under Section 245.15 within 30 days after such transaction. Any stockholder who believes that he or she may be required to file a report may obtain further information by writing to the Director, Bureau of Pricing and Domestic Aviation, Civil Aeronautics Board, Washington, D.C. 20428.

Southwest Airlines Co. is dedicated principally to serving shorthaul, commuter markets, primarily in the economically strong Southwest Sunbelt.

Southwest's philosophy and business strategy include:

Simplicity of Operations

- ☐ one type of aircraft, the Boeing 737-200 advanced series, with 118 seats
- ☐ one major crew domicile and maintenance facility
- ☐ simplified passenger check-in and fare structures
- ☐ cash register ticketing
- ☐ no interlining of tickets or baggage
- ☐ no food service

High Productivity

- ☐ daily aircraft utilization of 11 hours
- ☐ 10 minute turnaround times between most flights
- ☐ 2200 employees, working hard and enjoying providing high-quality service

Focus on Passenger Business

- ☐ service only for passengers and small packages
- ☐ no large air freight
- ☐ no U.S. mail

Serving Principally Shorthaul, Mass Transit Commuter Markets

- ☐ flight segments generally under two hours
- ☐ low fare structure competitive with the bus and auto travel
- ☐ stimulation of new air travelers from the automobile and the backyard





Southwest Airlines Co.
P. O. Box 37611
Love Field
Dallas, Texas 75235
214/353-6100