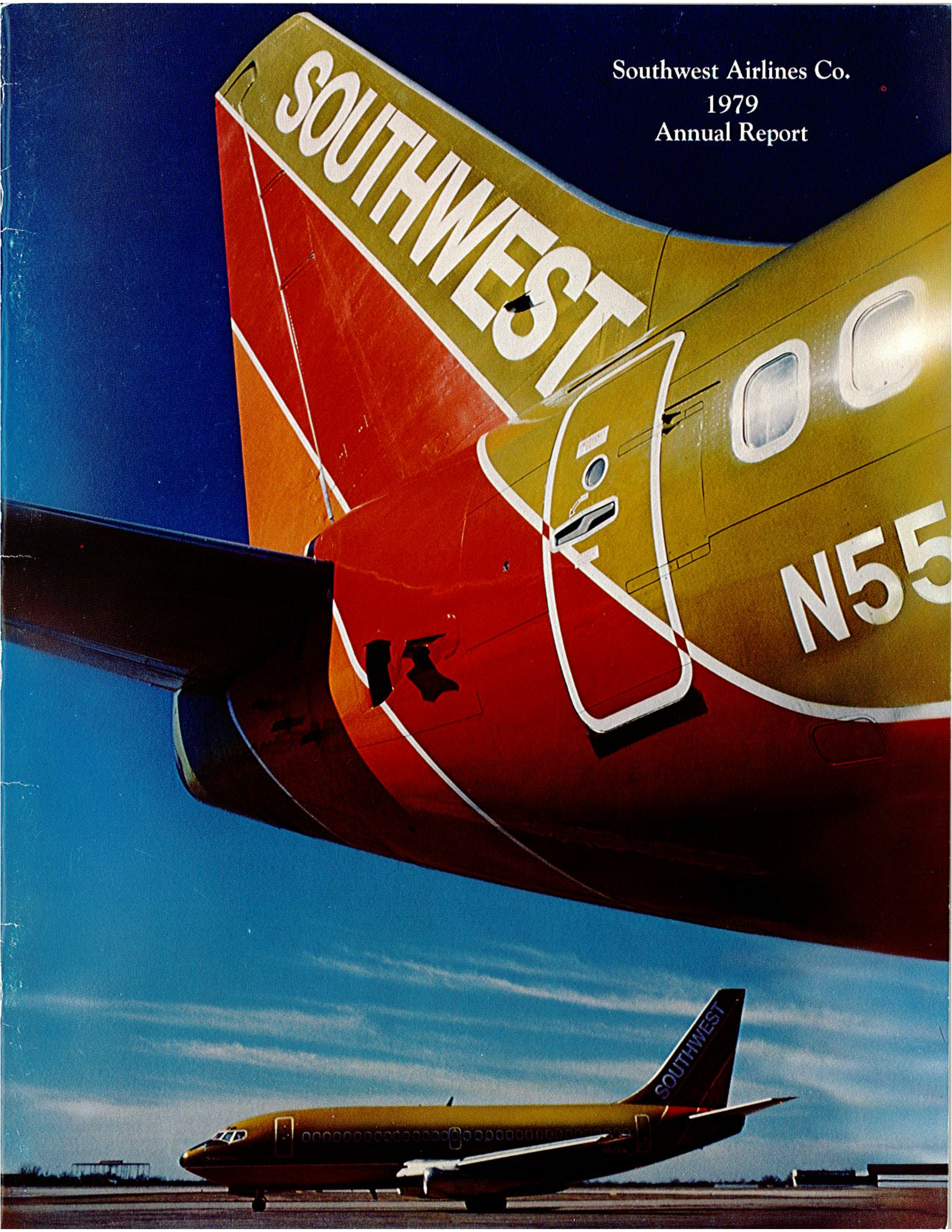
Southwest Airlines Co.
1979
Annual Report



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Southwest Airlines Co. is dedicated to serving short-haul, commuter markets 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 crew domicile and maintenance facility in Dallas
- 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
- 1600 employees, working hard and enjoying providing a high-quality service

Focus on Passenger Business

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

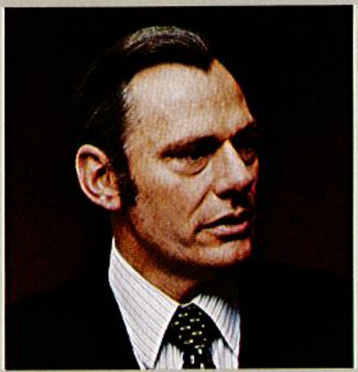
Serving Short-Haul, Mass Transit Commuter Markets

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

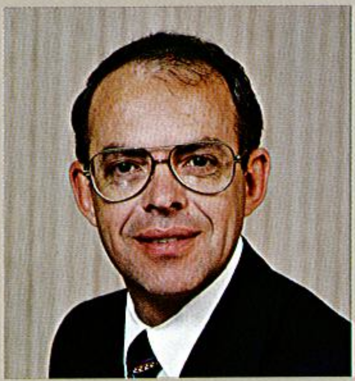
Highlights

	1979	1978	Percent Change
OPERATING DATA			
Trips operated	75,837	54,816	38.3%
Passengers carried	5,000,086	3,528,105	41.7
Passenger miles flown (000)	1,585,539	1,048,624	51.2
Available seat miles flown (000)	2,320,371	1,556,173	49.1
Passenger load factor	68.3%	67.4%	1.3
Average revenue per passenger mile	8.23¢	7.40¢	11.2
Number of employees at year-end	1,630	1,119	45.7
INCOME DATA			
Operating revenues	$136,114,000	$ 81,065,000	67.9%
Operating expenses	107,128,000	59,943,000	78.7
Operating income	28,986,000	21,122,000	37.2
Income before gain on disposition of aircraft and federal income tax	20,714,000	15,434,000	34.2
Income before accounting change —			
Amount	$ 16,652,000	$ 16,269,000	2.4
Per share	$ 3.70	$ 3.62	2.4
Net Income —			
Amount	$ 16,652,000	$ 17,004,000	(2.1)
Per share	$ 3.70	$ 3.78	(2.1)
Average shares outstanding	4,500,000	4,500,000	—
FINANCIAL DATA			
Working capital	$ 8,195,000	$ 9,667,000	(15.2)%
Flight and ground equipment - net	150,576,000	104,744,000	43.8
Capital expenditures	54,314,000	40,204,000	35.1
Stockholders' equity	58,412,000	42,889,000	36.2
Long-term debt/equity	1.50/1	1.45/1	N/A
Book value per share	$ 12.98	$ 9.53	36.2

Letter To Stockholders



Herbert D. Kelleher



Howard D. Putnam

HIGHLIGHTS OF 1979

An increase of 37.2% in operating income • revenues of $136,000,000 • 5,000,000 passengers boarded • expansion into interstate markets • achievement of a legislative compromise on Dallas Love Field air service • a 90.1% increase in the cost of jet fuel • $70,000,000 of long-term debt financing at attractive fixed interest rates • delivery of five new Boeing 737-200 advanced series aircraft • in all, a very difficult but most successful year.

PROFITABILITY

Our operating revenues were $136,114,000, up 67.9%, and our operating income was $28,986,000, up 37.2% despite the rapid escalation of fuel costs, labor costs and interest rates. Effective February 23, 1979, your Board of Directors approved a 3-for-2 stock split, increasing our shares outstanding to 4,500,000. Earnings per share in 1979 were $3.70, compared to $3.78 in 1978, adjusted for the 1979 split. The total earnings per share of $3.78 in 1978 included a $4,456,000 gain, net of taxes, from the disposition of aircraft plus $735,000 from the net cumulative effect of an accounting change, or $1.15 per share. Without these two nonrecurring items, our 1978 earnings per share would have been $2.63. The 1979 earnings of $3.70 thus represent a 40.7% increase over the 1978 net earnings per share, excluding nonrecurring gains.

Because of the excellent operating results of your Company in 1979, coupled with good prospects for 1980, on February 26, 1980 your Board approved a 14.3% increase in the anticipated annual dividend rate, from $.28 to $.32 per share.

TRAFFIC

A record 5,000,000 passengers were boarded, up 41.7% from 3,528,000 in 1978. Revenue passenger miles increased 51.2% to 1.586 billion. Our load factor was 68.33%, up from 67.38% in 1978, and our average revenue per passenger mile increased by 11.2% to $.0823, by the end of 1979.

FUEL

In 1978, fuel was 27.5% of our operating costs and 25.2% of our total costs. In 1979, a 90.1% increase in average price per gallon drove fuel to 35.1% of our operating costs and 32.5% of our total costs.

Although we were required to purchase approximately one-third of our fuel on the spot market in 1979, we held our average price per gallon at the industry average as the result of an excellent fuel purchasing effort. Because our fares are substantially below the CAB's Standard Industry Fare Level, even as modified downward in some of our markets by the lower, former intrastate fare level, we were, and are, able to secure fare increases on as little as one day's notice in order to offset fuel price and other cost increases. Thus, we did not experience in 1979, and do not anticipate experiencing in 1980, any diminution in earnings caused by an enforced regulatory time lag between the time of jet fuel price increases and the implementation of offsetting fare increases.

No flights were cancelled during 1979 as a consequence of the unavailability of fuel, although certain schedule modifications and flight speed limitations were adopted in order to curb its consumption. We have not experienced any fuel shortages thus far in 1980.

LONG-TERM FINANCING

In 1979, we completed two major financing transactions. These provided us long-term financing for our aircraft acquisitions and funds for general working capital purposes. The first transaction was the private placement of 15-year, 10.3% fixed-rate Equipment Trust Certificates totaling $70,053,000, or approximately 80% of the cost of ten Boeing 737-200 aircraft. Seven of these aircraft are now in operation; the remaining three will be delivered in the first quarter of 1980. The second transaction was the restructuring of our bank loan agreement to a $54,000,000 Revolving Credit Agreement which includes a 2-

year renewable revolving credit followed by a 6-year term loan. The interest rate on this debt floats at the prime rate. Total borrowings against this credit at December 31, 1979 were $42,000,000, thus providing us with access to an additional $12,000,000 of working capital not reflected in our financial statements.

We believe these combined financings represent a major step in the growth of Southwest. They will allow us greater flexibility to further serve existing market demands and address new market opportunities. The financings better match the maturity of our debt with the anticipated economic life of our aircraft and will also yield us a lower combined effective interest rate in today's volatile money markets.

OPERATIONS

We continued our high level of aircraft utilization, averaging 11 hours and 37 minutes per aircraft daily. We flew a total of 75,837 trips in 1979, up 38.3% over 1978.

We were pleased with the results of a *Texas Business* magazine poll, as set forth in the February 1980 issue:

> "In December, TEXAS BUSINESS asked a cross-sampling of its subscribers to rate the services of the seven airlines they flew most often. *The airline they singled out overwhelmingly in overall performance is Dallas-based Southwest Airlines.* More than 90 percent of those polled judged the overall quality of this airline as excellent or good."

Despite this encouraging endorsement, we are taking steps to improve our on-time performance in 1980. We consider our reputation and credibility with our customers for reliability, as well as low fares, of the utmost importance.

FLEET

We began 1979 with 13 Boeing 737-200 advanced jet aircraft with an average age of 18 months. During the year, we added five new B-737-200's at a cost of $44,159,000, bringing our total fleet to 18 owned aircraft. We also leased, from March 1, 1979 to January 12, 1980, one B-727-200 aircraft. Our plan for the intermediate term is to continue with only one type of aircraft, the B-737. Future orders include three B-737's to arrive on March 27, 1980, and three more in late 1980 or early 1981. We have options on six more 737's for 1982. A decision on these will be made in mid-1980 after further evaluations of fuel costs and traffic growth are completed.

During 1979 all aircraft were equipped with new slimline seats which added six seats per aircraft, bringing the total to 118, an increase of 5%. We retained our popular lounges.

INTERSTATE ROUTES

In our eighth year of operation, we crossed the Texas border with scheduled service between Houston-New Orleans and Dallas Love Field-New Orleans. We, and our wholly-owned subsidiary, Midway (Southwest) Airway Co., also received a number of other interstate route awards from the Civil Aeronautics Board (CAB), all of which are permissive in nature and need not be flown in order to be retained.

The CAB ruled that our entire route system was subject to its regulatory jurisdiction, but also held that we need not interline passengers with other airlines nor offer joint fares, thereby permitting us to continue to operate in our accustomed intrastate mode as primarily a low fare, point-to-point, commuter airline specialist.

Your Company became a CAB air carrier because of the latitude for competition in interstate markets afforded by passage of the Airline Deregulation Act of 1978, coupled with a favorable attitude on the part of the CAB and its staff towards such competition. Southwest has been able to obtain new interstate routes with relative ease and to increase its fares on short notice, while maintaining its traditional peak and off-peak fare structure at levels considerably below the Standard Industry Fare Level established by the CAB. In addition, the CAB and its staff have granted the Company a number of specific exemptions and classifications which have facilitated and eased the transition from a TAC (Texas Aeronautics Commission) carrier to a CAB air carrier. The Company reached the conclusion in the latter part of 1978 that, under the Deregulation Act as administered in a more permissive regulatory environment, the additional burdens of federal economic regulation would be outweighed by the additional opportunities to provide new, interstate services. Thus far, the Company believes that judgment to have been correct.

LOVE FIELD SERVICE

During 1979, the CAB issued a certificate to Southwest confirming its authority to serve its intra-Texas routes originally granted by the TAC, including the right to use Dallas Love Field in conjunction with such service.

In February 1980, after a "donnybrook" in the Congress of the United States, federal legislation was enacted which authorizes, under certain conditions met by Southwest, air service between Love Field and any points in the four adjacent states of Arkansas, Louisiana, New Mexico, and Oklahoma. This legislation also validates Southwest's right to continue its Love Field-New Orleans air service, which had been the subject of an appeal to the District of Columbia Circuit Court of Appeals.

After several months of battle in the Congress, we reluctantly accepted the Love Field compromise as the best obtainable under the prevailing political circumstances. Our right to serve Love Field as long as it remains open as an airport is now established as a matter of federal law, and we expect that the extremely heavy expenses, in time and money, incurred during the past seven years in order to assert and defend that right will cease. The contemplated net effect of the Love Field compromise is that we will defer inauguration of Chicago Midway Airport

continued

Service; emphasize Houston as the Texas hub for our interstate operations because of the unlimited interstate destinations available from that city; and focus more closely upon the economic potential of air service between Love Field and smaller cities in the four states adjoining Texas.

LABOR NEGOTIATIONS

We were unable to reach agreement on a new contract with the International Association of Machinists, who represent 106 mechanics, stock clerks, and cleaners, after nearly seven months of negotiation. We had no choice, in order to protect the future of your Company, but to take a strike on January 13, 1980. Again, however, the spirit and pride of Southwest's employees rose to the occasion, and they, along with management, kept the airline operating with twelve of our eighteen 737's providing scheduled service to every city in our system. Six days later, the IAM agreed to our pre-strike offer, and a three year contract was later signed.

We have no labor contracts subject to negotiation during 1980.

OUTLOOK 1980

After a strong 1979 spring, summer, and fall due to the healthy economy of Texas and a shortage of automobile gasoline, we experienced a slight softening in December and January traffic, which appears to be abating in February, 1980. We took immediate action to cancel about 10% of our daily departures from December 10 to February 1, 1980, saving approximately 1,500,000 gallons of fuel. In addition, we reduced our flying speed slightly in order to save approximately 45 gallons of fuel per flight, or an anticipated savings of $4,000,000 in 1980.

Subject to timely receipt of CAB approval, on April 1, 1980 we will, in keeping with our philosophy, inaugurate new, short-haul service between Dallas Love Field and Oklahoma City 14 times daily; on April 2 between Love Field and Tulsa 14 times daily; and on April 3 between Love Field and Albuquerque 8 times daily. We are excited about these new cities; their potential revenue contributions; and the opportunity to serve neighbors adjacent to our home State of Texas. We have been warmly received in advance by all three.

During the past year, we've had three fare increases: 7% in July 1979; 12% in September 1979; and 10% in January 1980. We are concerned about rising fares, and our goal is to keep fares as low as possible. Unfortunately, fuel costs necessitated increases. The position of our fares relative to those of competing carriers remains unchanged. We're still, on average, 40-50% below their unrestricted, standard coach offerings.

We believe 1980 can be a strong growth year, even with the adversities of fuel and the economy, because of our short-haul strengths; our commuter, mass transit market niche; our continued stress on simplicity; the high productivity of our aircraft and facilities; our location in the Sunbelt, and, most importantly, the productivity of over 1,600 great employees who, in 1979, added 18.1% to their annual incomes through Southwest Airlines' profit sharing plan. Barring presently unforeseen developments, all of this signifies to us that we enter 1980 in a different position from much of the airline industry. We are all committed to continuing to give our customers the best value and most friendly service possible, and we expect this policy to continue to produce increased earnings for our shareholders in 1980.

Sincerely yours,

Herbert D. Kelleher

Herbert D. Kelleher
Chairman of the Board

Howard D. Putnam

Howard D. Putnam
President and Chief Executive Officer

February 22, 1980

Top: SWA reservations agent Betty Johnson is taking one of the nine million telephone calls in the Arlington Reservations Center.

Bottom: SWA ticket agent Janette Owen, completes a ticketing transaction in Dallas, where 1,549,422 passengers were boarded in 1979.

Description of Business

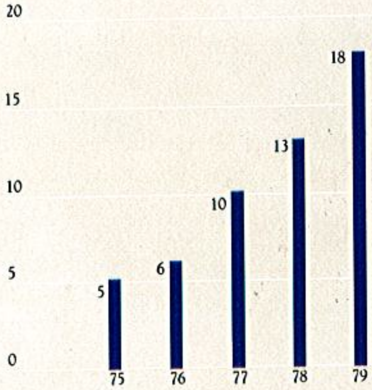
Southwest Airlines Co. provides a single-class commuter-type service principally between major cities in Texas. Initial operations of the Company began on June 18, 1971. Southwest operates scheduled air service, currently utilizing 18 owned Boeing 737-200 advanced series, 118-seat aircraft, between Houston, Dallas, San Antonio, the Lower Rio Grande Valley (served through Harlingen Airport), Austin, Corpus Christi, El Paso, Lubbock, Midland/Odessa, and Amarillo. In January 1979, it commenced service between Houston and New Orleans and in September 1979 between Dallas and New Orleans. Service between Dallas and Beaumont/Port Arthur/Orange began March 5, 1979. Southwest is the sole carrier offering service over its routes from the close-in airports of Dallas (Love Field) and Houston (Hobby).

Prior to December 1978, Southwest operated as an intrastate airline, subject to economic regulation only by the Texas Aeronautics Commission ("TAC"). In December 1978, as a result of its obtaining authority to extend service interstate to New Orleans, Southwest became subject to the jurisdiction of the Civil Aeronautics Board ("CAB"). The CAB has taken the position that such authority gives it plenary jurisdiction to regulate Southwest's entire system, thereby preempting any further economic regulation by the TAC. Under the Federal Aviation Act, as amended by the Airline Deregulation Act of 1978, the preexisting authority granted Southwest by the TAC to serve Texas routes (including Love Field and Hobby) is now part of its Federal authority, subject to any subsequent CAB action. Southwest was granted a CAB certificate covering such routes on November 15, 1979. It applied to the CAB for total or partial exemption of its route system from CAB regulation, which was denied on July 6, 1979.

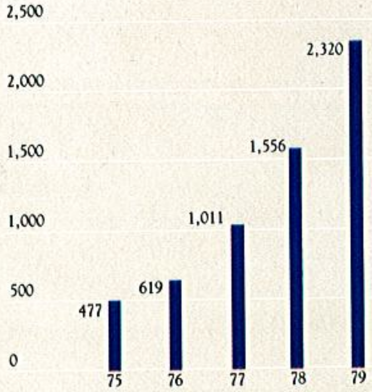
Southwest does not carry the United States mail, interline passengers, or engage in carrying air freight (other than small packages).

Southwest currently employs approximately 1600 employees.

Fleet Size
(Boeing 737-200's)

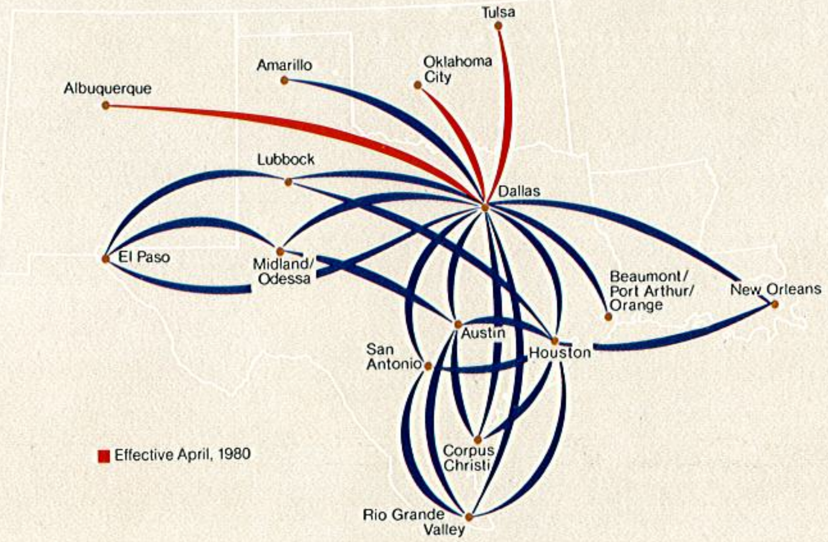


Available Seat Miles
(In Millions)



Passenger Load Factor

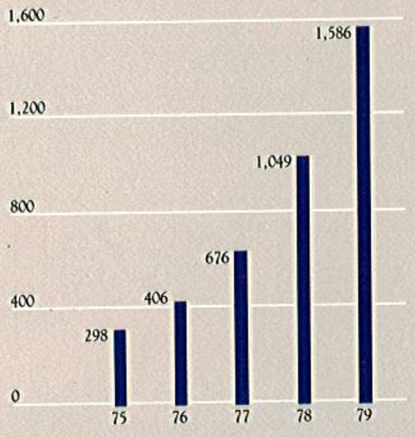
Southwest Airlines Co. Route Map



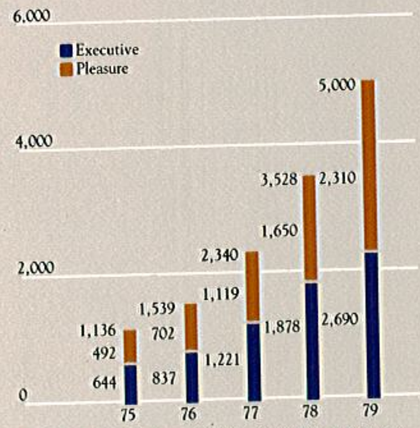
An engine check is performed on a Pratt & Whitney JT8D-9A engine by mechanics Karson Druckamiller and Asher Bell.

Review of Operations

Revenue Passenger Miles
(In Millions)

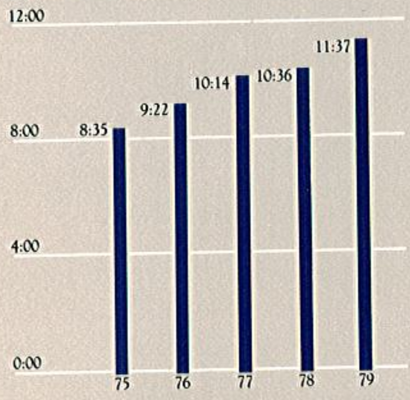


Revenue Passengers Carried
(In Thousands)



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)



In today's rapidly changing economic environment with continuing significant energy cost increases, the judicious matching of aircraft with an airline's route structure has become increasingly important. Also, the cost efficient use of the airline's fleet and the productivity of its operations is becoming more important.

FLEET

In 1979, Southwest added five new Boeing 737-200 advanced series aircraft to its fleet, bringing its total fleet to 18 owned aircraft. This aircraft offers the best fuel efficiency of any jet transport aircraft currently available for Southwest's route structure. In addition to its fuel efficiency, the 737 offers an economic combination of high passenger acceptance, quietness, optimum capacity for commuter markets, and requires minimal ground equipment support.

Southwest's fleet, which had an average age of 23 months at December 31, 1979, continues to be one of the youngest jet aircraft fleets in the airline industry.

During 1979 the entire fleet was converted from 112 to 118 seat configuration, while retaining the popular lounge areas. This increase in capacity is equivalent to approximately one additional aircraft at a capital requirement of only 13.6% of the cost of a new 737.

For the eighth consecutive year, Southwest increased the daily utilization of its fleet, thereby continuing its leadership role in the industry for efficient use of capacity. Aircraft utilization reached 11 hours 37 minutes per day, up 9.5%. This utilization was achieved despite an average flight segment time of only 53 minutes. During 1980 however, to improve on-time performance in certain markets where air traffic delays are experienced, utilization will be dropped slightly.

ROUTES

In 1979 Southwest expanded its cities served to 12. Service between New Orleans and Houston was initiated on January 25, followed by the initiation of direct service between New Orleans and Dallas on September 28, 1979. Service to Beaumont/Port Arthur/Orange was started on March 5, 1979.

The addition of these new routes, plus the fleet expansion, generated available seat miles of 2,320,371,000, up 49.1% from 1978.

Subject to timely receipt of CAB approval, service will be inaugurated in April, 1980, to Oklahoma City, Oklahoma; Tulsa, Oklahoma; and Albuquerque, New Mexico. These interstate routes fit Southwest's market criteria well and should provide excellent growth opportunities because of the continuing strength of our regional economy and the importance of these new routes within the energy industry.

TRAFFIC

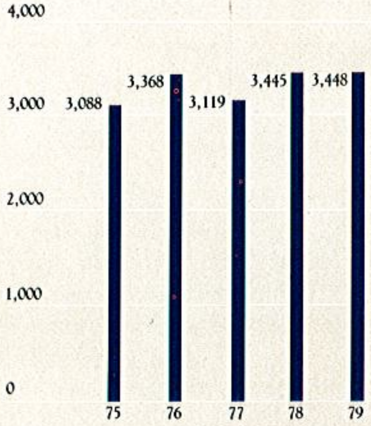
Revenue passenger miles, a key airline performance indicator, increased 51.2%, to 1,585,539,000, from the 1978 level of 1,048,624,000. A total of 5,000,000 passengers were carried in 1979, a 41.7% increase. These traffic statistics yielded a slight increase in the load factor from 1978 to 1979. The 1979 load factor of 68.33% continues to single out Southwest as one of the industry leaders in operating efficiency and asset utilization.

Over 8,500,000 pieces of baggage were handled in 1979 by SWA ramp personnel. Pictured is Dwayne Thomas, Chief Ramp Agent — Dallas.


DANGER

Review of Financial Performance

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



In 1979, Southwest Airlines continued its history of significant financial performance improvements. Revenues, operating income, dividends, and stockholders' equity grew to record levels. Two important financing transactions were completed and Southwest continued its pace-setting performance in cost control and productivity, which helped to mitigate a 90.1% increase in the cost per gallon of jet fuel from year end 1978 to year end 1979.

REVENUES AND CASH FLOW

Revenues in 1979 increased 67.9% to $136,114,000, compared to $81,065,000 in 1978. Total working capital from operations declined slightly to $29,357,000, down 3.9% from $30,556,000 in 1978, which included $8,522,000 of nonrecurring gains resulting from the disposition of aircraft. Long-term debt increased $57,865,000 to provide a total source of funds of $87,222,000.

As in prior years, improved financial performance resulted from Southwest's emphasis on planned, controlled growth within the business strategy outlined in the front of this report. Through the combination of high levels of asset utilization, strong employee productivity, and emphasis on cash flows, Southwest's long-term financial strength can continue to improve, while providing projected increases in both earnings and dividends.

CAPITAL EXPENDITURES

Total capital expenditures were $54,314,000 in 1979, an increase of 35.1% from the 1978 level of $40,204,000. The 1979 delivery of five Boeing 737-200 advanced series aircraft, plus deposits and progress payments on future aircraft deliveries, account for approximately 86.4% of the total capital expenditures. The remaining capital expenditures were principally for station improvements and support equipment related to route and schedule expansions.

During 1979, the corporate offices were moved to Dallas Love Field to provide an efficient consolidation with our flight departments, maintenance base and largest station.

CAPITALIZATION AND FINANCING

Two significant financing transactions were completed in 1979. The first transaction was the private placement of $70,053,000 of Equipment Trust Certificates covering ten aircraft, the last three of which will be delivered in the first quarter of 1980. These certificates bear a fixed rate of interest of approximately 10.3% and have a 15 year maturity. This successful financing is Southwest's first placement of debt in the long-term credit markets.

The second transaction was the restructuring of the previous bank loan agreement into a Revolving Credit Agreement. This $54,000,000 credit facility includes a 2-year renewable revolving credit followed by a 6-year term loan. The interest rate on the revolving credit agreement floats at the prime rate. Additional details of these transactions are outlined in the notes to the financial statements.

The completion of these transactions is a significant financial milestone for Southwest Airlines. First, a major portion of total long-term debt now bears an attractive fixed rate of interest, thus reducing the vulnerability of earnings to fluctuations in the prime rate. Second, the average life of debt outstanding was substantially lengthened from 3.48 to 6.32 years, thus yielding a better match between the economic life of the asset and its financing. Third, the revolving credit provides greater flexibility in the management of working capital, an important factor in a time of volatile money markets. This flexibility is reflected in the utilization of cash flows to reduce prime-related debt during the second

One of SWA's 5,000,086 passengers during 1979 purchases his ticket with a major credit card from a new automatic ticketing machine.


SOU
Tickets
SOUTHWEST AIRLINES

half of 1979. Working capital decreased slightly from prior year levels due to the execution of a strategy of using current assets to make maximum reductions in long-term bank debt as the prime rate began to increase rapidly. At the end of 1979, an additional $12,000,000, which is not included in the financial statements, was available from the revolving credit.

Because of 1979's solid growth in operating income, long-term debt as a percentage of total invested capital increased only slightly from 59.1% at year-end 1978 to 59.9% at year-end 1979, despite the additions to debt outlined above.

STOCKHOLDERS' EQUITY

Stockholders' equity increased 36.2% during 1979 to $58,412,000 from $42,889,000 at the beginning of the year. Return on stockholders' equity was 33.1% during 1979 compared to 50.3% in 1978. In 1978, however, nonrecurring gains on the disposition of aircraft generated an uncommonly high return. The 1978 and 1979 returns on equity are approximately equal after excluding the nonrecurring items from 1978 results.

On February 23, 1979, a 3-for-2 stock split was approved by the Board of Directors resulting in 4,500,000 shares outstanding. This stock split generated an effective 50% increase in the dividend rate. On February 26, 1980, the quarterly dividend was further increased 14.3% from $.07 to $.08 per share.

Book value per share during 1979 increased 36.2% from $9.53 to $12.98.

FUEL COSTS AND FARE INCREASES

Catastrophic fuel cost increases began in February 1979 following the decontrol of jet fuel and disruptions in the availability of foreign crude oil supplies. Outlined below is the history of fuel price increases over the past two years:

	Average Price Per Gallon	Cumulative % Increase
1978		
First Quarter	37.85¢	
Second Quarter	38.00¢	0.4%
Third Quarter	38.71¢	2.3%
Fourth Quarter	38.26¢	1.1%
Year	38.22¢	1.0%
1979		
First Quarter	39.45¢	4.2%
Second Quarter	55.25¢	46.0%
Third Quarter	66.90¢	76.8%
Fourth Quarter	70.98¢	87.5%
Year	59.35¢	56.8%

Although Southwest experienced no flight cancellations due to unavailability of fuel, fuel increased from 27.5% of operating expenses in 1978 to 35.1% in 1979. During 1979, Southwest purchased approximately one-third of its fuel on the spot market, due to limitations in fuel contracts arising from previously mandated fuel allocations.

As a result of these rapid fuel cost increases, Southwest was forced to increase its fares twice during 1979, once in July by 7% and again in September by 12%. However, the comparative value of transportation offered by Southwest in relationship to other carriers and alternative means of ground transportation did not deteriorate and, in some instances, even improved. It is Southwest's current intention to pass through in the form of fare increases all increases in the cost of jet fuel. However, the goal of Southwest is to provide the best transportation value available. To minimize these fare increases due to jet fuel costs, fuel conservation measures and stringent cost controls on other operating expenses will continue to be stressed.

COST STRUCTURE AND PRODUCTIVITY

During 1979 operating revenues increased 67.9% compared to an operating expense increase of 78.7%. This disparity resulted from the jet fuel cost increases outlined above and was mitigated by productivity gains. The Company's emphasis on employee productivity remains a primary point of difference between Southwest and the remainder of the airline industry.

Passengers boarded per employee, an important indicator of productivity, improved slightly in 1979 over the record setting 1978 level. Operating revenues per employee exhibited similar improvement, reaching $93,872 for the year 1979. The effect of the combination of high asset utilization and employee productivity on Southwest's unit cost per available seat mile is outlined below.

Category of Costs	Unit Cost Per Available Seat Mile 1979	1978	Percentage Increase (Decrease)
Aircraft fuel and oil	1.62¢	1.06¢	52.8%
Payroll and related	1.40	1.27	10.2%
Landing fees	.14	.14	—
Aircraft costs	.93	1.01	(7.9)%
All other	.53	.37	43.2%
Total operating costs	4.62¢	3.85¢	20.0%

Total unit costs increased 20.0%. Excluding fuel, operating expenses increased only 7.5%, however.

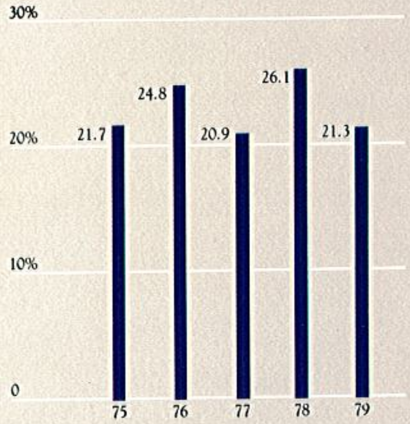
Once again, in 1979 the emphasis placed on stringent cost controls, productivity and cost effectiveness enabled Southwest to contain increases in operating costs excluding fuel below the rate of inflation.

INCOME TAXES

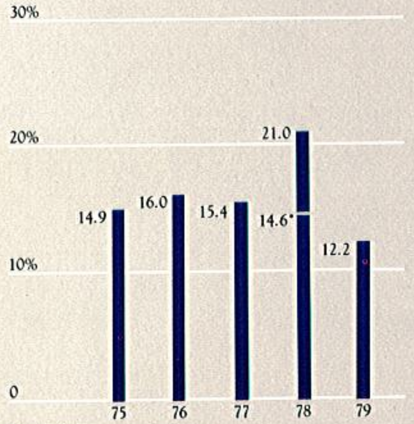
Federal income taxes provided for in 1979 were $4,062,000, resulting in an effective tax rate of 20%. The difference between the actual tax rate and the 46% statutory rate is primarily due to the $4,915,000 of current year investment tax credits generated from the acquisition of five new aircraft which were placed in service during 1979, along with other qualified capital additions. Also lowering the 1979 effective rate was $873,000 of additional investment tax credit as an in-

Flight Attendant Sandra Force serves one of the 1,093,464 complimentary cocktails served on executive class flights in 1979.

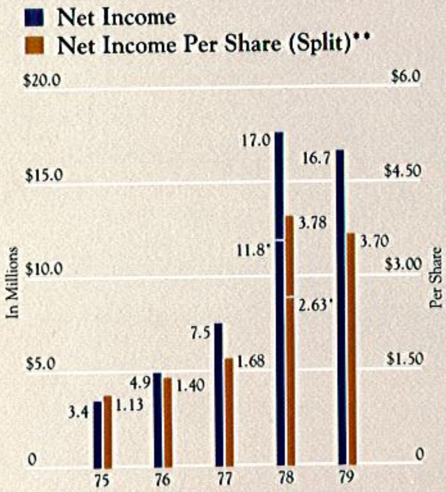
Net Operating Margin
(Operating Income as a Percentage of Operating Revenues)



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



*Excluding nonrecurring items.



*Excluding nonrecurring items.
**All per share net income figures have been restated to reflect a 3-for-2 stock split in 1979.

centive for instituting implementation of an Employee Stock Option Plan.

Deferred income taxes at December 31, 1979 were $12,919,000, 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 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 6 to the financial statements.

NET INCOME

Operating income increased 37.2% from $21,122,000 in 1978 to $28,986,000 in 1979.

Earnings per share in 1979 were $3.70 compared to $3.78 in 1978, after adjustment for the 1979 stock split. Included in the $3.78 in 1978 were a $4,456,000 gain net of tax from the disposition of aircraft plus $735,000 from the net cumulative effect of an accounting change for certain maintenance expenditures. These two items were the equivalent of $1.15 per share. Excluding these two nonrecurring items, our 1978 earnings per share would have been $2.63. Thus, the 1979 earnings of $3.70 represent a 40.7% increase over the 1978 net earnings, excluding nonrecurring items.

The net operating margin was 21.3% of total revenues, a decline from the all-time high generated during 1978. This decrease is primarily the result of the previously discussed accelerating increases in the cost of jet fuel.

The net profit margin likewise declined to 12.2% as a result of both the accelerating fuel cost increases experienced, and the impact during 1978 of the nonrecurring items outlined above.

PROFIT SHARING CONTRIBUTIONS

Southwest's employees receive a significant, meaningful incentive for their contributions to productivity and hence profitability. During 1979, the Employee Profit Sharing Plan added an average of 18.1% to the compensation of each employee in the Plan. The total contribution to the Plan, as defined by the Plan's contribution formula, was $3,430,000 for 1979, an increase of 46% from 1978.

During 1979, Southwest also adopted an Employee Stock Ownership Plan which, under federal tax laws, allows Southwest to claim an additional one percent investment tax credit if this amount is invested in Southwest stock on behalf of employees. An additional contribution and investment tax credit of $873,000 resulted from this Plan in 1979.

QUARTERLY EARNINGS STATEMENTS

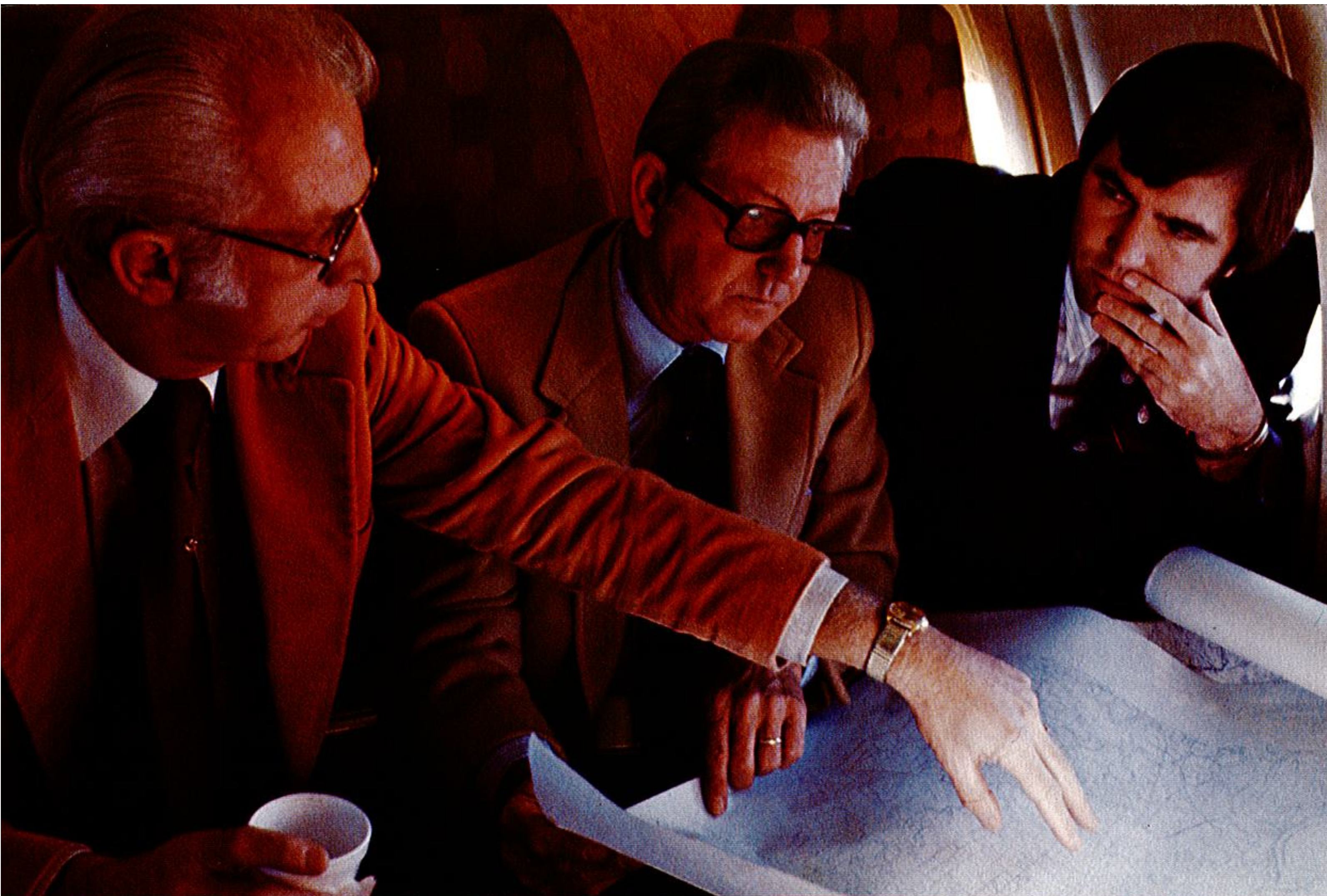
Unaudited quarterly financial results are outlined in Note 7 to the financial statements.

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 three-for-two stock splits in March 1978 and February 1979, were:

Period	Dividend	High	Low
1978			
1st Qtr . . .	$.0311	$12.58	$10.44
2nd Qtr . .	.0467	15.50	10.42
3rd Qtr . . .	.0467	20.33	13.67
4th Qtr . .	.0467	17.92	12.58
1979			
1st Qtr . . .	.07	19.88	13.50
2nd Qtr . .	.07	22.38	18.00
3rd Qtr . . .	.07	26.00	19.50
4th Qtr . .	.07	25.00	19.63
1980			
1st Two Months . .	.08	23.50	19.00

2,690,146 passengers flew on executive class flights in 1979.



Management's Discussion and Analysis of the Summary of Operations

Following is management's discussion and analysis of the consolidated statement of income as required under Rule 14a-3 of the Securities and Exchange Commission.

1979 COMPARED TO 1978

Revenues

Revenues for 1979 increased by 68% over those in 1978. This increase resulted largely from a 51% increase in revenue passenger miles (RPM's) and general fare increases of 7% and 12% which were implemented in July and September 1979, respectively. The increase in RPM's is primarily attributable to the added capacity created by the addition of five Boeing 737-200 aircraft to Southwest's fleet in 1979 and the use of one Boeing 727-200 which Southwest leased for part of the year. This capacity, as measured in available seat miles (ASM's), was 49% greater than that available in 1978. In addition, during 1979 all of Southwest's aircraft were converted from a 112 seat to a 118 seat configuration. Thus, these capacity increases, when combined with a slight increase in load factor and a fairly substantial increase in aircraft utilization, yielded the overall increase in revenue passenger miles flown.

Operating Expenses

Operating expenses increased by 79% from 1978 to 1979. The primary factors contributing to this rise were a 38% increase in the number of trips flown and substantial increases in the average cost of jet fuel. With its expanded fleet of aircraft Southwest flew 21,000 more trips in 1979 than in 1978. Rising prices of fuel during 1979 drove the per trip cost of fuel up by 65% over 1978 levels. The combined effect of more trips and higher jet fuel costs resulted in 1979 total fuel costs being 128% higher than those incurred in 1978.

Operating Income

Operating income in 1979 increased by 37% over 1978.

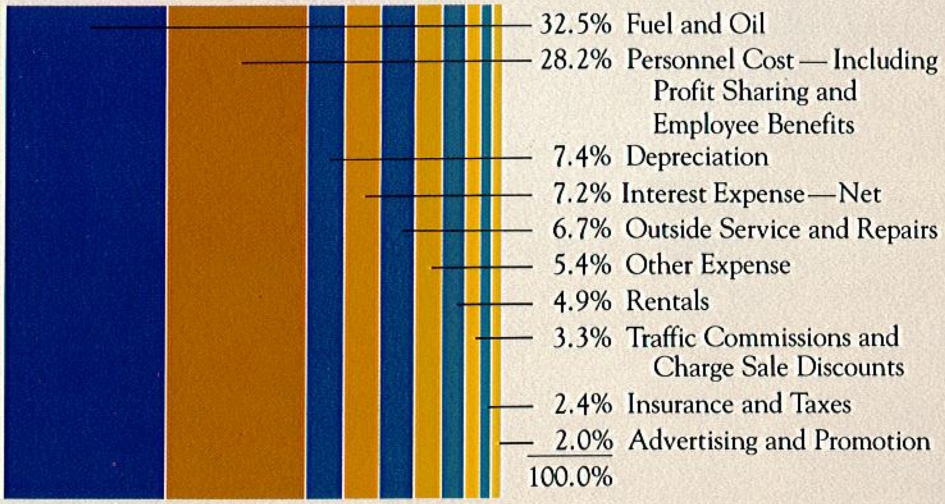
Interest Expense

Interest expense increased by 48% over 1978. This resulted from successive increases in the prime interest rate to which 48% of the Company's debt at year-end was tied and a net addition of $27,865,000 of long-term debt incurred in financing the five new aircraft acquired in 1979.

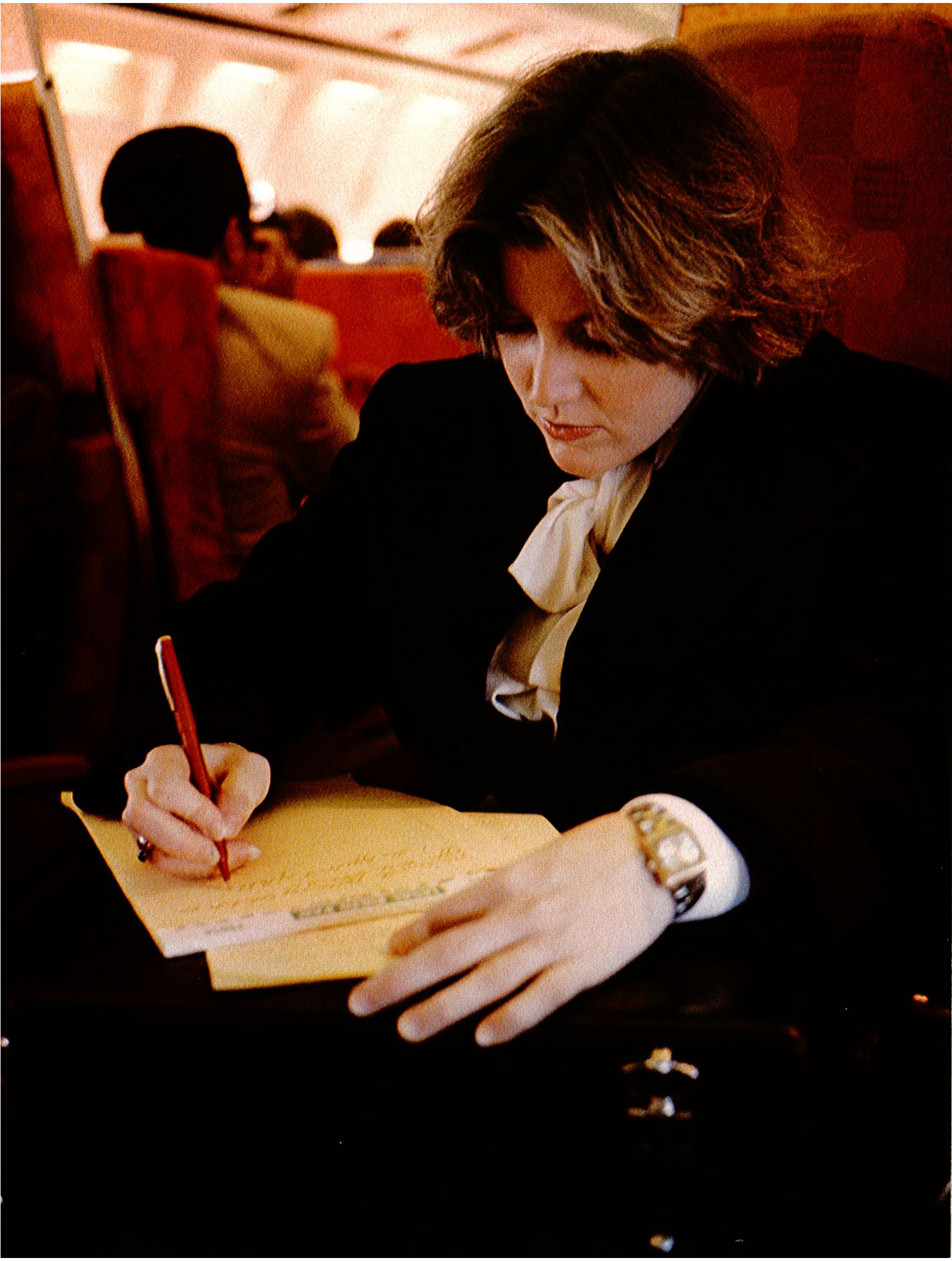
Federal Income Tax

The total tax provision for 1979 was $4,062,000, a decrease of 47%. In

Distribution of Expenses — 1979



Passengers enjoy working in the convenient lounge areas located in each aircraft.



1979 federal income taxes of $9,850,000 were offset by investment tax credits of $5,788,000 which included $873,000 generated by the adoption of an Employee Stock Ownership Plan in 1979. This yielded an effective tax rate for 1979 of 20% compared to the 1978 effective tax rate of 32%.

Net Income

Partially as a result of the factors outlined above, net income for 1979 decreased by 2% as compared to 1978. However, 1978 included $5,191,000 of aftertax gain resulting from two nonrecurring items: a gain on the disposition of aircraft (including three non-advanced series Boeing 737's) and the cumulative effect of a change in accounting for maintenance expenses. From this perspective, 1979 net operating income increased by 41% over that of 1978, excluding 1978's nonrecurring items.

1978 COMPARED TO 1977

Revenues

Revenues for 1978 increased by 65% over those in 1977. The increase resulted largely from a 55% increase in revenue passenger miles and a general fare increase of 11.5% which was implemented in July 1978. The increase in RPM's is primarily attributable to added capacity from the net addition of three aircraft to Southwest's fleet in 1978. The capacity as measured in ASM's was 54% greater in 1978 than that available in 1977. Thus, these capacity increases, when combined with slight increases in load factor and aircraft utilization, yielded the overall increase in revenue passenger miles flown.

Operating Expenses

Operating expenses increased by 55% from 1977 to 1978. The primary factors contributing to this rise were an increase in the number of trips flown and an increase in the average cost of jet fuel. With its expanded fleet of aircraft Southwest flew 55% more trips in 1978 than in 1977. Rising prices of fuel during 1978 increased the per trip cost of fuel by 5% over 1977 levels.

Operating Income

Operating income in 1978 increased 106% over 1977.

Interest Expense

Interest expense increased by 111% over 1977. This resulted from successive increases in the prime rate to which 50% of the Company's long-term debt was tied and the addition of $15,000,000 of new debt incurred in the acquisition of the new aircraft.

Federal Income Tax

Federal income taxes in 1978, generated from operating income and the gain on disposition of aircraft totaling approximately $11,462,000, were offset by investment tax credits of $3,775,000, while in 1977 the tax liability was totally offset by investment tax credits.

Net Income

Net income for 1978 increased by 125% over 1977. 1978 net income includes $4,456,000 in aftertax gains on the disposition of three aircraft and $735,000 cumulative effect of a change in accounting for maintenance expenses. Excluding these nonrecurring items, net income for 1978 increased by 57% over that of 1977.

Top: Southwest First Officer Ken Crowder visits with one of the "future pilots" who frequently fly unaccompanied on SWA flights.

Bottom: SWA is famous for its 10-minute turnarounds. Pictured, front to back, are Don Overturf, Joe Nelson, and Ray Navarro in the Dallas operations office who help make this possible.


GATE 4
GATE 3

Five Year Summary of Operations and Financial Results

	Years ended December 31,				
	1979	1978	1977	1976	1975
OPERATIONS AND TRAFFIC					
Revenue plane miles	**20,055,990**	13,894,400	9,027,213	5,524,395	4,309,478
Available seat miles (000)	**2,320,371**	1,556,173	1,011,048	618,732	477,166
Trips flown	**75,837**	54,816	35,415	22,311	17,552
Average length of flight segment	**264**	253	255	248	246
Size of B-737 fleet at year-end	**18**	13	10	6	5
Passengers carried	**5,000,086**	3,528,105	2,339,524	1,539,113	1,136,318
Revenue passenger miles (000)	**1,585,539**	1,048,624	675,668	406,269	298,458
Average passenger fare	**$ 26.10**	$ 21.99	$ 20.07	$ 19.18	$ 19.07
Yield per passenger mile	**8.23¢**	7.40¢	6.95¢	7.26¢	7.26¢
Actual load factor	**68.3%**	67.4%	66.8%	65.7%	62.5%
Break-even load factor**	**53.6%**	49.9%	52.9%	47.0%	49.2%
CAPITAL STRUCTURE (000)					
Total assets	**$ 172,495**	$ 118,706	$ 77,967	$ 43,703	$ 23,692
Aftertax return on total assets	**11.7%**	17.1%	12.2%	15.0%	15.3%
Working capital	**$ 8,195**	$ 9,667	$ 5,052	$ 8,026	$ 1,392
Current ratio	**1.64:1**	3.39:1	2.82:1	3.83:1	2.03:1
Flight and ground equipment-net	**$ 150,576**	$ 104,744	$ 69,853	$ 32,699	$ 20,787
Capital expenditures	**$ 54,314**	$ 40,204	$ 41,442	$ 13,730	$ 6,294
Long-term debt	**$ 87,374**	$ 62,000	$ 47,000	$ 20,000	$ 14,500
Long-term debt as a % of total invested capital	**59.9%**	59.1%	63.8%	50.8%	66.2%
INVESTOR STATISTICS					
Stockholders' equity (000)	**$ 58,412**	$ 42,889	$ 26,606	$ 19,345	$ 7,415
Return on Stockholders' equity	**33.1%**	50.3%*	33.0%	39.4%	60.1%
Average number of common shares outstanding	**4,500,000**	4,500,000	4,486,845	3,531,024	3,009,749
Common shares outstanding	**4,500,000**	4,500,000	4,500,000	4,455,000	3,016,943
Earnings per share	**$ 3.70**	$ 3.78*	$ 1.68	$ 1.40	$ 1.13
Dividends per share	**$ .28**	$ .17	$ .12	$ .02	—
Book Value per share	**$ 12.98**	$ 9.53	$ 5.91	$ 4.34	$ 2.46
PRODUCTIVITY AND UNIT COSTS					
Number of employees at year-end	**1,630**	1,119	892	517	392
Average numbers of employees	**1,450**	1,024	750	457	368
Passengers boarded per employee	**3,448**	3,445	3,119	3,368	3,088
Revenue passenger miles per employee (000)	**1,093**	1,024	901	889	811
Revenue per employee	**$ 93,872**	$ 79,165	$ 65,395	$ 67,657	$ 62,003
Fuel costs per available seat mile	**1.6¢**	1.1¢	1.0¢	.9¢	.8¢
All other operating costs per available seat mile	**3.0¢**	2.8¢	2.8¢	2.9¢	2.9¢
Total operating cost per available seat mile	**4.6¢**	3.9¢	3.8¢	3.8¢	3.7¢
Fuel cost per gallon-average	**59.3¢**	38.2¢	36.4¢	30.7¢	30.1¢
Fuel cost per gallon-year-end	**71.3¢**	37.5¢	37.2¢	33.1¢	31.1¢
Fuel as a % of operating costs	**35.1%**	27.5%	26.2%	22.8%	22.4%
Daily block hours per aircraft	**11:37**	10:36	10:14	9:22	8:35

Five Year Summary of Operations and Financial Results

	Years ended December 31, 1979	1978	1977	1976	1975
FINANCIAL (000)					
Operating revenues:					
Passenger	$131,573	$ 78,537	$ 47,645	$ 29,998	$ 22,031
Package express	4,057	2,364	1,318	865	757
Other	484	164	84	57	29
Total operating revenues	136,114	81,065	49,047	30,920	22,817
Operating expenses:					
Fuel and oil	37,598	16,509	10,152	5,302	4,007
Flight operations	12,689	7,049	4,255	2,590	1,888
Maintenance	7,675	5,711	4,834	3,147	2,385
Passenger services	5,868	3,723	2,233	1,404	1,052
Terminal operations	15,321	9,221	6,048	3,250	2,250
Promotion and sales	6,749	3,718	2,588	1,594	1,328
Insurance, taxes and administrative	8,444	5,223	3,834	2,693	2,394
Depreciation and amortization	8,482	6,436	3,880	2,352	2,111
Employee profit sharing	4,302	2,353	961	904	445
Total operating expenses	107,128	59,943	38,785	23,236	17,860
Operating income	28,986	21,122	10,262	7,684	4,957
Non-Operating expense (income):					
Interest and other income	(441)	(194)	(66)	(46)	(10)
Interest expense	8,713	5,882	2,783	1,220	1,296
	8,272	5,688	2,717	1,174	1,286
Income before gain on disposition of aircraft and federal income tax	20,714	15,434	7,545	6,510	3,671
Gain on disposition of aircraft	—	8,522	—	—	—
Income before federal income tax	20,714	23,956	7,545	6,510	3,671
Provision for federal income tax	4,062	7,687	—	1,571	1,507
Income before extraordinary items and accounting change	16,652	16,269	7,545	4,939	2,164
Extraordinary items	—	—	—	—	1,236
Net cumulative effect of accounting change	—	735	—	—	—
Net income	$ 16,652	$ 17,004	$ 7,545	$ 4,939	$ 3,400
PER SHARE DATA					
Weighted average common and common equivalent shares outstanding	4,500,000	4,500,000	4,486,845	3,531,024	3,009,749
Before extraordinary items and net cumulative effect of accounting change	$ 3.70	$ 3.62	$ 1.68	$ 1.40	$ .72
Net income	$ 3.70	$ 3.78*	$ 1.68	$ 1.40	$ 1.13

*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 $1.15.

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

Certain items previously reported have been reclassified to conform to the presentation at December 31, 1979.

Southwest Airlines Co.
Consolidated Balance Sheet
(in thousands)
December 31, 1979 and 1978

	1979	1978
Assets		
CURRENT ASSETS:		
Cash, including certificates of deposit of $6,685 ($2,215 in 1978) (Note 3)	$ 10,407	$ 8,665
Accounts receivable	9,157	3,987
Inventories of parts and supplies, at cost	1,236	586
Prepaid expenses	289	473
TOTAL CURRENT ASSETS	21,089	13,711
Flight and ground equipment (Note 2):		
Flight equipment — aircraft (Note 3)	138,390	94,015
Other flight and ground equipment	32,160	22,403
	170,550	116,418
Less allowance for depreciation	19,974	11,674
	150,576	104,744
Deferred charges and other assets	830	251
	$172,495	$118,706
Liabilities and Stockholders' Equity		
CURRENT LIABILITIES:		
Current maturities of long-term debt	$ 2,541	$ —
Accounts payable	5,533	3,247
Accrued liabilities	4,820	797
TOTAL CURRENT LIABILITIES	12,894	4,044
Long-term debt (Note 3)	87,374	62,000
Deferred federal income tax	12,919	9,410
Deferred compensation (Note 4)	397	363
Deferred profit sharing	499	—
Total liabilities	114,083	75,817
Commitments and contingencies (Notes 2 and 9)		
STOCKHOLDERS' EQUITY (Notes 3 and 4):		
Common stock, $1.00 par value; 15,000,000 shares authorized (5,000,000 shares in 1978); 4,500,000 shares issued and outstanding in 1979 (3,000,000 in 1978)	4,500	3,000
Capital in excess of par value	10,046	11,415
Retained earnings	43,866	28,474
Total Stockholders' Equity	58,412	42,889
	$172,495	$118,706

See accompanying notes.

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

	Years Ended December 31, 1979	1978
OPERATING REVENUES:		
Passenger	$ 131,573	$ 78,537
Package express	4,057	2,364
Other	484	164
Total operating revenues	136,114	81,065
OPERATING EXPENSES:		
Fuel and oil	37,598	16,509
Flight operations	12,689	7,049
Maintenance	7,675	5,711
Passenger services	5,868	3,723
Terminal operations	15,321	9,221
Promotion and sales	6,749	3,718
Insurance, taxes, and administrative	8,444	5,223
Depreciation	8,482	6,436
Employee profit sharing (Note 5)	4,302	2,353
Total operating expenses	107,128	59,943
OPERATING INCOME	28,986	21,122
NON-OPERATING EXPENSE		
Interest and other income	(441)	(194)
Interest expense (Note 3)	8,713	5,882
Net non-operating expense	8,272	5,688
Income before gain on disposition of aircraft and federal income tax	20,714	15,434
Gain on disposition of aircraft	—	8,522
Income before federal income tax	20,714	23,956
Provision for federal income tax (Note 6)	4,062	7,687
Income before accounting change	16,652	16,269
Net cumulative effect of accounting change (Note 8)	—	735
NET INCOME	$ 16,652	$ 17,004
INCOME PER COMMON AND COMMON EQUIVALENT SHARE:		
Weighted average common and common equivalent shares outstanding (1978 adjusted for 1979 stock split)	4,500,000	4,500,000
Income before accounting change	$3.70	$3.62
Net effect of accounting change	—	.16
Net income	$3.70	$3.78

See accompanying notes.

Southwest Airlines Co.
Consolidated Statement of Stockholders' Equity
(in thousands)

	Years Ended December 31, 1979 and 1978			
	Common stock	Capital in excess of par value	Retained earnings	Total
BALANCE AT DECEMBER 31, 1977	$2,000	$12,367	$12,240	$26,607
Three-for-two stock split	1,000	(1,000)	—	—
Cash dividends, $.17 per share	—	—	(770)	(770)
Compensation element of executive stock options (Note 4)	—	48	—	48
Net income — 1978	—	—	17,004	17,004
BALANCE AT DECEMBER 31, 1978	3,000	11,415	28,474	42,889
Three-for-two stock split	1,500	(1,500)	—	—
Cash dividends, $.28 per share	—	—	(1,260)	(1,260)
Compensation element of executive stock options (Note 4)	—	131	—	131
Net income — 1979	—	—	16,652	16,652
BALANCE AT DECEMBER 31, 1979	$4,500	$10,046	$43,866	$58,412

See accompanying notes.

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

	Years Ended December 31, 1979	1978
FINANCIAL RESOURCES WERE PROVIDED BY:		
Working capital provided from operations:		
Income before cumulative effect of accounting change	$16,652	$16,269
Items not affecting working capital during the current period:		
Depreciation	8,482	6,436
Deferred compensation and compensation element of executive stock options	215	125
Deferred federal income tax	3,460	7,726
Deferred profit sharing	499	—
Other	49	—
Total from operations	29,357	30,556
Issuance of long-term debt	57,865	15,000
Total source of funds	87,222	45,556
FINANCIAL RESOURCES WERE UTILIZED FOR:		
Net additions to flight and ground equipment	54,314	40,204
Cash dividends	1,260	770
Repayment of long-term debt	30,000	—
Reduction of long-term debt	2,541	—
Additions to (reductions in) deferred charges and other assets	579	(34)
Total application of funds	88,694	40,940
INCREASE (DECREASE) IN WORKING CAPITAL	$(1,472)	$ 4,616
CHANGES IN COMPONENTS OF WORKING CAPITAL:		
Increase (decrease) in current assets:		
Cash including certificates of deposit	$ 1,742	$ 3,818
Accounts receivable	5,170	1,728
Inventories	650	101
Prepaid expenses	(184)	235
	7,378	5,882
Increase (decrease) in current liabilities:		
Current maturities of long-term debt	2,541	—
Accounts payable	2,286	756
Accrued liabilities	4,023	510
	8,850	1,266
Increase (decrease) in working capital	$(1,472)	$ 4,616

See accompanying notes.

Southwest Airlines Co.
Notes to Consolidated Financial Statements

December 31, 1979 and 1978

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 balances and transactions have been eliminated.

Reclassifications of amounts previously reported in the financial statements at December 31, 1978, have been made to conform to the presentation at December 31, 1979.

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:

	Estimated useful life	Residual value
Aircraft	15 years	10%
Support flight equipment	12 years	4%
Ground equipment	3-10 years	4%
Leasehold improvements	3-20 years	—

Upon sale or retirement of equipment, other than support flight 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. When support flight equipment, which is depreciated on a group basis, is sold or retired, proceeds are credited and the related costs are charged to accumulated depreciation and no gain or loss is recognized.

The Company expenses major aircraft maintenance and overhaul costs as incurred. In years prior to 1978, the Company provided an airworthiness reserve for such costs (see Note 8).

Federal income tax —
Provision for federal income tax is based on financial statement income before federal income tax. Deferred federal income tax results principally from the use of accelerated depreciation methods and nonrecognition of gain on disposition of aircraft for federal income tax return purposes. Investment tax credits are accounted for by the flow-through method.

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 stock options which were considered as common stock equivalents in periods where their inclusion had a material effect. Per share information has been restated to reflect common stock splits.

2. Flight and ground equipment
The Company's investment in flight and ground equipment other than aircraft is summarized as follows (in thousands):

	1979	1978
Progress payments on additional aircraft	$ 9,562	$ 6,769
Support flight equipment	10,306	7,569
Ground equipment	7,266	4,434
Leasehold improvements	3,810	3,256
Construction in progress	1,216	375
	$32,160	$22,403

At December 31, 1979, the Company had contractual commitments of approximately $46,974,000 for the purchase of six Boeing 737-200 aircraft to be delivered in 1980 and 1981 (See Note 3).

3. Long-term debt
Total long-term debt less current maturities at December 31, 1979 and 1978 was composed of the following (in thousands):

	1979	1978
10.40% Equipment Trust Certificates due July 1, 1994 with semiannual principal and interest payments starting January 1, 1980	$25,074	$ —
10.30% Equipment Trust Certificates due January 1, 1995 with semiannual principal and interest payments starting July 1, 1980	20,300	—
Bank Loan Agreement	42,000	62,000
Total long-term debt, less current maturities	$87,374	$62,000

As of July 17, 1979 and September 10, 1979, the Company entered into equipment trust agreements with private lenders whereby the lenders agreed to lend to a bank, as trustee, 80% of the cost of seven Boeing 737-200 advanced series aircraft. The Company supplied the remaining funds to allow the trustee to purchase the aircraft. These loans are supported by Equipment Trust Certificates, issued by the trustee and guaranteed by the Company. When the semiannual payments to the trustee equal the principal and accrued interest on the certificates, the Company will acquire free and clear title to the aircraft. The Company also has the option to retire the unpaid balance after July 1, 1986 and December 15, 1986, respectively. Depending on the conditions surrounding such retirement, there could be a premium required for early retirement.

A third equipment trust agreement with principal of $22,187,000 due July 1, 1995, similar in substance to the 1979 agreements, was executed on September 20, 1979, to be effective upon delivery of three Boeing 737-200 advanced series aircraft during the first quarter of 1980. This agreement, bearing an interest rate of 10.30%, will require semiannual principal payments beginning January 1, 1981.

On July 6, 1979, the Company entered into a Revolving Credit Agreement with an agent bank and three other banks, superseding a prior loan agreement. The new agreement provides a $54,000,000 revolving line of credit expiring March 31, 1981, followed by a six-year term loan repayable in 24 quarterly installments beginning the first day of the calendar quarter following conversion to the term loan. The revolving line of credit is renewable annually for two-year periods with the consent of the banks.

The interest rate on borrowings under the revolving credit is equal to the agent bank's prime commercial rate and is payable quarterly. The interest rate on the term loan is equal to ½% over the agent bank's prime commercial rate. The commitment fee for the revolving credit is ½% per annum on the unused portion of the committed credit.

The Revolving Credit Agreement, which is secured by all aircraft not financed through the Equipment Trust Certificates, also provides for the maintenance of certain minimum net worth levels and working capital ratios and for certain restrictions as to additional borrowings, capital expenditures, and cash dividend payments. At December 31, 1979, the Company had retained earnings in the amount of $3,330,000 available for payment of cash dividends.

The Company and the various banks have an informal understanding that the Company will endeavor to maintain on deposit average cash balances equal to 10% of the total credit available plus 5% of borrowings under the Revolving Credit Agreement. It is understood between the parties that no such funds are restricted from withdrawal by the Company at any time.

At December 31, 1979, the Company had available $12,000,000 for future borrowings under the Revolving Credit Agreement.

Long-term debt principal repayments due in each of the next five years, but excluding the borrowings under the revolving line of credit are (in thousands):

1980	$2,541
1981	3,191
1982	3,191
1983	3,191
1984	3,191

4. Deferred compensation and stock options

Pursuant to an agreement with a former officer, the Company will pay him $50,000 annually, commencing in 1980 and continuing through the first quarter of 1991. At December 31, 1979, the Company had accrued all expenses under this deferred compensation agreement except for continuing accruals of interest on the unpaid balance at 7% per annum.

Executive options to purchase 22,500 shares of common stock at a purchase price of $1.00 per share were outstanding at December 31, 1979. Options to purchase 7,500 of these shares were exercisable at December 31, 1979, and options to purchase 7,500 shares become exercisable in each year 1980 and 1981. At the date of grant, the market price of the Company's common stock was $18.42 per share ($414,000 total). The Company is recording compensation expense ratably over the option period for the difference between the exercise price and market value at date of grant.

5. Employee profit sharing and cash bonus 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) in excess of $2,100,000 or the maximum amount deductible for federal income tax purposes.

The plan permits the Company to pay currently a portion of each eligible employee's profit sharing amount in the form of a cash bonus. 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.

Effective January 1, 1980, the plan was amended to permit voluntary employee contributions and to allow employees to direct investment of 50% of annual Company contributions for their account in one or more of four investment media, including the Company's common stock.

During 1979, the Company adopted for both 1978 and 1979, 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. The Company has recorded in 1979 an additional $873,000 of profit sharing expense and of investment tax credit as a result of adopting the plan.

6. Federal income tax

Provisions for federal income tax, net of investment tax credits for the years 1979 and 1978, are as follows (in thousands):

	1979	1978
Current	$ 602	$ —
Deferred	3,460	7,687
	$4,062	$7,687

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

	1979	%	1978	%
Income tax provision on income before accounting change at statutory rate	$ 9,528	46	$11,498	48
Investment tax credit	(4,915)	(24)	(3,775)	(16)
ESOP tax credit	(873)	(4)	—	—
Other	322	2	(36)	—
	$ 4,062	20	$ 7,687	32

Deferred federal income tax, resulting from timing differences in the recognition of income and expenses for tax and financial statement purposes, is principally due to the use of accelerated depreciation methods for tax reporting and nonrecognition of gain on disposition of aircraft for federal income tax reporting, as follows (in thousands):

	1979	1978
Timing differences in flight and ground equipment	$3,967	$6,761
Deferred compensation not deductible for tax purposes	(98)	(60)
Application of investment tax credits	(409)	1,365
Federal income tax relating to accounting change (net of investment tax credit of $156,000)	—	(379)
	$3,460	$7,687

At December 31, 1979, the Company had investment credit carryforwards of $899,000 for federal income tax purposes expiring in 1986 and none for financial statement purposes.

7. Quarterly financial data (unaudited)

Summarized quarterly financial data (in thousands of dollars except for per share amounts) for 1979 and 1978 are as follows:

	Three months ended			
	March 31	June 30	Sept. 30	Dec. 31
1979				
Revenues	$25,677	$32,272	$38,071	$40,094
Operating income	6,198	7,187	8,804	6,797
Income before tax	4,425	5,257	6,743	4,289
Net income	3,328	4,061	4,897	4,366
Income per share	.74	.90	1.09	.97

	Three months ended			
	March 31	June 30	Sept. 30	Dec. 31
1978				
Revenues	$16,052	$19,668	$22,488	$22,857
Operating income	3,221	4,927	6,630	6,344
Gain on disposition of aircraft	—	—	5,867	2,655
Income before tax	1,969	3,543	11,055	7,389
Net income before accounting change	1,969	3,012	6,765	4,523
Net income	2,704	3,012	6,765	4,523
Income per share	.60	.67	1.50	1.01

The adoption of an Employee Stock Ownership Plan during the fourth quarter of 1979 generated $873,000 of additional investment tax credit which resulted in a $77,000 net tax credit for the quarter.

8. Accounting change

In years prior to 1978, the Company provided an airworthiness reserve for major aircraft maintenance and overhaul costs. These costs were accumulated in the reserve on a per-flight-hour basis. Actual expenditures for major aircraft maintenance and overhaul costs were relieved from the reserve as incurred.

Effective January 1, 1978, the Company changed its method of accounting for major maintenance and overhaul costs from the reserve method to that of expensing such costs as incurred. The change was made to conform the Company's accounting for such costs to the predominant method in the airline industry and, in anticipation of possible interstate route awards, to utilize the established accounting policies of the Civil Aeronautics Board (CAB). The Company believes that the direct expense method is preferable because of changes in the physical manner in which airframes and engines are now being maintained and an increase in the Company's fleet size.

Net income for the year ended December 31, 1978, has been increased by approximately $735,000 (net of applicable federal income taxes and profit sharing of approximately $388,000), which represents the cumulative effect on years prior to 1978 of the aforementioned change.

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.

Subsequently, in December, 1974, a Civil Aeronautics Board of the United States (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 seeks to relitigate the right of the Company to remain at Love Field. Those carriers have 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.

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 is presently pending.

In 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.

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 and, also, that such legislation renders moot the appeal to the District of Columbia Circuit from the CAB's Love Field-New Orleans award.

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.

Total rental expenses charged to operations in 1979 and 1978 were $3,127,000 and $2,248,000, exclusive of landing fees of $2,557,000 and $856,000, 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 is leased through noncancellable operating leases. Minimum future obligations on all leases in effect at December 31, 1979 are as follows (in thousands):

1980	$ 1,331
1981	1,156
1982	958
1983	801
1984	639
After 1984	5,813
	$10,698

Auditor's Report

The Board of Directors and Stockholders
Southwest Airlines Co.

We have examined the accompanying consolidated balance sheet of Southwest Airlines Co. at December 31, 1979 and 1978, 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, 1979 and 1978, and the consolidated results of operations and consolidated changes in financial position for the years then ended, in conformity with generally accepted accounting principles consistently applied during the period subsequent to the change, with which we concur, made as of January 1, 1978, in the method of accounting for major maintenance and overhaul costs as described in Note 8 to the consolidated financial statements.

Arthur Young & Company

Dallas, Texas
January 30, 1980

Management's Responsibility for Financial Statements

The accompanying consolidated financial statements and related information included in this Annual Report were prepared by the management of Southwest Airlines Co. in conformance with generally accepted accounting principles appropriate in the circumstances applied on a consistent basis. The primary responsibility for the integrity of this financial information rests with management.

Southwest Airlines Co. maintains a system of internal accounting controls which is designed to provide reasonable assurance that assets are safeguarded, transactions are executed in accordance with management's authorization, and financial records are reliable as a basis for preparation of financial statements.

The independent public accountants provide an objective, independent review of management's discharge of its responsibilities as to the fairness of the financial statements. They review the Company's internal accounting controls and perform the necessary tests of procedures and accounting records to enable them to express their opinion on the fairness of the financial statements.

The Audit Committee of the Board of Directors, composed solely of Directors from outside the Company, meets with the independent public accountants, management, and the internal auditor periodically to review the work of each and ensure that each is properly discharging its responsibilities. The independent public accountants have free access to this Committee, without management present, to discuss the results of their audit work, the adequacy of internal financial controls, and the quality of financial reporting.

Howard D. Putnam

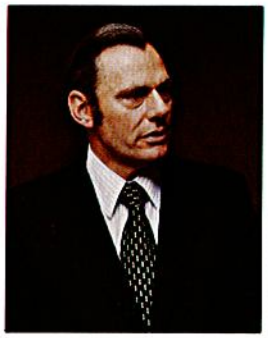
Howard D. Putnam, *President & Chief Executive Officer*

M. Philip Guthrie

M. Philip Guthrie, *Vice President — Finance & Chief Financial Officer*

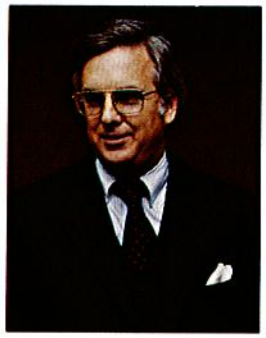
During 1979, by converting the fleet to slimline seats, Southwest added six seats per aircraft, or nearly the equivalent of an additional 737 to the fleet. Each aircraft now seats 118 passengers.

Officers



Kelleher

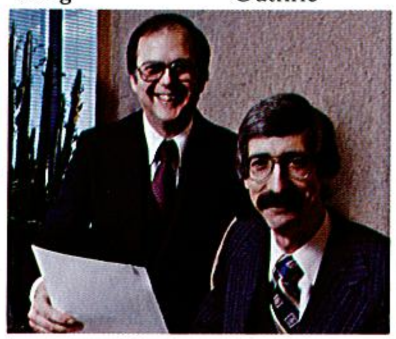
Putnam



King

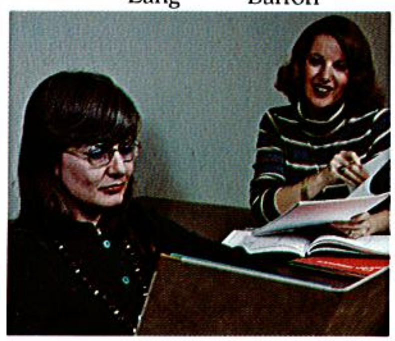
Guthrie Farr Thomson

Herring Franklin

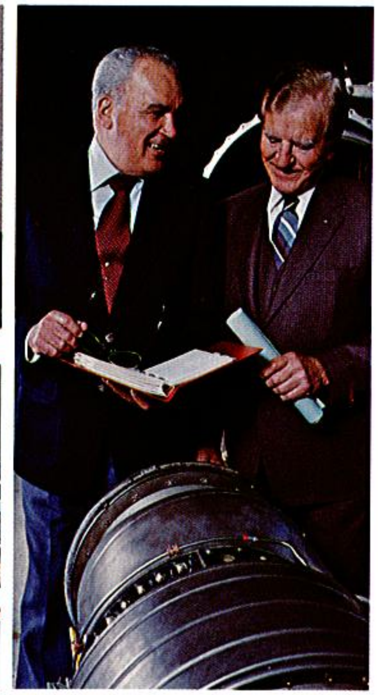


Lang Barron

Volz Keith



Barrett Phelps



Vidal Ogden

	Age	Officer Since
Herbert D. Kelleher *Chairman of the Board*	48	1967
Howard D. Putnam *President and Chief Executive Officer*	42	1978
Rollin W. King *Advisor — Special Projects*	48	1967
M. Philip Guthrie *Vice President — Finance and Chief Financial Officer*	35	1979
Herman H. Farr *Treasurer*	56	1973
Gary Barron *Vice President — Corporate Services*	35	1978
William W. Franklin *Vice President — Ground Operations*	52	1971
J. L. Herring *Vice President — Inflight Service*	56	1973
Camille T. Keith *Vice President — Public Relations*	35	1978
Edward W. Lang *Vice President — Personnel*	45	1978
Donald G. Ogden *Vice President — Flight Operations*	69	1971
John A. Vidal *Vice President — Maintenance*	61	1971
Thomas J. Volz *Vice President — Marketing*	36	1979
Colleen C. Barrett *Secretary*	35	1978
W. James Thomson *Assistant Treasurer*	31	1976
Sherry L. Phelps *Assistant Secretary*	30	1976

Directors

Bishop Johnson Putnam Adger Kelleher Barshop King

Seated left to right:

•‡Gene H. Bishop, *Chairman of the Board and Chief Executive Officer, Merchantile Texas Corporation, Dallas, Texas*

•Howard D. Putnam, *President and Chief Executive Officer, Southwest Airlines Co., Dallas, Texas*

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

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

•Rollin W. King, Advisor *Special Projects, Southwest Airlines Co., Dallas, Texas*

Standing left to right:

‡Travis C. Johnson, *Attorney, Johnson & Bowen, El Paso, Texas*

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

•Executive Committee
†Compensation Committee
‡Audit Committee

The following resolution was unanimously adopted by the Board of Directors following the untimely death of John D. Murchison:

WHEREAS, Mr. John D. Murchison of Dallas, Texas, was one of the first shareholders and Directors of Southwest Airlines Co. and a member of the Executive Committee of the Board; and

WHEREAS, Mr. Murchison's personal faith and commitment to Southwest enabled the Company to secure the capital necessary to prepare for commencement of operations; and

WHEREAS, Mr. Murchison's continuing counsel and advice to the Directors of the Company were invaluable; and

WHEREAS, the Directors of the Company greatly valued his friendship and personal contributions; and

WHEREAS, the untimely demise of Mr. Murchison has been a severe loss to Southwest Airlines Co. and bereaved his friends on the Board of Directors;

BE IT RESOLVED, that the Board of Directors of Southwest Airlines Co. extends to Mrs. John D. Murchison and her children the sincere and profound condolences of the Board and great appreciation for the monumental contributions made by Mr. John D. Murchison to the development and successful progress of Southwest Airlines Co.

Information for Southwest Airlines Investors

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
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 22, 1980 in the Auditorium of the Mercantile National 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).

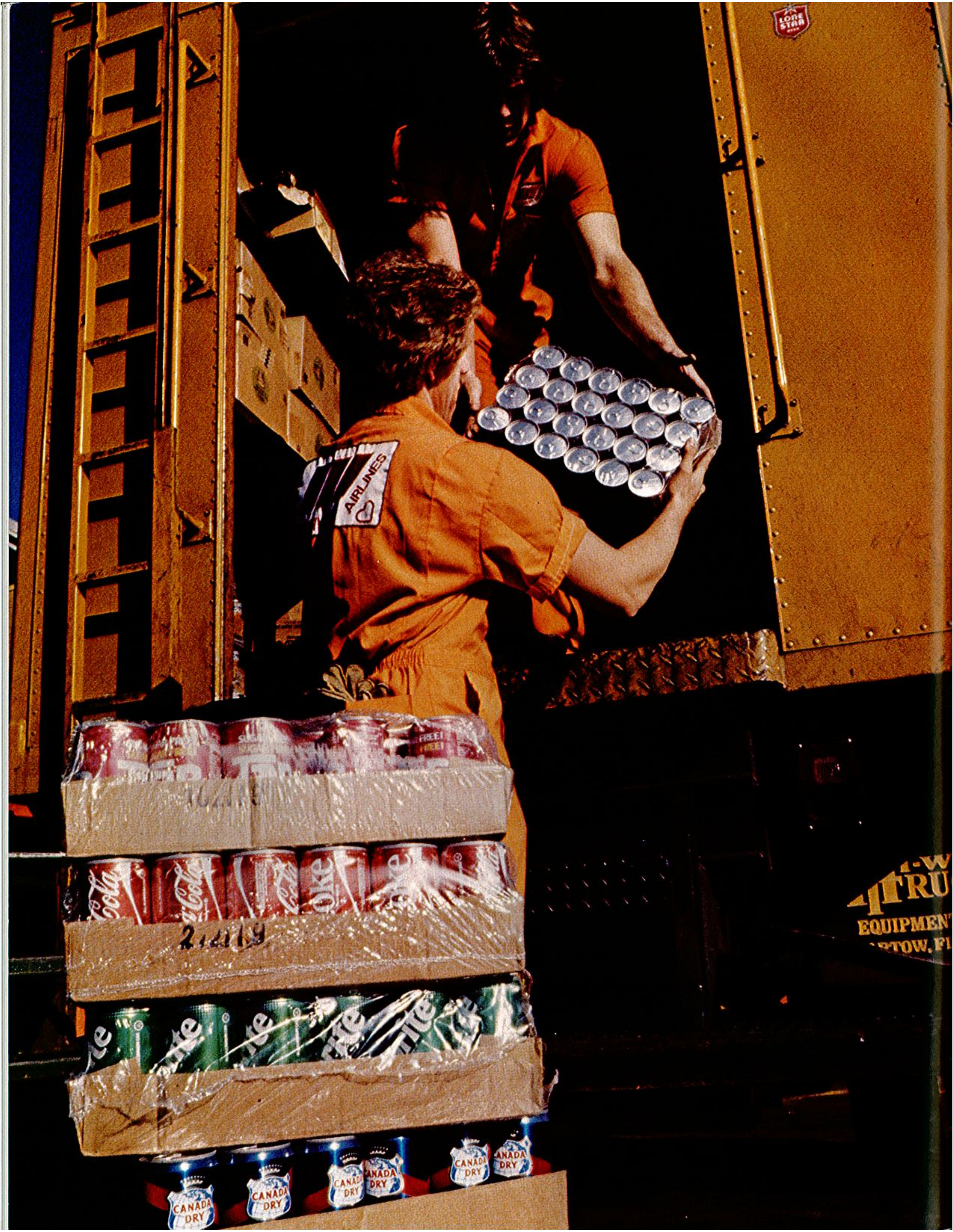
Any person acquiring ownership, either beneficially or as trustee, of more than 5 percent, in the aggregate, of any class of the capital stock or capital of Southwest Airlines Co. must file with the Civil Aeronautics Board within 10 days after such acquisition the report required by Civil Aeronautics 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.

Top: The ground crew demonstrates its efficiency in sorting and loading baggage during the ten minutes the aircraft is on the ground between flights. (r to l) Edwin Anderson, Terry Greene, Joe Draper

Bottom: RUSH — Southwest's counter to counter air freight service — shipped approximately 195,000 pieces of freight during 1979. Pictured is Robert Wyckoff, of Dallas.


SOUTHWEST


RUSH AIR CARGO
SOUTHWEST AIRLINES
DAL
KODAK PROCESSING
Purolator


LONE STAR
AIRLINES
CANADA DRY
EQUIPMENT

Danny Wooldridge and Dale Mitchusson, Dallas provisioning agents, are pictured preparing to load the aircraft galley with some of the 1,000,000 complimentary soft drinks which were consumed on Southwest flights during 1979.

SOUTHWEST AIRLINES

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