19 SOUTHWEST AIRLINES CO. 89

Annual Report

Guess who made the majors?

TRIPLE CROWN

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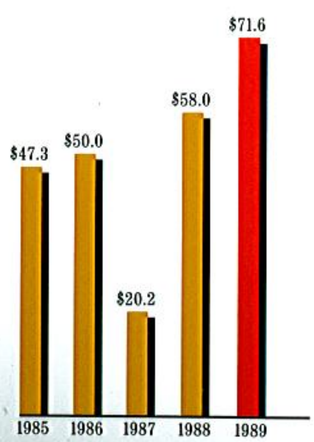
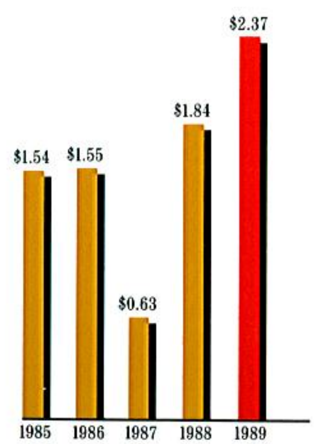
CONSOLIDATED HIGHLIGHTS

(dollars in thousands, except per share amounts)

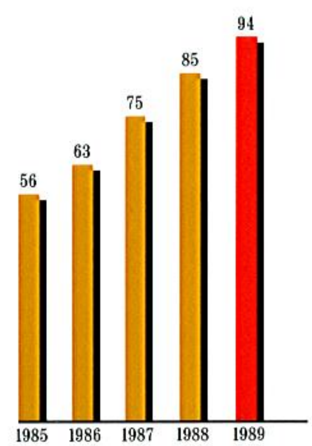
	1989	1988	Percent change
Operating revenues	$1,015,052	$860,434	18.0
Operating expenses	$917,426	$774,454	18.5
Operating income	$97,626	$85,980	13.5
Operating margin	9.6%	10.0%	(.4) pts.
Net income	$71,558	$57,952	23.5
Net income per common and common equivalent share	$2.37	$1.84	28.8
Stockholders' equity	$587,316	$567,375	3.5
Return on average stockholders' equity	12.4%	10.8%	1.6 pts.
Long-term debt as a % of total invested capital	37.6%	39.4%	(1.8) pts.
Stockholders' equity per common share outstanding	$20.10	$18.15	10.7
Revenue passengers carried	17,958,263	14,876,582	20.7
Revenue passenger miles (RPM)(000s)	9,281,992	7,676,257	20.9
Available seat miles (ASM)(000s)	14,796,732	13,309,044	11.2
Passenger load factor	62.7%	57.7%	5.0 pts.
Passenger revenue yield per RPM	10.49¢	10.79¢	(2.8)
Operating revenue yield per ASM	6.86¢	6.47¢	6.0
Operating expenses per ASM	6.20¢	5.82¢	6.5
Number of employees at yearend	7,760	6,467	20.0



Consolidated Net Income
(in millions)



Net Income Per Share



Fleet Size
(at yearend, Southwest only)

THE MAJORS

A *major* airline, as defined by the Department of Transportation, is an airline whose operating revenues for a 12-month period are one billion dollars or more. At yearend 1989, Southwest Airlines reported $1,015,000,000 in operating revenues, joining the auspicious ranks of American, Delta, Northwest, Pan Am, Texas Air (Continental and Eastern), Trans World, United, and USAir. Based on passenger originations, Southwest is the nation's eighth largest independent airline. This annual report is a tribute to our employees, the best team in the business, who made this milestone possible. And to the real winners, our Customers.

TO OUR SHAREHOLDERS

1989 was a splendid year in actuality and a somewhat troubling year in portent.

Our record 1989 operating revenues of over $1,000,000,000 promoted us to "Major" carrier status, as defined by the DOT. Our record 1989 operating income of $97,626,000 exceeded our 1988 operating income of $85,980,000 by 13.5 percent. And our 1989 net income of $71,558,000 established a new Company record for the second consecutive year, surpassing by 23.5 percent our previous record net income of $57,952,000 for the year 1988. 1989 earnings per share of $2.37 were also a record, surpassing by 28.8 percent the previous high of $1.84 per share achieved in 1988.

Record operating revenues; record operating income; record net income; and record earnings per share together comprise the "splendor" of 1989. The "troubling portent" lies in the fact that, as predicted in my third quarter 1989 letter to Shareholders, our fourth quarter 1989 net income was less than our fourth quarter 1988 net income.

Our fourth quarter 1989 operating revenues increased by only 13.2 percent, primarily caused by the recent diminution in domestic Customer traffic that our industry has been experiencing. Our fourth quarter 1989 operating expenses increased by 18.1 percent, however, as jet fuel prices soared 37.0 percent; landing fees and rentals increased 31.0 percent; and maintenance materials and repairs rose 27.7 percent, over fourth quarter 1988. The combination of a slackening in revenue growth and a disproportionate increase in operating expenses produced fourth quarter 1989 net income of $8,111,000, a reduction of 49.5 percent from the $16,073,000 of fourth quarter 1988. Earnings per share in fourth quarter 1989 were $.27, 47.1 percent less than the $.51 of fourth quarter 1988.

The demand-cost squeeze of fourth quarter 1989 has thus far been accentuated in January 1990 by flagging Customer demand, as compared to January 1989, and a spectacular year over year rise in jet fuel costs. At this point, it is quite clear that our first quarter 1990 financial results will be a major disappointment when compared to our record first quarter 1989 earnings of $19,644,000.

Our response to this early 1990 exigency has been to institute an emergency cost control program; to implement significant fuel burn conservation measures; and to seek to inaugurate selective, relatively modest February 1990 fare increases, which will not be so forbidding as to make us uncompetitive against the out-of-pocket costs of operating the automobile, an alternative mode of transportation in our short stage length markets.

At present, there are several favorable signs conjointly indicating an improvement in our 1990 earnings prospects: (1) jet fuel prices appear to be receding from the early January highs; (2) Customer bookings appear to be accelerating; (3) the economy of the energy belt seems to be improving; and (4) automobile gasoline prices have increased significantly.

Whatever the hazards of 1990, we feel that Southwest can confront and overcome them because of our traditional and abiding strengths:

1) Low cost of producing seat miles;

2) Conservative balance sheet;

3) Young, predominantly Stage III fleet;

4) Superb Customer service quality;

5) The finest, most loving and lovable people in the airline industry; and

6) Great team spirit.

In conclusion, we will be the first to fly the new 737-500 in commercial air service in March 1990; we will inaugurate air service to Burbank, California, in April 1990; we are continuing to repurchase our outstanding common stock under our 1,000,000 share buyback program announced in November 1989; and we will increase our available seat miles approximately nine percent in 1990 with the addition of 10 new Boeing 737-500s and two new Boeing 737-300s to our fleet.

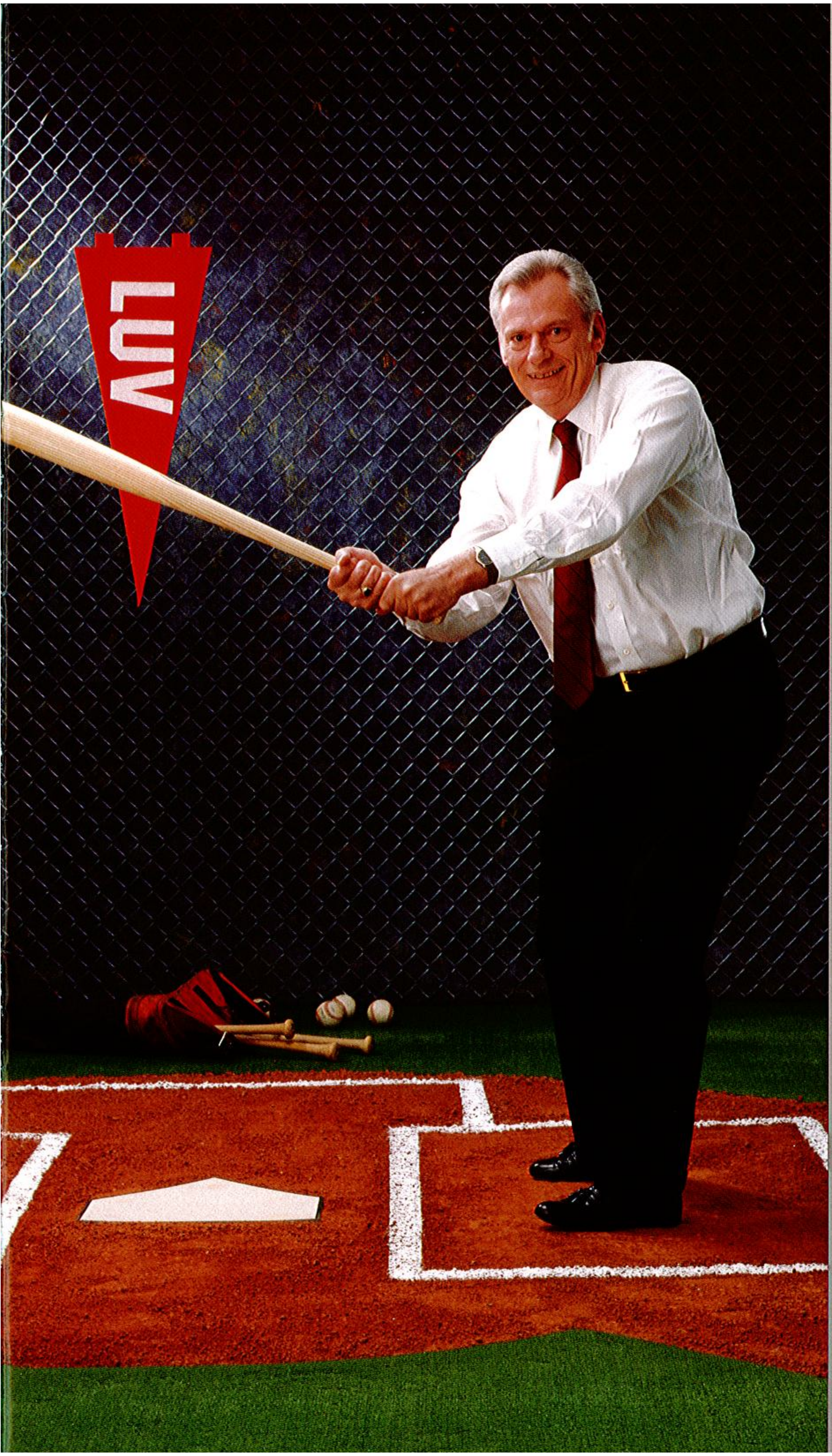
Most sincerely,

Herbert D. Kelleher

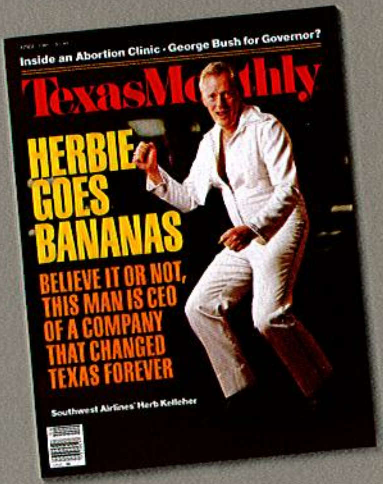
Herbert D. Kelleher
Chairman, President and CEO

January 27, 1990

Southwest Airlines' Annual LUV Golf Classic & Party, benefitting the Ronald McDonald Houses across our system, earned a record $130,000 in donations for our major charity.



Living up to his famous soliloquy, "We take our competition seriously, but we don't take ourselves too seriously," Chairman Kelleher graces the cover of the April 1989 issue of *Texas Monthly* magazine. This was a banner year for press coverage, with Southwest featured in major stories on CBS's *60 Minutes*, Turner Broadcasting's *Cable News Network*, and NBC's *Today* show.



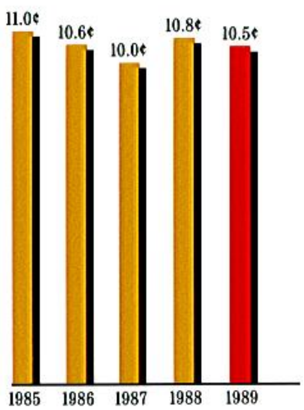
Southwest Airlines Co. is the nation's low fare, high Customer satisfaction airline. We primarily serve shorthaul city pairs, providing single class air transportation, which targets the business commuter as well as leisure travelers. The Company, incorporated in Texas, commenced Customer service on June 18, 1971 with three Boeing 737 aircraft serving three Texas cities — Dallas, Houston, and San Antonio. At yearend 1989, Southwest operated 94 Boeing 737 aircraft and provided service to 31 airports in 29 cities in the midwestern, southwestern, and western regions of the United States. The Company has one of the best overall Customer service records, the lowest operating cost structure per average stage length, and consistently offers our Customers the lowest and simplest fares in the domestic airline industry. LUV is our stock exchange symbol, selected to represent our home at Dallas Love Field, as well as the theme of our employee and Customer relationships.

The year was 1971. A young upstart airline named Southwest began Customer service with three Boeing 737 aircraft serving the "Texas Triangle" – Dallas, Houston, and San Antonio.

Founded by Herbert D. Kelleher and Rollin W. King, and commencing operations under the leadership of M. Lamar Muse, Southwest Airlines' early years were anything but auspicious. From the very outset, there was a tortuous and nearly fatal three-year legal battle, going all the way to the U.S. Supreme Court.

The big boys, Braniff and Texas International, were determined to squash the little upstart before it got off the ground. Luckily, attorney Kelleher beat them with a combination of legal acumen and good fortune.

However, Southwest was not immediately a home run. Founded on the simple strategy of low *fares*, lots of *flights*, and loads of *fun*, the little airline struggled through its humble beginnings, relying on exceptional service and a certain Southwest Spirit to win new Customers.



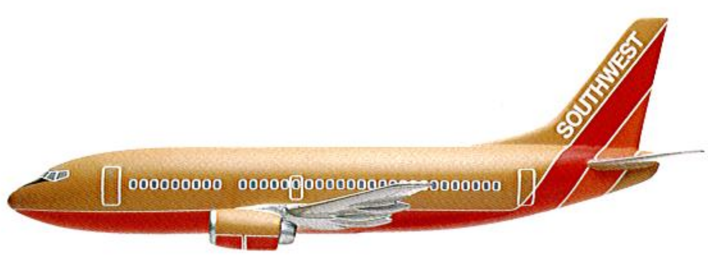
Average Revenue
Per Passenger Mile
(Southwest only)

BASIC STRATEGY — LOW FARES. The simple strategy originally developed in 1971 is still used today: low fares, high frequency, and quality Customer service. In the early years, Southwest's principal competitive advantage was our extraordinarily low and simple fare structure. We quickly became known as the low fare carrier.

The airline industry offers a myriad of complex fares and rules. Southwest strives to offer everyday low fares and avoid this complexity. Our unrestricted, unlimited coach fares are offered on a "peak/off peak" basis and are usually as low as our competitors' restricted fares. For travelers who can plan their travel in advance, we offer advance-purchase nonrefundable fares at an even further discount from our coach fares.

With the large number of fares offered by the industry, managing this aspect of an airline is challenging and complex. Sophisticated computer models are employed by Southwest to manage seat inventories and maximize revenues by examining historical trends and actual bookings by fare category. Southwest has continued to enhance our revenue management capabilities, realizing a 5.7 percent increase in 1989 in passenger revenue yield per available seat mile.

Southwest accepted delivery of our first Boeing 737-500, the quickest and quietest aircraft in its class, in February 1990. This new generation jet marks the latest addition to our fleet of 94 Boeing 737 aircraft, the youngest all-jet fleet among the major carriers.



BURGER KING®

WE DO IT LIKE YOU'D DO IT.™

Southwest's major promotion with Burger King was a whopping success. Numerous Customers took advantage of a free roundtrip companion ticket. Of those, many had never before flown Southwest.

Belinda Vela
Reservations Agent,
San Antonio

Don Buford
Captain, Houston

Teamwork is the key to Southwest's success. Two members of our all-star team relax between innings in our new Signal Uniforms. Agent Belinda Vela sports our new Signal FunWear; Captain Don Buford wears a signal tie. Signals, nautical flags used to communicate from ship-to-ship, recall an earlier era when service aboard luxury liners was genuinely friendly, splendidly colorful, and delivered with impeccable taste.

$34

MUSIC: Old scratchy record playing Lefty Frizzell tune
SINGER: "If you've got the money, honey...

6:30 a.m.

MUSIC: Record begins skipping, repeating
SINGER: "...I've got the time (6:30 a.m.)...I've got the time (7:55 a.m.)... " etc.

You get the idea.

MUSIC: Needle skips ahead to instrumental, fade

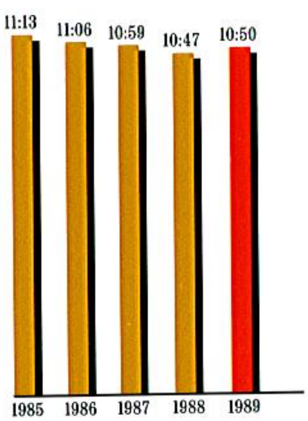
January 23, 1974. Less than three years after commencing service, Southwest Airlines carried our one millionth Customer.

By 1975, Southwest had caught the eye of Senator Edward Kennedy. The Massachusetts Senator wondered why Texans could fly between Dallas and Houston for significantly less money than New Englanders could fly a similar distance between New York and Boston.

Deregulation fever was beginning to take hold in the nation's capital. And it was a movement that matured at just the right time and in just the right way for Southwest's advantage. Now we had room to grow.

In October 1978, Congress passed the Airline Deregulation Act. Southwest rallied the team for the next big play — expansion.

SCHEDULING. By the end of the '70s, Southwest had already perfected our point-to-point high-frequency operating and Customer service strategy. With deregulation, however, the development of the so-called "hub and spoke" flight scheduling system began; passengers are routed through busy "hub" airports to make connecting flights. Southwest has adhered to our point-to-point method, however, which best serves the needs of the local shorthaul business traveler. We avoid busy hubs and connections and keep travelers' travel time to a minimum. Avoiding congested hubs also improves our ability to maintain our outstanding ontime performance record.

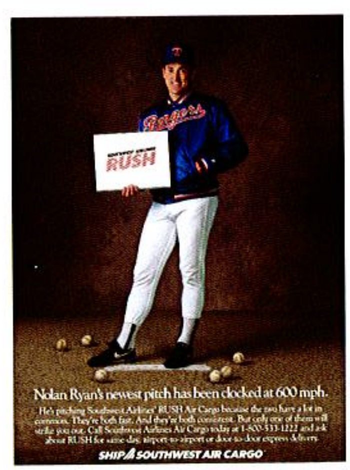


Aircraft Utilization
(hours and minutes per day, Southwest only)

Further underpinning our strategy, we specialize in high asset utilization, both in terms of ground facilities and aircraft. We strive to minimize the amount of time an aircraft stays at the gate, generally less than 15 minutes, so that it is in the air generating revenue. In fact, were we to schedule our flights according to conventional methods, we would need to increase our aircraft fleet by at least 30 percent.

Consistent with our desire to serve city pairs with strong local traffic demand, our strategy has been to offer frequent departures and arrivals at a given airport. The average number of daily departures per airport was 31 at the end of 1989, for example. Our largest airports, Dallas Love Field, Houston Hobby, and Phoenix Sky Harbor, accounted for 36 percent of the total daily flights or 116, 120, and 107, respectively.

Finally, we have carved out a shorthaul niche, generally flights of an hour or less, where keeping operating costs and Customer fares low is of paramount importance to effectively compete with ground transportation. Our average aircraft trip (stage) length was 375 miles in 1989, and our average Customer trip length was only slightly longer at 517 miles.



Texas Rangers superstar Nolan Ryan pitches Southwest's RUSH same-day Air Cargo service. They're both fast. They're both consistent. But only one of them will strike you out.

Joe Guardado
Ramp Agent, Los Angeles

Merlon Fitzpatrick
Operations Agent, Detroit

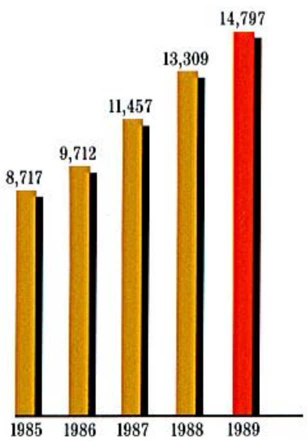
Consistency is a hallmark of our Customer service. Two teammates illustrate the consistent look of our new Signal Uniforms. Ramp Agent Joe Guardado sports rugged Signal RampWear; Operations Agent Merlon Fitzpatrick is dashing in his Signal DressWear.

ANNCR: Because most of our flights are short, this is what our meals look like on Southwest Airlines...

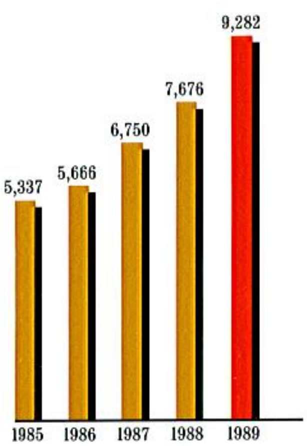
ANNCR: ...It's also what our fares look like.

ANNCR: Fly Southwest Airlines. It's like having your own Company Plane.

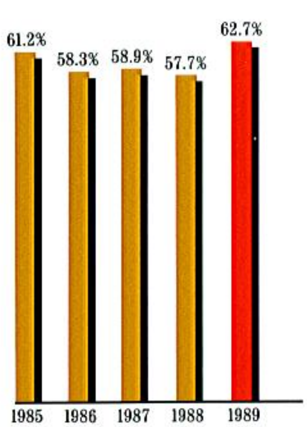
On January 25, 1979, Southwest began Customer service from Houston Hobby Airport to New Orleans with one roundtrip weekdays, marking our first service outside of Texas.



Available Seat Miles
(in millions, Southwest only)



Revenue Passenger Miles
(in millions, Southwest only)



Passenger Load Factor
(Southwest only)

The team was in an expansion mode — first, east to New Orleans, then north to Oklahoma City and Tulsa, then west to Albuquerque and beyond. By yearend 1983, Southwest was serving 20 cities. Net income for that year, a record $40,867,000. These were exciting times.

December 17, 1984, 10:35 a.m. On the same day and at the same time as the Wright Brothers' historic flight at Kitty Hawk, North Carolina, in 1903, Southwest unveiled our first Boeing 737-300 series aircraft. On hand for the inaugural flight and festivities were comedian Bob Hope and Brigadier General Charles E. "Chuck" Yeager.

Sunrise, May 23, 1988. Southwest Airlines Chairman Herb Kelleher and Sea World of Texas Chairman George Becker requested clearance at San Antonio International Airport to land Shamu®One, a Boeing 737-300 painted like a killer whale.

CUSTOMER SERVICE. The 1980s were remarkable with respect to the achievements by Southwest, particularly in the Customer service arena. For eight out of the last nine years we received the fewest complaints filed with the Department of Transportation (per Customer carried) of the 11 largest carriers in the U.S., just barely missing another first place finish in 1989. We achieved high levels of ontime aircraft arrival performance and compiled a superb baggage handling record. All this was accomplished through the tireless efforts of Southwest's employees, who continually stress caring, personal Customer service with our own special brand of fun.

Our service is geared to the shorthaul point-to-point traveler, with the objective of minimizing travel time. To support this, we offer quick ticketing, boarding, and seating procedures as well as our innovative in-flight services specially designed for trips of one hour or less. Beverage service is quick and efficient, with no meals necessary.

We also offer our frequent travelers free travel awards through membership in The Company Club® The rules are simple: Awards are earned based on trips rather than mileage and are issued to the member automatically upon being earned. The awards are valid for travel anywhere on the Southwest system, are transferable, and expire one year after they have been earned.

Shamu is a registered trademark of Sea World, Inc.

Shamu®One, one whale of a plane, is a sky-bound reminder of the partnership between Southwest Airlines and Sea World of Texas and California.

Martha McDown
Customer Service Agent,
Oklahoma City

James Kuminecz
Mechanic, Phoenix

Soomi Larson
Flight Attendant, Dallas

We take great pride in our Team Spirit at Southwest. Customer Service Agent Martha McDown draws cheers in a tailored Signal dress. Mechanic James Kuminecz is on deck in his Signal Uniform and Flight Attendant Soomi Larson lifts Customers' spirits in a classic blazer and skirt from our Signal DressWear collection.

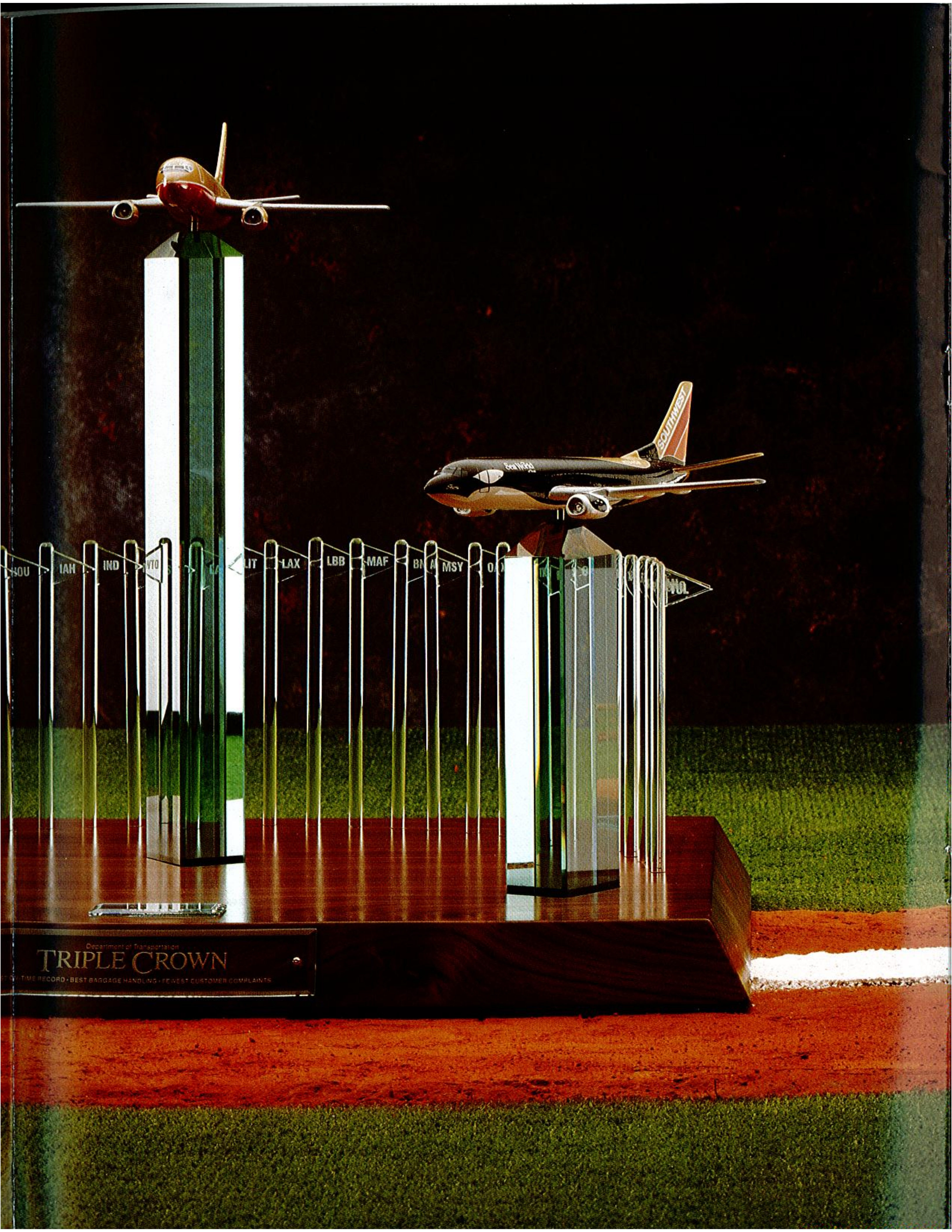
ANNCR: Southwest Airlines has one of the best ontime records in the country.

MAN: Mr. Smith, you're early!
ANNCR: Just something to remember.

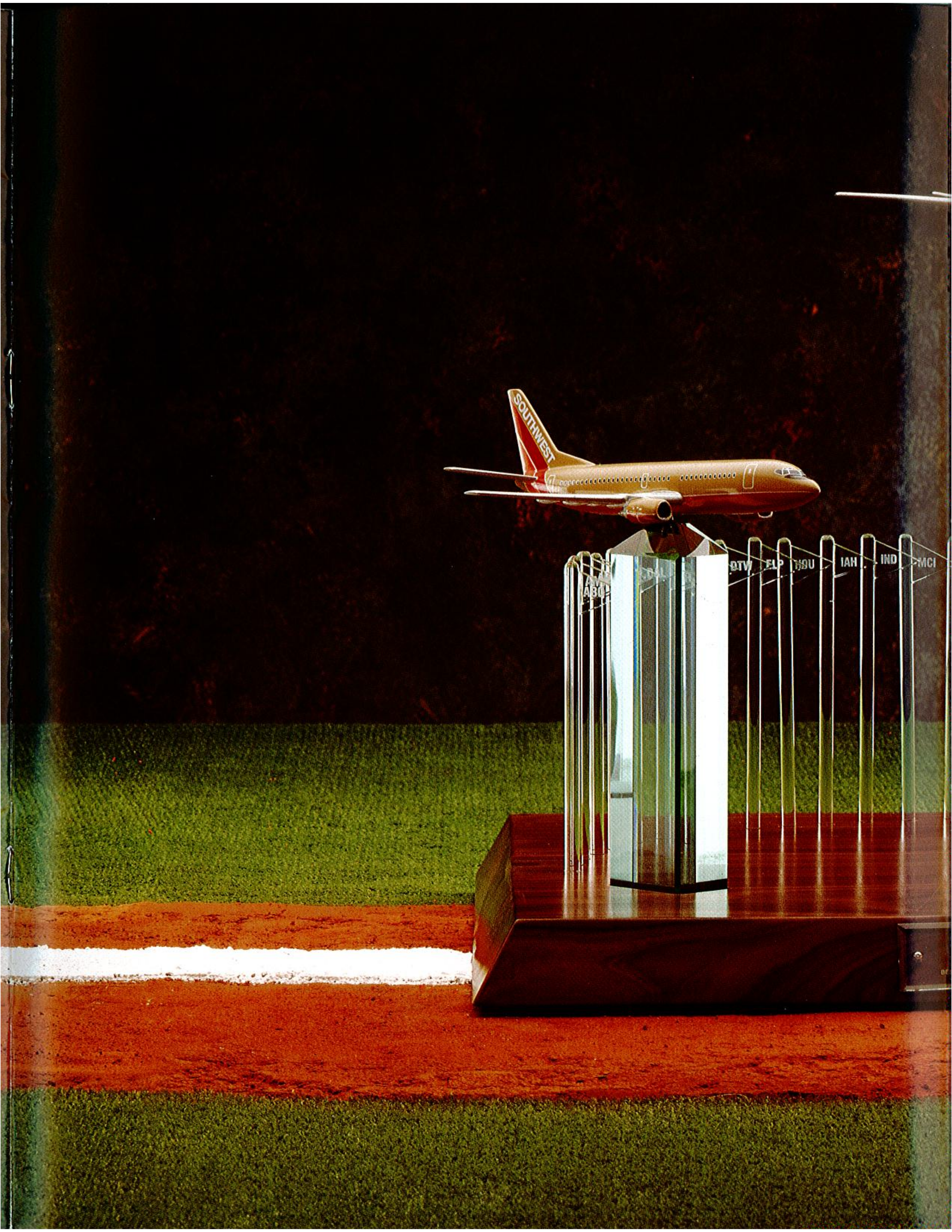
ANNCR: Fly Southwest Airlines. It's like having your own Company Plane.

In March 1988, Southwest Airlines became the first and only airline to win the coveted Triple Crown — Best Ontime Record, Best Baggage Handling, and Fewest Customer Complaints in a single month — as reported to the U.S. Department of Transportation. In September 1989, a repeat performance. Since 1971, our goal has been very simple: Charge the lowest possible fare. And provide the highest quality service. Thanks to our great Southwest team, that goal is a reality to millions of business commuters and leisure travelers. Will Southwest win a third Triple Crown? With this team, anything is possible.

EXTRA INNINGS: No other airline has won one. We just won our triple Triple! In February 1990, the the U.S. Department of Transportation announced that, for the third time, Southwest Airlines had the Best Ontime Record, Best Baggage Handling, and Fewest Customer Complaints in a single month for December 1989. Will Southwest go for the Grand Slam? Don't leave the stadium before the game's over.



IAH
IND
LIT
LAX
LBB
MAF
MSY
SOUTHWEST
Department of Transportation
TRIPLE CROWN
TIME RECORD • BEST BAGGAGE HANDLING • FEWEST CUSTOMER COMPLAINTS


SOUTHWEST
DTW
ELP
IAH
IND
MCI


MCI
LBB
MAF
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OKC
Department of Transportation
TRIPLE CROWN
BEST ON-TIME RECORD • BEST BAGGAGE HANDLING • FEWEST CUSTOMER COMPLAINTS

December 31, 1989. Southwest Airlines tallies the score. Operating revenues for the year exceed one billion dollars. Southwest has achieved *major* airline status, as defined by the Department of Transportation.

Southwest's fleet stands at 94 Boeing 737 aircraft — 46 737-200s and 48 737-300s. We accepted delivery of our first 737-500 in February 1990. The team has grown to 8,000 employees. We serve 29 cities and 31 airports in 14 states. Southwest has been profitable since 1973, with one of the healthiest balance sheets in the airline industry. In the last decade, we have had a cumulative net income of $434,185,000. Our total operating revenues over the last 10 years exceed $5.9 billion.

Now, as the nation's eighth largest independent airline (based on passenger originations), the future looks bright indeed.

OUTLOOK. 1989 was another record year for Southwest in terms of traffic, revenues, and net income. Given the nation's economic forecasts for 1990, the large number of scheduled aircraft deliveries for the industry and the record-setting traffic numbers we recorded for first half 1989, we are expecting our 1990 traffic growth and load factors to lag behind what we experienced in 1989. Thus far in 1990, this has proven to be correct. With respect to fares, we cannot predict what the highly competitive environment will bring in the year ahead.

We experienced significant operating cost increases throughout 1989, however, which served to dampen an otherwise very successful year. Fuel costs, in particular, escalated in the fourth quarter to a system average of 66 cents per gallon and then skyrocketed in January 1990 to 79 cents per gallon. As an energy-dependent Company, we are continually exploring ways to manage this risk more effectively, in addition to continually adding more fuel-efficient aircraft to the fleet (the 737-300 and -500). Even so, we are consistently among the lowest in the industry in terms of the average cost of fuel per gallon. Aircraft maintenance was the other cost category where larger increases were experienced in 1989 and are expected in 1990 due, in part, to the increase in the fleet of 737-300s which is more expensive to maintain than their 737-200 predecessor. Thus, the increased maintenance cost offsets, to an extent, the fuel savings obtained from these aircraft.

Our largest cost category, salaries, wages, and benefits, was up in 1989. Several labor contracts are under negotiation, with another scheduled for negotiation in 1990, including contracts for the pilots, certain ground operating personnel, and mechanics. Although we cannot predict the ultimate outcome of these negotiations, our goal is to position Southwest and our employees for continued prosperity and job security. We expect to reach agreements that will permit us to achieve both.

An ad in The Wall Street Journal *says it all: "If we charged as much as most airlines, we could have run this ad years ago." At yearend 1989, Southwest makes the majors.*

Kevin Cooper
Skycap, San Francisco

Vince Warren
Provisioner, Albuquerque

You don't make the majors without good coaching. Provisioner Vince Warren signals Skycap Kevin Cooper to go for extra bases.

January 1, 1990. Southwest begins the 1990s as the nation's premier low fare, high Customer satisfaction airline.

The major challenge facing the country's newest major airline is how to respond to a changing marketplace. We will continue to serve shorthaul city-pair markets, providing single class air transportation, and targeting the business commuter as well as leisure travelers.

But you don't win the pennant unless you're willing to go the extra mile. We believe the opportunities ahead far outweigh the obstacles in our path. Together with the best team in the business, our employees, we pledge to continue our successful journey.

FLEET AND EXPANSION PLANS. As we continue to expand our aircraft fleet and route structure, we are hopeful that the infrastructure necessary to support our nation's air travel requirements will expand as well, including gates, runways, airports, and air traffic control capacity. We are actively involved in such efforts, through our participation in and leadership of the Partnership for Improved Air Travel.

With respect to airport expansion, we opened two new airports in 1989, Oakland, California, and Indianapolis, Indiana, and have announced plans to open Burbank, California, in April 1990. We also plan a major improvement at Phoenix Sky Harbor as we move into the new Terminal 4 facility in the fall of 1990.

AIRCRAFT FLEET. Southwest still operates only Boeing 737 aircraft, having grown from three in 1971 to 94 at the end of 1989. This unique commitment to a single aircraft type significantly simplifies maintenance, flight operations, and training activities. The 737 has proven to be one of aviation's most successful aircraft — it is attractive and comfortable for Customers and is cost effective to operate from the airlines' perspective. And it is particularly well-suited for operation in Southwest's shorthaul markets.

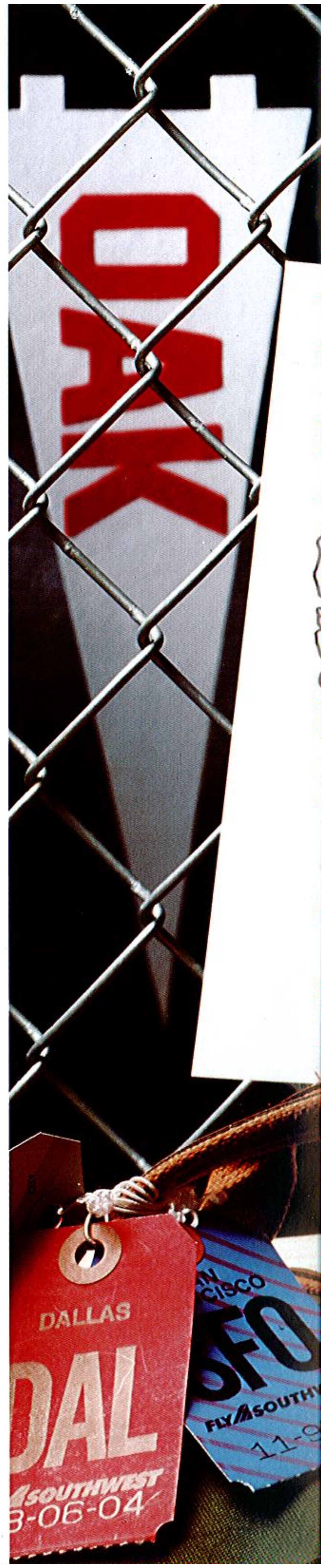
Slightly over half of the fleet are 737-300s, which are more fuel efficient than the older 737 models and which meet Stage III reduced noise level requirements. The 737-500 aircraft scheduled for future delivery use the same fuel efficient engine as the 737-300 and also meet Stage III noise requirements.

Southwest has the youngest pure-jet fleet in the nation, with an average age of 5.8 years, and has future delivery positions and options available to adequately meet our expansion needs and maintain a young efficient fleet. At December 31, 1989, Southwest had 94 aircraft on hand plus 46 firm deliveries on order and 36 options, as follows:

TYPE	SEATS	1989	1990	1991	1992	1993	1994	1995	1996
737-200	122	46	—	—	—	—	—	—	—
737-300	137	48	2	3	3	3	3	—	—
737-500	122	—	10	8	10	10	10	10	10
Total		94	12	11	13	13	13	10	10

In February 1990, Southwest reached an agreement in principle with The Boeing Company to exercise options on 16 737 aircraft deliverable in 1993-94. The formalization of this agreement will commit Southwest to purchase 62 aircraft in the 1990-94 time period. It is presently anticipated that a portion of the acquisition cost of these aircraft will be financed through internally generated funds, but that substantial external financing will also be required.

The Southwest Airlines Route System stretches from San Diego, Ontario, Los Angeles, Oakland, and San Francisco in the West to Birmingham and Nashville; from Detroit and Chicago to the Rio Grande Valley in Texas. We added two new cities in 1989, Oakland and Indianapolis.




NATIONAL
LINEUP CARD
SOUTHWEST AIRLINES
ABQ ALBUQUERQUE
AMA AMARILLO
AUS AUSTIN
BHM BIRMINGHAM
MDW CHICAGO
CRP CORPUS CHRISTI
DAL DALLAS (LOVE FIELD)
DET DETROIT
DTW DETROIT METRO
ELP EL PASO
HOU HOUSTON (HOBBY)
IAH HOUSTON (INTERCONTINENTAL)
IND INDIANAPOLIS
MCI KANSAS CITY (INTERNATIONAL)
LAS LAS VEGAS
LIT LITTLE ROCK
LAX LOS ANGELES
LBB LUBBOCK
MAF MIDLAND ODESSA
BNA NASHVILLE
MSY NEW ORLEANS
OAK OAKLAND
OKC OKLAHOMA CITY (WILL ROGERS)
ONT ONTARIO
PHX PHOENIX
HRL RIO GRANDE VALLEY (HARLINGEN)
STL ST. LOUIS
SAT SAN ANTONIO
SAN SAN DIEGO
SFO SAN FRANCISCO
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HOU
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SAT
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LAX
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Travis C. Johnson
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Herbert D. Kelleher
Chairman of the Board and President, Southwest Airlines Co., Dallas, Texas; Executive Committee

Rollin W. King
Consultant, Executive Development, Dallas, Texas; Audit and Executive Committees

Walter M. Mischer, Sr.
Chairman of the Board and Chief Executive Officer, The Mischer Corporation, Houston, Texas (real estate development); Audit and Compensation Committees

OFFICERS

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

Gary A. Barron*
Executive Vice President, Chief Operations Officer

John G. Denison*
Executive Vice President–Corporate Services

Colleen C. Barrett*
Vice President–Administration & Secretary

Daniel W. Hay
Vice President–Systems

J.L. Herring
Vice President–Energy & Provisioning

Camille T. Keith
Vice President–Special Marketing

Gary C. Kelly*
Vice President–Finance, Chief Financial Officer

William Q. Miller
Vice President–Inflight Service

James F. Parker*
Vice President–General Counsel

Paul J. Quinn
Vice President–Schedule Planning

Margaret Ann Rhoades
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Vice President–Marketing

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Vice President–Maintenance

James C. Wimberly
Vice President–Ground Operations

William D. Lyons
Controller

John D. Owen
Treasurer

Alan S. Davis
Director, Internal Audit and Special Projects

*Member of Executive Planning Committee

The Company Club offers our frequent flyers the shortest route to free trips.

1989 SOUTHWEST AIRLINES CO.

Annual Report
Financial Review

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Guess who made the majors?

TRIPLE CROWN

MANAGEMENT'S DISCUSSION AND ANALYSIS

RESULTS OF OPERATIONS

1989 COMPARED WITH 1988 The Company's consolidated net income for the year 1989 was a record $71.6 million ($2.37 per share) compared with $58.0 million ($1.84 per share) for 1988, an increase of 23.5 percent. This increase was primarily attributable to an increase in operating income of 13.5 percent resulting from traffic gains of 20.9 percent and an increase in nonoperating gains of $11.6 million, before the effects of income taxes.

Operating Revenues Consolidated passenger revenues, which accounted for 95.9 percent of total consolidated operating revenues, increased by 17.5 percent in 1989 to an all-time high of $973.6 million. This resulted primarily from a 20.9 percent increase in revenue passenger miles (RPMs) in 1989. The increase in passenger traffic exceeded the 11.2 percent increase in available seat miles (ASMs) resulting in a 5.0 point increase in the passenger load factor from 57.7 percent to 62.7 percent. The increase in passenger traffic was primarily attributable to Southwest's low fare structure in relation to its competition, improving overall economic conditions in Southwest's markets and successful first quarter 1989 promotional activities. As compared to 1988, the 1989 traffic increases were in part achieved by incrementally carrying a greater portion of lower-yielding leisure class passengers, resulting in a slight decrease in the passenger revenue yield per RPM of 2.8 percent to $.1049.

Freight revenues increased 30.1 percent in 1989 to $18.8 million from $14.4 million in 1988 due to a $2.8 million increase in U.S. mail revenues as a result of expanded U.S. Mail services in 1989. In addition, other revenues increased 28.6 percent in 1989 primarily from an 82.2 percent increase in charter revenues.

Operating Expenses Consolidated operating expenses increased 18.5 percent in 1989 to $917.4 million from $774.5 million in 1988. The primary factors contributing to the increase were the 11.2 percent increase in ASMs, resulting from the addition of nine new 737-300s to the aircraft fleet, and increases in salaries, wages and benefits; fuel and oil; and maintenance costs. This represents an increase in operating expenses per ASM of 6.5 percent over 1988 levels as follows:

Operating Expenses per ASM

	1989	1988	Increase (decrease)	Percent change
Salaries, wages and benefits	1.95¢	1.84¢	.11¢	6.0
Profit sharing	.08	.07	.01	14.3
Fuel and oil	1.14	.98	.16	16.3
Maintenance materials and repairs	.51	.41	.10	24.4
Agency commissions	.42	.40	.02	5.0
Aircraft rentals	.15	.17	(.02)	(11.8)
Landing fees and other rentals	.35	.30	.05	16.7
Depreciation	.49	.50	(.01)	(2.0)
Other	1.11	1.15	(.04)	(3.5)
Total	6.20¢	5.82¢	.38¢	6.5

The increase in salaries, wages and benefits on a per-ASM basis for 1989 primarily resulted from increases in headcount required for customer service and reservation personnel to handle the increased traffic demand; crew and ground salaries for increased charter activities; and health benefits costs. Headcount increased 20.0 percent in 1989 exceeding the 11.2 percent increase in ASMs but less than the 20.7 percent increase in passengers carried. Despite the increase in headcount, employee productivity was maintained, increasing slightly to 2,415 passengers handled per employee, up from 2,414 in 1988. In addition, average salary and benefit costs per employee declined approximately 2 percent from 1988 to 1989. Profit sharing expense per ASM increased in 1989 as a result of increased profitability as compared to 1988. Fuel and oil expenses increased as a result of an increase in the jet fuel average cost per gallon of 8.1¢ or 15.7 percent. Maintenance materials and repairs increased 24.4 percent per ASM primarily due to a higher number of regularly scheduled engine overhauls during 1989. Agency commissions were up slightly in 1989 on a per-ASM basis commensurate with the 17.5 percent increase in passenger revenues. Aircraft rentals decreased on a per-ASM basis for 1989 compared to 1988 as a result of adding nine new owned aircraft in 1989. Landing fees and rentals per ASM increased in 1989 primarily as a result of rate increases.

Other Consolidated other expenses (income) included interest expense, interest income and nonoperating gains and losses. Interest expense increased in 1989 as a result of capital lease obligations incurred in connection with the lease financing of five 737-300 aircraft in third quarter 1988. Interest income increased $5.7 million in 1989 due to higher investment balances available during most of 1989 from proceeds of

$158.8 million in the second half of 1988 and $91.2 million in the first three quarters of 1989 which were generated from sale and leaseback aircraft financings. See Consolidated Statement of Cash Flows for more information. Both 1989 and 1988 included nonoperating gains of $20.0 million and $8.3 million, respectively, as more fully described in Note 9 to the Consolidated Financial Statements.

Income Taxes The provision for income taxes increased in 1989 as a percentage of income before income taxes to 35.5 percent from 32.1 percent in 1988. The increase is primarily attributable to a reduction in available investment tax credits as a result of certain transitional rules contained in the Tax Reform Act of 1986. The investment tax credits utilized for financial reporting purposes, after providing deferred taxes for the corresponding reductions in the tax bases of the related assets, have declined from $3.4 million in 1988 to $1.4 million in 1989. See Note 10 to the Consolidated Financial Statements for further information.

1988 COMPARED WITH 1987 The Company's consolidated net income was $58.0 million in 1988 compared with $20.2 million in 1987, an increase of 187.5 percent. This increase was primarily attributable to an increase in operating income of $55.5 million. Operating revenues per ASM increased 10.8 percent versus an increase of only 3.7 percent in operating expenses per ASM.

Operating Revenues Consolidated passenger revenues, which accounted for more than 96 percent of total consolidated operating revenues, increased by 10.2 percent in 1988 to $828.3 million. This resulted from an increase in passenger revenue yield per RPM of 11.8 percent offset by a slight decrease in consolidated RPMs of 1.5 percent. Although 1988 RPMs at Southwest increased 926 million over 1987, the effect of discontinuing TranStar Airlines Corporation (TranStar) in 1987 was a decrease of 1,039 million RPMs in 1988 when compared to 1987 levels. For further discussion of TranStar, please refer to Note 2 to the Consolidated Financial Statements.

Southwest's 1988 operating revenues were $860.4 million, an increase over its 1987 operating revenues, excluding TranStar, of $161.8 million, or 23.2 percent. The increase was derived principally from a 22.6 percent increase in passenger revenues. Southwest added 10 aircraft or 1,852 million ASMs in 1988, an increase of 16.2 percent compared to Southwest's 1987 levels. Southwest's RPMs increased 13.7 percent in 1988, a slower rate of increase than the capacity growth of 16.2 percent resulting in a slight decrease in Southwest's system-wide load factor of 1.2 points to 57.7 percent. However, the RPM yield increased 7.8 percent, which, coupled with the 13.7 percent traffic increase, accounts for the overall 22.6 percent increase in passenger revenues. The increase in RPM yield resulted from a higher percentage of higher-yielding short-haul traffic in 1988 as compared to 1987 and was achieved without significant system-wide fare increases.

Operating Expenses Consolidated operating expenses increased 3.6 percent in 1988 primarily as a result of a 3.7 percent increase in operating expenses per ASM.

Operating expenses for Southwest, excluding TranStar in 1987, increased 17.8 percent, commensurate with its 16.2 percent increase in ASMs, from $657.5 million in 1987 to $774.5 million in 1988. This represents an increase per ASM of only 1.4 percent over 1987 levels. Southwest's salaries, wages and benefits expenses were largely unchanged from 1987 to 1988 on a per-ASM basis, increasing slightly by 2.8 percent primarily due to increased benefits costs. Average headcount increased 16.1 percent in 1988, commensurate with the 16.2 percent increase in ASMs but less than the 20.8 percent increase in 1988 passengers carried. Southwest's employee productivity improved in 1988 to an industry-leading 2,414 passengers handled per employee, up from 2,319 in 1987. The average salary cost per employee increased less than 1 percent from 1987 to 1988. Profit sharing expense per ASM increased in 1988 as a result of increased profitability as compared to 1987. Fuel expenses declined on a per-ASM basis in 1988 due primarily to a decrease in the annual average cost per gallon of 3.5¢ or 6.4 percent. In addition, less gallons per ASM were burned in 1988, attributable primarily to a higher mix of more fuel efficient 737-300 aircraft. Aircraft maintenance expenses per ASM declined 10.9 percent due principally to less engine overhaul costs resulting from a higher percentage of newer engines not requiring overhauls as compared to prior years. Agency commissions per ASM increased 14.3 percent in 1988 due to an increase in commissionable sales from travel agents in relation to total sales. Aircraft rentals per ASM increased 30.8 percent in 1988 versus 1987 as a result of financing seven aircraft during 1987 with long-term operating leases. Depreciation expense was reduced $3.3 million in 1988, or 3.8 percent per ASM, as a result of a change in the estimated useful lives and residual values of aircraft.

Other Consolidated other expenses (income) included interest expense, interest income and nonoperating gains and losses. Interest expense decreased in 1988 due to the reduction in TranStar debt of $75.8 million in connection with the 1987 TranStar shut-down (see Note 2 to the Consolidated Financial Statements). This decrease was partially offset by additional interest expense resulting from Southwest's capital lease financing of five aircraft in 1988. Interest income increased approximately $3.9 million in 1988 due to higher investment balances available from proceeds of $158.8 million generated from sale and leaseback aircraft financings. See Consolidated Statement of Cash Flows for further information. Both 1988 and 1987 included nonoperating gains of $8.3 million and $14.3 million, respectively, as more fully described in Notes 2 and 9 to the Consolidated Financial Statements.

Income Taxes The Provision for income taxes increased in 1988 as a percentage of income before income taxes to 32.1 percent from 30.7 percent in 1987, despite a decrease in the federal statutory rate from 40 percent to 34 percent. The increase is primarily attributable to a reduction in available investment tax credits as a result of certain transitional rules contained in the Tax Reform Act of 1986. The investment tax credits utilized for financial reporting purposes, after providing deferred taxes for the corresponding reductions in the tax bases of the related assets, have declined from $8.2 million in 1987 to $3.4 million in 1988. See Note 10 to the Consolidated Financial Statements for further information.

LIQUIDITY AND CAPITAL RESOURCES

The Company had $8.0 million in working capital at December 31, 1989 as compared to $112.1 million at December 31, 1988 and $88.7 million at December 31, 1987. The decrease in working capital during 1989 is primarily due to an increase in current liabilities of $43.0 million, resulting from increases in traffic and ASMs, and a $63.6 million decrease in cash. Cash provided from operations was $168.0 million in 1989, compared to $177.6 million in 1988 and $75.2 million in 1987. Additional funds of $91.2 million were generated in 1989 through the sale and leaseback of eight 737-200 aircraft subject to short-term operating leases. As a result of the sale and leaseback transactions, commitments for operating leases increased by $72.4 million. The cash generated from operations and the sale leaseback transactions, along with the $63.6 million reduction in cash on hand in 1989, was utilized by the Company primarily to finance aircraft-related capital expenditures, provide working capital, pay dividends and purchase treasury stock.

As a result of the significant increases in jet fuel costs experienced in late 1989 and early 1990, the Company increased certain fares in February 1990 to offset these additional costs. The modest increases in fares are not expected to deter customers but will somewhat offset the cash flow impact of the increased jet fuel costs.

Additional funds of $158.8 million were generated in 1988 through the sale and leaseback of eight aircraft: five were new 737-300 aircraft subject to long-term capital leases with three older 737-200 aircraft subject to short-term operating leases. As a result of the sale and leaseback transactions, obligations under capital leases increased by $124.1 million. Additional proceeds of $9.5 million were provided from the early payment of a note receivable. Those proceeds were primarily utilized to finance aircraft-related capital expenditures and provide working capital.

In 1987, funds of $178.0 million were provided through the sale and leaseback of seven 737-300 aircraft with another $163.1 million from the sale of TranStar assets, which included the assignment to a third party of all TranStar long-term debt. These proceeds were utilized to finance aircraft-related capital expenditures and provide working capital. TranStar's aircraft operating leases were also assumed by a third party as more fully described in Note 2 to the Consolidated Financial Statements. As a result of the sale and leaseback transactions, commitments for operating leases increased in 1987 by $336.3 million.

The Board of Directors, over the last two years, has authorized the Company, in the aggregate, to repurchase up to 3 million shares of the Company's common stock. In November 1989, the Company completed the acquisition of these shares and the Board of Directors authorized the Company to repurchase, from time to time, an additional 1,000,000 shares in the open market. As of March 6, 1990 the Company had repurchased 556,500 shares under the latest stock repurchase program.

Capital commitments for the Company consisted primarily of scheduled aircraft acquisitions. At yearend, Southwest had eight 737-300s and 38 737-500s on firm order with options to purchase another six 737-300s and up to 30 737-500s. Aggregate funding required for these commitments was $818.6 million at yearend. See Note 3 to the Consolidated Financial Statements for further information.

The Company has various options available to meet its capital and operating commitments, including cash on hand at December 31, 1989 of $146.4 million, internally generated funds and a revolving credit line with a group of banks of up to $170 million (none of which had been drawn at December 31, 1989). In addition, the Company will consider various borrowing or leasing options to maximize earnings and cash flow.

QUARTERLY FINANCIAL DATA (UNAUDITED)

(in thousands except per share amounts)

	Three months ended			
1989	March 31	June 30	Sept. 30	Dec. 31
Operating revenues	$229,387	$263,646	$266,419	$255,600
Operating income	21,931	28,787	32,647	14,261
Income before income taxes	30,273	29,655	38,031	13,023
Net income	19,644	19,237	24,566	8,111
Net income per common and common equivalent share	0.64	0.64	0.81	0.27

	Three months ended			
1988	March 31	June 30	Sept. 30	Dec. 31
Operating revenues	$178,572	$216,925	$239,117	$225,820
Operating income	1,528	23,512	39,496	21,444
Income before income taxes	243	22,247	39,097	23,773
Net income	168	15,125	26,586	16,073
Net income per common and common equivalent share	0.01	0.48	0.85	0.51

COMMON STOCK PRICE RANGES AND DIVIDENDS

Southwest's common stock is listed on the New York Stock Exchange and is traded under the symbol LUV. The high and low sales prices of the common stock on the Composite Tape and the quarterly dividends per share paid on the common stock were:

Period	Dividend	High	Low
1989			
1st Quarter	$0.035	$26.00	$19.63
2nd Quarter	0.035	28.75	24.75
3rd Quarter	0.035	30.75	25.50
4th Quarter	0.035	28.63	21.63
1988			
1st Quarter	$0.0325	$18.13	$13.13
2nd Quarter	0.0325	19.13	15.63
3rd Quarter	0.0325	19.13	15.25
4th Quarter	0.0350	20.88	16.88

As of February 23, 1990, there were 5,856 holders of record of the Company's common stock.

Southwest Airlines Co.

CONSOLIDATED BALANCE SHEET

(in thousands except share and per share amounts)

	December 31, 1989	1988
Assets		
Current assets:		
Cash and cash equivalents	$ 146,364	$ 209,983
Accounts receivable	37,951	37,045
Inventories of parts and supplies, at cost	12,484	8,790
Prepaid expenses and other current assets	7,079	9,211
Total current assets	203,878	265,029
Property and equipment, at cost (Notes 3, 5 and 6):		
Flight equipment	1,255,076	1,126,474
Ground property and equipment	164,362	124,840
Deposits on flight equipment purchase contracts	137,956	109,742
	1,557,394	1,361,056
Less allowance for depreciation	353,137	325,088
	1,204,257	1,035,968
Other assets	6,961	7,392
	$1,415,096	$1,308,389
Liabilities and Stockholders' Equity		
Current liabilities:		
Accounts payable	$ 47,986	$ 35,286
Accrued liabilities (Note 4)	94,816	76,165
Air traffic liability	32,938	27,059
Income taxes payable	3,990	4,408
Current maturities of long-term debt	16,168	9,986
Total current liabilities	195,898	152,904
Long-term debt less current maturities (Note 5)	354,147	369,541
Deferred income taxes	118,395	101,374
Deferred gains from sale and leaseback of aircraft	157,030	115,314
Other deferred liabilities	2,310	1,881
Commitments and contingencies (Notes 2, 3 and 6)		
Stockholders' equity (Note 7):		
Common stock, $1.00 par value: 100,000,000 shares authorized; 32,254,271 shares issued in 1989 and 32,254,269 shares in 1988	32,254	32,254
Capital in excess of par value	175,170	175,170
Retained earnings	441,591	374,211
	649,015	581,635
Less treasury stock, at cost (3,032,800 shares in 1989; 995,800 shares in 1988)	61,699	14,260
Total stockholders' equity	587,316	567,375
	$1,415,096	$1,308,389

See accompanying notes.

Southwest Airlines Co.

CONSOLIDATED STATEMENT OF INCOME

(in thousands except per share amounts)

	Years ended December 31, 1989	1988	1987
Operating revenues:			
Passenger	$ 973,568	$828,343	$751,649
Freight	18,771	14,433	13,428
Other	22,713	17,658	13,251
Total operating revenues	1,015,052	860,434	778,328
Operating expenses:			
Salaries, wages and benefits (Note 8)	301,066	255,046	222,461
Fuel and oil	168,579	130,321	140,334
Maintenance materials and repairs	75,842	54,208	59,469
Agency commissions	61,362	53,063	47,444
Aircraft rentals	21,636	22,629	22,001
Landing fees and other rentals	51,902	40,441	38,860
Depreciation	72,343	66,169	65,484
Other operating expenses	164,696	152,577	151,828
Total operating expenses	917,426	774,454	747,881
Operating income	97,626	85,980	30,447
Other expenses (income):			
Interest expense	33,496	29,209	30,682
Capitalized interest	(10,227)	(9,279)	(8,066)
Interest income	(16,637)	(10,970)	(7,028)
Net gains on disposals of TranStar assets less provision for operating losses during shut-down period (Note 2)	–	–	(10,181)
Nonoperating gains, net (Note 9)	(19,988)	(8,340)	(4,033)
Total other expenses (income)	(13,356)	620	1,374
Income before income taxes	110,982	85,360	29,073
Provision for income taxes (Note 10)	39,424	27,408	8,918
Net income	$ 71,558	$ 57,952	$ 20,155
Net income per common and common equivalent share (Note 11)	$2.37	$1.84	$.63

See accompanying notes.

Southwest Airlines Co.

CONSOLIDATED STATEMENT OF STOCKHOLDERS' EQUITY

Three years ended December 31, 1989

(in thousands except per share amounts)

	Common stock	Capital in excess of par value	Retained earnings	Treasury stock	Total
Balance at December 31, 1986	$32,254	$175,170	$ 304,426	$ –	$511,850
Purchase of treasury stock	–	–	–	(13,627)	(13,627)
Issuance of treasury stock upon exercise of stock options	–	–	(14)	79	65
Cash dividends, $.13 per share	–	–	(4,165)	–	(4,165)
Net income – 1987	–	–	20,155	–	20,155
Balance at December 31, 1987	32,254	175,170	320,402	(13,548)	514,278
Purchase of treasury stock	–	–	–	(712)	(712)
Cash dividends, $.1325 per share	–	–	(4,143)	–	(4,143)
Net income – 1988	–	–	57,952	–	57,952
Balance at December 31, 1988	32,254	175,170	374,211	(14,260)	567,375
Purchase of treasury stock	–	–	–	(47,439)	(47,439)
Cash dividends, $.14 per share	–	–	(4,178)	–	(4,178)
Net income – 1989	–	–	71,558	–	71,558
Balance at December 31, 1989	$32,254	$175,170	$ 441,591	$ (61,699)	$587,316

See accompanying notes.

Southwest Airlines Co.

CONSOLIDATED STATEMENT OF CASH FLOWS

(in thousands)

	Years ended December 31, 1989	1988	1987
Cash flows from operating activities:			
Net income	$ 71,558	$ 57,952	$ 20,155
Adjustments to reconcile net income to cash provided by operating activities:			
Depreciation and amortization	72,343	66,169	65,484
Deferred income taxes	17,021	15,456	(2,785)
Amortization of deferred gains on sale and leaseback of aircraft	(15,092)	(4,444)	(2,670)
Gains from sales of TranStar assets (Note 2)	–	–	(31,824)
Gains from sale and leaseback of aircraft (Note 9)	(10,818)	(5,552)	–
Changes in certain assets and liabilities:			
Decrease (increase) in accounts receivable	(906)	7,071	(10,603)
Decrease (increase) in other current assets	(1,562)	(3,731)	5,374
Increase in accounts payable and accrued liabilities	31,351	27,581	21,825
Increase in air traffic liability	5,879	15,519	3,672
Increase (decrease) in other current liabilities	(418)	(2,579)	4,074
Other	(1,337)	4,203	2,449
Net cash provided by operating activities	168,019	177,645	75,151
Cash flows from investing activities:			
Purchases of property and equipment	(261,906)	(264,531)	(235,040)
Proceeds from sales of TranStar assets (Note 2)	–	–	163,102
Proceeds from sales of other property and equipment	574	1,176	1,005
Net cash used in investing activities	(261,332)	(263,355)	(70,933)
Cash flows from financing activities:			
Proceeds from sale and leaseback transactions	91,180	158,750	178,000
Proceeds from (acquisition of) note receivable	–	9,533	(9,533)
Purchase of treasury stock	(47,439)	(712)	(13,627)
Payment of long-term debt and capital lease obligations	(9,986)	(9,743)	(84,050)
Payment of cash dividends	(4,178)	(4,143)	(4,165)
Other	117	(726)	(2,970)
Net cash provided by financing activities	29,694	152,959	63,655
Net increase (decrease) in cash and cash equivalents	(63,619)	67,249	67,873
Cash and cash equivalents at beginning of period	209,983	142,734	74,861
Cash and cash equivalents at end of period	$146,364	$209,983	$142,734
Cash payments for:			
Interest, net of amount capitalized	$ 16,915	$ 14,645	$ 23,525
Income taxes	22,829	14,774	5,826
Financing activities not affecting cash:			
Capital lease obligations incurred	$ –	$124,123	$ –

See accompanying notes.

Southwest Airlines Co.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

December 31, 1989

1. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

Basis of presentation The consolidated financial statements include the accounts of Southwest Airlines Co. (Southwest) and its wholly owned subsidiaries, TranStar Airlines Corporation (TranStar), Southwest Jet Fuel Co. and Southwest Airlines Eurofinance N.V. (collectively referred to as the Company). All significant intercompany balances and transactions have been eliminated. The decision was made to discontinue TranStar's operations effective July 1987 as described in Note 2. Accordingly, the results of TranStar's operations subsequent to that date were included in "Other expenses (income)" in the caption "Net gains on disposals of TranStar assets less provision for operating losses during shut-down period."

Cash and cash equivalents Short-term investments that are highly liquid and have original maturity dates of three months or less are considered cash equivalents.

Inventories Inventories of flight equipment expendable parts, materials and supplies are valued at cost. These items are charged to expense when issued for use.

Property and equipment Depreciation is provided by the straight-line method to residual values over periods ranging from 15 to 20 years for flight equipment and three to 30 years for ground property and equipment. The Company charges aircraft maintenance costs to operations as incurred. Property under capital leases and related obligations are recorded at an amount equal to the present value of future minimum lease payments computed on the basis of the lessee's incremental borrowing rate, or when known, the interest rate implicit in the lease. Amortization of property under capital leases is on a straight-line basis over the lease term and is included in depreciation expense.

Revenue recognition Passenger revenue is recognized when the transportation is provided. Tickets sold but not yet used are included in "Air traffic liability."

Frequent flyer awards The Company accrues the estimated incremental cost to provide transportation for travel awards when earned under its Company Club frequent flyer program.

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

2. TRANSTAR

Effective June 30, 1985, Southwest acquired the stock of Muse Air Corporation, which was subsequently renamed TranStar, for approximately $68 million consisting of approximately $40.5 million in cash; 830,320 shares of Southwest common stock; and 1,080,320 warrants to purchase Southwest common stock at $35 per share, subject to adjustment, expiring on June 25, 1990. The acquisition was accounted for as a purchase and, accordingly, the results of operations of TranStar were included in the consolidated financial statements from the date of acquisition.

Due to substantial operating losses, TranStar's management decided in July 1987 to cease operations and liquidate TranStar's assets and liabilities. Accordingly, the effects of this decision were recorded as of July 1. TranStar discontinued its scheduled airline operations in August 1987. Later in 1987, TranStar sold all its owned aircraft and related spare parts and equipment; assigned its rights and obligations as a lessee with respect to all leased aircraft; and effected a nontaxable liquidating dividend of remaining net assets to Southwest at December 31, 1987 and thus, ceased all operations. Proceeds pursuant to these aircraft sale agreements were $77.8 million in cash and assumption of all aircraft-related debt ($25.8 million face value of notes and $50.0 million face value of Equipment Trust Certificates) and all aircraft-related lease obligations. TranStar also sold its delivery positions for two MD-80 aircraft for cash and assumption of debt equivalent to progress payments made by TranStar on the positions ($8 million). TranStar remains secondarily liable on the Equipment Trust Certificates and certain of the lease agreements assigned. Ultimately, aircraft should be available, if necessary, to satisfy a substantial portion of the Company's secondary liabilities.

Operating results for TranStar included in the Company's consolidated financial statements for the year ended December 31, 1987 were (in thousands):

Operating revenues	$ 80,499
Operating expenses	(91,233)
Other expenses, net	(4,451)
Net gains on asset disposals	31,824
Provision for operating losses during shut-down period	(21,643)
Loss before income taxes	$ (5,004)

3. COMMITMENTS

At December 31, 1989, the Company's contractual commitments consisted primarily of scheduled aircraft acquisitions. Two 737-300s are scheduled for delivery in 1990 and three each in 1991 and 1992. Ten 737-500s are scheduled for delivery in 1990, eight in 1991, 10 in 1992 and 10 in 1993. In addition, the Company has options to purchase up to six 737-300s during 1993 and 1994 and 30 737-500s during 1994-1996. The Company has the option to substitute 737-400s or 737-300s for 18 737-500s to be delivered in 1992 and 1993 and for the 30 options in 1994-1996. Aggregate funding needed for these commitments was approximately $818.6 million at December 31, 1989 due as follows: $232.8 million in 1990, $230.8 million in 1991, $218.9 million in 1992 and $136.1 million in 1993.

4. ACCRUED LIABILITIES

(in thousands)	1989	1988
Aircraft rentals	$ 21,511	$ 18,339
Engine overhauls	9,902	7,778
Vacation pay	13,754	10,644
Profit sharing (Note 8)	12,400	9,940
Taxes, other than income	9,204	8,356
Interest	13,324	7,662
Other	14,721	13,446
	$ 94,816	$ 76,165

5. LONG-TERM DEBT

(in thousands)	1989	1988
9% Notes due 1996	$100,000	$100,000
6¾% Convertible Subordinated Debentures due 1998	35,000	35,000
French Export Credit Agreement	10,101	12,626
10.4% ETCs due July 1, 1994	8,957	10,748
10.3% ETCs due January 1, 1995	7,701	9,101
10.3% ETCs due July 1, 1995	8,876	10,355
Capital leases (Note 6)	195,465	197,337
Industrial Revenue Bonds	2,925	3,475
Other	1,814	1,494
	370,839	380,136
Less current maturities	16,168	9,986
Less debt discount	524	609
	$354,147	$369,541

In March 1986, Southwest issued $100 million in unsecured 9% Notes due March 1, 1996. Interest is payable semi-annually on March 1 and September 1 and the entire principal balance is payable at maturity. The Notes are redeemable at the issuer's option on or after March 1, 1993 at par plus accrued interest.

The 6¾% Convertible Subordinated Debentures were issued by Southwest Airlines Eurofinance N.V. and are convertible into common stock at any time on or before July 1, 1998, unless previously redeemed, at a conversion price of $38.30 per share, subject to adjustment in certain events. Interest is payable on July 1 of each year. The Debentures are redeemable at the issuer's option at 100% of face value.

The French Export Credit Agreement requires semi-annual installments of principal and interest through December 20, 1993. The debt is secured by one 737-300 and one 737-200 aircraft and bears interest at 10.5% per annum.

The 10.3% and 10.4% Equipment Trust Certificates require semi-annual principal and interest payments and are secured by ten 737-200 advanced series aircraft with a net book value of approximately $35 million at December 31, 1989.

The Industrial Revenue Bonds mature in series annually through 1994. Interest is payable semi-annually on January 1 and July 1 at an effective rate of 60% of prime but not less than 7½% or more than 15%. The Bonds are secured by Southwest's Reservations Center in San Antonio.

In addition to the credit facilities described above, Southwest has a Bank Credit Agreement with a group of domestic banks that permits Southwest to borrow through December 18, 1991 on a revolving credit basis up to the primary commitment ($45 million at December 31, 1989). The primary commitment can be increased to as much as $170 million at Southwest's option. Interest rates on borrowings under the Credit Agreement can be, at the option of Southwest, the agent bank's prime rate, ⅜% over LIBOR or ⅜% over domestic certificate of deposit rates. The commitment fee is ¼% per annum on the unused portion of the primary commitment and ⅛% per annum on the difference between $170 million and the amount of the primary commitment. There were no outstanding borrowings under this agreement at December 31, 1989 or 1988.

Long-term debt principal payments, excluding capital leases, due in the next five years are (in thousands):

1990	$9,130
1991	7,820
1992	7,845
1993	7,895
1994	5,045

6. LEASES

Total rental expense for operating leases charged to operations in 1989, 1988 and 1987 was $48,112,000, $43,435,000 and $41,713,000, respectively. The majority of the Company's corporate office and terminal operations space, as well as 22 aircraft, were under operating leases. The amounts applicable to capital leases included in property and equipment were (in thousands):

	1989	1988
Flight equipment	$196,505	$196,505
Less accumulated amortization	27,945	18,653
	$168,560	$177,852

At December 31, 1989, obligations under capital leases and noncancelable operating leases for future minimum lease payments were (in thousands):

	Capital leases	Operating leases
1990	$ 23,608	$ 51,285
1991	17,660	50,755
1992	18,508	48,485
1993	19,824	44,525
1994	19,819	42,516
After 1994	300,883	376,715
Total minimum lease payments	400,302	$614,281
Less amount representing interest	204,837	
Present value of minimum lease payments	195,465	
Less current portion	7,038	
Long-term portion	$188,427	

7. COMMON STOCK

At December 31, 1989, the Company had 36,700,710 shares of common stock reserved for issuance upon the conversion of convertible securities; pursuant to employee profit sharing and stock option plans; for warrants issued in the TranStar acquisition (of which two warrants were exercised in 1989) and upon exercise of rights pursuant to the Common Share Purchase Rights Plan (the Plan).

Pursuant to the Plan, each outstanding share of the Company's common stock is accompanied by one common share purchase right (Right). Each Right entitles its holder to purchase one share of common stock for $75 and is exercisable only in the event of a proposed takeover, as defined by the Plan. The Company may redeem the Rights at $.05 per Right prior to the time that 20 percent of the common stock has been acquired by a person or group. If the Company is acquired or if certain self-dealing transactions occur, as defined in the Plan, each Right will entitle its holder to purchase for $75 that number of the acquiring company's or the Company's common shares, as provided in the Plan, having a market value of $150. The Rights will expire no later than July 30, 1996.

8. EMPLOYEE PROFIT SHARING PLAN

Substantially all of the Company's employees are members of the Southwest Airlines Co. Profit Sharing Plan (the Plan). Total profit sharing expense charged to operations in 1989, 1988 and 1987 was $12,398,000, $9,931,000 and $1,596,000, respectively. The Plan provides that Southwest 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.

9. NONOPERATING GAINS

In 1989 and 1988, gains of $10,818,000 and $5,552,000, respectively, were recognized on the sale and subsequent short-term leaseback of eight 737-200 aircraft in 1989 and three 737-200 aircraft in 1988. The Company recognized gains of $5,926,000, $3,608,000 and $4,297,000 in 1989, 1988 and 1987, respectively, from sales of certain financial assets. Also in 1989, the Company recognized a gain of $2,296,000 from the settlement of a contingency related to the 1987 TranStar aircraft sale.

10. INCOME TAXES

The provision for income taxes differed from the amount that resulted from applying the statutory federal income tax rates (34% in 1989 and 1988 and 40% in 1987) to income before income taxes as follows (in thousands):

	1989	1988	1987
Federal income tax provision at statutory rate	$37,734	$29,022	$11,629
Investment tax credit	(1,430)	(3,415)	(8,193)
Effect of TranStar basis differences that resulted from purchase accounting adjustments	–	–	4,008
Nondeductible expenses	530	503	785
State income tax provision, net of federal benefit	2,283	1,272	360
Other	307	26	329
	$39,424	$27,408	$ 8,918

The provision for income taxes included deferred taxes resulting from timing differences in the recognition of revenue and expense for financial and tax reporting purposes. The provision for income taxes consisted of (in thousands):

	1989	1988	1987
Current	$22,403	$11,952	$11,703
Deferred:			
Depreciation	24,739	14,361	5,600
Deferred gains on sale/leaseback	(20,508)	(14,326)	(17,635)
Net operating loss utilized	–	9,999	10,015
Investment tax credits	15,039	6,640	1,671
Vacation pay	(961)	(1,176)	–
Other	(1,288)	(42)	(2,436)
Total deferred provision (benefit)	17,021	15,456	(2,785)
Total	$39,424	$27,408	$ 8,918

At December 31, 1989, the Company had available $1.9 million in credit carryforwards for federal income tax purposes. The carryforwards will expire in 2004 if not previously utilized.

The Financial Accounting Standards Board issued Statement No. 96 (Accounting for Income Taxes) in December 1987. This standard requires an asset and liability approach to accounting for differences between the tax basis of an asset or liability and its reported amount in the financial statements. Under the accounting rules, deferred taxes will be determined by applying the provisions of enacted tax laws, and adjustments will be required for changes in tax laws and rates. The effect of the Company's anticipated change to this Statement has not been accurately estimated at this date but is expected to be material primarily as a result of reducing net deferred tax credits for reductions in income tax rates promulgated by the Tax Reform Act of 1986 (46% to 40% to 34%). The standard, as amended, requires adoption in 1992, although earlier adoption is permitted. The Company has not adopted the standard as of December 31, 1989 and has not determined in which year it will adopt the standard.

11. NET INCOME PER SHARE

Net income per common and common equivalent share is computed based on the weighted average number of common and common equivalent shares outstanding (30,172,000 in 1989, 31,466,000 in 1988 and 32,091,000 in 1987). Shares issuable upon the conversion of Convertible Subordinated Debentures are not considered in the computation because their effect is anti-dilutive or is not material.

REPORT OF INDEPENDENT AUDITORS

The Board of Directors and Shareholders
Southwest Airlines Co.

We have audited the accompanying consolidated balance sheet of Southwest Airlines Co. as of December 31, 1989 and 1988, and the related consolidated statements of income, stockholders' equity, and cash flows for each of the three years in the period ended December 31, 1989. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with generally accepted auditing standards. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the financial statements referred to above present fairly, in all material respects, the consolidated financial position of Southwest Airlines Co. at December 31, 1989 and 1988, and the consolidated results of its operations and its cash flows for each of the three years in the period ended December 31, 1989, in conformity with generally accepted accounting principles.

Ernst + Young

Dallas, Texas
January 26, 1990

Southwest Airlines Co.

SUPPLEMENTARY INFORMATION PARENT COMPANY ONLY

Summary of Operations (in thousands)	Years ended December 31, 1989	1988	1987
Operating revenues:			
Passenger	$ 973,568	$ 828,343	$ 675,397
Freight	18,771	14,433	12,329
Other	22,713	17,658	10,937
Total operating revenues	1,015,052	860,434	698,663
Operating expenses:			
Salaries, wages and benefits	301,066	255,046	206,140
Fuel and oil	168,579	130,321	121,900
Maintenance materials and repairs	75,842	54,208	52,331
Agency commissions	61,362	53,063	40,498
Aircraft rentals	21,636	22,629	14,834
Landing fees and other rentals	51,902	40,441	33,593
Depreciation	72,343	66,169	59,139
Other operating expenses	164,696	152,577	129,047
Total operating expenses	917,426	774,454	657,482
Operating income	97,626	85,980	41,181
Other expenses (income), net	(13,356)	620	7,104
Equity in loss of TranStar*	–	–	(5,004)
Income before income taxes	110,982	85,360	29,073
Provision for income taxes	39,424	27,408	8,918
Net income	$ 71,558	$ 57,952	$ 20,155

Operating Statistics (Southwest only)	1989	1988	1987
Revenue passengers carried	17,958,263	14,876,582	12,313,114
RPMs (000s)	9,281,992	7,676,257	6,749,942
ASMs (000s)	14,796,732	13,309,044	11,456,730
Load factor	62.7%	57.7%	58.9%
Average length of passenger haul	517	516	548
Trips flown	304,673	274,859	246,046
Average passenger fare	$54.21	$55.68	$54.85
Passenger revenue yield per RPM	10.49¢	10.79¢	10.01¢
Operating revenue yield per ASM	6.86¢	6.47¢	6.10¢
Operating expenses per ASM	6.20¢	5.82¢	5.74¢
Fuel cost per gallon (average)	59.46¢	51.37¢	54.88¢
Number of employees at yearend	7,760	6,467	5,765
Size of fleet at yearend**	94	85	75

*For comparison purposes, TranStar has been presented on an equity basis for 1987, rather than a consolidated basis.

**Includes leased aircraft

Southwest Airlines Co.

TEN YEAR SUMMARY

Selected Consolidated Financial Data

(in thousands except per share amounts)	1989	1988	1987	1986
Operating revenues:				
Passenger	$ 973,568	$ 828,343	$ 751,649	$ 742,287
Freight	18,771	14,433	13,428	13,621
Other	22,713	17,658	13,251	12,882
Total operating revenues	1,015,052	860,434	778,328	768,790
Operating expenses	917,426	774,454	747,881	679,827
Operating income	97,626	85,980	30,447 (3)	88,963
Other expense (income), net	(13,356)(1)	620 (2)	1,374 (4)	23,517 (5)
Income before income taxes	110,982	85,360	29,073	65,446
Provision for income taxes	39,424	27,408	8,918	15,411
Net income	$ 71,558	$ 57,952	$ 20,155	$ 50,035
Net income per common and common equivalent share	$2.37	$1.84	$ .63	$1.55
Cash dividends per common share	$ .14	$.1325	$ .13	$ .13
Total assets	$1,415,096	$1,308,389	$1,042,640	$1,061,419
Long-term obligations	$354,147	$369,541	$251,130	$339,069
Stockholders' equity	$587,316	$567,375	$514,278	$511,850

Consolidated Financial Ratios

	1989	1988	1987	1986
Return on average total assets	5.2%	5.1%	1.9%	4.8%
Return on average stockholders' equity	12.4%	10.8%	4.0%	10.3%
Debt as a percentage of invested capital	37.6%	39.4%	32.8%	39.8%

Consolidated Operating Statistics

	1989	1988	1987	1986
Revenue passengers carried	17,958,263	14,876,582	13,503,242	13,637,515
RPMs (000s)	9,281,992	7,676,257	7,789,376	7,388,401
ASMs (000s)	14,796,732	13,309,044	13,331,055	12,574,484
Load factor	62.7%	57.7%	58.4%	58.8%
Average length of passenger haul	517	516	577	542
Trips flown	304,673	274,859	270,559	262,082
Average passenger fare	$54.21	$55.68	$55.66	$54.43
Passenger revenue yield per RPM	10.49¢	10.79¢	9.65¢	10.05¢
Operating revenue yield per ASM	6.86¢	6.47¢	5.84¢	6.11¢
Operating expenses per ASM	6.20¢	5.82¢	5.61¢	5.41¢
Fuel cost per gallon (average)	59.46¢	51.37¢	54.31¢	51.42¢
Number of employees at yearend	7,760	6,467	5,765	5,819
Size of fleet at yearend (8)	94	85	75	79

(1) Includes $10.8 million gains on sales of aircraft, $5.9 million from the sale of certain financial assets and $2.3 million from the settlement of a contingency
(2) Includes $5.5 million gains on sales of aircraft and $3.6 million from the sale of certain financial assets
(3) Includes TranStar's results through June 30, 1987
(4) Includes $10.1 million net gains from the discontinuance of TranStar's operations and $4.3 million from the sale of certain financial assets
(5) Includes a gain of $4 million from the sale of aircraft delivery positions
(6) Includes the accounts of TranStar since June 30, 1985
(7) Includes a gain from the sale of tax benefits relating to three aircraft of $11 million
(8) Includes leased aircraft

1985 (6)	1984	1983	1982	1981	1980
$ 656,689	$ 519,106	$ 433,388	$ 317,996	$ 258,612	$ 204,260
13,643	12,115	10,357	9,469	8,326	6,080
9,340	4,727	4,491	3,724	3,420	2,708
679,672	535,948	448,236	331,189	270,358	213,048
601,148	467,451	379,738	291,964	221,854	164,219
78,524	68,497	68,498	39,225	48,504	48,829
17,740	649	4,927	(5,165) (7)	239	7,539
60,784	67,848	63,571	44,390	48,265	41,290
13,506	18,124	22,704	10,386	14,100	12,843
$ 47,278	$ 49,724	$ 40,867	$ 34,004	$ 34,165	$ 28,447
$1.54	$1.69	$1.40	$1.28	$1.35	$1.30
$ .13	$ .13	$ .13	$ .13	$ .11	$ .09
$1,002,403	$646,244	$587,258	$420,542	$291,823	$224,442
$381,308	$153,314	$158,701	$106,306	$58,934	$77,892
$466,004	$361,768	$314,556	$240,627	$176,503	$106,964
5.6%	8.1%	8.1%	9.6%	13%	14.1%
11.4%	14.7%	14.2%	16.7%	23.5%	36.0%
45%	29.8%	33.5%	30.6%	25%	42.1%
12,651,239	10,697,544	9,511,000	7,965,554	6,792,927	5,976,621
5,971,400	4,669,435	3,893,821	3,022,142	2,310,181	2,024,097
9,884,526	7,983,093	6,324,224	4,907,945	3,633,351	2,969,448
60.4%	58.5%	61.6%	61.6%	63.6%	68.2%
472	436	409	379	340	339
230,227	200,124	175,421	140,030	110,301	91,143
$51.91	$48.53	$45.57	$39.92	$38.07	$34.18
11.00¢	11.12¢	11.13¢	10.52¢	11.19¢	10.09¢
6.88¢	6.71¢	7.09¢	6.75¢	7.44¢	7.17¢
6.08¢	5.86¢	6.00¢	5.95¢	6.11¢	5.53¢
78.17¢	82.44¢	85.92¢	94.51¢	101.67¢	84.49¢
5,271	3,934	3,462	2,913	2,129	1,839
70	54	46	37	27	23

CORPORATE DATA

Transfer Agent and Registrar
MTrust Corp. N.A.
P.O. Box 2320
Dallas, Texas 75221-2320

Stock Exchange Listing
New York Stock Exchange
Ticker Symbol: LUV

Auditors
Ernst & Young
Dallas, Texas

Corporate Offices
P.O. Box 36611
Love Field
Dallas, Texas 75235-1611

Annual Meeting
The Annual Meeting of Shareholders of Southwest Airlines Co. will be held at 10:00 a.m. on May 16, 1990 at the Southwest Airlines Corporate Headquarters, 2702 Love Field Drive, Dallas, Texas.

SEC Form 10-K
Shareholders 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 36611, Love Field, Dallas, Texas 75235-1611.

SOUTHWEST

Southwest Airlines Co.

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