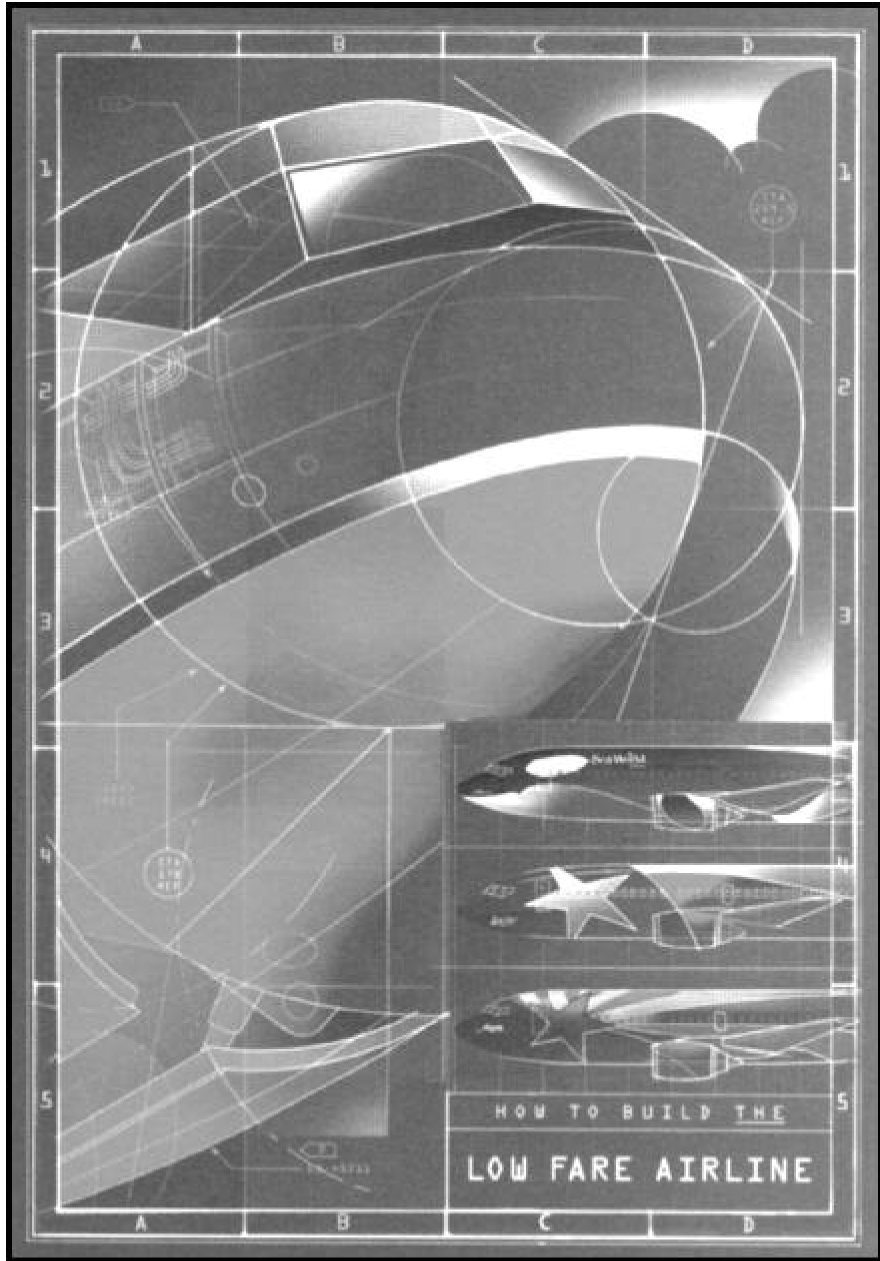
Southwest Airlines Co. 1994 Annual Report



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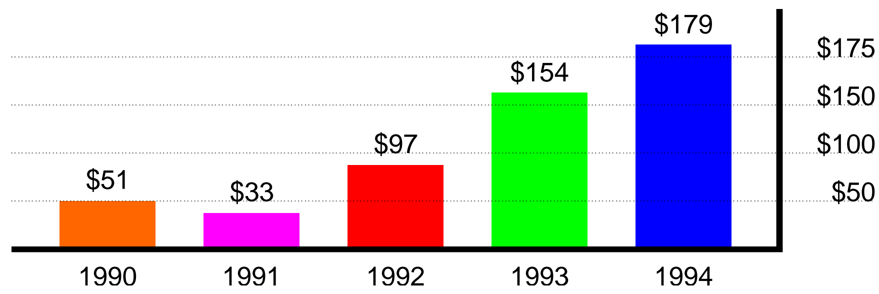
Consolidated Highlights

(Dollars in thousands except per share amounts)

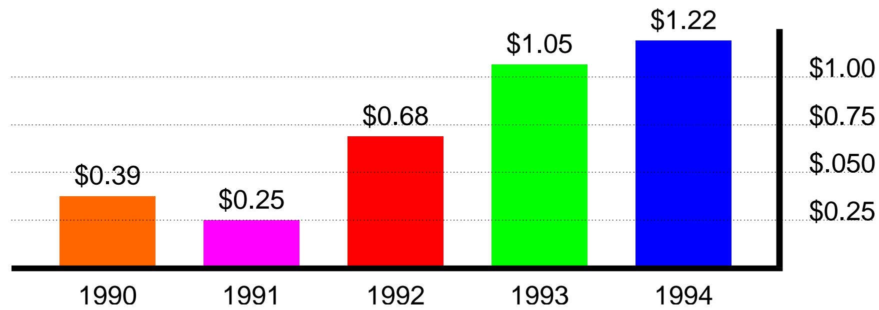
	1994	1993	Percent Change
Operating revenues	$2,591,933	$2,296,673	12.9
Operating expenses	$2,275,224	$2,004,700	13.5
Operating income	$316,709	$291,973	8.5
Operating margin	12.2%	12.7%	(0.5)pts.
Net income [(1)]	$179,331	$154,284	16.2
Net margin [(1)]	6.9%	6.7%	0.2pts.
Net income per common and common equivalent share [(1)]	$1.22	$1.05	16.2
Stockholders equity	$1,238,706	$1,054,019	17.5
Return on average stockholders equity [(1)]	15.6%	16.0%	(0.4)pts.
Debt as a percentage of invested capital	32.0%	37.7%	(5.7)pts.
Stockholders equity per common share outstanding	$8.65	$7.38	17.2
Revenue passengers carried	42,742,602	36,955,221	15.7
Revenue passenger miles (RPM) (000s)	21,611,266	18,827,288	14.8
Available seat miles (ASM) (000s)	32,123,974	27,511,000	16.8
Passenger load factor	67.3%	68.4%	(1.1)pts
Passenger revenue yield per RPM	11.56¢	11.77¢	(1.8)
Operating revenue yield per ASM	8.07¢	8.35¢	(3.4)
Operating expenses per ASM	7.08¢	7.25¢	(2.3)
Number of Employees at yearend	16,818	15,175	10.8

(1) 1993 amounts exclude cumulative effect of accounting changes

Net Income



Net Income per Share



Low Fares

Southwest Airlines was built, from the ground up, to save our Customers time and money. The blueprint looks simple enough: Never lose sight of your vision. Keep productivity high and fares low. Maintain a young, pure jet fleet. Consistently deliver Triple Crown® Service. And let your Southwest Spirit come shining through.

Many have tried to build a low fare airline. But only Southwest has built THE Low Fare Airline. Even if someone could duplicate everything else we do (and nobody's done it yet), they could never match our Southwest Spirit. When we built Southwest Airlines, we broke the mold.

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 1994, Southwest operated 199 Boeing 737 aircraft and provided service to 45 airports in 44 cities principally in the midwestern, southwestern, and western regions of the United States. Southwest has one of the best overall Customer Service records, one of the lowest operating cost structures, and consistently offers 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.

To Our Shareholders

In 1994, Southwest Airlines produced a profit of $179.3 million, a 16.2 percent increase over the $154.3 million of 1993, excluding the cumulative effect of 1993 accounting changes. Our net profit margin was 6.9 percent in a year when the domestic passenger carrier industry, as a whole, basically broke even.

In 1994, we also:

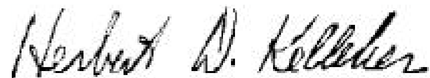
1. Completed negotiation of the launch contract for the Boeing 737-700 and the definition of our new aircraft to be received by Southwest beginning in fourth quarter 1997;
2. Completed negotiation of a contract for installation of Heads Up Displays (HUD) in the cockpits of our 737-300s, -500s, and -700s, providing greater landing and takeoff capabilities in adverse weather conditions, such as fog;
3. Acquired Morris Air and smoothly, successfully, and profitably integrated Morris into Southwest within nine months;
4. Including Morris, added seven new cities and introduced 30 percent more capacity to the Southwest system;
5. Designed, developed, tested, and prepared to go nationwide on January 31, 1995 with "Ticketless" air travel;
6. On an interim basis, after our ouster from Apollo and System One, introduced our own Southwest "CRS" (SWAT) for very high volume travel agencies and overnight ticket delivery for high volume travel agencies;
7. Introduced three-day Ticket By Mail for direct consumers;
8. Defined the functionality and negotiated a contract with American Airlines for entry into Basic SABRE, which, on May 1, 1995, will afford automated access to our Reservations System for 60 percent of our travel agency sales, and, we are convinced, produce lesser overall distribution costs for Southwest; while also providing our first direct, computerized access to the consumer through Easy SABRE and Commercial SABRE;
9. Negotiated a contract with the State of Arkansas and City of Little Rock and designed and built our 900-Agent Little Rock Reservations Center;
10. Negotiated and signed a collective bargaining agreement with the IAM covering 5,000 Reservation Sales and Customer Service Agents;
11. Negotiated a landmark Pilot contract with the Southwest Airlines Pilots' Association (SWAPA), fundamentally offering stock options in lieu of pay increases;
12. Sustained a year-long collision with Continental Lite, indirectly in Texas and directly on the Midway Airport-Cleveland-Baltimore axis of our system;
13. Met the United Shuttle assault head-on in California on October 1, 1994;
14. Won our third annual Triple Crown for best baggage handling; best ontime performance; and fewest Customer complaints per Customer carried;
15. Placed first in the Airline Quality Rating statistics; and
16. Operated 624,476 flights, carrying 42,742,602 Customers in perfect safety.

Our 1994 fourth quarter earnings of $20.3 million represented a 47 percent decline from the record $38.4 million of fourth quarter 1993. The principal causes for this decline were our own aggressive 30 percent expansion in Southwest's capacity, as roughly 20 percent of our available seat miles were devoted to newly developing markets; Continental Airlines' repetitive "50 percent off" sales, which both deprived us of Customers and reduced yields per revenue passenger mile; and, to a lesser extent, the introduction of the United Shuttle in our Oakland markets. We also experienced a technological problem with our Reservations System, which has since been cured.

We presently expect the aftereffects of fourth quarter 1994 to persist through first quarter 1995, resulting in reduced load factors; lower yields; and substantially reduced earnings, as compared to first quarter 1994. As our most recent fare increases begin to take effect and our penetration of our new markets continues, we currently anticipate that our yields and load factors will begin to improve in the second quarter of 1995, with a hoped for full recovery occurring in third quarter 1995, barring any profound changes in the fortunes of the airline industry or of the economy. Our battle with the United Shuttle will continue in 1995, but we expect our California operations to be profitable for the year. Excluding fuel and profitsharing, we also are planning to reduce our 1995 operating costs per ASM below those of 1994.

In 1994, our People made an enormous investment in the future of Southwest Airlines. Only Southwest's People could have effectively handled so much change so successfully. While a number of other airlines may attempt to imitate Southwest, none of them can duplicate the spirit, unity, "can do" attitudes, and marvelous *esprit de corps* of the Southwest Employees, who continually provide superb Customer Service to each other and to the traveling public. Just as the past has belonged to Southwest because of our People's goodwill, dedication, and energy, so shall Southwest seize the future!

Most sincerely,



Herbert D. Kelleher
Chairman, President, and
Chief Executive Officer
February 9, 1995

Low Cost

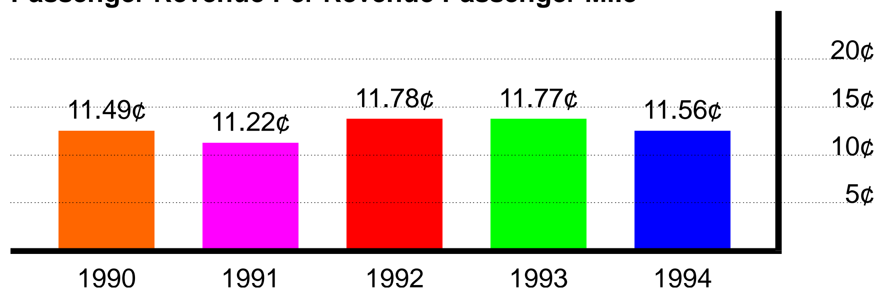
Southwest has the lowest cost structure among all major airlines. In the intensely competitive airline industry, this is the most important aspect of our business strategy, after safety, as it allows us to profitably offer Customers what they want most from safe air transportation—low fares. Southwest is THE Low Fare Airline every day, everywhere we fly.

Our operating costs per available seat mile were 2.3 percent lower in 1994 than 1993, a distinct accomplishment considering the heavy expansion cost we incurred in 1994 to develop new markets. The foundation of our cost structure includes a commitment to a principal market niche, which allows us to streamline our marketing and operations; high asset utilization and Employee productivity; and the Southwest Spirit of our Employees.

Our distribution costs are also lower than most of our competitors because of our dominant market presence; our simple and reliably low fare structure; and the ease of dealing with us directly. In 1994, we took steps to lower our distribution costs further, by enhancing our Ticket By Mail product and introducing Ticketless travel. Each of these initiatives made it easier for our Customers to secure travel on Southwest. Also, in January 1995, we reached an agreement with AMR's SABRE unit as the launch customer for its new "Basic Booking Request" level, a "no-frills" product for travel agencies and direct Customers that allows them automated access to our reservations system for booking purposes. This new service will be available May 1, 1995, and will further reduce our operating cost per passenger.

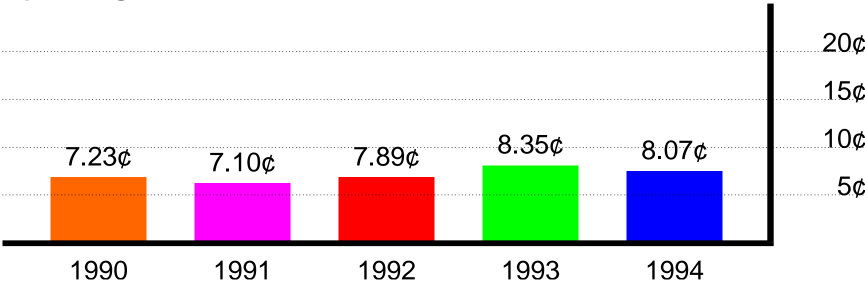
Our focus on low operating costs will continue to be intense in 1995. Distribution costs will continue to be a primary focus as we roll out Ticketless systemwide on January 31, 1995; implement SABRE's new Basic Booking Request level on May 1, 1995; explore other automated booking opportunities; and embark on a new internal reservations system development effort scheduled for completion no later than 1997. We also reached a landmark ten-year agreement with our Pilots in January 1995, calling for stock options in exchange for, among other things, no trip rate increases for the next five years. Finally, our expansion plans for 1995 will be more conservative (possibly only one new city), resulting in lower advertising and marketing expenditures per available seat mile than in 1994.

Passenger Revenue Per Revenue Passenger Mile

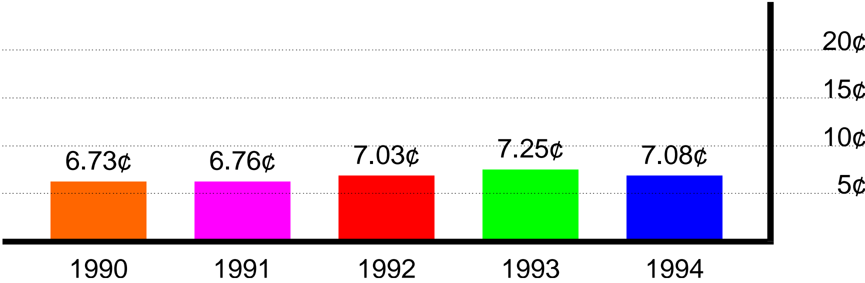


Low Cost (continued)

Operating Revenue Per Available Seat Mile



Operating Expense Per Available Seat Mile



Productivity

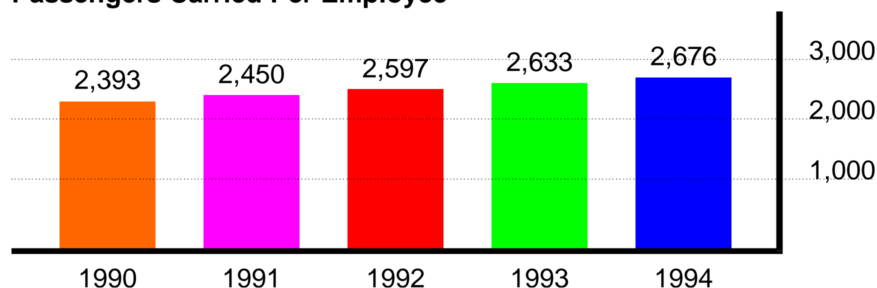
A cornerstone of our low operating cost structure is our high asset utilization and Employee productivity. We are continually able to achieve the highest productivity of any U.S. airline. One reason for our productivity advantage is our dedication to the shorthaul, high-frequency, low-fare, point-to-point market niche. As a consequence, we only provide service to communities that have sufficient local traffic to support our high-frequency operations profitably.

We schedule our aircraft on a point-to-point, not hub-and-spoke, basis and focus on local, not through or connecting, traffic. As a result, approximately 80 percent of our Customers fly nonstop. Our point-to-point route system, as compared to hub-and-spoke, provides for more direct nonstop routings for shorthaul Customers and, therefore, minimizes stops, connections, delays, and total trip time. In addition, we serve many conveniently located satellite or downtown airports such as Dallas Love Field, Houston Hobby, Chicago Midway, Oakland, Burbank, Ontario, San Jose, and Baltimore. We avoid many congested hub airports altogether and enhance our ability to sustain high productivity and reliable ontime performance.

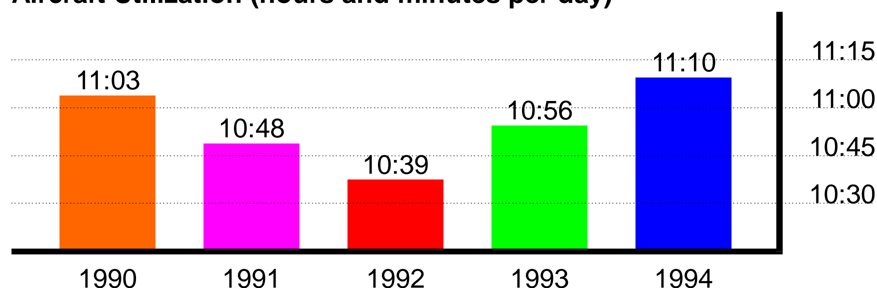
Aircraft are scheduled to minimize the amount of time the aircraft is at the gate, generally less than 20 minutes, thereby reducing the number of aircraft and gate facilities that would otherwise be required. Because of our shorthaul market focus, we require and have only one aircraft type, the Boeing 737. This drastically simplifies scheduling, maintenance, flight operations, and training activities.

All combined, the point-to-point route system; high frequency and uncongested airport selection; single aircraft type; high asset utilization; and high Employee productivity produce a very safe, efficient, and cost-effective operation with exceptional ontime performance.

Passengers Carried Per Employee



Aircraft Utilization (hours and minutes per day)



Jet Fleet

We operate only one aircraft type, the jet Boeing 737 series. At yearend 1994, we had 199 aircraft in the fleet, consisting of 124 -300s; 50 -200s; and 25 -500s. We operate our Boeing 737 jets in an all-coach configuration and believe they are attractive, safe, and comfortable for our Customers and cost-effective to operate in high-frequency short- to medium-range markets. Operating a single aircraft type has proven to be efficient and safe.

Our fleet age is among the youngest of the major airlines at 7.6 years. Almost 75 percent of our fleet have the newer Stage 3 engines, which are quieter and more fuel-efficient. Despite the increased cost of owning newer aircraft, we still have the lowest overall operating costs because of our high productivity. Not only is our young fleet quiet and fuel-efficient, it's also very reliable. In 1994, only 0.86 percent of our flights were canceled or delayed due to mechanical incidents, which also contributes to lower operating costs.

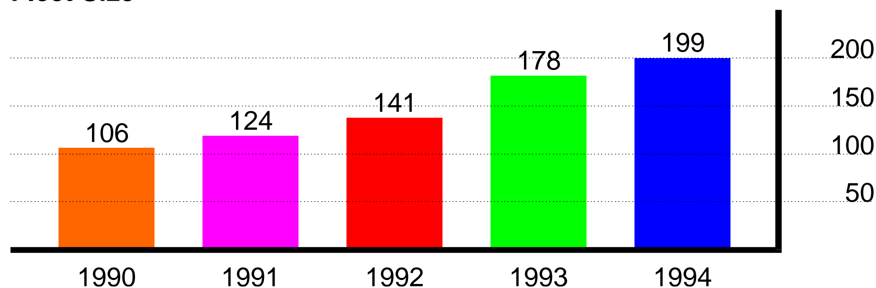
In 1994, we agreed to be the launch customer with Boeing for the third time. The new Boeing 737-700 model will debut in fourth quarter 1997. Our agreement allows for a comparatively lower capital cost and the -700 is also expected to be quieter, more fuel-efficient, and more efficient to maintain than its -300 counterpart. The new aircraft model is planned to fly faster, longer, and higher, as well. From an operational perspective, it is expected to carry the same type rating as the rest of the 737 family, thereby allowing for virtually the same scheduling, training, and maintenance operations as today.

At yearend 1994, we owned 97 of the 199 aircraft in the fleet. Of the remaining 102 aircraft, 72 were operated pursuant to long-term leases with various renewal and purchase options at the end of the lease periods and 30 of the older -200s were under short-term leases expiring over the next several years.

We currently intend to expand our fleet by 27 aircraft in 1995, an available seat mile increase of approximately 14 percent. In total, including an agreement in principle for two used aircraft in second quarter 1995, at December 31, 1994, we had 118 firm orders and 74 purchase options for Boeing 737 aircraft as follows:

Type	Seats	1994	1995	1996	1997	1998	1999	2000	2001	2002	2003	2004
737-200	122	50	–	–	–	–	–	–	–	–	–	–
737-300	137	124	27	18	21	–	–	–	–	–	–	–
737-500	122	25	–	–	–	–	–	–	–	–	–	–
737-700	137	–	–	–	4	21	21	21	18	18	18	5
TOTAL		199	27	18	25	21	21	21	18	18	18	5

Fleet Size



Service

Southwest was specifically built to meet the needs of our shorthaul Customers, and it works. In 1994, we won the Triple Crown for Customer Service for the third consecutive year—best ontime performance; best baggage handling; and highest Customer Satisfaction of any major U.S. airline. No other airline has won the Triple Crown for even a single month.

Our superb, consistent ontime performance record results from a combination of efficient aircraft scheduling; careful selection of airports served; and quick and efficient ticketing and boarding procedures.

Our superior baggage handling is achieved despite our quick aircraft turns at the gate. In addition, this record has been compiled at a time when Southwest is carrying record and ever-increasing amounts of cargo and U.S. mail. Our streamlined approach to shorthaul flights, coupled with the caring and dedicated attitudes of our Ground Operations Employees, enables us to control and handle our Customers' baggage efficiently with minimal loss.

Our outstanding Customer Satisfaction rating is earned from a variety of factors, including frequent, convenient flights; dependably low fares; a generous Company Club program that rewards frequent flyers with free trips; confirmed but open seating; superior beverage service without the need for a meal as the flights are short; but, most of all, the friendly, caring, and enthusiastic service delivered by our Employees.

We also received in 1994 the top ranking in the annual Airline Quality Rating report for 1993, a joint product of the University of Nebraska at Omaha's Aviation Institute, the National Institute for Aviation Research, and the W. Frank Barton School of Business at Wichita State University.

While the amenities may be "low frills," our Triple Crown Customer Service rankings attest to the fact that we deliver what the Customer wants in shorthaul markets.

Department of Transportation Rankings for 1994

Airline	Ontime Performance	Baggage Handling	Customer Satisfaction
Southwest	1	1	1
Northwest	2	9	4
Alaska	3	5	3
United	4	6	6
American	5	3	5
America West	6	2	8
Delta	7	4	2
TWA	8	7	9
USAir	9	8	7
Continental	10	10	10

Spirit

A multitude of challenges faced the People of Southwest Airlines in 1994. The mark of a true champion is the ability to "rise to the occasion" and meet challenges. We believe our Employees showed their true Southwest Spirit in 1994, accomplishing three- or four-fold what a normal year would bring.

First, Morris Air was acquired in December 1993. By October, an unprecedented seven new cities had been converted from Morris to the Southwest route system. Morris' Utah Reservation Center was converted to Southwest in October. All 21 Morris aircraft have either been acquired by Southwest or secured pursuant to long-term lease. By first quarter 1995, all Morris aircraft will have been reconfigured to match the Southwest livery, and all operations will have been transferred to Southwest. Morris was profitable as a separate entity each month it operated, well ahead of our expectations. By all accounts, it was one of the smoothest and most successful mergers ever.

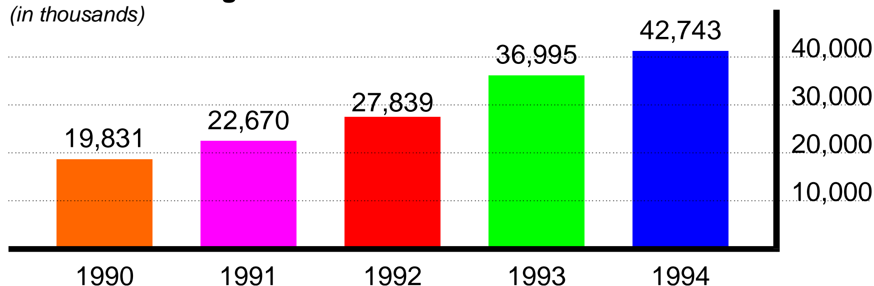
In May 1994, the computer reservations systems (CRSs) used by some travel agencies and owned by United Airlines (Apollo) and Continental Airlines (System One) disabled their automated ticketing function for Southwest travel. Rather than pay the fees demanded by these CRSs, we responded quickly with our own travel agency solutions: direct access and ticketing for the 50 largest agencies (SWAT); overnight delivery of Southwest-produced tickets for approximately 300 large travel agencies; improved access to Ticket By Mail for direct Customers by reducing the time limit from seven days out from the date of travel to three days; and Ticketless travel, which eliminates the need to print a paper ticket altogether. We also committed to provide agencies with automated booking capabilities into our reservations system in 1995. We recently defined and negotiated an agreement with SABRE to allow for full CRS participation in a very cost-effective manner, which satisfies this commitment for agencies using SABRE.

We successfully concluded a labor agreement with our Customer Service Employees, represented by the IAM, and an unprecedented ten-year agreement with our Pilots, represented by SWAPA.

Intense marketing campaigns were mounted to counter industry fare sales and increased competition in shorthaul markets. Despite heavy advertising costs to support seven new cities and these campaigns, our overall cost per available seat mile actually declined in 1994 as our People posted record earnings. Another Triple Crown was earned for Customer Service Excellence.

While this doesn't cover all that our People accomplished in 1994, it gives you an idea of their strength, unity, alacrity, and dedication. Thanks to our People and their tremendous Southwest Spirit, Southwest is positioned strategically stronger than ever, while, at the same time, posting superior results.

Revenue Passengers Carried
(in thousands)



Expansion

1994 was the most aggressive year ever for Southwest Airlines. Strategically, this strengthened and diversified further our route system in the face of increasing shorthaul competition. Seven new cities were converted from Morris into Southwest, along with Morris' 21 aircraft plus another 21 aircraft acquired by Southwest directly during the year.

Four cities were converted from Morris to Southwest in second quarter 1994: Seattle, Portland, Spokane, and Orange County. Three cities were converted in October 1994: Salt Lake City, Boise, and Tucson. Seven cities previously served by Morris were discontinued in 1994 including Eugene, Fresno, Palm Springs, Laughlin, Colorado Springs, Denver, and Anchorage.

At the end of the year, 16 percent of our ASM capacity was deployed intra-California; 43 percent in the remaining part of the western region (west of Texas); 22 percent in the heartland region (Texas, Oklahoma, Arkansas, and Louisiana); and 19 percent in the remainder, referred to as the midwest region.

Growth in California was robust again in 1994, as our share of the intra-California market grew to 56.4 percent as of second quarter 1994 on traffic growth of 33.0 percent. The Shuttle by United began operations in October 1994, with some service directly overlapping Southwest city-pair markets. As of the end of 1994, the Shuttle overlapped roughly 13 percent of Southwest's available seat mile capacity.

Our mature Texas markets grew a steady 3.5 percent in 1994. Southwest still ranks first in passenger boardings at ten of the 11 Texas airports served and has an intra-Texas market share as of second quarter 1994 of 70.8 percent.

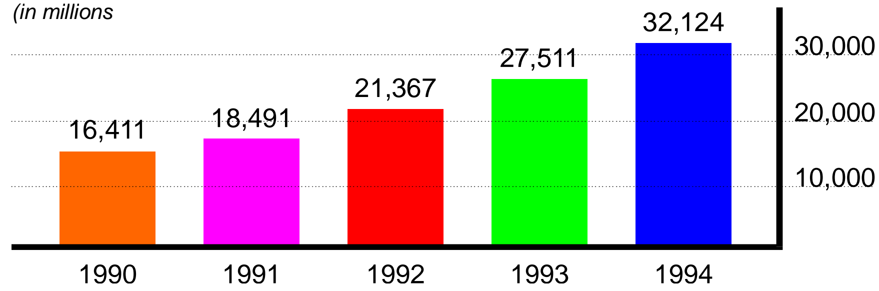
Our Chicago Midway expansion began in earnest in 1992 and is now up to 86 daily departures. Baltimore and Louisville were added in 1993. Omaha has been announced as a March 1995 addition. We are the largest carrier at Chicago Midway and second largest in St. Louis.

Southwest Airlines Destinations

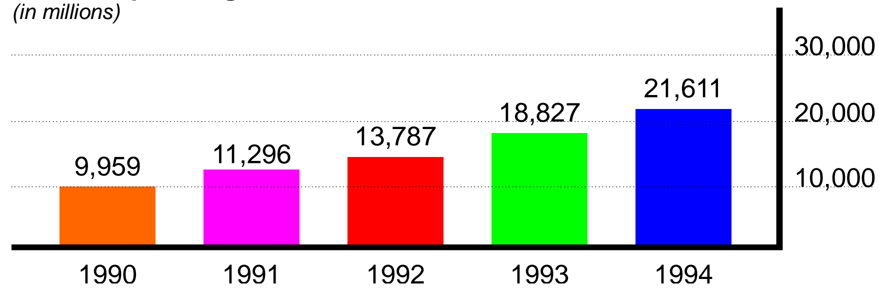
Albuquerque (ABQ)
Amarillo (AMA)
Austin (AUS)
Baltimore (BWI)
Birmingham (BHM)
Boise (BOI)
Burbank (BUR)
Chicago Midway (MDW)
Cleveland (CLE)
Columbus (CMH)
Corpus Christi (CRP)
Dallas Love Field (DAL)
Detroit Metro (DTW)
El Paso (ELP)
Harlingen (HRL)
Houston Hobby (HOU)
Houston Intercontinental (IAH)
Indianapolis (IND)
Kansas City (MCI)
Las Vegas (LAS)
Little Rock (LIT)
Los Angeles (LAX)
Louisville (SDF)
Lubbock (LBB)
Midland/Odessa (MAF)
Nashville (BNA)
New Orleans (MSY)
Oakland (OAK)
Oklahoma City (OKC)
Omaha (OMA)
Ontario (ONT)
Orange County (SNA)
Phoenix (PHX)
Portland (PDX)
Reno/Tahoe (RNO)
Sacramento (SMF)
St. Louis (STL)
Salt Lake City (SLC)
San Antonio (SAT)
San Diego (SAN)
San Francisco (SFO)
San Jose (SJC)
Seattle (SEA)
Spokane (GEG)
Tucson (TUS)
Tulsa (TUL)

Expansion (continued)

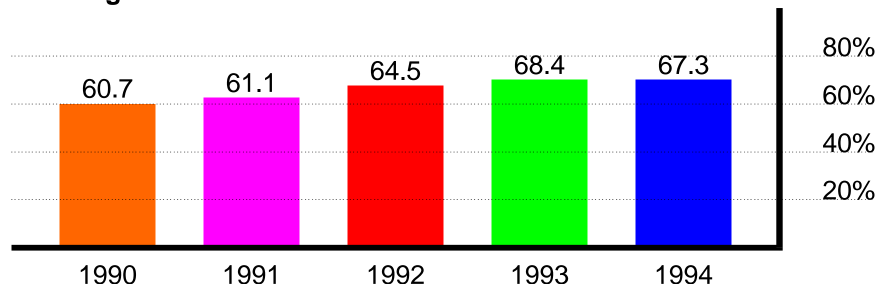
Available Seat Miles
(in millions



Revenue passenger Miles
(in millions)



Passenger Load Factor



Outlook

Southwest Airlines believes we are well positioned for future financial success in the rough and tumble airline industry:

- We have one of the world's best safety records according to the International Airline Passengers Association.
- We have the lowest cost structure of any U.S. major airline.
- We have been consistently profitable in each of the last 22 years in an industry notorious for generating losses.
- We have an "A" credit rating on our secured debt, assuring us adequate access to capital markets to meet our expansion needs cost-effectively.
- We have a robust and diverse route structure that spans 45 cities in 22 states.
- We have the dominant market share in our niche, the shorthaul, high-frequency, point-to-point market, with over 65 percent in our top 100 markets as of second quarter 1994.
- We offer the best Customer Service according to U.S. Department of Transportation statistics.

All because we have the hardest working and most spirited Employees in our industry who earned us not only the best profit margins and financial returns among the major airlines but also billing as one of America's top ten companies to work for according to Robert Levering and Milton Moskowitz's 1993 best-seller, *The 100 Best Companies to Work For in America.*

In 1995, we believe we will further strengthen our Company's distribution systems including increased reservation capacity; the systemwide rollout of Ticketless travel; and the introduction of SABRE's new Basic Booking Request. Further, we are hopeful that these and other initiatives will lead to lower unit costs per ASM in 1995 versus 1994.

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

Industry Conditions

The 1990s have been devastating financially for the domestic passenger airline industry, with Southwest as the sole exception among larger carriers. Since 1990, the industry has been shrinking and we have been expanding. We are now carrying more than twice the number of passengers annually than in 1990, an annualized growth rate of 21 percent. In 1993, with the advent of Continental Lite and plans laid for the United Shuttle, the competitive trend away from Southwest began to reverse. In 1994, in the face of our own aggressive expansion, we experienced a massive increase of new competitive service from United, Continental, Reno, and TWA. We also were negatively impacted by the industry's use of persistent fare sales during the fourth quarter, which occurred at a time when we were aggressively converting Morris Air Corporation (Morris) to Southwest's operations and were experiencing operating difficulties of our own in reservations and revenue management. The result was a 47 percent decline in earnings in fourth quarter 1994 as compared to fourth quarter 1993. Many of the operational issues that surfaced during fourth quarter 1994 have been, or will soon be, addressed, most notably reservations capacity. However, some of their effects will carry over into the first two quarters of 1995, and, further, we cannot predict the actions of our competitors.

In response to these increasing competitive pressures, we implemented several measures. However, we face significantly more competition than we did a year ago, which may also continue to adversely affect comparisons to 1994 quarterly performances, particularly in first half 1995.

As compared to year ago levels, load factors and passenger revenue yields are currently down (the consolidated load factor for January 1995 was 57.8 percent, compared with 63.1 percent for the same month a year ago). Our expectation is that this trend will continue at least during first half 1995. As expected, the integration of Morris into Southwest during 1994, which included 21 aircraft and seven new cities, resulted in our immediate competitive presence in the northwestern region of the U.S. and Salt Lake City. However, these new markets, which are in the development stage and, therefore, understandably low-yielding, will need to improve for overall yields to compare favorably to year ago levels. While there is no way to predict precisely how fast these markets will develop, we are encouraged by the pace thus far. We have also been encouraged with Customer acceptance of recent price increases, which may improve yield comparisons.

From an operating cost perspective, we have been pleased with recent favorable trends versus year ago levels, including fuel prices. Our goal is to continue this trend in 1995, despite our basic lack of control over fuel prices. Significant cost reduction opportunities lie in distribution costs. Ticketless travel, the new SABRE Basic Booking Request, our enhanced Ticket By Mail product, and expanded reservations operations should all combine to help reduce distribution costs. During 1995, we currently plan to add twenty-seven 737-300 aircraft to our fleet and one new city, Omaha, Nebraska, to our route system, which will allow us to focus on strengthening our existing route system.

Results Of Operations

1994 COMPARED WITH 1993 The Company's consolidated net income for 1994 was $179.3 million ($1.22 per share), as compared to the corresponding 1993 amount (before the cumulative effect of accounting changes) of $154.3 million ($1.05 per share), an increase of 16.2 percent. The increase in earnings was primarily attributable to an increase in operating income of 8.5 percent and a decrease in other expenses (nonoperating) of 46.9 percent.

OPERATING REVENUES Consolidated operating revenues increased by 12.9 percent in 1994 to $2,591.9 million, compared to $2,296.7 million for 1993. This increase in 1994 operating revenues was derived from a 12.7 percent increase in passenger revenues. Revenue passenger miles (RPMs) increased 14.8 percent in 1994, compared to a 16.8 percent increase in available seat miles (ASMs), resulting in a decrease in load factor from 68.4 percent in 1993 to 67.3 percent in 1994. The 1994 ASM growth resulted from the addition of 21 aircraft during 1994.

Freight revenues in 1994 were $54.4 million, compared to $42.9 million in 1993. The 26.9 percent increase in freight revenues exceeded the 16.8 percent increase in ASMs for the same period primarily due to increased air freight volumes and United States mail services.

OPERATING EXPENSES Consolidated operating expenses for 1994 were $2,275.2 million, compared to $2,004.7 million in 1993, an increase of 13.5 percent, compared to the 16.8 percent increase in ASMs. On a per-ASM basis, operating expenses (excluding 1993 merger expenses) decreased 2.3 percent in 1994. The primary factors contributing to this decrease were an 8.8 percent decrease in average jet fuel cost per gallon and lower agency commission costs, offset by increased aircraft rentals.

Operating expenses per ASM for 1994 and 1993 (excluding 1993 merger expenses) were as follows:

Operating expenses per ASM	1994	1993	Increase (decrease)	Percent change
Salaries, wages, and benefits	2.13¢	2.12¢	.01¢	0.5%
Profitsharing and Employee savings plans	.22	.21	.01	4.8
Fuel and oil	1.00	1.11	(.11)	(9.9)
Maintenance materials and repairs	.59	.59	-	-
Agency commissions	.47	.53	(.06)	(11.3)
Aircraft rentals	.42	.39	.03	7.7
Landing fees and other rentals	.46	.47	(.01)	(2.1)
Depreciation	.43	.44	(.01)	(2.3)
Other	1.36	1.39	(.03)	(2.2)
Total	7.08¢	7.25¢	(.17)¢	(2.3)%

Salaries, wages, and benefits per ASM increased only .5 percent in 1994. This increase resulted from a 3.0 percent increase inaverage salary and benefits cost per Employee, partially offset by slower average headcount growth, which increased only 13.8 percent in 1994 versus the 1994 capacity (ASM) increase of 16.8 percent. The majority of the increase in average salary and benefits cost related to increased health benefits and workers' compensation costs. Employee productivity improved from 2,633 passengers handled per Employee in 1993 to 2,676 in 1994.

Profitsharing and Employee savings plan expenses per ASM increased 4.8 percent in 1994. The increase is primarily the result of increased matching contributions to Employee savings plans resulting from increased Employee participation and higher matching rates in 1994 for Flight Attendants and Customer Service Employees under their respective collective bargaining agreements.

Fuel and oil expenses per ASM decreased 9.9 percent in 1994, primarily due to an 8.8 percent reduction in the average jet fuel cost per gallon from 1993. Jet fuel prices remained relatively stable throughout 1994, with quarterly averages ranging from $0.51 to $0.56 per gallon. Since year-end, fuel prices have averaged approximately $0.54 per gallon.

In August 1993, the Revenue Reconciliation Act of 1993 was enacted, which, among other things, included an increase of 4.3 cents per gallon in transportation fuel tax, which becomes effective September 30, 1995, for jet fuel used in commercial aviation. This additional fuel tax will increase fuel expenses approximately $7.5 million in fourth quarter 1995.

Maintenance materials and repairs per ASM was unchanged in 1994 compared to 1993.

Agency commissions per ASM decreased 11.3 percent due to a lower mix of travel agency sales and lower 1994 passenger revenue per ASM. The lower travel agency sales mix resulted from 1994 enhancements to Southwest's ticket delivery systems for direct Customers, as described below.

In response to actions taken by our competitor-owned reservations systems, we reduced our operating costs and enhanced our ticket delivery systems by developing our own Southwest Airlines Air Travel (“SWAT”) system allowing high-volume travel agents direct access to reservations; introduced overnight ticket delivery for travel agents; reduced to three the number of advance days reservations required for overnight delivery of tickets to customers (Ticket By Mail); developed our own Ticketless system, which was rolled out system-wide on January 31, 1995; and subscribed to a new level of service with SABRE that will automate the booking process for SABRE travel agencies effective May 1, 1995. We also continue to actively pursue other cost-effective solutions for automating non-SABRE travel agency bookings.

Aircraft rentals per ASM increased 7.7 percent in 1994. The increase primarily resulted from a third quarter 1994 sale/leaseback transaction involving ten new 737-300 aircraft and a lease of three used aircraft under long-term operating leases. At December 31, 1994, 44.7 percent of the Company's fleet was subject to operating leases, compared to 43.3 percent at December 31, 1993.

Other operating expenses per ASM decreased 2.2 percent in 1994 compared to 1993. The overall decrease is primarily attributable to operating efficiencies resulting from the transition of Morris operational functions to Southwest, primarily contract services which decreased $8.8 million (24.4 percent per ASM), offset by an increase in advertising costs of $24.1 million (22.9 percent per ASM) primarily associated with the start-up of seven new cities and new competitive pressures in 1994.

OTHER "Other expenses (income)" included interest expense, interest income, and nonoperating gains and losses. Interest expense decreased $5.1 million in 1994 due to the March 1, 1993 redemption of $100 million senior unsecured notes due 1996 and the repayment of approximately $54.0 million of Morris long-term debt during first quarter 1994. Capitalized interest increased $8.6 million in 1994 as a result of higher levels of advance payments on aircraft compared to 1993. Interest income for 1994 decreased $1.9 million primarily due to lower cash balances available for short-term investment.

INCOME TAXES The provision for income taxes decreased in 1994 as a percentage of income before taxes, including cumulative effect of accounting changes, to 40.1 percent from 40.6 percent in 1993. The 1993 rate was higher due to deferred tax adjustments in 1993 related to the 1993 increase in the federal corporate income tax rate from 34 percent to 35 percent(see Note 11 to the Consolidated Financial Statements). This was offset by increased 1994 effective state income tax rates.

1993 COMPARED WITH 1992 Prior to 1993, Morris operated as a charter carrier. In 1993, Morris began operating as a FAR 121 Certificated Air Carrier, or scheduled service carrier, consistent with Southwest. For comparability from 1993 to 1992, the statistical and operating data for 1992 are based on scheduled passenger service only (i.e., Southwest). Accordingly, RPMs and ASMs for 1992 relate only to scheduled carrier operations.

The Company's consolidated income for the year 1993 was $154.3 million ($1.05 per share), before the cumulative effect of accounting changes, compared to pro forma consolidated income of $97.4 million ($.68 per share) for 1992, an increase of 58.4 percent. The increase in earnings was primarily attributable to an increase in operating income of 50.7 percent and was achieved despite an increase in the federal income tax rate, which increased the provision for income taxes $6.5 million, or $.04 per share.

OPERATING REVENUES Consolidated operating revenues increased by 27.4 percent in 1993 to $2,296.7 million. Operating revenue per ASM for scheduled service carrier operations increased in 1993 to $.0835 from $.0789 in 1992. The increase in consolidated operating revenues was primarily related to a 36.5 percent increase in passenger revenues, which accounted for 96.5 percent of total operating revenues in 1993 versus 90.1 percent in 1992.

Consolidated RPMs increased 36.6 percent in 1993, which exceeded the 28.8 percent increase in ASMs, resulting in an increase in the load factor from 64.5 percent to 68.4 percent. The 1993 ASM increase resulted from the conversion of the Morris system from charter to scheduled service and the addition of 16 aircraft to the Southwest fleet. The additional 16 Southwest aircraft were primarily used to expand California, St. Louis, and Chicago markets and to initiate service from Louisville, Baltimore, and San Jose.

Freight revenues increased in 1993 to $42.9 million from $33.1 million in 1992. The 29.6 percent increase in freight revenues exceeded the 28.8 percent ASM increase primarily due to further expansion of United States mail services and increased freight marketing programs.

Charter and other revenues decreased in 1993 from 1992 on a consolidated basis as Morris converted its operations in 1993 to scheduled service from charter operations. In 1993, consistent with the beginning of scheduled carrier service, Morris revenues were primarily derived from scheduled operations and, accordingly, classified as "passenger" revenues. Morris charter revenues totaled $117.8 million in 1992.

OPERATING EXPENSES Consolidated operating expenses increased 24.6 percent to $2,004.7 million from $1,609.2 million in 1992. The primary factors contributing to the increase were the 28.8 percent increase in ASMs; increased contributions to profitsharing and Employee savings plans; higher agency commissions; higher aircraft rentals; and increased maintenance costs.

On a consolidated basis, the Company incurred $10.8 million of one-time merger expenses in connection with the December 1993 Morris acquisition. These expenses included $1.9 million of various professional fees; $4.7 million for disposal of duplicate or incompatible property and equipment; and $4.2 million for Employee relocation and severance costs related to elimination of duplicate or incompatible operations. As required for financial reporting purposes, these expenses have been reported as operating expenses.

Salaries, wages, and benefits per ASM decreased 2.3 percent in 1993. Excluding the effects of Morris, Southwest's cost per ASM for salaries, wages, and benefits increased .9 percent from 1992 to 1993. This increase resulted from a 2.2 percent increase in salaries and wages, offset by a 5.0 percent decrease in health benefit and workers' compensation costs per ASM. Headcount for Southwest increased 17.0 percent in 1993, slightly more than the 15.9 percent increase in ASMs. However, Employee productivity improved to 2,633 passengers handled per Employee in 1993 from 2,597 in 1992.

Morris contracted out all ground handling services, which are included in “other operating expenses.” Consequently, salaries, wages, and benefits on a per-ASM basis are considerably lower for Morris than for Southwest contributing to the decrease in consolidated salaries, wages, and benefits per ASM.

Profitsharing and Employee savings plan expenses per ASM increased 16.7 percent in 1993. The increase was primarily the result of higher earnings in 1993. For additional information, see Note 10 to the Consolidated Financial Statements.

Fuel and oil expenses per ASM decreased 2.6 percent in 1993 due to a 2.7 percent reduction in the average cost per gallon of jet fuel from 1992. Jet fuel prices remained relatively stable throughout 1993, continuing the trend which began in 1992, with quarterly averages ranging from $0.57 to $0.63 per gallon.

Maintenance materials and repairs per ASM increased 5.4 percent in 1993. This increase was primarily the result of higher airframe component repairs and higher amortization of capitalized scheduled airframe overhauls.

Agency commissions per ASM increased 6.0 percent in 1993 primarily due to increased passenger revenues per ASM.

Aircraft rentals per ASM increased 30.0 percent in 1993. The increase was primarily attributable to the expansion of Morris scheduled operations, which leased 18 of its 21 aircraft, 11 of which were leased in 1993. Additionally, the increase partially resulted from the sale/leaseback financing by Southwest, since late 1992, of seven 737-300 aircraft with long-term operating leases. Also in 1993, Southwest leased one used 737-300 aircraft under a long-term operating lease and one used 737-200 aircraft under a short-term operating lease.

Depreciation expense per ASM decreased 8.5 percent in 1993 due to the expansion of Morris, which, as stated above, consisted primarily of a leased aircraft fleet.

Other operating expenses per ASM increased 13.8 percent from 1992 to 1993. This increase is primarily the result of higher usage of contract services at Morris. As previously discussed, Morris contracted for all ground handling service, along with various other services that are handled internally at Southwest.

OTHER "Other expenses(income)" included interest expense, interest income, and nonoperating gains and losses. Interest expense, net of capitalized interest, decreased 7.0 percent in 1993 due to the March 1, 1993 early redemption of $100 million in senior unsecured 9% Notes due 1996. See Note 6 to the Consolidated Financial Statements for further information. Net nonoperating losses in 1993 resulted from the write-down of certain internal system development costs and the settlement of certain employment-related litigation for $1.7 million.

INCOME TAXES The provision for income taxes increased in 1993, as a percentage of income before income taxes and cumulative effect of accounting changes, to 40.6 percent from pro forma 38.1 percent in 1992. The increase was primarily the result of the increase in the federal income tax rate. See Note 11 to the Consolidated Financial Statements for further information.

Liquidity And Capital Resources

Cash provided from operations was $412.7 million in 1994, compared to $392.7 million in 1993. During 1994, additional funds of $315.0 million were generated from the sale and leaseback of ten new 737-300 aircraft subject to long-term operating leases (increasing total commitments for operating leases by $619.0 million).

During 1994, capital expenditures of $788.6 million were primarily for the purchase of 18 new 737-300 aircraft, one used 737-300 aircraft previously leased by Morris, and progress payments for future aircraft deliveries. At December 31, 1994, capital commitments of the Company consisted primarily of scheduled aircraft acquisitions.

As of January 1995, Southwest had one-hundred-sixteen 737s on firm order, including twenty-five to be delivered in 1995, with options to purchase another seventy-four. Aggregate funding required for firm commitments approximated $3,042.7 million through the year 2001 of which $602.6 million related to 1995. See Note 4 to the Consolidated Financial Statements for further information.

The Company recently completed the construction of a $10.0 million reservation center in Little Rock, Arkansas, which began accepting calls on January 24, 1995, and announced that it will build an additional reservation center in Oklahoma City scheduled to open in second quarter 1995. Total estimated cost of the new Oklahoma City reservation center is approximately $10.0 million.

As of December 31, 1994 and since 1990, the Company had authority from its Board of Directors to purchase 3,750,000 shares of its common stock from time-to-time on the open market. No shares have been purchased since 1990.

The Company has various options available to meet its capital and operating commitments, including cash on hand at December 31, 1994 of $174.5 million, internally generated funds, and a revolving credit line with a group of banks of up to $300 million (none of which had been drawn at December 31, 1994). In addition, the Company will also consider various borrowing or leasing options to maximize earnings and supplement cash requirements.

At yearend, the Company had outstanding shelf registrations for the issuance of $100 million senior unsecured notes and $98 million pass-through certificates relating to sale/leaseback transactions. The Company presently intends to utilize these sources of financing during 1995.

Cash provided from operations was $392.7 million in 1993 as compared to $282.1 million in 1992. During 1993, additional funds of $90.0 million were generated from the sale and leaseback of three new 737-300 aircraft subject to long-term operating leases (increasing total commitments for operating leases by $145.0 million). Morris also generated $17.8 million from certain bank borrowings. These proceeds were primarily used to finance aircraft-related capital expenditures and to provide working capital.

Consolidated Balance Sheet

	Dec 31, 1994	Dec 31, 1993
Assets		
Current assets:		
Cash and cash equivalents	$ 174,538	$ 295,571
Accounts receivable	75,692	70,484
Inventories of parts and supplies, at cost	37,565	31,707
Deferred income taxes (Note 11)	9,822	10,475
Prepaid expenses and other current assets	17,281	23,787
Total current assets	314,898	432,024
Property and equipment, at cost (Notes 3, 4, and 7):		
Flight equipment	2,564,551	2,257,809
Ground property and equipment	384,501	329,605
Deposits on flight equipment purchase contracts	393,749	242,230
	3,342,801	2,829,644
Less allowance for depreciation	837,838	688,280
	2,504,963	2,141,364
Other assets	3,210	2,649
	$2,823,071	$2,576,037
Liabilities and Stockholders' Equity		
Current liabilities:		
Accounts payable	$117,599	$94,040
Accrued liabilities (Note 5)	288,979	265,333
Air traffic liability	106,139	96,146
Income taxes payable		7,025
Current maturities of long-term debt	9,553	16,068
Total current liabilities	522,270	478,612
Long-term debt less current maturities (Note 6)	583,071	639,136
Deferred income taxes (Note 11)	232,850	183,616
Deferred gains from sale and leaseback of aircraft	217,677	199,362
Other deferred liabilities	28,497	21,292
Commitments and contingencies (Notes 4, 7, and 11)		
Stockholders' equity (Notes 8 and 9):		
Common stock, $1.00 par value: 500,000,000 shares authorized; 143,255,795 shares issued and outstanding in 1994 and 142,756,308 shares in 1993	143,256	142,756
Capital in excess of par value	151,746	141,168
Retained earnings	943,704	770,095
Total stockholders' equity	1,238,706	1,054,019
	$2,823,071	$2,576,037

In thousands except share and per share amounts.

Consolidated Statement Of Income

	Dec 31, 1994	Dec 31, 1993	Dec 31, 1992
Operating revenues:			
Passenger	$2,497,765	$2,216,342	$1,623,828
Freight	54,419	42,897	33,088
Charter and other	39,749	37,434	146,063
Total operating revenues	2,591,933	2,296,673	1,802,979
Operating expenses:			
Salaries, wages, and benefits (Note 10)	756,023	641,747	512,983
Fuel and oil	319,552	304,424	257,481
Maintenance materials and repairs	190,308	163,395	122,561
Agency commissions	151,247	144,941	113,504
Aircraft rentals	132,992	107,885	77,472
Landing fees and other rentals	148,107	129,222	105,929
Depreciation	139,045	119,338	101,976
Other operating expenses	437,950	382,945	317,269
Merger expenses (Note 2)	-	10,803	-
Total operating expenses	2,275,224	2,004,700	1,609,175
Operating income	316,709	291,973	193,804
Other expenses (income):			
Interest expense	53,368	58,460	59,084
Capitalized interest	(26,323)	(17,770)	(15,350)
Interest income	(9,166)	(11,093)	(10,672)
Nonoperating (gains) losses, net	(693)	2,739	3,299
Total other expenses	17,186	32,336	36,361
Income before income taxes and cumulative effect of accounting changes	299,523	259,637	157,443
Provision for income taxes (Note 11)	120,192	105,353	55,816
Income before cumulative effect of accounting changes	179,331	154,284	101,627
Cumulative effect of accounting changes (Note 3)	-	15,259	12,538
Net income	$179,331	$169,543	$114,165
Per share amounts (Notes 3, 8, and 12):			
Income before cumulative effect of accounting changes	$ 1.22	$ 1.05	$ .71
Cumulative effect of accounting changes	-	.10	.09
Net income	$ 1.22	$ 1.15	$ .80

Consolidated Statement Of Stockholders' Equity

Years Ended December 31, 1994, 1993, And 1992 (in thousands except per share amounts)

	Common Stock	Capital In Excess of Par Value	Retained Earnings	Treasury Stock	Total
Balance at December 31, 1991	$45,265	$79,240	$515,885	$(4,597)	$635,793
Public common stock offering (Note 8)	2,328	82,094	-	2,524	86,946
Conversion of debentures (Note 6)	1,371	34,678	-	-	36,049
Two-for-one stock split (Note 8)	46,180	(46,180)	-	-	-
Sale (retirement) of treasury stock, pooled company	(307)	60	-	1,434	1,187
Issuance of common and treasury stock upon exercise of executive stock options and pursuant to Employee stock option and purchase plans and related tax benefit (Note 9)	156	3,359	-	553	4,068
Sale of preferred stock, pooled company	1,054	13,584	-	-	14,638
Cash dividends, $.03533 per share	-	-	(4,890)	-	(4,890)
Cash distributions of pooled company (Note 2)	-	-	(5,388)	-	(5,388)
Reclassification of retained earnings, pooled company (Note 2)	-	13,844	(13,844)	-	-
Reinstatement of deferred taxes, pooled company (Note 2)	-	(3,032)	-	-	(3,032)
Net income - 1992	-	-	114,165	-	114,165
Balance at December 31, 1992	96,047	177,647	605,928	(86)	879,536
Three-for-two stock split (Note 8)	46,325	(46,325)	-	-	-
Issuance of common and treasury stock upon exercise of executive stock options and pursuant to Employee stock option and purchase plans and related tax benefit (Note 9)	384	9,846	-	86	10,316
Cash dividends, $.03867 per share	-	-	(5,376)	-	(5,376)
Net income - 1993	-	-	169,543	-	169,543
Balance at December 31,1993	142,756	141,168	770,095	-	1,054,019
Issuance of common stock upon exercise of executive stock options and pursuant to Employee stock option and purchase plans and related tax benefit (Note 9)	500	10,578	-	-	11,078
Cash dividends, $.04000 per share	-	-	(5,722)	-	(5,722)
Net income - 1994	-	-	179,331		179,331
Balance at December 31,1994	$143,256	$151,746	$943,704	$ -	$1,238,706

Consolidated Statement Of Cash Flows

	Dec 31, 1994	Dec 31, 1993	Dec 31, 1992
Cash flows from operating activities:			
Net income	$179,331	$169,543	$114,165
Cumulative effect of accounting changes (Note 3)	-	(15,259)	(12,538)
Income before cumulative effect of accounting changes	179,331	154,284	101,627
Adjustments to reconcile net income to cash provided by operating activities:			
Depreciation	139,045	119,338	101,976
Deferred income taxes	49,887	53,200	21,260
Amortization of deferred gains on sale and leaseback of aircraft	(30,341)	(32,509)	(32,719)
Amortization of scheduled airframe overhauls	14,216	11,630	6,930
Changes in certain assets and liabilities:			
Increase in accounts receivable	(5,208)	(14,253)	(7,440)
Decrease(increase) in other current assets	648	(9,641)	(12,000)
Increase in accounts payable and accrued liabilities	52,679	67,585	65,706
Increase in air traffic liability	9,993	30,212	18,602
Increase(decrease) in other current liabilities	(4,690)	2,393	12,179
Other	7,106	10,440	5,978
Net cash provided by operating activities	412,666	392,679	282,099
Cash flows from investing activities:			
Purchases of property and equipment	(788,649)	(524,169)	(432,528)
Net cash used in investing activities	(788,649)	(524,169)	(432,528)
Cash flows from financing activities:			
Issuance of long-term debt	-	17,810	113,827
Proceeds from public common stock offering(Note 8)	-	-	86,946
Proceeds from aircraft sale and leaseback transactions	315,000	90,000	120,000
Proceeds from sale of preferred stock, pooled company	-	-	14,638
Payment of long-term debt and capital lease obligations	(63,071)	(120,098)	(10,358)
Payment of cash dividends	(5,722)	(5,376)	(4,890)
Cash distributions of pooled company(Note 2)	-	-	(5,389)
Proceeds from Employee stock plans	8,743	6,743	3,517
Other	-	(7)	802
Net cash provided by (used in) financing activities	254,950	(10,928)	319,094
Net increase (decrease) in cash and cash equivalents	(121,033)	(142,418)	168,665
Cash and cash equivalents at beginning of period	295,571	437,989	269,324
Cash and cash equivalents at end of period	$174,538	$295,571	$437,989
Cash payments for:			
Interest, net of amount capitalized	$26,598	$43,161	$39,936
Income taxes	80,461	45,292	27,728

Notes to Consolidated Financial Statements

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 (the Company). All significant intercompany balances and transactions have been eliminated. Certain prior year amounts have been reclassified for comparison purposes.

CASH AND CASH EQUIVALENTS Cash equivalents consist of investment grade commercial paper issued by major financial institutions that are highly liquid and have original maturity dates of three months or less. Cash and cash equivalents are carried at cost, which approximates market value.

INVENTORIES Inventories of flight equipment expendable parts, materials, and supplies are carried at average 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 (see Note 3) and 3 to 30 years for ground property and equipment. 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.

AIRCRAFT AND ENGINE MAINTENANCE The cost of engine overhauls and routine maintenance costs for aircraft and engine maintenance are charged to maintenance expense as incurred. Scheduled airframe overhaul costs are capitalized at amounts not to exceed the fair market value of the related aircraft and amortized over the estimated periods benefited, presently 8 years. Modifications that significantly enhance the operating performance or extend the useful lives of aircraft or engines are capitalized and amortized over the remaining life of the asset.

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 of providing free travel awards earned under its Company Club Frequent Flyer program.

ADVERTISING The Company expenses the production costs of advertising as incurred. Advertising expense for the years ended December 31, 1994, 1993, and 1992 was $79,475,000, $55,344,000, and $42,068,000, respectively.

2. Acquisition

On December 31, 1993, Southwest exchanged 3,574,656 newly issued shares of its common stock for all of the outstanding stock of Morris Air Corporation (Morris), a low-fare commercial/charter air carrier based in Salt Lake City. The acquisition was accounted for as a pooling of interests and, accordingly, the Company's consolidated financial statements were restated to include the accounts and operations of Morris for all periods prior to the acquisition.

Prior to 1993, Morris was treated as an S-Corporation for federal and state income tax purposes under applicable provisions of the Internal Revenue Code and various state tax laws. Therefore, no provision for income taxes was made prior to 1993. Morris made regular cash distributions to its shareholders sufficient to meet their tax liabilities. Upon termination of S-Corporation status on December 31, 1992, the undistributed S-Corporation retained earnings were reclassified to capital in excess of par value. Additionally, Morris established $3,032,000 of deferred income taxes for the cumulative differences in the timing of reporting certain items for financial statement and income tax purposes. These deferred taxes related primarily to depreciation. The establishment of deferred taxes was offset by a reduction of capital in excess of par value.

Merger expenses of $10,803,000 relating to the merger of Southwest and Morris have been included in 1993 operating expenses as required for financial reporting purposes; however, these expenses have been separately reported as “merger expenses” to reflect the impact of the nonrecurring expenses on operating results. Included in these one-time costs resulting from the merger were $1,900,000 of various professional fees; $4,703,000 for disposal of duplicate or incompatible property and equipment; and $4,200,000 for Employee relocation and severance costs related to elimination of duplicate or incompatible operations. During 1994, the integration of Morris into Southwest was substantially completed, including the disposal of incompatible property and equipment and settlement of Employee relocation and severance costs.

3. Accounting Changes

Income Taxes Effective January 1, 1993, the Company adopted Statement of Financial Accounting Standards No. 109, “Accounting for Income Taxes” (SFAS 109). As a result of adopting SFAS 109, the Company recorded deferred tax assets of $6,977,000 and reduced deferred tax liabilities by $9,048,000 at January 1, 1993, which resulted in an increase to the Company's 1993 net income of $16,025,000 ($.11 per share) for the cumulative effect of the accounting change.

Postretirement Benefits Effective January 1, 1993, the Company adopted Statement of Financial Accounting Standards No. 106, “Employers' Accounting for Postretirement Benefits Other Than Pensions” (SFAS 106). The cumulative effect of this change in accounting method at January 1, 1993 reduced 1993 net income by $766,000 (net of benefit from income taxes of $469,000) or $.01 per share. The effect of adopting SFAS 106 on 1993 income before cumulative effect of accounting changes was not material.

Scheduled Airframe Overhauls Prior to January 1, 1992, the Company expensed scheduled airframe overhaul costs as incurred. This practice was adopted at a time when costs were relatively constant from year to year and consistent with the growth of the fleet.

Given the significant growth of the Company's fleet and the Company's 1991 modification of its airframe overhaul maintenance program with the Federal Aviation Administration (FAA), Southwest changed its method of accounting for scheduled airframe overhauls costs from the direct expense method to that of capitalizing and amortizing the costs over the periods benefited. The Company believes this method is preferable because it results in charges to expense that are consistent with the growth in the fleet; improves financial reporting; and better matches revenues and expenses.

For the year ended December 31, 1992, the Company recognized approximately $6,900,000 in amortization of airframe overhaul expense. Had the direct expense method been used to provide for scheduled airframe overhaul costs during the year ended December 31, 1992, income before cumulative effect of accounting change would have been reduced by approximately $9,800,000 (net of provision for income taxes and profitsharing of approximately $8,800,000), or approximately $.07 per share.

This change in accounting principle had the effect of a one-time adjustment increasing net income for the year ended December 31, 1992 by approximately $12,538,000 (net of provision for income taxes and profitsharing of approximately $11,500,000).

CHANGE IN ACCOUNTING ESTIMATE Effective January 1, 1992, the Company revised the estimated useful lives of its 737-200 aircraft from 15 years to 15-19 years. This change was the result of the Company's assessment of the remaining useful lives of its 737-200 aircraft following the recent promulgation of rules by the FAA for the phase out of Stage 2 aircraft by December 31, 1999. The effect of this change was to reduce depreciation expense approximately $3,680,000, or $.03 per share, for the year ended December 31, 1992.

4. Commitments

The Company's contractual purchase commitments consist primarily of scheduled aircraft acquisitions. Twenty-five 737-300 aircraft are scheduled for delivery in 1995, 18 in 1996, and ten in 1997. Four 737-700s are scheduled for delivery in 1997, 16 in 1998, 16 in 1999, 15 in 2000, and 12 in 2001. In addition, the Company has options to purchase up to eleven 737-300s in 1997 and up to sixty-three 737-700s during 1998-2004. The Company has the option, which must be exercised two years prior to the contractual delivery date, to substitute 737-400s or 737-500s for the 737-300s to be delivered during 1997 and 737-600s or 737-800s for the 737-700s delivered subsequent to 1999. Aggregate funding needed for these commitments was approximately $3,042.7 million, subject to adjustments for inflation, due as follows: $602.6 million in 1995, $489.5 million in 1996, $447.8 million in 1997, $445.4 million in 1998, $452.9 million in 1999, $366.0 million in 2000, and $238.5 million in 2001. In addition, the Company has an agreement in principle to lease two used 737-300 aircraft in 1995.

The Company uses jet fuel fixed price swap arrangements to hedge its exposure to price fluctuations on approximately 5 percent of its annual fuel requirements. As of December 31, 1994, the Company had jet fuel swap agreements with broker-dealers to exchange monthly payments on notional quantities amounting to 2,100,000 gallons per month, over the ensuing three months. Under the swap agreements, the Company pays or receives the difference between the daily average jet fuel price and a fixed price of approximately $.518 per gallon. Gains and losses on such transactions are recorded as adjustments to fuel expense and have been insignificant. Although the agreements expose the Company to credit loss in the event of nonperformance by the other parties to the agreements, the Company does not anticipate such nonperformance.

5. Accrued Liabilities (in thousands)

	1994	1993
Aircraft rentals	$67,407	$55,459
Profitsharing and savings plans (Note 10)	53,512	45,691
Aircraft maintenance costs	37,330	37,853
Vacation pay	31,801	26,781
Taxes, other than income	25,001	19,183
Interest	20,270	21,311
Merger expenses	-	8,527
Other	53,658	50,528
	$288,979	$265,333

6. Long-Term Debt (In Thousands)

	1994	1993
9 1/4% Notes due 1998	$100,000	100,000
9.4% Notes due 2001	100,000	100,000
8 3/4% Notes due 2003	100,000	100,000
7 7/8% Notes due 2007	100,000	100,000
Capital leases (Note 7)	195,756	204,904
Secured notes payable to financial institutions, repaid in 1994	-	53,950
Industrial Revenue Bonds, repaid in 1994	-	375
Other	435	13
	596,191	659,242
Less current maturities	9,553	16,068
Less debt discount	3,567	4,038
	$583,071	$639,136

On March 1, 1993, the Company redeemed the $100 million in senior unsecured 9% Notes due March 1, 1996 issued in March 1986. The Notes were redeemed at par plus accrued interest.

On September 9, 1992, Southwest issued $100 million of senior unsecured 7 7/8% Notes due September 1, 2007. Interest is payable semi-annually on March 1 and September 1. The Notes are not redeemable prior to maturity.

During 1991, the Company issued $100 million of senior unsecured 9 1/4% Notes, $100 million of senior unsecured 9.4% Notes, and $100 million of senior unsecured 8 3/4% Notes due February 15, 1998, July 1, 2001, and October 15, 2003, respectively. Interest on the Notes is payable semi-annually. The Notes are not redeemable by the Company prior to maturity.

The fair values, based on quoted market prices, of these Notes at December 31, 1994, were as follows (in thousands):

9 1/4% Notes due 1998	$102,000
9.4% Notes due 2001	103,820
8 3/4% Notes due 2003	100,670
7 7/8% Notes due 2007	93,070

In 1992, certain Convertible Subordinated Debentures issued by Southwest Airlines Eurofinance N.V. were redeemed. The principal amount of $35,000,000 was converted into 1,370,902 shares (unadjusted for the 1993 and 1992 stock splits) of Southwest's common stock at the conversion price of $25.53 per share. The conversion was primarily a noncash transaction and, therefore, was excluded from the Statement of Cash Flows.

In addition to the credit facilities described above, Southwest has an unsecured Bank Credit Agreement with a group of domestic banks that permits Southwest to borrow through December 14, 1996 on a revolving credit basis up to $300 million. Interest rates on borrowings under the Credit Agreement can be, at the option of Southwest, the agent bank's prime rate, .30% over LIBOR, or .50% over domestic certificate of deposit rates. The commitment fee is 0.1875% per annum. There were no outstanding borrowings under this agreement at December 31, 1994 or 1993.

7. Leases

Total rental expense for operating leases charged to operations in 1994, 1993, and 1992 was $198,987,000, $167,303,000, and $125,835,000, respectively. The majority of the Company's terminal operations space, as well as 89 aircraft, were under operating leases. The amounts applicable to capital leases included in property and equipment were (in thousands):

	1994	1993
Flight equipment	$233,324	$232,853
Less accumulated amortization	88,656	74,234
	$144,668	$158,619

Future minimum lease payments under capital leases and noncancelable operating leases, with initial or remaining terms in excess of one year, at December 31, 1994, were (in thousands):

	Capital Leases	Operating Leases
1995	$26,282	$176,439
1996	28,897	178,253
1997	26,843	168,132
1998	32,903	148,017
1999	20,999	137,845
After 1999	191,096	1,559,478
Total minimum lease payments	327,020	$2,368,164
Less amount representing interest	131,264	
Present value of minimum lease payments	195,756	
Less current portion	9,542	
Long-term portion	$186,214	

The aircraft leases can generally be renewed at rates, based on fair market value at the end of the lease term, for one to five years. Most aircraft leases have purchase options at or near the end of the lease term at fair market value, but generally not to exceed a stated percentage of the lessor's defined cost of the aircraft.

8. Common Stock

At December 31, 1994, the Company had common stock reserved for issuance pursuant to Employee stock benefit plans (12,009,293 shares) and upon exercise of rights pursuant to the Common Stock Rights Agreement (Agreement), as amended (155,265,088 shares).

Pursuant to the Agreement, 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 at an exercise price of $16.67 and is exercisable only in the event of a proposed takeover, as defined by the Agreement. The Company may redeem the Rights at $.0111 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 Agreement, each Right will entitle its holder to purchase for $16.67 that number of the acquiring company's or the Company's common shares, as provided in the Agreement, having a market value of two times the exercise price of the Right. The Rights will expire no later than July 30, 1996.

On May 19, 1993, the Company's Board of Directors declared a three-for-two stock split, distributing 46,325,147 shares on July 15, 1993. On May 20, 1992, the Company's Board of Directors declared a two-for-one stock split, distributing 46,180,531 shares on July 15, 1992.

In February 1992, the Company sold 2,500,000 shares (unadjusted for the subsequent 1993 and 1992 stock splits) of its common stock (2,327,892 new shares and 172,108 shares from treasury) in a public offering. Net proceeds from the sale of approximately $86,946,000 were added to the working capital of the Company for general corporate purposes, including the acquisition of aircraft and related equipment.

9. Stock Plans

In May 1991, the Company's stockholders approved the Incentive Stock Option Plan and the Non-Qualified Stock Option Plan. Under the Incentive Stock Option Plan, options to purchase a maximum of 9,000,000 shares of Southwest common stock may be granted to key Employees. Under the Non-Qualified Stock Option Plan, options to purchase up to 750,000 shares of Southwest common stock may be granted to key Employees and non-employee directors. Under each plan, the option price per share may not be less than the fair market value of a share on the date the option is granted and the maximum term of an option may not exceed 10 years.

Information regarding the stock option plans is summarized below:

	Incentive Plan	Non-Qualified Plan
Outstanding December 31, 1991	3,948,957	282,825
Granted	430,974	97,950
Exercised	(251,817)	(4,350)
Surrendered	(111,210)	(1,800)
Outstanding December 31, 1992	4,016,904	374,625
Granted	724,646	22,512
Exercised	*(198,285)	**(94,810)
Surrendered	(230,978)	(1,050)
Outstanding December 31, 1994	4,312,287	301,277
Granted	794,714	63,918
Exercised	(190,159)	(9,940)
Surrendered	(104,880)	-
Outstanding December 31, 1994	4,811,962	355,255

Exercisable	Incentive Plan	Non-Qualified Plan
1994	572,244	163,936
1993	314,322	108,509
1992	198,474	142,575

Available for granting in future periods:	Incentive Plan	Non-Qualified Plan
1994	3,447,694	279,165
1993	4,137,528	343,083
1992	4,631,196	364,545

Average price of exercised options:	Incentive Plan	Non-Qualified Plan
1994	$8.23	$7.85
1993	$7.14	$7.37
1992	$6.10	$11.36

* Includes 108,113 pre-split shares and 36,115 post-split shares, of which 5,476 pre-split shares and 72 post-split shares were issued from treasury.

** Includes 12,740 pre-split shares and 75,700 post-split shares.

The exercise price of outstanding options ranged from $6.02 to $37.44 in 1994, $6.02 to $19.71 in 1993, and $6.02 to $12.06 in 1992.

In 1991, the Company's stockholders also approved the Employee Stock Purchase Plan that provides for the sale of common stock to Employees of the Company at a price equal to 90% of the market value at the end of each purchase period. Common stock purchases are paid for through periodic payroll deductions. Participants under the plan received 290,054 shares in 1994, 182,459 shares (59,442 pre-split shares and 93,296 post-split shares) in 1993 and 166,436 shares in 1992 at average prices of $24.98, $25.25, and $12.89, respectively.

At December 31, 1994, 1993, and 1992, 1,489,753, 1,504,752, and 1,512,252 options to purchase the Company's common stock were also outstanding related to employment contracts with the Company's president and chief executive officer. Exercise prices range from $1.00 to $11.33 per share. Options for 15,000 shares, 7,500 shares (5,000 pre-split shares, of which 968 shares were issued from treasury), and 22,500 shares were exercised in 1994, 1993, and 1992, respectively.

Effective January 12, 1995, the Company adopted, pursuant to a collective bargaining agreement between the Company and the Southwest Airlines Pilots' Association (SWAPA), the 1995 SWAPA Non-Qualified Stock Option Plan (SWAPA Plan). Under the terms of the SWAPA Plan, 18,000,000 common shares have been reserved for issuance. An initial grant of approximately 14.5 million shares was made on the effective date at an option price of $20.00 per share. On September 1 of each year of the agreement, commencing September 1, 1996, additional options will be granted to Pilots that became eligible during that year at an option price equal to the fair market value of the common stock of the Company on the date of grant plus 5 percent. Options vest in ten annual increments of 10 percent and must be exercised prior to January 31, 2007, or within a specified time upon retirement or termination. In the event that SWAPA exercises its option to make the collective bargaining agreement amendable on or before September 1, 1999, any unexercised options will be canceled on December 1, 1999.

10. Employee Profitsharing And Savings Plans

Substantially all of Southwest's Employees are members of the Southwest Airlines Co. Profitsharing Plan (the Plan). Total profitsharing expense charged to operations in 1994, 1993, and 1992 was $52,782,000, $44,959,000, and $26,363,000, respectively. The Company also elected to contribute $3,605,000 in 1992 as a result of an accounting change (see Note 3).

The Company sponsors Employee savings plans under Section 401(k) of the Internal Revenue Code. The plans cover substantially all full-time Employees. The amount of matching contributions varies by Employee group. Company contributions generally vest over five years with credit for prior years' service granted. Company matching contributions expensed in 1994, 1993, and 1992 were $19,817,000, $13,986,000, and $11,611,000, respectively.

11. Income Taxes

Effective January 1, 1993, the Company changed its method of accounting for income taxes from the deferred method to the liability method as required by SFAS 109 (see Note 3).

Under SFAS 109, deferred income taxes reflect the net tax effects of temporary differences between the carrying amounts of assets and liabilities for financial reporting purposes and the amounts used for income tax purposes. The components of deferred tax assets and liabilities at December 31, 1994 and 1993 are as follows (in thousands):

	1994	1993
Deferred tax liabilities:		
Accelerated depreciation	$343,585	$299,195
Scheduled airframe overhauls	23,966	21,512
Other	55,953	45,734
Total deferred tax liabilities	423,504	366,441
Deferred tax assets:		
Deferred gains from sale and leaseback of aircraft	95,602	87,358
Capital and operating leases	38,240	33,637
Alternative minimum tax credit carry forward	22,778	32,122
Other	43,856	40,183
Total deferred tax assets	200,476	193,300
Net deferred tax liability	$223,028	$173,141

In August 1993, the Revenue Reconciliation Act of 1993 (the “1993 Act”) was enacted, which contains numerous provision changes including an increase in the federal corporate income tax rate from 34 percent to 35 percent effective January 1, 1993. As a result, the Company recognized approximately $4.0 million of additional expense related to deferred tax liabilities existing on January 1, 1993.

The provision for income taxes before the cumulative effect of accounting changes is comprised of the following (in thousands):

	Liability Method		Deferred Method
	1994	1993	1992
Current:			
Federal	$59,603	$46,744	$30,586
State	10,702	5,409	3,970
Total current	70,305	52,153	34,556
Deferred:			
Federal	46,470	48,524	18,144
State	3,417	4,676	3,116
Total deferred	49,887	53,200	21,260
	$120,192	$105,353	$55,816

The components of the provision for deferred income taxes as reported under the previous method of accounting for the year ended December 31, 1992 are as follows (in thousands):

	1992
Depreciation	$27,947
Deferred gains on sale\leasebacks	(4,275)
Scheduled airframe overhauls	6,336
Vacation pay	(1,220)
Alternative minimum tax	(10,645)
Other, net	3,117
	$21,260

In January 1994, Southwest received an examination report from the Internal Revenue Service proposing certain adjustments to Southwest's income tax returns for 1987 and 1988. The adjustments relate to certain types of aircraft financings consummated by Southwest, as well as other members of the aviation industry during that time period. Southwest intends to vigorously protest the adjustments proposed with which it does not agree. The industry's difference with the IRS involves complex issues of law and fact that are likely to take a substantial period of time to resolve. Management believes that final resolution of such protest will not have a materially adverse effect upon the results of operations of Southwest.

The effective tax rate on income before cumulative effect of accounting changes differed from the federal income tax statutory rate for the following reasons (in thousands):

	Liability Method		Deferred Method
	1994	1993	1992
Tax at statutory U.S. tax rates	$104,833	$90,873	$53,531
Less amount associated with S-Corporation earnings of Morris (Note 2)	-	-	(3,607)
	104,833	$90,873	$49,924
Nondeductible items	3,689	1,361	1,131
State income taxes, net of federal benefit	9,177	6,632	5,124
Effect of increase in U.S. statutory rates	-	3,957	-
Other, net	2,493	2,530	(363)
Total income tax provision	$120,192	$105,353	$55,816

12. Net Income Per Common And Common Equivalent Share

Net income per common and common equivalent share is computed based on the weighted average number of common and common equivalent shares outstanding (147,305,374 in 1994, 147,144,568 in 1993, and 142,945,890 in 1992). Fully diluted earnings per share have not been presented as the fully dilutive effect of shares issuable upon the exercise of options under the Company's Stock Option Plans or conversion of Convertible Subordinated Debentures is anti-dilutive or is not material.

Independent Auditors

The Board of Directors and Shareholders, Southwest Airlines Co.

We have audited the accompanying consolidated balance sheets of Southwest Airlines Co. as of December 31, 1994 and 1993, and the related consolidated statements of income, stockholders' equity, and cash flows for each of the three years in the period ended December 31, 1994. 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, 1994 and 1993, and the consolidated results of its operations and its cash flows for each of the three years in the period ended December 31, 1994, in conformity with generally accepted accounting principles.

As discussed in Note 3, during 1993, the Company changed its method of accounting for income taxes and postretirement benefits. Also as discussed in Note 3, during 1992, the Company changed its method of accounting for scheduled airframe overhauls.

ERNST & YOUNG LLP
Dallas, Texas
January 26, 1995

Corporate Data

Transfer Agent and Registrar

Continental Stock Transfer & Trust Company
2 Broadway
New York, New York 10004
(212) 509-4000

Stock Exchange Listing

New York Stock Exchange
Ticker Symbol: **LUV**

Auditors

Ernst & Young LLP
Dallas, Texas
General Offices
P. O. Box 36611
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 18, 1995 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, Dallas, Texas 75235-1611.

Directors

Samuel E. Barshop
Chairman of the Board,
S. Barshop Investments Ltd.,
San Antonio, Texas; Audit and Compensation Committees

Gene H. Bishop
Retired Chairman and Chief Executive Officer,
Life Partners Group, Inc., Dallas, Texas; Audit, Compensation, and Executive Committees

C. Webb Crockett
Shareholder, Fennemore Craig,
Attorneys at Law, Phoenix, Arizona;
Audit Committee

William P. Hobby, Jr.
Former Lieutenant Governor of Texas;
Chairman of the Board,
H&C Communications, Houston, Texas;
Audit and Compensation Committees

Travis C. Johnson
Partner, Johnson & Bowen,
Attorneys at Law, El Paso, Texas;
Audit Committee

Herbert D. Kelleher
Chairman of the Board, President, and Chief Executive Officer of Southwest Airlines, Co., Dallas, Texas; Executive Committee

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

Walter M. Mischer, Sr.
Chairman of the Board and Chief Executive Officer, Southern Investors Service Co., Inc., Houston, Texas (Real Estate Development); Audit and Compensation Committees

June M. Morris
Founder and former Chief Executive Officer of Morris Air Corporation, Salt Lake City, Utah; Audit Committee

Officers

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

Colleen C. Barrett*
Executive Vice President–Customers and Corporate Secretary

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

John G. Denison*
Executive Vice President –Corporate Services

Carolyn R. Bates
Vice President–Reservations

Alan S. Davis
Vice President–Internal Audit and Special Projects

Camille T. Keith
Vice President–Special Marketing

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

Pete McGlade
Vice President–Schedule Planning

William Q. Miller
Vice President–Inflight Service

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Vice President–General Counsel

Robert W. Rapp, Jr.
Vice President–Systems

Ron Ricks*
Vice President–Governmental Affairs

Dave Ridley
Vice President–Marketing and Sales

Joyce C. Rogge
Vice President–Advertising and Promotions

Roger W. Saari
Vice President–Fuel and Administrative Purchasing

Elizabeth P. Sartain
Vice President–People

Paul E. Sterbenz
Vice President–Flight Operations

Keith L. Taylor
Vice President–Revenue Management

James C. Wimberly*
Vice President–Ground Operations

William D. Lyons
Controller

John D. Owen
Treasurer

* Indicates Member of Executive Planning Committee

Dedication

This Southwest Airlines Annual Report is dedicated to our 1994 Heroes of the Heart, our Technical Services Department, the most spirited group of Electronic Technicians in the industry. Your efficiency and resourcefulness help make us the Low Fare Airline.