

SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

FORM 10-Q

(Mark One)

☒ QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES
EXCHANGE ACT OF 1934

For the quarterly period ended September 30, 2005 or

☐ TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES
EXCHANGE ACT OF 1934

For the transition period from _____ to _____

Commission file No. 1-7259

Southwest Airlines Co.

(Exact name of registrant as specified in its charter)

TEXAS

(State or other jurisdiction of
incorporation or organization)

74-1563240

(IRS Employer
Identification No.)

P.O. Box 36611, Dallas, Texas

(Address of principal executive offices)

75235-1611

(Zip Code)

Registrant's telephone number, including area code: **(214) 792-4000**

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days. Yes ☒ No ☐

Indicate by check mark whether the registrant is an accelerated filer (as defined in Rule 12b-2 of the Exchange Act.) Yes ☒ No ☐

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act.) Yes ☐ No ☒

Indicate the number of shares outstanding of each of the issuer's classes of common stock, as of the latest practicable date.

Number of shares of Common Stock outstanding as of the close of business on October 19, 2005:

792,725,729

SOUTHWEST AIRLINES CO.
FORM 10-Q
Part I - FINANCIAL INFORMATION

Item 1. Financial Statements

Southwest Airlines Co.
Condensed Consolidated Balance Sheet
(in millions)
(unaudited)

	<u>September 30, 2005</u>	<u>December 31, 2004</u>
ASSETS		
Current assets:		
Cash and cash equivalents	\$ 2,428	\$ 1,048
Short-term investments	185	257
Accounts and other receivables	334	248
Inventories of parts and supplies, at cost	153	137
Fuel hedge contracts	944	428
Prepaid expenses and other current assets	65	54
Total current assets	<u>4,109</u>	<u>2,172</u>
Property and equipment, at cost:		
Flight equipment	10,786	10,037
Ground property and equipment	1,266	1,202
Deposits on flight equipment purchase contracts	657	682
	<u>12,709</u>	<u>11,921</u>
Less allowance for depreciation and amortization	3,364	3,198
	<u>9,345</u>	<u>8,723</u>
Other assets	1,292	442
	<u>\$ 14,746</u>	<u>\$ 11,337</u>
LIABILITIES AND STOCKHOLDERS' EQUITY		
Current liabilities:		
Accounts payable	\$ 495	\$ 420
Accrued liabilities	2,038	1,047
Air traffic liability	776	529
Current maturities of long-term debt	149	146
Total current liabilities	<u>3,458</u>	<u>2,142</u>
Long-term debt less current maturities	1,861	1,700
Deferred income taxes	2,311	1,610
Deferred gains from sale and leaseback of aircraft	140	152
Other deferred liabilities	221	209
Stockholders' equity:		
Common stock	790	790
Capital in excess of par value	297	299
Retained earnings	4,474	4,089
Accumulated other comprehensive income	1,194	417
Treasury stock, at cost	-	(71)
Total stockholders' equity	<u>6,755</u>	<u>5,524</u>
	<u>\$ 14,746</u>	<u>\$ 11,337</u>

See accompanying notes.

Southwest Airlines Co.
Condensed Consolidated Statement of Income
(in millions, except per share amounts)
(unaudited)

	Three months ended September 30,		Nine months ended September 30,	
	2005	2004	2005	2004
OPERATING REVENUES:				
Passenger	\$ 1,912	\$ 1,612	\$ 5,372	\$ 4,694
Freight	32	28	99	82
Other	45	34	125	99
Total operating revenues	1,989	1,674	5,596	4,875
OPERATING EXPENSES:				
Salaries, wages, and benefits	693	612	2,000	1,823
Fuel and oil	337	247	947	723
Maintenance materials and repairs	110	113	319	351
Aircraft rentals	36	45	121	134
Landing fees and other rentals	118	104	345	306
Depreciation and amortization	121	108	348	318
Other operating expenses	301	254	860	785
Total operating expenses	1,716	1,483	4,940	4,440
OPERATING INCOME	273	191	656	435
OTHER EXPENSES (INCOME):				
Interest expense	32	21	89	62
Capitalized interest	(10)	(10)	(28)	(30)
Interest income	(13)	(5)	(31)	(14)
Other (gains) losses, net	(104)	4	(112)	16
Total other expenses (income)	(95)	10	(82)	34
INCOME BEFORE INCOME TAXES	368	181	738	401
PROVISION FOR INCOME TAXES	141	62	276	143
NET INCOME	\$ 227	\$ 119	\$ 462	\$ 258
 NET INCOME PER SHARE, BASIC	 \$.29	 \$.15	 \$.59	 \$.33
NET INCOME PER SHARE, DILUTED	\$.28	\$.15	\$.57	\$.32
 WEIGHTED AVERAGE SHARES OUTSTANDING:				
Basic	789	781	786	784
Diluted	810	812	811	815

See accompanying notes.

Southwest Airlines Co.
Condensed Consolidated Statement of Cash Flows

(in millions)

(unaudited)

	Three months ended September 30,		Nine months ended September 30,	
	2005	2004	2005	2004
CASH FLOWS FROM OPERATING ACTIVITIES:				
Net income	\$ 227	\$ 119	\$ 462	\$ 258
Adjustments to reconcile net income to cash provided by operating activities:				
Depreciation and amortization	121	108	348	318
Deferred income taxes	138	60	271	141
Amortization of deferred gains on sale and leaseback of aircraft	(4)	(4)	(12)	(12)
Amortization of scheduled airframe inspections & repairs	13	13	36	40
Changes in certain assets and liabilities:				
Accounts and other receivables	(42)	(24)	(85)	(74)
Other current assets	(83)	(21)	(93)	(33)
Accounts payable and accrued liabilities	216	111	1,006	393
Air traffic liability	28	(15)	246	182
Other	(12)	13	(23)	(7)
Net cash provided by operating activities	602	360	2,156	1,206
CASH FLOWS FROM INVESTING ACTIVITIES:				
Purchases of property and equipment, net	(274)	(496)	(993)	(1,366)
Change in short-term investments, net	(185)	16	72	36
Acquisition of assets from ATA Airlines, Inc.	-	-	(6)	-
Net cash used in investing activities	(459)	(480)	(927)	(1,330)
CASH FLOWS FROM FINANCING ACTIVITIES:				
Issuance of long-term debt	-	350	300	408
Proceeds from Employee stock plans	21	12	58	52
Payments of long-term debt and capital lease obligations	(1)	(1)	(136)	(22)
Payments of cash dividends	(4)	(4)	(14)	(14)
Repurchase of common stock	-	(110)	(55)	(246)
Other, net	-	(3)	(2)	(7)
Net cash provided by financing activities	16	244	151	171
NET INCREASE IN CASH AND CASH EQUIVALENTS	159	124	1,380	47
CASH AND CASH EQUIVALENTS AT BEGINNING OF PERIOD	2,269	1,407	1,048	1,484
CASH AND CASH EQUIVALENTS AT END OF PERIOD	\$ 2,428	\$ 1,531	\$ 2,428	\$ 1,531
CASH PAYMENTS FOR:				
Interest, net of amount capitalized	\$ 21	\$ 14	\$ 53	\$ 31
Income taxes	\$ 3	\$ 2	\$ 3	\$ 4

See accompanying notes.

Southwest Airlines Co.
Notes to Condensed Consolidated Financial Statements
(unaudited)

1. BASIS OF PRESENTATION

The accompanying unaudited condensed consolidated financial statements of Southwest Airlines Co. (Company or Southwest) have been prepared in accordance with accounting principles generally accepted in the United States for interim financial information and with the instructions to Form 10-Q and Article 10 of Regulation S-X. Accordingly, they do not include all of the information and footnotes required by accounting principles generally accepted in the United States for complete financial statements. The unaudited condensed consolidated financial statements for the interim periods ended September 30, 2005 and 2004, include all adjustments, which are, in the opinion of management, necessary for a fair presentation of the results for the interim periods. This includes all normal and recurring adjustments, and other accounting entries as described herein. The Condensed Consolidated Balance Sheet as of December 31, 2004, has been derived from the Company's audited financial statements as of that date but does not include all of the information and footnotes required by generally accepted accounting principles for complete financial statements. Financial results for the Company, and airlines in general, are seasonal in nature. Historically, the Company's second and third fiscal quarters have been more profitable than its first and fourth fiscal quarters. Operating results for the three and nine months ended September 30, 2005, are not necessarily indicative of the results that may be expected for the year ended December 31, 2005. For further information, refer to the consolidated financial statements and footnotes thereto included in the Southwest Airlines Co. Annual Report on Form 10-K for the year ended December 31, 2004.

Certain prior period amounts have been reclassified to conform to the current presentation including, but not limited to the following: in the Condensed Consolidated Balance Sheet as of December 31, 2004, the Company has reclassified certain amounts as "Short-term investments", that were previously classified as "Cash and cash equivalents"; in the Condensed Consolidated Statement of Cash Flows for the three and nine months ended September 30, 2004, changes in the amounts of "Short-term investments" are classified as cash flows from investing activities; in the Condensed Consolidated Statement of Income for the three and nine months ended September 30, 2004, amounts previously classified as "Agency commissions" are now classified in "Other operating expenses."

2. STOCK-BASED EMPLOYEE COMPENSATION

The Company has stock-based compensation plans covering the majority of its Employee groups, including plans adopted via collective bargaining, a plan covering the Company's Board of Directors, and plans related to employment contracts with certain Executive Officers of the Company. The Company accounts for stock-based compensation utilizing the intrinsic value method in accordance with the provisions of Accounting Principles Board Opinion No. 25 (APB 25), "Accounting for Stock Issued to Employees" and related Interpretations. Accordingly, no compensation expense is recognized for fixed option plans because the exercise prices of Employee stock options equal or exceed the market prices of the underlying stock on the dates of grant. See Note 10 for additional information.

The following table represents the effect on net income and earnings per share if the Company had applied the fair value based method and recognition provisions of Statement of Financial Accounting Standards (SFAS) No. 123, "Accounting for Stock-Based Compensation," to stock-based Employee compensation (in millions, except per share amounts):

	Three months ended September 30,		Nine months ended September 30,	
	2005	2004	2005	2004
Net income, as reported	\$ 227	\$ 119	\$ 462	\$ 258
Add: Stock-based Employee compensation expense included in reported income, net of related tax effects	-	-	-	-
Deduct: Total stock-based Employee compensation expense determined under fair value based methods for all awards, net of related tax effects	(10)	(41)	(30)	(63)
Pro forma net income	\$ 217	\$ 78	\$ 432	\$ 195
Net income per share				
Basic, as reported	\$.29	\$.15	\$.59	\$.33
Basic, pro forma	\$.28	\$.10	\$.55	\$.25
Diluted, as reported	\$.28	\$.15	\$.57	\$.32
Diluted, pro forma	\$.27	\$.10	\$.54	\$.24

3. DIVIDENDS

During the three month periods ended March 31, June 30, and September 30, 2005, dividends of \$.0045 per share were declared on the 783 million shares, 787 million shares, and 790 million shares of common stock then outstanding, respectively. During the three month periods ended March 31, June 30, and September 30, 2004, dividends of \$.0045 per share were declared on the 784 million shares, 785 million shares, and 779 million shares of common stock then outstanding, respectively.

4. NET INCOME PER SHARE

The following table sets forth the computation of basic and diluted net income per share (in millions except per share amounts):

	Three months ended September 30, 2005	2004	Nine months ended September 30, 2005	2004
NUMERATOR:				
Net income available to common stockholders	\$ 227	\$ 119	\$ 462	\$ 258
DENOMINATOR:				
Weighted-average shares outstanding, basic	789	781	786	784
Dilutive effect of Employee stock options	21	31	25	31
Adjusted weighted-average shares outstanding, diluted	810	812	811	815
NET INCOME PER SHARE:				
Basic	\$.29	\$.15	\$.59	\$.33
Diluted	\$.28	\$.15	\$.57	\$.32

5. FINANCIAL DERIVATIVE INSTRUMENTS

Fuel Contracts - Airline operators are inherently dependent upon energy to operate and, therefore, are impacted by changes in jet fuel prices. Jet fuel and oil expense for the three months ended September 30, 2005 and 2004, represented approximately 19.6 percent and 16.7 percent, respectively, of Southwest's operating expenses for those periods. The Company endeavors to acquire jet fuel at the lowest possible prices. Because jet fuel is not traded on an organized futures exchange, liquidity for jet fuel hedging is limited. However, the Company has found commodities for effective hedging of jet fuel costs, primarily crude oil, and refined products such as heating oil, and unleaded gasoline. The Company utilizes financial derivative instruments as hedges to decrease its exposure to jet fuel price increases. The Company does not purchase or hold any derivative financial instruments for trading purposes.

The Company utilizes financial derivative instruments for both short-term and long-term time frames. In addition to the significant hedging positions the Company had in place for the first nine months of 2005, the Company also has significant future hedging positions. The Company currently has a mixture of purchased call options, collar structures, and fixed price swap agreements in place to hedge approximately 85 percent of its remaining 2005 total anticipated jet fuel requirements. These positions are capped at crude oil prices of \$26 per barrel and the Company has also hedged the refinery margins on the majority of those positions. As of September 30, 2005, the "spot" market price for a barrel of crude oil was over \$66. The Company is over 70 percent hedged for 2006 at approximately \$36 per barrel and has also hedged the refinery margins on most of those positions. The Company is also over 55 percent hedged for 2007 at approximately \$37 per barrel, approximately 35 percent hedged for 2008 at approximately \$37 per barrel, and approximately 30 percent hedged for 2009 at approximately \$39 per barrel.

The fair value of the Company's financial derivative instruments at September 30, 2005, was a net asset of approximately \$2.2 billion. The current portion of this net asset, approximately \$944 million, is classified as "Fuel hedge contracts" and the noncurrent portion, approximately \$1.2 billion, is classified in "Other assets" in the Condensed Consolidated Balance Sheet. The fair value of the derivative instruments, depending on the type of instrument, was determined by the use of present

value methods or standard option value models with assumptions about commodity prices based on those observed in underlying markets.

The Company accounts for its fuel hedge derivative instruments as cash flow hedges, as defined in Statement of Financial Accounting Standards No. 133, *Accounting for Derivative Instruments and Hedging Activities*, as amended (SFAS 133). Under SFAS 133, all derivatives designated as hedges that meet certain requirements are granted special hedge accounting treatment. Generally, utilizing the special hedge accounting, all periodic changes in fair value of the derivatives designated as hedges that are considered to be effective, as defined, are recorded in "Accumulated other comprehensive income" until the underlying jet fuel is consumed. However, the Company is exposed to the risk that periodic changes will not be effective, as defined, or that the derivatives will no longer qualify for special hedge accounting. To the extent that the periodic changes in the fair value of the derivatives are not effective, that ineffectiveness is recorded to "Other gains and losses" in the income statement. Likewise, if a hedge ceases to qualify for hedge accounting, those periodic changes in the fair value of derivative instruments are recorded to "Other gains and losses" in the income statement in the period of the change.

Ineffectiveness is inherent in hedging jet fuel with derivative positions based in other crude oil related commodities, especially given the magnitude of the current fair market value of the Company's fuel hedge derivatives and the recent volatility in the prices of refined products. Due to the volatility in markets for crude oil and related products, the Company is unable to predict the amount of ineffectiveness each period, including the loss of hedge accounting, which could be determined on a derivative by derivative basis or in the aggregate. This may result in increased volatility in the Company's results. The significant increase in the amount of hedge ineffectiveness and unrealized gains on derivative contracts settling in future periods recorded during the first nine months of 2005 was due to a number of factors. These factors included: the recent significant increase in energy prices, the number of derivative positions the Company holds, significant weather events that have affected refinery capacity and the production of refined products, and the volatility of the different types of products the Company uses in hedging. The number of instances in which the Company has discontinued hedge accounting for specific hedges has increased recently, primarily due to these reasons. In these cases, the Company has determined that the hedges will not regain effectiveness in the time period remaining until settlement and therefore must discontinue special hedge accounting, as defined by SFAS 133. When this happens, any changes in fair value of the derivative instruments are marked to market through earnings in the period of change. As the fair value of the Company's hedge positions increases in amount, there is a higher degree of probability that there will be continued variability recorded in the income statement and that the amount of hedge ineffectiveness and unrealized gains or losses recorded in future periods will be material. This is primarily due to the fact that small differences in the correlation of crude oil related products are leveraged over large dollar volumes.

During the three months ended September 30, 2005 and 2004, the Company recognized \$276 million and \$131 million in gains in "Fuel and oil" expense, respectively, from hedging activities. The Company also recognized approximately \$9 million and \$6 million of net expense, respectively, related to amounts excluded from the Company's measurements of hedge effectiveness, in "Other (gains) losses, net" during third quarter 2005, and third quarter 2004. During the three months ended September 30, 2005, the Company recognized approximately \$109 million of additional income in "Other (gains) losses, net," related to the ineffectiveness of its hedges and the loss of hedge accounting for certain hedges. Of this amount, approximately \$73 million of the additional income was

unrealized, mark-to-market changes in the fair value of derivatives due to the discontinuation of hedge accounting for certain contracts that will settle in future periods, approximately \$14 million was ineffectiveness associated with hedges designated for future periods, and \$22 million was ineffectiveness and mark-to-market gains related to hedges that settled during third quarter 2005. During the three months ended September 30, 2004, the Company recognized approximately \$2 million of additional income in "Other (gains) losses, net," related to the ineffectiveness of its hedges.

As of September 30, 2005, the Company had approximately \$1.2 billion in unrealized gains, net of tax, in "Accumulated other comprehensive income" related to fuel hedges. Included in this total are approximately \$544 million in net unrealized gains (net of tax) that are expected to be realized in earnings during the twelve months following September 30, 2005.

Interest Rate Swaps – In previous periods, the Company entered into interest rate swap agreements relating to its \$350 million 5.25% senior unsecured notes due October 1, 2014, its \$385 million 6.5% senior unsecured notes due March 1, 2012 and its \$375 million 5.496% Class A-2 pass-through certificates due November 1, 2006. Under these interest rate swap agreements, the Company pays the London InterBank Offered Rate (LIBOR) plus a margin every six months on the notional amount of the debt, and receives the fixed stated rate of the notes every six months until the date the notes become due.

The Company's interest rate swap agreements qualify as fair value hedges, as defined by SFAS 133. The fair value of the interest rate swap agreements, which are adjusted regularly, are recorded in the Company's balance sheet as an asset or liability, as necessary, with a corresponding adjustment to the carrying value of the long-term debt. The fair value of the interest rate swap agreements, excluding accrued interest, at September 30, 2005 was a liability of approximately \$25 million. This amount is recorded in "Other deferred liabilities" in the unaudited Condensed Consolidated Balance Sheet. In accordance with fair value hedging, the offsetting entry is an adjustment to decrease the carrying value of long-term debt.

6. COMPREHENSIVE INCOME

Comprehensive income included changes in the fair value of certain financial derivative instruments, which qualify for hedge accounting, and unrealized gains and losses on certain investments. For the first nine months of 2005, the Company's comprehensive income increased significantly, due to the substantial change in the fair value of the Company's hedge positions. Since comprehensive income is reported net of tax, there was also a significant increase in the Company's deferred tax liability compared to December 31, 2004. See Note 5 for further information. Comprehensive income totaled \$421 million and \$1.2 billion, respectively, for the three and nine months ended September 30, 2005. Comprehensive income totaled \$353 million and \$656 million, respectively, for the three and nine months ended September 30, 2004. The differences between net income and comprehensive income for each of these periods was as follows (in millions):

	Three months ended September 30, 2005	2004
Net income	\$ 227	\$ 119
Unrealized gain on derivative instruments, net of deferred taxes of \$123 and \$146	194	234
Other, net of deferred taxes of \$0 and \$0	-	-
Total other comprehensive income	194	234
Comprehensive income	\$ 421	\$ 353

	Nine months ended September 30, 2005	2004
Net income	\$ 462	\$ 258
Unrealized gain on derivative instruments, net of deferred taxes of \$493 and \$252	777	397
Other, net of deferred taxes of \$0 and \$0	-	1
Total other comprehensive income	777	398
Comprehensive income	\$ 1,239	\$ 656

A rollforward of the amounts included in "Accumulated other comprehensive income," net of taxes, is shown below (in millions):

	Fuel hedge derivatives	Other	Accumulated other comprehensive income (loss)
Balance at June 30, 2005	\$ 999	\$ 1	\$ 1,000
Third quarter 2005 changes in value	357	-	357
Reclassification to earnings	(163)	-	(163)
Balance at September 30, 2005	\$ 1,193	\$ 1	\$ 1,194

	Fuel hedge derivatives	Other	Accumulated other comprehensive income (loss)
Balance at December 31, 2004	\$ 416	\$ 1	\$ 417
2005 changes in value	1,144	-	1,144
Reclassification to earnings	(367)	-	(367)
Balance at September 30, 2005	\$ 1,193	\$ 1	\$ 1,194

7. LONG-TERM DEBT

During February 2005, the Company issued \$300 million senior unsecured Notes (Notes) due 2017. The Notes bear interest at 5.125 percent, payable semi-annually in arrears, with the first payment made on September 1, 2005. Southwest used the net proceeds from the issuance of the Notes, approximately \$296 million, for general corporate purposes.

During first quarter 2005, the Company redeemed its \$100 million senior unsecured 8% Notes on their maturity date of March 1, 2005.

8. OTHER ASSETS AND ACCRUED LIABILITIES (in millions)

	September 30, 2005	December 31, 2004
Noncurrent fuel hedge contracts, at fair value	\$ 1,211	\$ 368
Other	81	74
Other assets	\$ 1,292	\$ 442
	September 30, 2005	December 31, 2004
Counterparty fuel hedge deposits	\$ 1,195	\$ 330
Accrued vacation pay	131	120
Accrued aircraft rent	109	127
Accrued profitsharing	115	89
Deferred income taxes	282	218
Other	206	163
Accrued liabilities	\$ 2,038	\$ 1,047

9. POSTRETIREMENT BENEFITS

The following table sets forth the Company's periodic postretirement benefit cost for each of the interim periods identified:

	Three months ended September 30,	
(In millions)	2005	2004
Service cost	\$ 3	\$ 3
Interest cost	1	1
Amortization of prior service cost	-	1
Recognized actuarial loss	-	-
Net periodic postretirement benefit cost	<u>\$ 4</u>	<u>\$ 5</u>

	Nine months ended September 30,	
(In millions)	2005	2004
Service cost	\$ 9	\$ 8
Interest cost	3	3
Amortization of prior service cost	1	2
Recognized actuarial loss	-	-
Net periodic postretirement benefit cost	<u>\$ 13</u>	<u>\$ 13</u>

10. RECENTLY ISSUED ACCOUNTING STANDARDS

In December 2004, the FASB issued SFAS No. 123R, “Share-Based Payment”. SFAS No. 123R is a revision of SFAS No. 123, “Accounting for Stock Based Compensation”, and supersedes APB 25. Among other items, SFAS 123R eliminates the use of APB 25 and the intrinsic value method of accounting, and requires companies to recognize the cost of employee services received in exchange for awards of equity instruments, based on the grant date fair value of those awards, in the financial statements. The effective date of SFAS 123R had been set for the first reporting period beginning after June 15, 2005, which is third quarter 2005 for calendar year companies. However, on April 14, 2005, the Securities and Exchange Commission (SEC) announced the effective date of SFAS 123R was suspended until January 1, 2006, for calendar year companies. Early adoption is allowed.

SFAS 123R permits companies to adopt its requirements using either a “modified prospective” method, or a “modified retrospective” method. Under the “modified prospective” method, compensation cost is recognized in the financial statements beginning with the effective date, based on the requirements of SFAS 123R for all share-based payments granted after that date, and based on the requirements of SFAS 123 for all unvested awards granted prior to the effective date of SFAS 123R. Under the “modified retrospective” method, the requirements are the same as under the “modified prospective” method, but also permits entities to restate financial statements of previous periods based on proforma disclosures made in accordance with SFAS 123.

The Company currently utilizes a standard option pricing model (i.e., Black-Scholes) to measure the fair value of stock options granted to Employees. While SFAS 123R permits entities to continue to use such a model, the standard also permits the use of a “lattice” model. The Company

has not yet determined which model it will use to measure the fair value of employee stock options granted after the adoption of SFAS 123R.

SFAS 123R also requires that the benefits associated with the tax deductions in excess of recognized compensation cost be reported as a financing cash flow, rather than as an operating cash flow as required under current literature. This requirement will reduce net operating cash flows and increase net financing cash flows in periods after the effective date. These future amounts cannot be estimated because they depend on, among other things, when employees exercise stock options.

The Company currently expects to adopt SFAS 123R effective January 1, 2006, based on the new effective date announced by the SEC, and plans to utilize the modified retrospective method. As such, the Company would restate prior period financial statements upon adoption. The Company has not yet determined the financial statement impact of adopting SFAS 123R for periods beyond 2005.

Item 2. Management's Discussion and Analysis of Financial Condition and Results of Operations

Comparative Consolidated Operating Statistics

Relevant Southwest comparative operating statistics for the three and nine months ended September 30, 2005 and 2004 are as follows:

	Three months ended September 30,		Change
	2005	2004	
Revenue passengers carried	20,637,620	18,334,448	12.6%
Enplaned passengers	23,595,749	21,102,752	11.8%
Revenue passenger miles (RPMs) (000s)	16,365,420	14,164,101	15.5%
Available seat miles (ASMs) (000s)	21,853,579	19,486,103	12.1%
Load factor	74.9%	72.7%	2.2 pts
Average length of passenger haul (miles)	793	773	2.6%
Average aircraft stage length (miles)	612	576	6.3%
Trips flown	261,812	248,981	5.2%
Average passenger fare	\$92.63	\$87.90	5.4%
Passenger revenue yield per RPM (cents)	11.68	11.38	2.6%
Operating revenue yield per ASM (cents)	9.10	8.59	5.9%
Operating expenses per ASM (cents)	7.85	7.61	3.2%
Operating expenses per ASM, excluding fuel (cents)	6.31	6.34	(0.5)%
Fuel costs per gallon, excluding fuel tax	\$1.006	\$.803	25.3%
Fuel consumed, in gallons (millions)	332	306	8.5%
Number of Employees at period-end	31,382	30,657	2.4%
Size of fleet at period-end	439	415	5.8%

	Nine months ended September 30,		Change
	2005	2004	
Revenue passengers carried	58,208,534	53,193,484	9.4%
Enplaned passengers	66,154,155	60,921,204	8.6%
Revenue passenger miles (RPMs) (000s)	45,083,739	40,282,260	11.9%
Available seat miles (ASMs) (000s)	63,424,106	56,641,218	12.0%
Load factor	71.1%	71.1%	0.0 pts.
Average length of passenger haul (miles)	775	757	2.4%
Average aircraft stage length (miles)	605	572	5.8%
Trips flown	769,262	729,836	5.4%
Average passenger fare	\$92.30	\$88.23	4.6%
Passenger revenue yield per RPM (cents)	11.92	11.65	2.3%
Operating revenue yield per ASM (cents)	8.82	8.61	2.4%
Operating expenses per ASM (cents)	7.79	7.84	(0.6)%
Operating expenses per ASM, excluding fuel (cents)	6.30	6.56	(4.0)%
Fuel costs per gallon, excluding fuel tax	\$.978	\$.806	21.3%
Fuel consumed, in gallons (millions)	961	891	7.9%
Number of Employees at period-end	31,382	30,657	2.4%
Size of fleet at period-end	439	415	5.8%

Material Changes in Results of Operations

Summary

The Company's third quarter 2005 net income was \$227 million (\$.28 per share, diluted), an increase of \$108 million, or 90.8 percent, compared to third quarter 2004 net income of \$119 million (\$.15 per share, diluted). Third quarter 2005 represented the Company's 58th consecutive quarterly profit. The Company's fuel hedging program once again greatly mitigated record-high market fuel prices during third quarter 2005. The Company's fuel hedging program resulted in a reduction to fuel and oil expense of \$276 million and also resulted in an additional \$22 million in gains from derivative contracts that also settled in the period. In addition, the Company recorded an additional \$87 million (\$53 million net tax, or \$.07 per share, diluted) in gains from hedge ineffectiveness on positions that settle in future periods and for future period derivative contracts that did not qualify for SFAS 133 hedge accounting during third quarter. See Note 5 to the unaudited condensed consolidated financial statements. However, even with the Company's strong hedge position, fuel cost per gallon increased 25.3 percent versus third quarter 2004.

Third quarter 2005 operating income increased \$82 million, or 42.9 percent, compared to third quarter 2004. This growth was primarily driven by an 18.8 percent increase in revenues, and a good cost performance excluding fuel. The increase in revenues primarily resulted from the 12.1 percent increase in the Company's capacity (available seat miles) and strong industry demand. The capacity increase, along with a 15.5 percent increase in revenue passenger miles (RPMs), resulted in a third quarter 2005 load factor of 74.9 percent, which was the highest for any third quarter in the Company's history. The third quarter 2004 load factor was 72.7 percent. RPM yields also improved 2.6 percent as a result of modest fare increases, and the Company's expansion efforts at Chicago Midway Airport, including \$19 million in revenues generated from the Company's codeshare arrangement with ATA Airlines (ATA.) ATA continues to reorganize in Chapter 11, and is seeking exit financing. As part of its reorganization efforts, ATA recently announced it will be discontinuing service in Chicago Midway to Minneapolis, Newark, and Boston in fourth quarter 2005. While the Company's codeshare activity will decline, as a consequence, we will pursue opportunities to continue Southwest's growth at Midway. We have been pleased with our expansion efforts at Midway this year.

Third quarter 2005 CASM (cost per available seat mile) declined slightly compared to third quarter 2004, excluding fuel. Including fuel expense, third quarter 2005 CASM increased 3.2 percent. The largest increases in unit costs were in fuel expense, as previously mentioned, and in other operating expenses, primarily as a result of higher fuel taxes. The Company continued its focus on controlling non-fuel costs. As a result of increased workforce productivity, the Company has been able to continue expanding flights without a commensurate increase in overall headcount. At September 30, 2005, the Company's headcount per aircraft was 71 versus a year-ago level of 74. These productivity enhancements have helped the Company absorb cost pressures from wage and benefit increases. Based on recent trends, however, the Company currently expects fourth quarter unit costs, excluding fuel, to moderately exceed third quarter's 6.31 cents per ASM.

As a result of the recent worker strike at Boeing, which has since been resolved, the Company's new aircraft deliveries from September through December 2005 were impacted. The combination of this strike and the reduction in service to New Orleans following Hurricane

Katrina in August 2005, will result in the Company's year-over-year capacity growth for fourth quarter 2005 being less than planned. The Company currently expects fourth quarter 2005 capacity to grow approximately seven percent versus fourth quarter 2004.

For the nine months ended September 30, 2005, net income was \$462 million (\$.57 per share, diluted), an increase of \$204 million, or 79.1 percent, versus the comparable period of 2004 net income of \$258 million (\$.32 per share, diluted). Operating income for the nine months ended September 30, 2005 increased \$221 million, or 50.8 percent, compared to the same period of 2004. This significant increase in operating income was primarily due to the strengthening airline revenue environment and to the Company's ongoing cost reduction efforts, which resulted in a 4.0 percent decrease in CASM, excluding fuel.

The Company began service to Fort Myers, Florida, on October 2, 2005, representing the 61st city the Company now serves. The Company also has announced that it will soon begin service to Denver, Colorado, representing the 62nd city and 32nd state the Company serves. The starting date and schedule for service to Denver will be announced during fourth quarter 2005.

Comparison of three months ended September 30, 2005, to three months ended September 30, 2004

Revenues

Consolidated operating revenues increased by \$315 million, or 18.8 percent, primarily due to a \$300 million, or 18.6 percent, increase in passenger revenues. The increase in passenger revenues was primarily due to a 15.5 percent increase in revenue passenger miles (RPMs) flown.

Third quarter 2005 capacity, as measured by available seat miles (ASMs), increased 12.1 percent compared to third quarter 2004. The capacity increase resulted from the net addition of 24 aircraft (net of 13 retirements) since the end of third quarter 2004. The third quarter 2005 load factor was 74.9 percent, an increase of 2.2 points compared to the same period of 2004. The Company also experienced a 12.6 percent increase in revenue passengers carried compared to third quarter 2004.

The third quarter 2005 passenger yield per RPM increased 2.6 percent to 11.68 cents from 11.38 cents in third quarter 2004. The higher RPM yield was primarily due to modest fare increases and an overall improvement in industry demand, especially for the Company's low fares. Unit revenue (operating revenue per ASM) also increased 5.9 percent, due to the combination of higher RPM yields and the higher load factor. The Company's favorable load factor and unit revenue trends have continued in October 2005. Based on bookings and these traffic trends, the Company expects fourth quarter 2005 unit revenue results to exceed the fourth quarter 2004 unit revenue of 8.18 cents, despite year-over-year capacity growth of seven percent.

Consolidated freight revenues increased by \$4 million, or 14.3 percent. The majority of the increase was due to an increase in freight and cargo revenues, primarily as a result of the increase in capacity versus third quarter 2004. The Company expects fourth quarter 2005 freight revenue to be in line with fourth quarter 2004, despite the planned capacity increase of seven percent. Other revenues increased by \$11 million, or 32.4 percent, compared to third quarter 2004. In excess of 40 percent of the increase was in excess baggage charges, as the Company modified its fee policy related to the weight of checked baggage. The remainder of the increase was spread among other items, including

commissions earned from programs the Company sponsors with certain business partners, such as the Company sponsored Chase Visa card, and charter revenues. The Company expects another year-over-year other revenue increase in fourth quarter 2005; however, at a lower rate than in third quarter 2005.

Operating expenses

To a large extent, changes in operating expenses for airlines are driven by changes in capacity, or ASMs. The following presents Southwest's operating expenses per ASM for the three months ended September 30, 2005 and 2004, followed by explanations of changes on a per-ASM basis:

	Three months ended September 30, 2005	2004	Per ASM Change	Percent Change
Salaries, wages, and benefits	3.17	3.14	.03	1.0
Fuel and oil	1.54	1.27	.27	21.3
Maintenance materials and repairs	.50	.58	(.08)	(13.8)
Aircraft rentals	.16	.23	(.07)	(30.4)
Landing fees and other rentals	.55	.53	.02	3.8
Depreciation	.55	.55	-	-
Other operating expenses	1.38	1.31	.07	5.3
Total	7.85	7.61	.24	3.2

Operating expenses per ASM were 7.85 cents, a 3.2 percent increase compared to 7.61 cents for third quarter 2004. The majority of the year-over-year CASM increase was due to higher fuel costs, as the Company's cost per gallon of fuel increased 25.3 percent versus the prior year. Excluding fuel, year-over-year CASM was approximately flat, as higher salaries, wages, and benefits from an increase in profitsharing expense, and higher other operating expenses were mostly offset by lower maintenance expense and aircraft rentals.

Salaries, wages, and benefits expense per ASM increased 1.0 percent primarily due to higher profitsharing expense, as a result of the significant increase in the Company's earnings available for profitsharing versus third quarter 2004. Excluding profitsharing expense, salaries, wages, and benefits declined versus the prior year as a result of lower benefits expense per ASM, specifically workers compensation expense. The Company currently expects Salaries, wages, and benefits in fourth quarter 2005 to be up compared to the 3.06 cents per ASM experienced in fourth quarter 2004.

Fuel and oil expense per ASM increased 21.3 percent primarily due to an increase in the average jet fuel price per gallon. The average fuel cost per gallon in third quarter 2005 was \$1.01, 25.3 percent higher than third quarter 2004, including the effects of hedging activities. Prior to third quarter 2005, the Company had hedged approximately 85 percent of its anticipated fuel needs. This resulted in third quarter gains recorded in fuel and oil expense of \$276 million. In other efforts to control fuel expense, the Company has added Blended Winglets to all of its Boeing 737-700 aircraft. These enhancements extend the range of these aircraft, enable the aircraft to burn less fuel, lower potential engine maintenance costs, and reduce takeoff noise. All new 737-700 aircraft now arrive from Boeing with winglets installed. The Company has experienced

annual fuel consumption savings of approximately three percent for each aircraft outfitted with the winglets.

For fourth quarter 2005, the Company has fuel hedges in place for approximately 85 percent of its expected fuel consumption with a combination of derivative instruments that effectively cap prices at approximately \$26 per barrel of crude oil and has hedged the refinery margins on the majority of those positions. The majority of the Company's near term hedge positions are also in the form of option contracts. However, given the unprecedented surge in Gulf Coast jet fuel refinery margins following Hurricanes Katrina and Rita, the Company expects its fourth quarter 2005 jet fuel cost per gallon to be well above the third quarter 2005 jet fuel cost per gallon. Unless Gulf Coast jet fuel prices recede from current levels, the Company's fourth quarter 2005 jet fuel cost per gallon could exceed \$1.25, excluding the impact of any ineffectiveness on the Company's hedges. During the first nine months of 2005, because of the continued rise in energy prices, the fair values of the Company's fuel hedge contracts have increased significantly. At September 30, 2005, the estimated net fair value of these contracts was \$2.2 billion. See Note 5 to the unaudited condensed consolidated financial statements for further discussion of the Company's hedging activities.

Maintenance materials and repairs per ASM decreased 13.8 percent primarily due to a decrease in repair events for aircraft engines. The Company currently expects maintenance materials and repairs per ASM for fourth quarter 2005 to be approximately flat with fourth quarter 2004.

Aircraft rentals per ASM decreased 30.4 percent compared to third quarter 2004. The majority of the decrease per ASM was due to the renegotiation of several aircraft leases over the past twelve months, that resulted in both lower lease rates and the reclassification of four aircraft from operating leases to capital leases. Expense associated with capital lease aircraft is recorded as depreciation. In addition, all of the aircraft acquired in 2004, except for one, and all of the aircraft acquired in 2005, are owned by the Company. The Company currently expects another year-over-year decline in aircraft rentals per ASM for fourth quarter 2005, but at a lesser rate than the third quarter 2005 decrease.

Landing fees and other rentals per ASM were up 3.8 percent compared to third quarter 2004. A slight increase in other rentals per ASM was mostly offset by a slight decrease in landing fees per ASM. The Company expects an increase in landing fees and other rentals per ASM in fourth quarter 2005 compared to fourth quarter 2004, primarily due to a large number of credits from airports' audits of prior periods received in fourth quarter 2004. The Company expects to receive a lesser amount of credits during fourth quarter 2005.

Depreciation expense per ASM was flat compared to third quarter 2005. An increase in the number of aircraft owned or on capital lease was offset by the retirement of equipment associated with the Company's 737-200 aircraft, the remainder of which were phased out of the Company's fleet in January 2005. For fourth quarter 2005, the Company currently expects depreciation per ASM to be up from third quarter 2005.

Other operating expenses per ASM increased 5.3 percent compared to third quarter 2004. Approximately one-third of the increase was due to higher fuel sales taxes due to the substantial increase in jet fuel prices. Of the remainder of the increase, the most significant item was higher credit card fees associated with the increase in revenues. The Company currently expects Other

operating expenses per ASM for fourth quarter 2005 to be higher than the 1.36 cents per ASM experienced in fourth quarter 2004 due to the same reasons noted for third quarter 2005.

Through the 2003 Emergency Wartime Supplemental Appropriations Act, the federal government has continued to provide supplemental third-party war-risk insurance coverage to commercial carriers for renewable 60-days periods, at substantially lower premiums than prevailing commercial rates and for levels of coverage not available in the commercial market. The government-provided supplemental coverage from the Wartime Act is currently set to expire on December 31, 2005. Although another extension beyond this date is expected, if such coverage is not extended by the government, the Company could incur substantially higher insurance costs in future periods.

Other

Interest expense increased \$11 million, or 52.4 percent compared to third quarter 2004. The majority of the increase was due to an increase in interest rates, due to the fact that most of the Company's long-term debt is at floating rates. See Notes 5 and 7 to the unaudited condensed consolidated financial statements for more information.

Capitalized interest was flat compared to the prior year, as a decrease in progress payment balances for future aircraft deliveries was offset by an increase in interest rates.

Interest income increased by \$8 million, or 160.0 percent, primarily due to an increase in rates earned on cash and investments.

"Other (gains) losses, net" primarily includes amounts recorded in accordance with SFAS 133. During third quarter 2005, the Company recognized approximately \$9 million of expense related to amounts excluded from the Company's measurements of hedge effectiveness. Also in third quarter 2005, the Company recognized approximately \$109 million of additional income in "Other (gains) losses, net," related to the ineffectiveness of its hedges and the loss of hedge accounting for certain hedges. Of this amount, approximately \$73 million of the additional income was unrealized, mark-to-market changes in the fair value of derivatives due to the discontinuation of hedge accounting for certain contracts that will settle in future periods, approximately \$14 million was unrealized ineffectiveness associated with hedges designated for future periods, and \$22 million was ineffectiveness and mark-to-market gains related to contracts that settled during third quarter 2005. See Note 5 to the unaudited condensed consolidated financial statements for more information on the Company's hedging activities. In third quarter 2004, the Company recognized approximately \$6 million of expense related to amounts excluded from the Company's measurements of hedge effectiveness and \$2 million in income related to the ineffectiveness of its hedges.

The Company's effective tax rate increased to 38.3 percent in third quarter 2005 from 34.1 percent in third quarter 2004. The prior year rate was favorably impacted by an adjustment related to the ultimate resolution of an airline industry-wide issue regarding the tax treatment of certain aircraft engine maintenance costs. The Company currently expects its fourth quarter 2005 effective rate to be 38 to 39 percent, and its full year 2005 effective rate to be in the 37 to 38 percent range.

Comparison of nine months ended September 30, 2005, to nine months ended September 30, 2004

Revenues

Consolidated operating revenues increased by \$721 million, or 14.8 percent, primarily due to a \$678 million, or 14.4 percent, increase in passenger revenues. The increase in passenger revenues was primarily due to an 11.9 percent increase in revenue passenger miles (RPMs) flown.

Capacity for the nine months ended September 30, 2005, as measured by available seat miles (ASMs), increased 12.0 percent compared to the nine months ended September 30, 2004. The capacity increase resulted from the net addition of 24 aircraft (net of 13 retirements) since the end of third quarter 2004. Load factor for the nine months ended September 30, 2005 was 71.1 percent, the same as the prior year. The Company also experienced a 9.4 percent increase in revenue passengers carried compared to the nine months ended September 30, 2004.

Passenger yield per RPM for the nine months ended September 30, 2005 increased 2.3 percent to 11.92 cents from 11.65 cents in the nine months ended September 30, 2004, primarily due to less fare discounting during the same 2005 period. Unit revenue (operating revenue per ASM) increased 2.4 percent to 8.82 cents compared to the nine months ended September 30, 2004, due to the increase in RPM yield and strong performances in both freight and other revenues.

Consolidated freight revenues increased by \$17 million, or 20.7 percent. Approximately 55 percent of the increase was due to an increase in mail revenues, as the U.S. Postal Service shifted more business to commercial carriers. Other revenues increased by \$26 million, or 26.3 percent, compared to the nine months ended September 30, 2004. Approximately one-third of the increase was due to an increase in excess baggage charges, as the Company modified its fee policy related to the weight of checked baggage. Another one-third of the increase was from commissions earned from programs the Company sponsors with certain business partners, such as the Company sponsored Chase Visa card.

Operating expenses

To a large extent, changes in operating expenses for airlines are driven by changes in capacity, or ASMs. The following presents Southwest's operating expenses per ASM for the nine months ended September 30, 2005 and 2004, followed by explanations of changes on a per-ASM basis:

	Nine months ended September 30, 2005	2004	Per ASM Change	Percent Change
Salaries, wages, and benefits	3.15	3.22	(.07)	(2.2)
Fuel and oil	1.49	1.28	.21	16.4
Maintenance materials and repairs	.50	.62	(.12)	(19.4)
Aircraft rentals	.19	.24	(.05)	(20.8)
Landing fees and other rentals	.55	.54	.01	1.9
Depreciation	.55	.56	(.01)	(1.8)
Other operating expenses	1.36	1.38	(.02)	(1.4)
Total	7.79	7.84	(.05)	(.6)

Operating expenses per ASM were 7.79 cents, a .6 percent decrease compared to 7.84 cents for the nine months ended September 30, 2004. The Company was able to hold approximately flat or reduce unit costs in every cost category, except fuel expense, through a variety of cost reduction or productivity efforts. These efforts, however, were almost entirely offset by the significant increase in the cost of fuel. Excluding fuel, CASM was 4.0 percent lower than the nine months ended September 30, 2004, at 6.30 cents per ASM.

Salaries, wages, and benefits expense per ASM decreased 2.2 percent. In the nine months ended September 30, 2004, salaries, wages, and benefits included approximately \$13 million in severance and benefits associated with the Company's Reservations Center consolidation, \$11 million of bonus pay and benefits associated with the Company's voluntary early-out plan offered to all Employees except officers, and approximately \$7 million in pay and benefit increases associated with the Company's labor agreement with its Flight Attendants (an additional \$5 million related to per diem increases was included in "Other operating expenses"). Excluding these costs, salaries, wages, and benefits were approximately flat on a per ASM basis compared to the nine months ended September 30, 2004. Higher average wage rates and higher profitsharing expense per ASM from the increase in earnings were offset by continued productivity efforts that have enabled the Company to reduce headcount while continuing to grow its aircraft fleet, as well as lower benefits expense, primarily health care.

Fuel and oil expense per ASM increased 16.4 percent primarily due to an increase in the average jet fuel price per gallon. The average fuel cost per gallon in the nine months ended September 30, 2005 was 97.8 cents, 21.3 percent higher than the nine months ended September 30, 2004, including the effects of hedging activities. For the nine months ended September 30, 2005, the Company was hedged for approximately 85 percent of its fuel needs, resulting in gains recorded in fuel and oil expense of \$627 million.

Maintenance materials and repairs per ASM decreased 19.4 percent primarily due to a decrease in repair events for aircraft engines.

Aircraft rentals per ASM decreased 20.8 percent compared to the nine months ended September 30, 2004. The majority of the decrease per ASM was due to the Company's growth occurring with purchased aircraft. All of the aircraft acquired in 2004, except for one, and all of the aircraft acquired thus far in 2005, are owned by the Company.

Landing fees and other rentals per ASM were up slightly compared to the nine months ended September 30, 2004, as higher landing fees per ASM were mostly offset by a decline in other rentals per ASM. The Company experienced a 3.7 percent increase in landing fees per ASM, primarily due to higher rates paid. This was partially offset by a decrease in other rentals expense per ASM, primarily due to efficiencies gained by capacity growth exceeding the expansion of gate and counter space at airports.

Depreciation expense per ASM decreased 1.8 percent primarily due to the retirement of equipment associated with the Company's 737-200 aircraft, the remainder of which were phased out of the Company's fleet in January 2005.

Other operating expenses per ASM decreased 1.4 percent compared to the nine months ended September 30, 2004. There were decreases per ASM in several cost categories, including advertising costs, personnel expenses, and insurance expense. These and other smaller decreases were partially offset by higher fuel sales taxes due to the substantial increase in fuel prices.

Other

Interest expense increased \$27 million, or 43.5 percent compared to the nine months ended September 30, 2004. The majority of the increase was due to an increase in interest rates. The majority of the Company's long-term debt is at floating rates. See Notes 5 and 7 to the unaudited condensed consolidated financial statements for more information.

Capitalized interest decreased by \$2 million, or 6.7 percent, primarily due to a decrease in progress payment balances for future aircraft deliveries.

Interest income increased by \$17 million, or 121.4 percent, primarily due to an increase in rates earned on cash and investments.

"Other (gains) losses, net" primarily includes amounts recorded in accordance with SFAS 133. See Note 5 to the unaudited condensed consolidated financial statements for more information on the Company's hedging activities. During the nine months ended September 30, 2005, the Company recognized approximately \$26 million of expense related to amounts excluded from the Company's measurements of hedge effectiveness. Also during the nine months ended September 30, the Company recognized approximately \$134 million of additional income in "Other (gains) losses, net," related to the ineffectiveness of its hedges and the loss of hedge accounting for certain hedges. Of this amount, approximately \$85 million of the additional income was unrealized, mark-to-market changes in the fair value of derivatives due to the discontinuation of hedge accounting for certain contracts that will settle in future periods, approximately \$28 million was unrealized ineffectiveness associated with hedges designated for future periods, and \$21 million was ineffectiveness and mark-to-market gains related to contracts that settled during the first nine months of 2005. For the nine months ended September 30, 2004, the Company recognized approximately \$18 million of expense related to amounts excluded from the Company's measurements of hedge effectiveness and \$3 million in income related to the ineffectiveness of its hedges.

The Company's effective tax rate increased to 37.4 percent in the nine months ended September 30, 2005, from 35.7 percent in the nine months ended September 30, 2004. The prior year rate was favorably impacted by an adjustment related to the ultimate resolution of an airline industry-wide issue regarding the tax treatment of certain aircraft engine maintenance costs, and lower state income taxes.

Liquidity and Capital Resources

Net cash provided by operating activities was \$2.2 billion for the nine months ended September 30, 2005, compared to \$1.2 billion in the same prior year period. The increase was primarily due to an increase in Accounts payable and accrued liabilities, primarily from an \$865 million increase in counterparty deposits associated with the Company's fuel hedging program

during 2005, and the increase in net earnings versus the prior year. See Item 3, and Notes 5 and 8 to the unaudited condensed consolidated financial statements. Net cash provided by operating activities was \$2.1 billion for the 12 months ended September 30, 2005. Cash generated from operating activities for the 12 months ended September 30, 2005, was primarily used to finance capital expenditures.

Net cash flows used in investing activities during the nine months ended September 30, 2005, totaled \$927 million compared to \$1.3 billion in 2004. Investing activities in both years consisted primarily of payments for new 737-700 aircraft delivered to the Company and progress payments for future aircraft deliveries. In addition, investing activities for the nine months ended September 30, 2005, was reduced \$72 million by a change in the balance of the Company's short-term investments, namely auction rate securities. Cash flows used in investing activities for the 12 months ended September 30, 2005, totaled \$1.3 billion.

Net cash generated from financing activities during the nine months ended September 30, 2005, was \$151 million compared to \$171 million generated in 2004. The Company generated \$300 million from the February 2005 issuance of senior unsecured Notes due 2017. This was partially offset by cash used to redeem the \$100 million senior unsecured 8% Notes due March 1, 2005, and to repurchase \$55 million of the Company's common stock.

In fourth quarter 2004, Southwest was selected as the winning bidder at a bankruptcy-court approved auction for certain ATA assets. As part of the transaction, which was approved in December 2004, Southwest provided ATA with \$40 million in debtor-in-possession financing while ATA remains in bankruptcy, and has also guaranteed the repayment of an ATA construction loan to the City of Chicago for \$7 million. The \$40 million debtor-in-possession financing, which was set to mature September 30, 2005, has been extended to December 31, 2005 (coinciding with ATA's expected emergence from bankruptcy). This loan is classified as "Accounts and other receivables" in the Consolidated Balance Sheet, and the estimated fair value of the Company's guarantee of the ATA construction loan, which is not material, is classified as part of "Other deferred liabilities". The debtor-in-possession financing bears interest at a rate equal to the higher of 8 percent or LIBOR plus 5 percent, and interest is payable to Southwest monthly. Upon ATA's emergence from bankruptcy, Southwest has committed to convert the debtor-in-possession financing to a term loan, payable over five years.

ATA is currently pursuing funding that would enable its emergence from bankruptcy. Although ATA's planned emergence has been extended to December 31, 2005, there is no assurance that ATA will exit bankruptcy protection on this date, or that funding will be found that would enable ATA to emerge from bankruptcy. ATA has disclosed that, in addition to certain specific reorganization objectives, it will need a capital infusion of \$50 million to \$100 million to provide it with the liquidity necessary to continue as a going concern through December 31, 2005. Although the Company's loan to ATA is secured by certain specified assets, if ATA is unable to obtain adequate funding and/or does not emerge from bankruptcy, loans made by Southwest to ATA may not be repaid in full. As of September 30, 2005, Southwest has not recorded an uncollectibility reserve for the ATA loan as management believes the receivable is recoverable.

Contractual Obligations and Contingent Liabilities and Commitments

Southwest has contractual obligations and commitments primarily for future purchases of aircraft, payment of debt, and lease arrangements. Through the first nine months of 2005, the Company has received 27 new 737-700 aircraft from Boeing. Prior to third quarter 2005, the Company had expected a total of 34 new 737-700s for the year. However, due to a Boeing labor dispute that was just resolved at the end of third quarter 2005, the Company's remaining deliveries for 2005 are expected to be delayed, and one of these aircraft is not expected to be delivered until January 2006. Based on recent information provided by Boeing, the following table details the Company's current firm orders, options, and purchase rights through 2012.

	Current Schedule	
	Firm	Options*
2005**	33	-
2006	33	-
2007	27	29
2008	6	45
2009-2012	-	177
Total	99	251

* Includes purchase rights

** Includes 27 aircraft delivered through September 30, 2005

The following table details information on the 439 aircraft in the Company's fleet as of September 30, 2005:

737 Type	Seats	Average Age (Yrs)	Number of Aircraft	Number Owned	Number Leased
-300	137	14.4	194	112	82
-500	122	14.4	25	16	9
-700	137	3.6	220	218	2
TOTALS		9.0	439	346	93

The Company has the option, which must be exercised two years prior to the contractual delivery date, to substitute -600s or -800s for the -700s. Based on the current revised delivery schedule provided by Boeing following the resolution of their labor dispute, aggregate funding needed for firm aircraft commitments was approximately \$1.4 billion, subject to adjustments for inflation, due as follows: \$188 million remaining in 2005, \$704 million in 2006, \$445 million in 2007, and \$80 million thereafter.

The Company has various options available to meet its capital and operating commitments, including cash on hand at September 30, 2005, of \$2.4 billion, internally generated funds, and the Company's fully available \$600 million revolving credit facility. The Company will also consider various borrowing or leasing options to maximize earnings and supplement cash requirements.

During first quarter 2005, the Company issued \$300 million senior unsecured Notes (Notes) due 2017. The Notes bear interest at 5.125 percent, payable semi-annually in arrears, with the first payment due on September 1, 2005. Also during first quarter 2005, the Company redeemed its \$100 million 8% senior unsecured notes on the maturity date of March 1, 2005. See Note 7 to the condensed consolidated financial statements.

The Company currently has outstanding shelf registrations for the issuance of up to \$1.3 billion in public debt securities and pass through certificates, which it may utilize for aircraft financings or other purposes in the future.

Forward looking statements

Some statements in this Form 10-Q (or otherwise made by the Company or on the Company's behalf from time to time in other reports, filings with the Securities and Exchange Commission, news releases, conferences, World Wide Web postings or otherwise) which are not historical facts may be "forward-looking statements" within the meaning of Section 21E of the Securities Exchange Act of 1934 and the Private Securities Litigation Reform Act of 1995. Forward-looking statements include statements about Southwest's estimates, expectations, beliefs, intentions, or strategies for the future, and the assumptions underlying these forward-looking statements. Southwest uses the words "anticipates," "believes," "estimates," "expects," "intends," "forecasts," "may," "will," "should," and similar expressions to identify these forward-looking statements. Forward-looking statements involve risks and uncertainties that could cause actual results to differ materially from historical experience or the Company's present expectations. Factors that could cause these differences include, but are not limited to:

- Items directly linked to the September 11, 2001, terrorist attacks, such as the adverse impact of new airline and airport security directives on the Company's costs and Customer demand for travel, changes in the Transportation Security Administration's scope for managing U.S. airport security, and the possibility of further terrorist attacks or additional incidents that could cause the public to question the safety and/or efficiency of air travel.
- The availability and cost of war-risk and other aviation insurance, including the federal government's provision of third party war-risk coverage to airlines. The government's coverage currently extends to December 31, 2005. However, there are no assurances that such coverage will be extended beyond December 31, 2005.
- War or other military actions by the U.S. or others.
- Competitive factors, such as fare sales and capacity decisions, changes in competitors' flight schedules, mergers and acquisitions, codesharing programs, and airline bankruptcies.
- General economic conditions, which could adversely affect the demand for travel in general and consumer ticket purchasing habits, as well as decisions by major freight Customers on how they allocate freight deliveries among different types of carriers.
- Factors that could affect the Company's ability to control its costs, such as the results of Employee labor contract negotiations, Employee hiring and retention rates, costs for health

care, capacity decisions by the Company and its competitors, unscheduled required aircraft airframe or engine repairs and regulatory requirements, changes in commission policy, availability of capital markets, and future financing decisions made by the Company.

- Factors affecting the Company's fuel expense, including, but not limited to, the largely unpredictable prices of jet fuel, crude oil, heating oil, and unleaded gasoline, the continued effectiveness of the Company's fuel hedges, changes in the Company's overall fuel hedging strategy, and the continued ability of commodities used in fuel hedging to qualify for special hedge accounting.
- Disruptions to operations related to the supply of jet fuel, adverse weather conditions, including catastrophic events such as hurricanes, and air traffic control-related constraints.
- Internal failures of technology or large-scale external interruptions in technology infrastructure, such as power, telecommunications, or the internet.
- Risks involved with the Company's acquisition of certain assets from ATA Airlines, Inc. (ATA), including the collectibility of loans made to ATA, and the continued success of the Company's codeshare agreement with ATA.

Caution should be taken not to place undue reliance on the Company's forward-looking statements, which represent the Company's views only as of the date this report is filed. The Company undertakes no obligation to update publicly or revise any forward-looking statement, whether as a result of new information, future events or otherwise.

Item 3. Quantitative and Qualitative Disclosures About Market Risk

As discussed in Note 5 to the unaudited condensed consolidated financial statements, the Company utilizes financial derivative instruments to hedge its exposure to material increases in jet fuel prices. During the first nine months of 2005, because of the continued upward trend in energy prices, the fair values of the Company's fuel hedge contracts have increased significantly. At September 30, 2005, the estimated gross fair value of outstanding contracts was \$2.2 billion, compared to \$796 million at December 31, 2004.

Outstanding financial derivative instruments expose the Company to credit loss in the event of nonperformance by the counterparties to the agreements. However, the Company does not expect any of the counterparties to fail to meet their obligations. The credit exposure related to these financial instruments is represented by the fair value of contracts with a positive fair value at the reporting date. To manage credit risk, the Company selects and periodically reviews counterparties based on credit ratings, limits its exposure to a single counterparty, and monitors the market position of the program and its relative market position with each counterparty. At September 30, 2005, the Company had agreements with seven counterparties containing early termination rights and/or bilateral collateral provisions whereby security is required if market risk exposure exceeds a specified threshold amount or credit ratings fall below certain levels. At September 30, 2005, the Company held \$1.2 billion in fuel hedge related cash collateral deposits and \$150 million in U.S. Treasury Bills, under these bilateral collateral provisions. These collateral deposits serve to decrease, but not totally eliminate, the credit risk associated with the Company's hedging program. The cash deposits, which can have a significant impact on the Company's cash balance and cash flows as of and for a particular operating period, are included in "Accrued liabilities" on the Consolidated Balance Sheet and are included as "Operating cash flows" in the Consolidated Statement of Cash Flows. In accordance with SFAS 140, *Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities*, the U.S. Treasury Bills, supplied as non-cash collateral by counterparties, are not reflected on the Company's Consolidated Balance Sheet. See also Note 8 to the unaudited condensed consolidated financial statements.

See Item 7A "Quantitative and Qualitative Disclosures About Market Risk" in the Company's Annual Report on Form 10-K for the year ended December 31, 2004 and Note 5 to the unaudited condensed consolidated financial statements for further information about Market Risk.

Item 4. Controls and Procedures

Disclosure Controls and Procedures

The Company maintains disclosure controls and procedures designed to ensure that it is able to collect the information it is required to disclose in the reports it files with the Securities and Exchange Commission (SEC), and to process, summarize and disclose this information within the time periods specified in the rules of the SEC. Based on an evaluation of the Company's disclosure controls and procedures as of the end of the period covered by this report conducted by the Company's management, with the participation of the Chief Executive and Chief Financial Officers, the Chief Executive and Chief Financial Officers believe that these controls and procedures are effective to ensure that the Company is able to collect, process, and disclose the

information it is required to disclose in the reports it files with the SEC within the required time periods.

Internal Control over Financial Reporting

There were no changes in the Company's internal control over financial reporting (as defined in Rules 13(a)-15(f) and 15(d)-15(f) under the Exchange Act) during the fiscal quarter ended September 30, 2005, that have materially affected , or are reasonably likely to materially affect, the Company's internal control over financial reporting.

PART II. OTHER INFORMATION

Item 1. Legal Proceedings

The Company is subject to various legal proceedings and claims arising in the ordinary course of business, including, but not limited to, examinations by the Internal Revenue Service (IRS). The IRS regularly examines the Company's federal income tax returns and, in the course thereof, proposes adjustments to the Company's federal income tax liability reported on such returns. It is the Company's practice to vigorously contest those proposed adjustments it deems lacking of merit.

The Company's management does not expect that the outcome in any of its currently ongoing legal proceedings or the outcome of any proposed adjustments presented to date by the IRS, individually or collectively, will have a material adverse effect on the Company's financial condition, results of operations or cash flow.

Item 2. Unregistered Sales of Equity Securities and Use of Proceeds

None

Item 3. Defaults upon Senior Securities

None

Item 4. Submission of Matters to a Vote of Security Holders

None

Item 5. Other Information

None

Item 6. Exhibits

a) Exhibits

- 31.1 Rule 13a-14(a) Certification of Chief Executive Officer
- 31.2 Rule 13a-14(a) Certification of Chief Financial Officer
- 32.1 Section 1350 Certifications of Chief Executive Officer and Chief Financial Officer

SIGNATURES

Pursuant to the requirements of the Securities Exchange Act of 1934, the Registrant has duly caused this report to be signed on its behalf by the undersigned thereunto duly authorized.

SOUTHWEST AIRLINES CO.

October 21, 2005

By /s/ Laura Wright

Laura Wright
Chief Financial Officer
(Principal Financial and
Accounting Officer)

EXHIBIT INDEX

<u>Exhibit No.</u>	<u>Description</u>
Exhibit 31.1	- Rule 13a-14(a) Certification of Chief Executive Officer
Exhibit 31.2	- Rule 13a-14(a) Certification of Chief Financial Officer
Exhibit 32.1	- Section 1350 Certifications of Chief Executive Officer and Chief Financial Officer