

SOUTHWEST AIRLINES CO. © FIVE SYMBOLS OF FREEDOM

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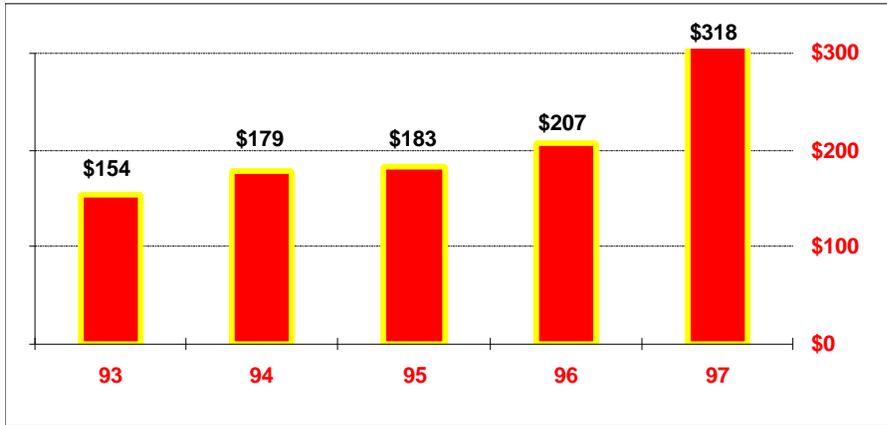
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CONSOLIDATED HIGHLIGHTS

(DOLLARS IN THOUSANDS, EXCEPT PER SHARE AMOUNTS)

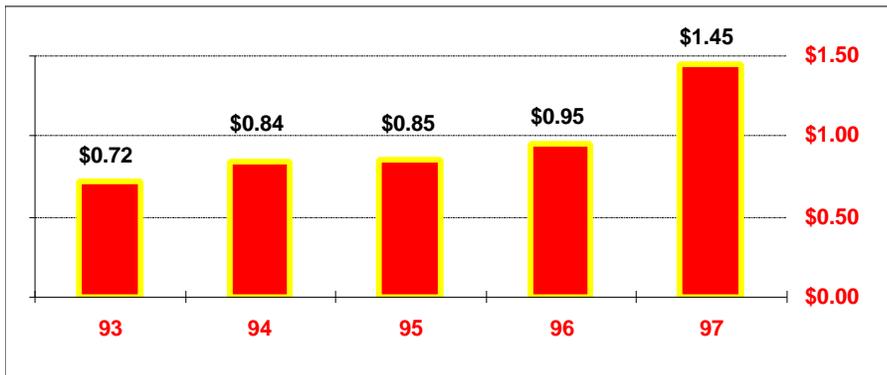
	1997	1996	CHANGE
Operating revenues	\$3,816,821	\$3,406,170	12.1%
Operating expenses	\$3,292,585	\$3,055,335	7.8%
Operating income	\$524,236	\$350,835	49.4%
Operating margin	13.7%	10.3%	3.4 pts.
Net income	\$317,772	\$207,337	53.3%
Net margin	8.3%	6.1%	2.2 pts.
Net income per share, basic	\$1.45	\$.95	52.6%
Net income per share, diluted	\$1.40	\$.92	52.2%
Stockholders' equity	\$2,009,018	\$1,648,312	21.9%
Return on average stockholders' equity	17.4%	13.5%	3.9 pts.
Stockholders' equity per common share outstanding	\$9.08	\$7.57	19.9%
Revenue passengers carried	50,399,960	49,621,504	1.6%
Revenue passenger miles (RPMs) (000s)	28,355,169	27,083,483	4.7%
Available seat miles (ASMs) (000s)	44,487,496	40,727,495	9.2%
Passenger load factor	63.7%	66.5%	(2.8) pts.
Passenger revenue yield per RPM	12.84¢	12.07¢	6.4%
Operating revenue yield per ASM	8.58¢	8.36¢	2.6%
Operating expenses per ASM	7.40¢	7.50¢	(1.3)%
Number of Employees at yearend	23,974	22,944	4.5%

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NET INCOME

(in millions)



NET INCOME PER SHARE, BASIC



NET INCOME PER SHARE, DILUTED

SOUTHWEST AIRLINES IS A SYMBOL OF FREEDOM. SINCE 1971, OUR LOW FARES HAVE GIVEN MILLIONS OF AMERICANS THE FREEDOM TO FLY. FROM OUR FLAG TO OUR OPEN SEATING, FROM OUR ALL-JET FLEET TO OUR DECLARATION OF FREEDOM, OUR SOUTHWEST SPIRIT ILLUMINATES OUR PAST, GUIDES OUR PRESENT, AND FORGES OUR FUTURE.

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 1997, Southwest operated 261 Boeing 737 aircraft and provided service to 52 airports in 51 cities throughout the United States. Southwest has the lowest operating cost structure in the domestic airline industry and consistently offers the lowest and simplest fares. Southwest also has one of the best overall Customer Service records. 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.

T **TO OUR SHAREHOLDERS: 1997 WAS SOUTHWEST AIRLINES' 25TH CONSECUTIVE YEAR OF PROFITABILITY IN AN INDUSTRY LONG NOTED FOR ITS VULNERABILITY TO ECONOMIC CYCLES. OUR PEOPLE'S ABILITY TO PRODUCE PROFITS IN BAD, AS WELL AS GOOD, ECONOMIC TIMES HAS REWARDED THEM WITH JOB SECURITY AND INCREASING PROSPERITY.**

It has also produced bountiful returns for our Shareholders, including, of course, our Employee-Shareholders. Put very simply, on behalf of our Employees and our Shareholders, our goal for the next 25 years is to replicate our successes of the last 25 years.

Our 1997 earnings of \$317.8 million (diluted net income per share of \$1.40) surpassed the \$207.3 million of 1996 (diluted net income per share of \$.92) by 53.3 percent, as our operating revenues increased 12.1 percent while every category of operating expenses, except salaries, wages, and benefits (up 13.7 percent), increased by a lesser percentage, resulting in an aggregate operating expense growth of 7.8 percent on a 9.2 percent expansion of available seat mile capacity.

Our first Boeing 737-700s were placed in commercial service in January 1998, and we anticipate receiving 22 of these greatly advanced and most economical and efficient new model aircraft in 1998. Because of our confidence in the 737-700 and its importance to the future competitive success of Southwest Airlines, in December 1997 we exercised options, and placed purchase orders, for 59 additional aircraft, raising our total firm orders to 129 and providing ample coverage, through options, of our potential fleet needs through 2006.

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At present, we anticipate devoting approximately one-third of our 1998 incremental capacity to opening two new cities and the other two-thirds to augmenting service levels in our existing markets.

Our People have made Southwest Airlines an enjoyable and exciting place to work, filled with an immense feeling of pride in accomplishment, by them and for our nation. Every new city that Southwest enters — from Providence to San Diego and from Seattle to Tampa — immediately experiences enormous increases in air travel for both business and personal reasons. The air service provided by our People frees Americans to move about their country; enshrines Southwest as a Symbol of Freedom for the United States; and honors our People as our industry's foremost Freedom Fighters. *Fortune* magazine, after an extensive survey and evaluation, recently pronounced Southwest Airlines the "best place to work for in America." Our People make it that way: they do well for themselves through doing good for others. I salute their humanistic and altruistic spirits — their goodness that has led to greatness.

Most sincerely,

Herbert D. Kelleher
Chairman, President, and
Chief Executive Officer
February 1, 1998

OUR SOUTHWEST FLAG REPRESENTS A HIGH-FLYING TRIBUTE TO OUR PEOPLE — A SKY-BLUE FIELD EMBRACING OUR FAMOUS WINGED HEART, A CONSTANT REMINDER OF OUR PROUD BEGINNINGS AT DALLAS LOVE FIELD.

Southwest started 26 years ago with only three planes serving three Texas cities. From those humble beginnings, we grew steadily over the years. Now, we operate the largest Boeing 737 fleet in the world and proudly serve much of the United States, coast to coast. But we have never forgotten our calling, giving Americans the freedom to fly.

Since the beginning, Southwest has also stood for low fares. Before Southwest, it was just too expensive to fly. Even today, in markets we do not serve, fares are three times higher, or more, than our everyday coach fares. That puts air travel out of reach of most Americans and puts Southwest fares in great demand across the United States. Last year alone, there were over 100 cities requesting our service. It is not surprising, given that we are a boost to local economies. And for Southwest, it's a vast air travel market opportunity mostly ignored by our competitors.

Since the beginning, Southwest has also stood for the highest standards of quality. We don't and won't sacrifice quality for low cost. In fact, at Southwest, it's just the opposite. Not only do Customers get the lowest price, they get the best Service. Consider the following: we operate one of the youngest, most efficient, and most reliable fleets in the world; our Employees are topnotch, highly skilled, tremendously experienced industry leaders; and our history clearly demonstrates our commitment to quality as we are a perennial leader in safety, ontime performance, baggage handling, and fewest canceled flights.

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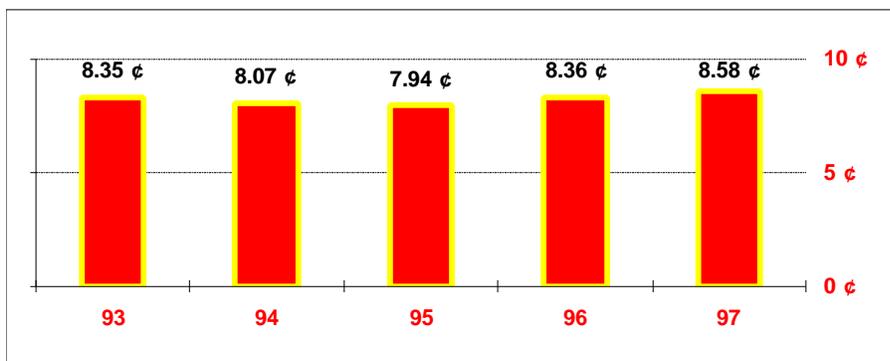
For the second year in a row, Southwest was rated at the top in terms of quality service in the Airline Quality Rating study, conducted annually by the W. Frank Barton School of Business at Wichita State University and the University of Nebraska at Omaha. Southwest also ranked number one in *Money* magazine's first rating of the major United States carriers in 1997, which was based on safety, price, ontime performance, baggage handling, and Customer Service.

And, finally, since the beginning, Southwest has been dedicated to People: our Employees and our Customers. *Fortune* magazine recently named Southwest as the best company to work for in America. And for our seventh straight year, we had the best Customer Satisfaction record of any major United States airline, based on statistics published by the Department of Transportation.

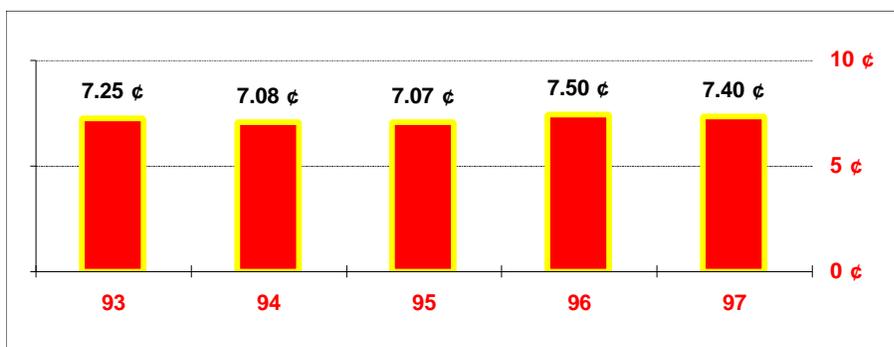
“WHEN I PLEDGE MY ALLEGIANCE TO THE UNITED STATES OF AMERICA, I SILENTLY ADD MY ALLEGIANCE TO SOUTHWEST AIRLINES. THIS IS MORE THAN A COMPANY, IT IS A CRUSADE.”

**Elizabeth P. Sartain
Vice President -People**

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OPERATING REVENUE PER AVAILABLE SEAT MILE



OPERATING EXPENSES PER AVAILABLE SEAT MILE

OUR FARES ARE CONSISTENTLY THE LOWEST, SIMPLEST FARES IN THE DOMESTIC AIRLINE INDUSTRY. BY KEEPING COSTS LOW, WE KEEP OUR FARES LOW. THIS, IN TURN, GIVES CUSTOMERS THE FREEDOM TO FLY.

Southwest is and always has been a very different airline — from the operating strategy we employ to the way we treat our Employees and Customers. But the difference we are most famous for is our ability to generate high profits with low fares. The secret, of course, is low costs, and our operating strategy is a significant ingredient of our low cost formula.

Our operating strategy is unique in the airline industry, and it has, indeed, revolutionized air travel over the last 26 years. We start with a principal focus on the shorthaul traveler, where our average flight time is about an hour. We streamline service to meet the shorthaul traveler's needs. Then, we identify city pairs that can generate substantial amounts of business and leisure traffic with Southwest service.

We offer lots of flights to meet business travelers' demands for schedule convenience and flexibility. We offer low fares that meet all travelers' needs, especially leisure travelers. We specialize in nonstop, not connecting, service. In our experience, this is what Customers want in shorthaul markets. And it is far more cost-efficient than the accepted "hub and spoke" industry standard.

This market focus allows us to be substantially more efficient and productive than the rest of the airline industry. Our aircraft and airport facilities are used continuously throughout the day, maximizing utilization and minimizing ground time. Our aircraft "turn" times at the airport are less

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than half the industry standard. Therefore, we get lots more use of our aircraft and much lower unit costs.

We also use only one aircraft type, the Boeing 737, in an all-coach configuration. This substantially reduces costs versus the industry due to simplified operations, training, scheduling, and maintenance. Our fleet of 737s is young, safe, comfortable, clean, and perfectly suited for shorthaul flights.

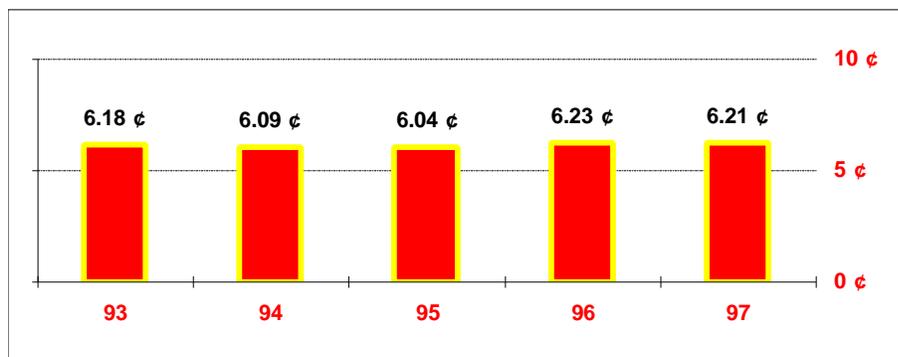
Our fare structure is simple and this means the cost of selling our product is less than industry average. Over 60 percent of our Customers buy travel on Southwest on a ticketless basis — it is easier for our Customers and less expensive for Southwest than a paper ticket. Boarding the aircraft is also fast and efficient.

Finally, and most importantly, we have a Culture that values efficiency, hard work, innovation, and simplicity. Our People have the will and the desire to produce low costs. That's how the low cost producer keeps finding ways to reduce costs further.

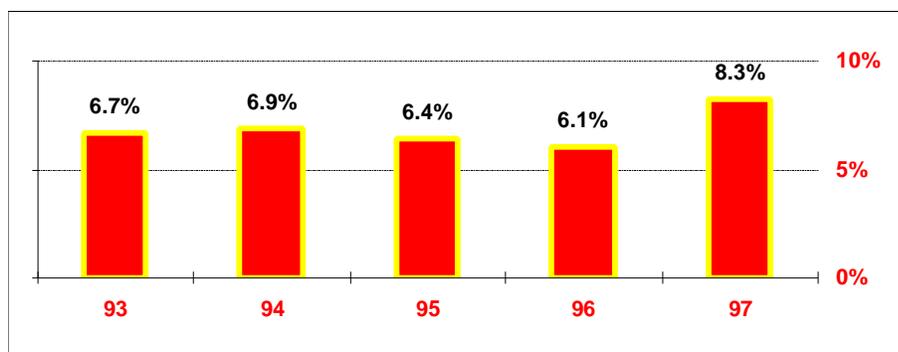
“WE ARE A LOW FARE AIRLINE BY PHILOSOPHY. WHEN WE GO INTO A NEW MARKET OUR COMPETITORS USUALLY LOWER THEIR FARES. THE DIFFERENCE IS OUR FARES STAY LOW — WHENEVER AND WHEREVER WE FLY.”

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

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OPERATING EXPENSES PER AVAILABLE SEAT MILE
(excluding fuel and related taxes)



NET MARGIN

OUR SOUTHWEST SPIRIT BURNS AS BRIGHTLY TODAY AS IT HAS FOR THE PAST 26 YEARS — A TORCH THAT SYMBOLIZES OUR PLEDGE TO OUR CUSTOMERS: “WE GIVE YOU THE FREEDOM TO FLY.”

If not for the fighting Southwest Spirit and determination exemplified by our founders 26 years ago, we would never have been cleared for takeoff. From the start, seemingly insurmountable odds were stacked against Southwest. It was only the remarkable courage, perseverance, and innovation of our early leaders that enabled us to overcome adversity and prove that an airline can profitably offer low fares. That tradition of Southwest Spirit continues today.

Because of our People's devoted efforts, 1997 was outstanding for Southwest Airlines. We posted our sixth consecutive yearly record profit and our 25th consecutive year of profitability, outperforming the airline industry once again in terms of Customer Satisfaction and financial results. It was the culmination of many things, not the least of which was lower costs.

In recent years, we have had many challenges, including increased competition and taxes. As competition increased in our markets and as federal taxes increased, we found ways to reduce other costs, ensuring strong profitability and future growth.

We recently reached a ten-year engine maintenance agreement with General Electric Engine Services, which will help control engine repair costs on our 737-300 and -500 aircraft. We also have a similar agreement on our 737-700 aircraft.

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As the launch customer of the 737-700 and the largest operator of 737s in the world, our agreement with Boeing provides us with lower capital costs. In addition, the -700 is expected to be quieter, more fuel efficient, and more easily maintainable than its -300 counterpart, which will result in lower maintenance and fuel costs.

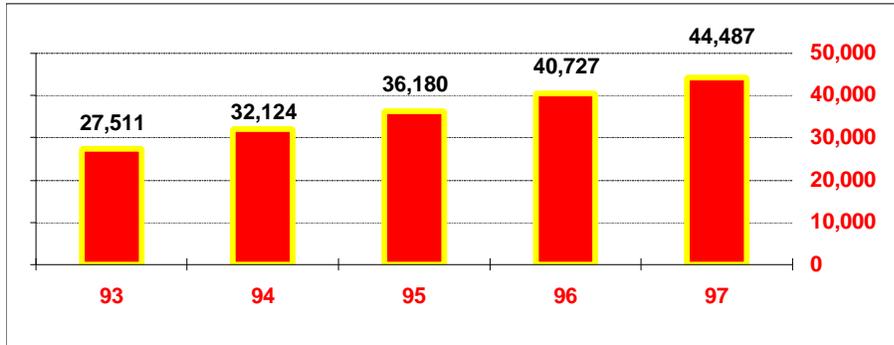
We also have many other efforts underway in all areas of the Company to improve productivity and reduce costs.

Only the People of Southwest could produce such a banner year. They are warm, caring, compassionate individuals who are willing to do whatever it takes to bring the freedom of flight to their fellow Americans. They have built a unique and powerful Culture that is the envy of corporate America. In every respect, our Employees are the very best, which is the reason we are one of the most successful carriers in the domestic airline industry today.

“THERE’S A CERTAIN SOUTHWEST SPIRIT THAT REFLECTS EVERYTHING WE STAND FOR, EVERYTHING WE STRIVE FOR. IT IS OUR GUIDING PRINCIPLE, OUR COMMON GOAL, OUR FIERY FLAME OF FREEDOM.”

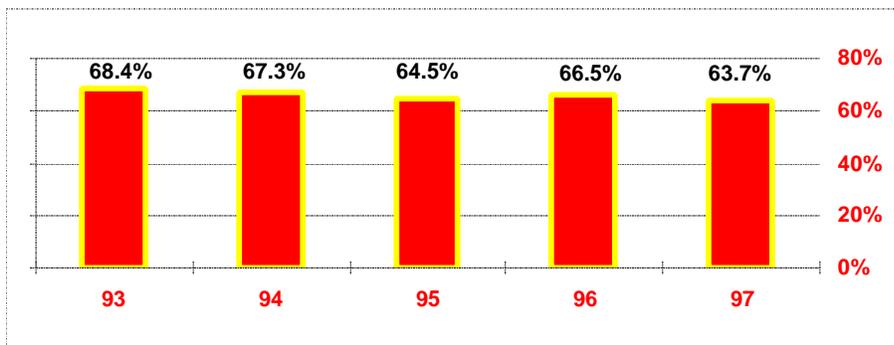
Colleen C. Barrett
Executive Vice President -Customers

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AVAILABLE SEAT MILES

(in millions)



PASSENGER LOAD FACTOR

OUR FLIGHTS ARE DESIGNED TO GIVE OUR CUSTOMERS FLEXIBILITY. BEFORE WE VENTURE INTO A NEW CITY, WE FIRST MAKE SURE THAT THERE ARE LOTS OF DAILY FLIGHTS TO THE CITIES WE CURRENTLY SERVE.

Southwest provides service to communities that can benefit from high-frequency, low cost air transportation and have sufficient local traffic to support our operations profitably. Because we focus primarily on the local shorthaul Customer, we schedule our aircraft on a point-to-point, not hub and spoke, basis. Consequently, 75 to 80 percent of our Customers fly nonstop. This is in sharp contrast to the rest of the industry, where the majority of traffic connects.

Southwest's point-to-point route system, as compared to hub and spoke, provides our Customers with extensive nonstop routings that minimize connections, delays, and travel time. Because of our high frequencies and quick turnarounds (approximately 20 minutes), ground time is also minimal for the 20 to 25 percent of our passengers who have connecting flights. The combination of our extensive route system and high frequency approach provides both our business and leisure travelers maximum flexibility and convenience.

Since we fully understand the value of our Customers' time and money, we also serve many conveniently located satellite or downtown airports, such as Dallas Love Field, Houston Hobby, Chicago Midway, Oakland, Burbank, Ft. Lauderdale, Providence, and Baltimore to name a few, which further reduces total trip time and transportation expenses to and from the airport. By avoiding congested hub airports, we also enhance our ability to sustain high ontime performance.

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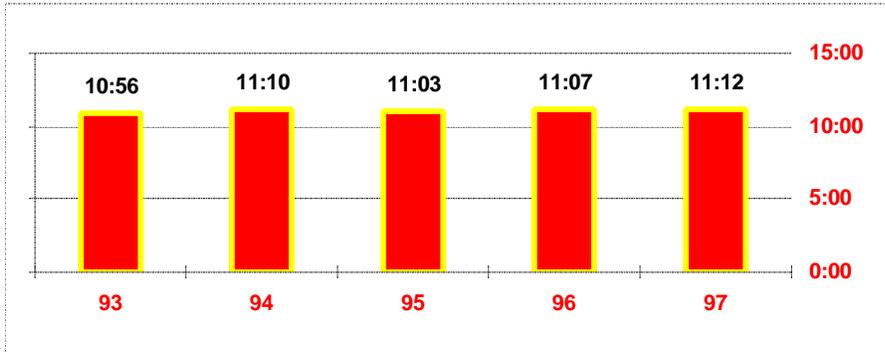
In today's fast-paced society, Customers demand not only low fares but flexibility and convenience as well. That is why our extensive route system, frequent flights, and uncongested airport selection are so important, especially in such a highly competitive industry. Although we serve only 52 airports, we have 2,300 flights per day. The average number of daily departures per airport is approximately 44, providing maximum convenience and flexibility to our valued Customers.

Not coincidentally, our desire to offer convenient, frequent flights at convenient, uncongested airports meshes well with our desire to operate efficiently. Scheduling frequent flights with minimum ground time at efficient airports contributes to the highest productivity in the industry and, in turn, the lowest operating costs.

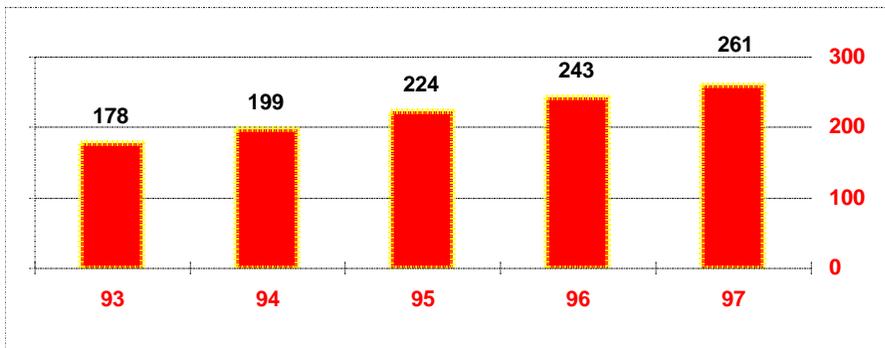
“SOUTHWEST’S FREQUENT FLIGHTS ARE AS FUNDAMENTAL TO OUR SUCCESS AS LOW FARES. SO IF YOU MISS A FLIGHT, CHANCES ARE GOOD THERE WILL BE ANOTHER ONE DEPARTING WITHIN THE NEXT HOUR OR SO.”

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

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AIRCRAFT UTILIZATION
(hours and minutes per day)



FLEET SIZE
(at yearend)

OUR DECLARATION OF FREEDOM AFFIRMS OUR COMMITMENT TO ALWAYS PROVIDE LOW FARES — EVERY SEAT, EVERY FLIGHT, EVERY DAY. IT IS A PLEDGE INSCRIBED BOTH ON PAPER AND IN OUR HEARTS.

The People of Southwest are Freedom Fighters, ensuring affordable fares are available to as many people as possible. As business people, our Employees understand how low fares are critical in our shorthaul market niche. Since we are primarily a shorthaul carrier, low fares are essential. With an average aircraft trip length of 425 miles, ground transportation has always been our most significant competitor. Therefore, we must charge low fares, every seat, every flight, every day, regardless of what our airline competitors charge.

Our pledge to our Customers has worked. We have developed a reputation as the low fare policeman in the industry, THE Low Fare Airline. Customers think of us when they think of low fares and depend on us to keep fares low. We are committed to continue that tradition.

The results are remarkable. Through Southwest service, communities achieve economic freedom when it comes to airfares. The number of travelers expands by three- and four-fold after Southwest enters a market and slashes fares. This is especially true in shorthaul markets where ground transportation is a viable option. In many cases, people just weren't traveling at all. That changes once Southwest enters the market.

Since low costs are obviously mandatory to offer low fares at a profit, and since our airline competitors' costs are more than ours, we tend to dominate our shorthaul, low fare marketplace. This effect is enhanced when we combine frequent flights, convenient airports, and outstanding

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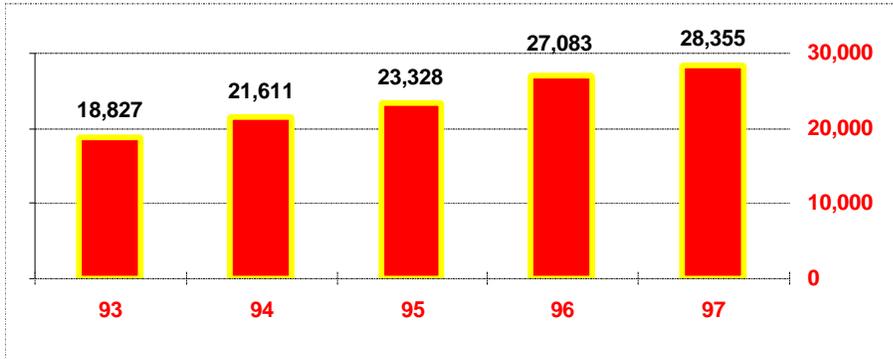
Customer Service. We are built primarily for shorthaul markets, where we are the preferred choice.

The market statistics attest to this strategy. We consistently rank first in market share in 80 to 85 percent of our top city pairs and, in the aggregate, achieve a 60 to 65 percent market share of all the city-pair markets served by Southwest. We also ranked first or second in terms of Customers boarded in the majority of our 52 airports served in 1997. Interestingly, even though we serve only 52 airports in the United States, we are still the fifth largest of the U.S. airlines in terms of originating passengers. Low costs and, therefore, low fares are an enormous competitive advantage, particularly when combined with high-quality service.

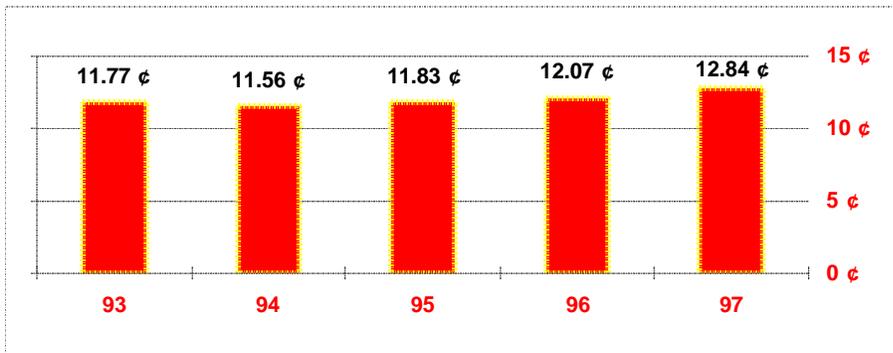
“FREEDOM IS SOMETHING WE NEVER TAKE FOR GRANTED, AS A COUNTRY OR AS A COMPANY. WE WILL ALWAYS HONOR OUR PLEDGE TO ALL OUR CUSTOMERS. IT IS A DECLARATION WE ARE PROUD TO UPHOLD.”

**Joyce C. Rogge, Vice President-
Advertising and Promotions**

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REVENUE PASSENGER MILES
(in millions)



PASSENGER REVENUE PER PASSENGER MILE

THE FUTURE OF FREEDOM LOOKS BRIGHT, AS LONG AS WE RENEW OUR PLEDGE EVERY DAY. OUR NEXT NEW CITY WILL SHARE ALL THE BENEFITS OF ALL OUR EXISTING CITIES, INCLUDING OUR LOW FARES AND TRIPLE CROWN SERVICE.

Southwest is financially and strategically positioned to take advantage of short- to medium-range point-to-point opportunities. We remain the undisputed low cost leader in the airline industry and are continuing our efforts to widen the margin even further. In spite of our rapid growth and the intense competition we've faced, operating cash flows have been remarkable, covering almost 90 percent of our capital expenditures in 1997. Our balance sheet remains very strong, as evidenced by "A-" credit ratings from the three agencies that rate us (Standard & Poor's, Moody's, and Duff & Phelps). This ensures adequate and cost-effective access to the capital markets to meet future expansion needs.

While the industry continues to demonstrate unprecedented capacity restraint, Southwest will continue its strategy of controlled growth. In January 1998, Southwest announced its increased commitment to Boeing's Next-Generation 737-700 by exercising options on 47 -700s for delivery in 1999-2004 and by ordering an additional 12 -700s for delivery in 2000-2004. In addition, we obtained 42 more options from Boeing for delivery in 2004-2006. These 59 additional orders and 42 additional options bring our future commitment, as of yearend, to 188 aircraft and make Southwest Boeing's largest customer for the best selling Next-Generation 737s.

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Our future commitment to Boeing's Next-Generation 737-700 will significantly contribute to our ability to remain the lowest cost producer in the airline industry, which will, in turn, allow us to continue introducing low fares to many new U.S. cities. This new aircraft model also has the capability to fly quieter, faster, farther, and higher and carries the same type rating as the rest of the 737 family.

This increased commitment to our baseline growth beyond 1998 (approximately ten percent per annum in 1999 and 2000) affirms our pledge to bring safe, affordable, quality service to many more Americans allowing them to go, see, and do things never before dreamed possible. While we are temporarily limited to a six to seven percent increase in capacity in 1998 due to Boeing's recent production delays and a tight aircraft market, we still plan to add two new cities in 1998. Most importantly, our goal is to generate annual earnings growth of at least 15 percent through our continued focus on cost control and increased revenues.

“PEOPLE ALWAYS WANT TO KNOW WHERE WE’RE GOING NEXT. THE ANSWER IS ALWAYS THE SAME: WE’RE GOING WHERE THE FREEDOM TO FLY WILL MAKE A DIFFERENCE TO THE CITIES WE SERVE.”

**John G. Denison, Executive
Vice President–Corporate Services**

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737 Type	Seats	Average Age (Yrs.)	Number of Aircraft
-200	122	16.9	47
-300	137	6.5	186
-500	122	6.7	25
-700	137	—	3
Total	133	8.3	261

JET FLEET

December 31, 1997

	1998	1999	2000	2001	2002	2003	2004	2005	2006	Total
Firm orders:	22	25	23	21	21	8	6	—	—	126
Options:	—	—	—	—	—	13	13	18	18	62
Total:	22	25	23	21	21	21	19	18	18	188

BOEING 737-700 FIRM ORDERS AND OPTIONS

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DESTINATIONS

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

*New 1997 destinations.

TRIPLE CROWN SERVICE IS MORE THAN A SLOGAN, IT IS A BENCHMARK. SOUTHWEST HAS WON FIVE ANNUAL TRIPLE CROWNS — NO. 1 IN ONTIME ARRIVALS, BAGGAGE HANDLING, AND CUSTOMER SATISFACTION.

Southwest Airlines is the only airline that has ever won the annual Triple Crown — #1 in On-time Arrivals, Baggage Handling, and Customer Satisfaction among all major airlines, as published in U.S. Department of Transportation consumer reports.

When Southwest won an unprecedented fourth consecutive annual Triple Crown in 1995, Chairman Herb Kelleher issued his famous “Gimme Five” challenge:

“If you earn a fifth annual Triple Crown, I’ll paint the name of every person in this Company on a Boeing 737.”

We did. And he did. Behold Triple Crown One, a signature salute to the 25,000+ Employees who made this fifth win possible and retired the Triple Crown trophy. True to his word, Herb painted everyone’s name onboard this high-flying tribute to our Southwest Spirit.

If Herb gives us yet another challenge, let’s just say that he’d better have an extra plane in the hangar and his paintbrush handy.

“IF THERE’S ONE THING I’VE LEARNED ABOUT OUR INCREDIBLE SOUTHWEST EMPLOYEES, IT’S NEVER GIVE THEM A CHALLENGE UNLESS YOU’RE PREPARED TO PAY THE PIPER...OR IN THIS CASE, PAINT THE PLANE.”

Herbert D. Kelleher
Chairman, President, and Chief
Executive Officer

**SOUTHWEST AIRLINES CO.
1997 ANNUAL REPORT — FINANCIAL REVIEW**

**MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND
RESULTS OF OPERATIONS**

YEAR IN REVIEW

In 1997, Southwest posted a record annual profit for the sixth consecutive year and a profit for the 25th consecutive year. Net income for 1997 benefited from record passenger revenue yields and continued cost control, widening our industry-leading cost advantage.

At the end of 1997, Southwest served 51 cities in 25 states. We added service to Jacksonville, Florida and Jackson, Mississippi in 1997 and have been very pleased with the results, thus far. We also expanded our existing service to certain cities in 1997, especially Nashville, Providence, and our Florida markets. Plans for 1998 include the addition of 14 more aircraft, net, and service to two new cities. We will continue to add additional flights to cities we already serve. Any further expansion in 1998 will be dependent upon additional aircraft availability.

We were the launch customer for the new Boeing 737-700 aircraft, taking our first delivery in December 1997. The -700 is expected to contribute to our low cost advantage as it is more fuel efficient, less maintenance intensive, and has a lower capital outlay than the -300. We added 18 new Boeing 737s to our fleet in 1997: 15 -300s and three -700s. In 1998, we are currently scheduled to receive 22 -700s and retire eight older -200s (three in first quarter 1998; one in second quarter 1998; and four in fourth quarter 1998). We currently are interested in adding more 737 aircraft in 1998 if we can find aircraft at reasonable prices.

At the present time, Boeing is experiencing production delays related to the 737 production line. Thus far, these delays have not had a significant impact on our operations as we were able to defer the retirement of some older -200s and have earned cash penalty payments from Boeing. Boeing currently expects delays to continue in 1998, which temporarily delays our expansion. Boeing will continue to compensate Southwest for these production delays.

In August 1997, the Taxpayer Relief Act of 1997 was enacted, which included, among other things, a revision of the then current ten percent federal excise tax on domestic tickets. Effective October 1, 1997, through September 30, 1998, the tax rate was reduced to nine percent of the amount paid for transportation beginning on or after October 1, 1997, and a new \$1.00 flight segment tax was imposed. From October 1, 1998 to September 30, 1999, the tax rate will decrease to eight percent and the

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segment tax will increase to \$2.00. Beginning October 1, 1999, the tax rate will change to 7.5 percent of the ticket price. The segment tax will increase to \$2.25 from October 1, 1999 to December 31, 1999; \$2.50 during 2000; \$2.75 during 2001; and \$3.00 per segment during 2002. Thereafter, the \$3.00 segment tax will be indexed to changes in the Consumer Price Index (CPI). The legislation also included a new tax on the sale of frequent flyer miles, raised the international departure fee, and instituted a new international arrival fee.

Management estimates these changes may increase Southwest's tax burden by roughly \$30 million in 1998 as the effect of the new tax is to shift an increasing portion of the excise tax burden to low fare, shorthaul carriers such as Southwest. Effective October 1, 1997, the Company raised fares to offset the increased excise taxes. While the fare increases mitigated the additional tax burden in fourth quarter 1997, management cannot accurately predict the future effects of tax or fare increases. (This paragraph contains forward-looking statements which involve uncertainties that could result in actual results differing materially from expected results. Some significant factors include, but may not be limited to, regulations implementing the tax, competitors' responses to the tax, and the ability to pass through the tax in the form of fare increases.)

On October 27, 1997, the International Air Transportation Competition Act of 1979 was amended to allow scheduled service from Dallas Love Field to Alabama, Mississippi, and Kansas. The Company now offers scheduled service from Dallas Love Field to Jackson via connecting flights through Houston and service from Dallas Love Field to Birmingham via connecting flights through New Orleans and Houston. No additional flights have been added, thus far, from Dallas Love Field to Alabama, Mississippi, or Kansas.

RESULTS OF OPERATIONS

1997 COMPARED WITH 1996 The Company's consolidated net income for 1997 was \$317.8 million (\$1.40 per share, diluted), as compared to the corresponding 1996 amount of \$207.3 million (\$.92 per share, diluted), an increase of 53.3 percent. The prior years' earnings per share amounts have been restated for the 1997 three-for-two stock split (see Note 6 to the Consolidated Financial Statements).

OPERATING REVENUES Consolidated operating revenues increased by 12.1 percent in 1997 to \$3,816.8 million, compared to \$3,406.2 million for 1996. This increase in 1997 operating revenues was derived primarily from an 11.3 percent increase in passenger revenues as a result of a 4.7 percent increase in revenue passenger miles (RPMs) and a 6.4 percent increase in passenger revenue yield per RPM. Southwest's passenger revenues benefited from a strong U.S. economy, strong demand for air travel, increased fares, and a favorable mix of higher yielding fares.

The 4.7 percent increase in RPMs in 1997, coupled with a 9.2 percent increase in available seat miles (ASMs), resulted in a decrease in load factor from 66.5 percent in 1996 to 63.7 percent in 1997. The decrease in load factor was primarily the result of less promotional fare activity in 1997. The 1997 ASM growth resulted from the addition of 18 aircraft during the year.

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The January 1998 load factor decreased to 54.0 percent from 60.2 percent in January 1997 due to heavy promotional fare activities in the 1997 period. However, revenue yield per passenger mile continues to be strong in January 1998 despite difficult comparisons due to the lapse of the federal excise tax from January 1 to March 7, 1997. Comparisons in February and March will be more difficult due to fare increases in February 1997. (The immediately preceding sentence is a forward-looking statement which involves uncertainties that could result in actual results differing materially from expected results. Some significant factors include, but may not be limited to, competitive pressure such as fare sales and capacity changes by other carriers, general economic conditions, and variations in advance booking trends.)

Freight revenues in 1997 were \$94.8 million, compared to \$80.0 million in 1996. The 18.4 percent increase in freight revenues exceeded the 9.2 percent increase in ASMs for the same period primarily due to an increase in United States mail services and increased air freight volumes resulting, in part, from the United Parcel Service labor strike during third quarter 1997.

Other revenues increased by 45.6 percent in 1997 to \$82.9 million, compared to \$56.9 million in 1996. This increase is primarily due to the sale of frequent flyer segment credits to participating partners in the Company's Rapid Rewards frequent flyer program.

OPERATING EXPENSES Consolidated operating expenses for 1997 were \$3,292.6 million, compared to \$3,055.3 million in 1996, an increase of 7.8 percent, compared to the 9.2 percent increase in capacity. Operating expenses per ASM decreased 1.3 percent in 1997, compared to 1996, primarily due to lower jet fuel prices; lower aircraft engine repair costs; and favorable results from numerous Companywide cost reduction efforts.

Unit costs are expected to benefit in first quarter 1998, versus first quarter 1997, from lower jet fuel prices. Excluding jet fuel costs, operating expenses per ASM are expected to increase primarily due to higher maintenance costs as management believes first quarter 1998 maintenance unit costs will be higher than the same period in 1997 due to an unusually low number of aircraft engine overhauls performed in first quarter 1997. (The immediately preceding two sentences are forward-looking statements which involve uncertainties that could result in actual results differing materially from expected results. Such uncertainties include, but may not be limited to, the largely unpredictable levels of jet fuel prices.)

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Operating expenses per ASM for 1997 and 1996 were as follows:

OPERATING EXPENSES PER ASM

	1997	1996	INCREASE (DECREASE)	PERCENT CHANGE
Salaries, wages, and benefits	2.26¢	2.22¢	.04¢	1.8%
Employee profitsharing and savings plans	.30	.23	.07	30.4
Fuel and oil	1.11	1.19	(.08)	(6.7)
Maintenance materials and repairs	.58	.62	(.04)	(6.5)
Agency commissions	.35	.35	—	—
Aircraft rentals	.45	.47	(.02)	(4.3)
Landing fees and other rentals	.46	.46	—	—
Depreciation	.44	.45	(.01)	(2.2)
Other	1.45	1.51	(.06)	(4.0)
Total	<u>7.40¢</u>	<u>7.50¢</u>	<u>(.10)¢</u>	<u>(1.3)%</u>

Salaries, wages, and benefits per ASM increased 1.8 percent in 1997. This increase resulted primarily from a 2.4 percent increase in 1997 average salary and benefits cost per Employee, partially offset by slower growth in the number of Employees. The increase in average salary and benefits cost per Employee primarily is due to increased health care costs.

The Company's Flight Attendants are subject to an agreement with the Transport Workers Union of America, AFL-CIO (TWU), which became amendable May 31, 1996. The Company reached an agreement with the TWU, which was ratified by its membership in December 1997. The new contract becomes amendable in May 2002.

The Company's Customer Service and Reservations Sales Agents are subject to an agreement with the International Association of Machinists and Aerospace Workers, AFL-CIO (IAM), which became amendable in November 1997 and is currently under negotiation. Flight Dispatchers are represented by the Southwest Airlines Employees Association, pursuant to an agreement which became amendable in November 1997 and is also currently under negotiation.

Profitsharing and Employee savings plans expense per ASM increased 30.4 percent in 1997, primarily due to higher earnings available for profitsharing.

Fuel and oil expenses per ASM decreased 6.7 percent in 1997, primarily due to a 4.6 percent decrease from 1996 in the average jet fuel cost per gallon, coupled with a slight decrease in the average fuel burn rate from 1996. The average price paid for jet fuel in 1997 was \$.6246 compared to \$.6547 in 1996. During fourth quarter 1997, the average cost per gallon decreased 17.5 percent to \$.6040 compared to \$.7323 in fourth quarter 1996. In January 1998, fuel prices averaged approximately \$.53 per gallon.

Maintenance materials and repairs per ASM decreased 6.5 percent in 1997, compared to 1996, primarily as a result of lower engine overhaul costs in the first three quarters of 1997, when compared to the same periods in 1996.

On August 1, 1997, the Company signed a ten-year engine maintenance contract with General Electric Engine Services, Inc. (General Electric). Under the terms of the

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contract, Southwest will pay General Electric a rate per flight hour in exchange for General Electric performing substantially all engine maintenance for the CFM56-3 engines on the 737-300 and 737-500 aircraft. The Company has a similar agreement with General Electric with respect to the engines on the 737-700 aircraft. Maintenance on the Pratt & Whitney JT8-D engines on the 737-200 aircraft will continue to be performed by General Electric on a time and materials basis. By consolidating its engine repair work and committing to ten years, Southwest believes it will spend substantially less over the course of the contract versus what it would have spent absent this new agreement. (The immediately preceding sentence is a forward-looking statement which involves uncertainties that could result in actual results differing materially from expected results; such uncertainties include the number of unscheduled engine removals, labor rates, and competition in the engine overhaul market.)

Agency commissions per ASM remained unchanged in 1997, when compared to 1996, as the mix of commissionable sales was relatively unchanged.

Aircraft rentals per ASM decreased 4.3 percent in 1997, compared to 1996, primarily due to a lower percentage of the aircraft fleet being leased.

Depreciation expense per ASM decreased 2.2 percent in 1997, compared to 1996, due to an increase in the average life of depreciable assets.

Other operating expenses per ASM decreased 4.0 percent in 1997, compared to 1996, primarily due to lower credit card processing costs, insurance rates, passenger costs, communications costs, and favorable results from numerous other Companywide cost reduction efforts.

OTHER "Other expenses (income)" included interest expense, capitalized interest, interest income, and nonoperating gains and losses. Interest expense increased \$4.2 million in 1997 primarily due to the February 1997 issuance of \$100 million of senior unsecured 7 3/8% Debentures due March 1, 2027. Capitalized interest decreased \$2.5 million in 1997 as a result of the timing of payments related to aircraft purchase contracts. Interest income for 1997 increased \$10.8 million primarily due to higher invested cash balances.

INCOME TAXES The provision for income taxes, as a percentage of income before taxes, decreased in 1997 to 38.5 percent from 39.3 percent in 1996. The decrease resulted from lower effective state tax rates, including a reduced California income tax rate.

1996 COMPARED WITH 1995 The Company's consolidated net income for 1996 was \$207.3 million (\$.92 per share, diluted), as compared to the corresponding 1995 amount of \$182.6 million (\$.82 per share, diluted), an increase of 13.5 percent.

OPERATING REVENUES Consolidated operating revenues increased by 18.6 percent in 1996 to \$3,406.2 million, compared to \$2,872.8 million for 1995. This increase in 1996 operating revenues was derived primarily from an 18.4 percent increase in passenger revenues. RPMs increased 16.1 percent in 1996, compared to a 12.6 percent increase in ASMs, resulting in an increase in load factor from 64.5 percent in 1995 to 66.5 percent in 1996. The 1996 ASM growth resulted from the net addition of 19 aircraft during the year: 22 additions and three retirements.

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In December 1995, because of the impasse in the federal budget, Congress allowed the ten percent federal excise tax to lapse. This benefited Southwest's revenues until late August 1996 when Congress reimposed the tax through December 31, 1996. The reimposition of the excise tax negatively impacted Revenue trends in third and fourth quarters 1996, as compared to revenue trends in the first half of 1996.

In celebration of the Company's 25th Anniversary, Southwest launched a fare sale in July 1996 for travel between August 19 and October 31, 1996. The sale was extremely popular and resulted in record advance bookings, with more than four and a half million seats sold. Although July and early August load factors and revenues were negatively impacted by telephone line congestion experienced during the sale, revenues for September and October 1996 were positively impacted with very heavy passenger volumes.

Freight revenues in 1996 were \$80.0 million, compared to \$65.8 million in 1995. The 21.5 percent increase in freight revenues exceeded the 12.6 percent increase in ASMs for the same period primarily due to increased air freight volumes and United States mail services.

Other revenues increased by 23.3 percent in 1996 to \$56.9 million, compared to \$46.2 million in 1995. This increase primarily was due to increased charter revenue.

OPERATING EXPENSES Consolidated operating expenses for 1996 were \$3,055.3 million, compared to \$2,559.2 million in 1995, an increase of 19.4 percent, compared to the 12.6 percent increase in capacity. Operating expenses per ASM increased 6.1 percent in 1996 compared to 1995, primarily due to significantly higher jet fuel prices along with a 4.3 cent per gallon federal jet fuel tax implemented October 1, 1995. Excluding jet fuel costs and related taxes, operating expenses per ASM were up 3.1 percent in 1996 compared to 1995.

Salaries, wages, and benefits per ASM increased 2.3 percent in 1996. This increase resulted primarily from a 16.2 percent increase in 1996 average headcount, which outpaced the 1996 capacity (ASM) increase of 12.6 percent, and offset a .8 percent decrease in average salary and benefits cost per Employee. The 16.2 percent increase in average headcount primarily was the result of a 24.3 percent increase in Reservations Sales Agents in 1996. Excluding Reservations Sales Agents, total average headcount increased 13.1 percent, in line with capacity.

Fuel and oil expenses per ASM increased 17.8 percent in 1996, primarily due to an 18.6 percent increase in the average jet fuel cost per gallon from 1995. The average price paid for jet fuel in 1996 was \$.6547 compared to \$.5522 in 1995. During fourth quarter 1996, the average cost per gallon increased 25.0 percent to \$.7323 compared to \$.5859 in fourth quarter 1995.

Maintenance materials and repairs per ASM increased 3.3 percent in 1996, compared to 1995, primarily as a result of increased scheduled airframe inspections during 1996.

Agency commissions per ASM increased 2.9 percent in 1996, compared to 1995, which was slightly slower than the 5.2 percent increase in passenger revenues per ASM.

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Landing fees and other rentals per ASM increased 4.5 percent in 1996, compared to 1995, which included an airport credit of \$4.9 million.

Depreciation expense per ASM increased 4.7 percent in 1996, compared to 1995, due to an increase in the percentage of owned aircraft.

Other operating expenses per ASM increased 9.4 percent in 1996, compared to 1995. This increase was primarily due to increased advertising costs resulting from the expansion into Florida and Providence, Rhode Island, as well as a new advertising campaign; the 4.3 cent per gallon tax on commercial aviation jet fuel purchased for use in domestic operations, which became effective October 1, 1995; and increased airport security costs. The additional fuel tax increased 1996 and 1995 "other operating expenses" by \$32.7 million and \$7.4 million, respectively.

OTHER "Other expenses (income)" included interest expense, capitalized interest, interest income, and nonoperating gains and losses. Capitalized interest decreased \$9.1 million in 1996 as a result of certain amendments to aircraft purchase contracts during third quarter 1995 that affected the timing of payments. Interest income for 1996 increased \$5.7 million primarily due to higher invested cash balances.

INCOME TAXES The provision for income taxes, as a percentage of income before taxes, decreased in 1996 to 39.3 percent from 40.2 percent in 1995. The decrease primarily was the result of lower effective state tax rates.

LIQUIDITY AND CAPITAL RESOURCES

Cash provided from operations was \$610.6 million in 1997, compared to \$615.2 million in 1996. (Operating cash flows in 1996 were inflated by \$79.4 million due to a one-time deferral allowed by the federal government for payment of excise taxes. On a pro forma basis, operating cash flows would have been \$690.0 million in 1997 versus \$535.8 million in 1996.)

During 1997, additional funds of \$98.8 million were generated from the February issuance of \$100 million of senior unsecured 7 3/8% Debentures due March 1, 2027. These proceeds primarily were used to finance aircraft-related capital expenditures and to provide working capital.

During 1997, capital expenditures of \$688.9 million primarily were for the purchase of 15 new 737-300 aircraft and three new 737-700 aircraft along with progress payments for future aircraft deliveries. At December 31, 1997, capital commitments of the Company primarily consisted of scheduled aircraft acquisitions and related flight equipment.

As of December 31, 1997, Southwest had 126 new 737-700s on firm order, including 22 to be delivered in 1998, with options to purchase another 62. Aggregate funding required for firm commitments approximated \$3,109.8 million through the year 2004, of which \$565.7 million related to 1998. See Note 2 to the Consolidated Financial Statements for further information.

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As of December 31, 1997, the Company had authority from its Board of Directors to purchase up to 2,500,000 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, 1997, of \$623.3 million, internally generated funds, and a revolving credit line with a group of banks of up to \$475 million (none of which had been drawn at December 31, 1997). In addition, the Company will also consider various borrowing or leasing options to maximize earnings and supplement cash requirements.

The Company currently has outstanding shelf registrations for the issuance of \$414.4 million of public debt securities, which it currently intends to utilize for aircraft financing in 1998 and 1999.

MARKET RISK

In 1997, the Securities and Exchange Commission issued new rules (Item 305 of Regulation S-K), which require disclosure of material risks, as defined in Item 305, related to market risk sensitive financial instruments. As defined, Southwest currently has market risk sensitive instruments related to jet fuel prices and interest rates.

Airline operators are inherently dependent upon energy to operate and, therefore, are impacted by changes in jet fuel prices. Jet fuel consumed in 1997 represented approximately 15.0 percent of Southwest's operating expenses. Southwest endeavors to acquire jet fuel at the lowest prevailing prices possible.

The Company hedges its exposure to jet fuel price market risk only on a conservative, limited basis. The fair value of outstanding derivative commodity instruments (primarily purchased crude oil call options) related to the Company's jet fuel price market risk during 1997 and at December 31, 1997 was immaterial. For further discussion, see Note 1 to the Consolidated Financial Statements.

Airline operators are also inherently capital intensive, as the vast majority of the Company's assets are aircraft, which are long lived. The Company's strategy is to capitalize itself conservatively and grow capacity steadily and profitably. While Southwest does use financial leverage, it has maintained a strong balance sheet and "A-" or equivalent credit ratings on its senior unsecured debt with three rating agencies (Standard & Poor's, Moody's, and Duff & Phelps).

As disclosed in Note 4 to the Consolidated Financial Statements, the Company has outstanding unsecured debt of \$600 million at December 31, 1997, of which only \$500 million is long-term. This long-term debt represents only 14.5 percent of total noncurrent assets at December 31, 1997. The Company has an average maturity of 11 years for the long-term debt at fixed rates averaging 7.8 percent, which is below average rates prevailing over the last ten years.

At December 31, 1997, the Company operated 119 aircraft under operating and capital leases at rates that are substantially fixed. As defined in Item 305, leases are not market risk sensitive financial instruments and, therefore, are not included in the

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interest rate sensitivity analysis below. Commitments related to leases are disclosed in Note 5 to the Consolidated Financial Statements.

The Company does not have significant exposure to changing interest rates on its long-term debt because the interest rates are fixed and the financial leverage is modest. Additionally, the Company does not have significant exposure to changing interest rates on invested cash, which was \$623 million at December 31, 1997. The Company invests available cash in certificates of deposit and investment grade commercial paper that have maturities of three months or less. As a result, the interest rate market risk implicit in these investments at December 31, 1997, is low, as the investments mature within three months. The Company has not undertaken any additional actions to cover interest rate market risk and is not a party to any other interest rate market risk management activities.

The Company does not purchase or hold any derivative financial instruments for trading purposes.

INTEREST RATE SENSITIVITY A ten percent change in market interest rates over the next year would not impact the Company's earnings or cash flow as the interest rates on the Company's long-term debt are fixed and its cash investments are short-term. A ten percent change in market interest rates would not have a material effect on the fair value of the Company's publicly traded long-term debt or its short-term cash investments.

IMPACT OF THE YEAR 2000

Based on a recently completed assessment, the Company has determined that it will be required to modify, upgrade, or replace significant portions of its internal software, including financial, reservations, maintenance, and human resources related software, so that its computer systems will properly utilize dates beyond December 31, 1999. As of December 31, 1997, the Company has commenced its year 2000 remediation program, has secured substantially all the required resources, and expects to substantially complete its internal year 2000 efforts by March 31, 1999. The Company believes that by completing the planned remediation program, the year 2000 issue will not adversely impact the Company's operations or operating results. However, if the program is not completed, or not completed timely, the year 2000 issue could have a material impact on the operations of the Company.

In addition, the Company has contacted its critical suppliers and other entities to determine the extent to which the Company's interface systems are vulnerable to those third parties' failure to remediate their own year 2000 issues. While the Company has not been informed of any material risks associated with these entities, there is no guarantee that the systems of these critical suppliers or other entities, including the Federal Aviation Administration, on which the Company relies, will be timely converted and will not have an adverse effect on the Company's systems or operations.

The Company has expensed \$4.0 million of costs incurred to date related to the year 2000 issue. The total remaining cost of the year 2000 project is presently estimated at \$15 million, which will be expensed as incurred. These amounts include only costs directly related to resolving the year 2000 issue. The costs of the project and the date on which the Company believes it will complete the year 2000 modifications are based

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on management's best estimates, which were derived utilizing numerous assumptions of future events, including the continued availability of certain resources. However, there can be no guarantee that these estimates will be achieved and actual results could differ materially from those anticipated. Specific factors that might cause such material differences include, but are not limited to, the availability and cost of personnel trained in this area and the ability to locate and correct all relevant computer codes.

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CONSOLIDATED BALANCE SHEET

(IN THOUSANDS EXCEPT SHARE AND PER SHARE AMOUNTS)	DECEMBER 31,	
	1997	1996
ASSETS		
Current assets:		
Cash and cash equivalents	\$623,343	\$581,841
Accounts receivable	76,530	73,440
Inventories of parts and supplies, at cost	52,376	51,094
Deferred income taxes (Note 9)	18,843	11,560
Prepaid expenses and other current assets	<u>35,324</u>	<u>33,055</u>
Total current assets	806,416	750,990
Property and equipment, at cost (Notes 2 and 5):		
Flight equipment	3,987,493	3,435,304
Ground property and equipment	601,957	523,958
Deposits on flight equipment purchase contracts	<u>221,874</u>	<u>198,366</u>
	4,811,324	4,157,628
Less allowance for depreciation	<u>1,375,631</u>	<u>1,188,405</u>
	3,435,693	2,969,223
Other assets	<u>4,051</u>	<u>3,266</u>
	<u>\$4,246,160</u>	<u>\$3,723,479</u>
LIABILITIES AND STOCKHOLDERS' EQUITY		
Current liabilities:		
Accounts payable	\$160,891	\$214,232
Accrued liabilities (Note 3)	426,950	368,625
Air traffic liability	153,341	158,098
Current maturities of long-term debt (Note 4)	121,324	12,327
Other current liabilities	<u>6,007</u>	<u>12,122</u>
Total current liabilities	868,513	765,404
Long-term debt less current maturities (Note 4)	628,106	650,226
Deferred income taxes (Note 9)	438,981	349,987
Deferred gains from sale and leaseback of aircraft	256,255	274,891
Other deferred liabilities	45,287	34,659
Commitments and contingencies (Notes 2, 5, and 9)		
Stockholders' equity (Notes 6 and 7):		
Common stock, \$1.00 par value: 680,000,000 shares authorized; 221,207,083 and 145,112,090 shares issued and outstanding in 1997 and 1996, respectively	221,207	145,112
Capital in excess of par value	155,696	181,650
Retained earnings	<u>1,632,115</u>	<u>1,321,550</u>
Total stockholders' equity	<u>2,009,018</u>	<u>1,648,312</u>
	<u>\$4,246,160</u>	<u>\$3,723,479</u>

See accompanying notes.

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CONSOLIDATED STATEMENT OF INCOME

(IN THOUSANDS EXCEPT PER SHARE AMOUNTS)	YEARS ENDED DECEMBER 31,		
	1997	1996	1995
OPERATING REVENUES:			
Passenger	\$3,639,193	\$3,269,238	\$2,760,756
Freight	94,758	80,005	65,825
Other	82,870	56,927	46,170
Total operating revenues	3,816,821	3,406,170	2,872,751
OPERATING EXPENSES:			
Salaries, wages, and benefits (Note 8)	1,136,542	999,719	867,984
Fuel and oil	494,952	484,673	365,670
Maintenance materials and repairs	256,501	253,521	217,259
Agency commissions	157,211	140,940	123,380
Aircraft rentals	201,954	190,663	169,461
Landing fees and other rentals	203,845	187,600	160,322
Depreciation	195,568	183,470	156,771
Other operating expenses	646,012	614,749	498,373
Total operating expenses	3,292,585	3,055,335	2,559,220
OPERATING INCOME	524,236	350,835	313,531
OTHER EXPENSES (INCOME):			
Interest expense	63,454	59,269	58,810
Capitalized interest	(19,779)	(22,267)	(31,371)
Interest income	(36,616)	(25,797)	(20,095)
Nonoperating (gains) losses, net	221	(1,732)	1,047
Total other expenses	7,280	9,473	8,391
INCOME BEFORE INCOME TAXES	516,956	341,362	305,140
PROVISION FOR INCOME TAXES (NOTE 9)	199,184	134,025	122,514
NET INCOME	\$317,772	\$207,337	\$182,626
NET INCOME PER SHARE, BASIC (NOTES 6, 7, AND 10)	\$1.45	\$.95	\$.85
NET INCOME PER SHARE, DILUTED (NOTES 6, 7, AND 10)	\$1.40	\$.92	\$.82

See accompanying notes.

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CONSOLIDATED STATEMENT OF STOCKHOLDERS' EQUITY

	Years ended December 31, 1997, 1996, and 1995			
	Common stock	Capital in excess of par value	Retained earnings	Total
(IN THOUSANDS EXCEPT PER SHARE AMOUNTS)				
Balance at December 31, 1994	\$143,256	\$151,746	\$943,704	\$1,238,706
Issuance of common stock upon exercise of executive stock options and pursuant to Employee stock option and purchase plans (Note 7)	777	9,907	-	10,684
Tax benefit of options exercised	-	1,051	-	1,051
Cash dividends, \$.02667 per share	-	-	(5,749)	(5,749)
Net income — 1995	-	-	182,626	182,626
Balance at December 31, 1995	144,033	162,704	1,120,581	1,427,318
Issuance of common stock upon exercise of executive stock options and pursuant to Employee stock option and purchase plans (Note 7)	1,079	14,513	-	15,592
Tax benefit of options exercised	-	4,433	-	4,433
Cash dividends, \$.02932 per share	-	-	(6,368)	(6,368)
Net income — 1996	-	-	207,337	207,337
Balance at December 31, 1996	145,112	181,650	1,321,550	1,648,312
Three-for-two stock split (Note 6)	73,578	(73,578)	-	-
Issuance of common stock upon exercise of executive stock options and pursuant to Employee stock option and purchase plans (Note 7)	2,517	37,818	-	40,335
Tax benefit of options exercised	-	9,806	-	9,806
Cash dividends, \$.0331 per share	-	-	(7,207)	(7,207)
Net income — 1997	-	-	317,772	317,772
Balance at December 31, 1997	<u>\$221,207</u>	<u>\$155,696</u>	<u>\$1,632,115</u>	<u>\$2,009,018</u>

See accompanying notes.

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CONSOLIDATED STATEMENT OF CASH FLOWS

(IN THOUSANDS)	YEARS ENDED DECEMBER 31,		
	1997	1996	1995
CASH FLOWS FROM OPERATING ACTIVITIES:			
Net income	\$317,772	\$207,337	\$182,626
Adjustments to reconcile net income to net cash provided by operating activities:			
Depreciation	195,568	183,470	156,771
Deferred income taxes	81,711	67,253	48,147
Amortization of deferred gains on sale and leaseback of aircraft	(15,414)	(18,263)	(24,286)
Amortization of scheduled airframe overhauls	20,540	20,539	17,337
Changes in certain assets and liabilities:			
Accounts receivable	(3,090)	6,341	(4,089)
Other current assets	6,243	(19,534)	(11,857)
Accounts payable and accrued liabilities	8,751	132,096	61,937
Air traffic liability	(4,757)	26,942	25,017
Other current liabilities	(4,204)	5,334	1,050
Other	<u>7,468</u>	<u>3,713</u>	<u>3,789</u>
Net cash provided by operating activities	610,588	615,228	456,442
CASH FLOWS FROM INVESTING ACTIVITIES:			
Purchases of property and equipment	<u>(688,927)</u>	<u>(677,431)</u>	<u>(728,643)</u>
Net cash used in investing activities	(688,927)	(677,431)	(728,643)
CASH FLOWS FROM FINANCING ACTIVITIES:			
Issuance of long-term debt	98,764	-	98,811
Proceeds from aircraft sale and leaseback transactions	-	330,000	321,650
Payment of long-term debt and capital lease obligations	(12,665)	(12,695)	(10,379)
Payment of cash dividends	(6,593)	(6,216)	(5,749)
Proceeds from Employee stock plans	<u>40,335</u>	<u>15,592</u>	<u>10,693</u>
Net cash provided by financing activities	119,841	326,681	415,026
NET INCREASE IN CASH AND CASH EQUIVALENTS	41,502	264,478	142,825
CASH AND CASH EQUIVALENTS AT BEGINNING OF PERIOD	581,841	317,363	174,538
CASH AND CASH EQUIVALENTS AT END OF PERIOD	<u>\$623,343</u>	<u>\$581,841</u>	<u>\$317,363</u>
CASH PAYMENTS FOR:			
Interest, net of amount capitalized	\$42,372	\$36,640	\$25,277
Income taxes	107,066	66,447	73,928

See accompanying notes.

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NOTES TO CONSOLIDATED FINANCIAL STATEMENTS DECEMBER 31, 1997

1. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

BASIS OF PRESENTATION Southwest Airlines Co. (Southwest) is a major domestic airline that provides shorthaul, high frequency, point-to-point, low fare service. The consolidated financial statements include the accounts of Southwest and its wholly owned subsidiaries (the Company). All significant intercompany balances and transactions have been eliminated. The preparation of financial statements in conformity with generally accepted accounting principles requires management to make estimates and assumptions that affect the amounts reported in the financial statements and accompanying notes. Actual results could differ from these estimates. Certain prior year amounts have been reclassified for comparison purposes.

CASH AND CASH EQUIVALENTS Cash equivalents consist of certificates of deposit and investment grade commercial paper issued by major corporations and financial institutions that are highly liquid and have original maturities 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 12 to 20 years for flight equipment 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 Company'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. The Company records impairment losses on long-lived assets used in operations when events and circumstances indicate that the assets might be impaired and the undiscounted cash flows to be generated by those assets are less than the carrying amounts of those assets.

AIRCRAFT AND ENGINE MAINTENANCE The cost of engine overhauls and routine maintenance costs for aircraft and engines are charged to maintenance expense as incurred. Scheduled airframe overhaul costs are capitalized and amortized over the estimated period benefited, presently ten 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 transportation is provided. Tickets sold but not yet used are included in "Air traffic liability," which includes estimates that are evaluated and adjusted periodically. Any adjustments resulting therefrom are included in results of operations for the periods in which the evaluations are completed.

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FREQUENT FLYER PROGRAM The Company accrues the estimated incremental cost of providing free travel awards earned under its Rapid Rewards frequent flyer program. The Company also sells flight segment credits to companies participating in its Rapid Rewards frequent flyer program. The revenue from the sale of flight segment credits is recognized when the credits are sold.

ADVERTISING The Company expenses the costs of advertising as incurred. Advertising expense for the years ended December 31, 1997, 1996, and 1995 was \$112,961,000, \$109,136,000, and \$92,087,000, respectively.

STOCK-BASED EMPLOYEE COMPENSATION Pursuant to Statement of Financial Accounting Standards No. 123 (SFAS 123), *Accounting for Stock-Based Compensation*, the Company accounts for stock-based compensation plans utilizing the provisions of Accounting Principles Board Opinion No. 25 (APB 25), *Accounting for Stock Issued to Employees* and related Interpretations because, as discussed in Note 7, the alternative fair value accounting provided for under SFAS 123 requires use of option valuation models that were not developed for use in valuing employee stock options.

EARNINGS PER SHARE In 1997, the Financial Accounting Standards Board issued Statement of Financial Accounting Standards No. 128 (SFAS 128), *Earnings per Share*. SFAS 128 replaced the calculation of primary and fully diluted earnings per share with basic and diluted earnings per share. Unlike primary earnings per share, basic earnings per share excludes any dilutive effects of stock options. Diluted earnings per share is similar to the previously reported fully diluted earnings per share. Earnings per share amounts for all periods have been restated and presented to conform to the SFAS 128 requirements.

DERIVATIVE FINANCIAL INSTRUMENTS The Company utilizes purchased crude oil call options and fixed price swap agreements to hedge a portion of its exposure to fuel price fluctuations. At December 31, 1997, 1996, and 1995, and during the years then ended, outstanding call options and swap agreements were immaterial.

The cost of purchased crude oil call options and gains and losses on fixed price swap agreements are deferred and expensed to fuel expense in the same month that the underlying fuel being hedged is used. Gains and losses resulting from hedging positions terminated or settled early are recorded to fuel expense in the month of termination or settlement. Gains and losses on hedging transactions have not been material.

Any such 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.

The Company does not hold or issue any financial instruments for trading purposes.

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2. COMMITMENTS

The Company's contractual purchase commitments consist primarily of scheduled aircraft acquisitions. Twenty-two 737-700 aircraft are scheduled for delivery in 1998, 25 in 1999, 23 in 2000, 21 in 2001, 21 in 2002, eight in 2003, and six in 2004. In addition, the Company has options to purchase up to 62 -700s during 2003-2006. The Company has the option, which must be exercised two years prior to the contractual delivery date, to substitute 737-600s or 737-800s for the -700s scheduled subsequent to 1999.

Aggregate funding needed for these commitments is approximately \$3,109.8 million, subject to adjustments for inflation, due as follows: \$565.7 million in 1998, \$747.1 million in 1999, \$574.1 million in 2000, \$510.1 million in 2001, \$434.5 million in 2002, \$172.8 million in 2003, and \$105.5 million in 2004.

3. ACCRUED LIABILITIES

(IN THOUSANDS)	1997	1996
Aircraft rentals	\$123,669	\$121,384
Employee profitsharing and savings plans (Note 8)	92,857	61,286
Vacation pay	50,812	44,763
Other	<u>159,612</u>	<u>141,192</u>
	<u>\$426,950</u>	<u>\$368,625</u>

4. LONG-TERM DEBT

(IN THOUSANDS)	1997	1996
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
8% Notes due 2005	100,000	100,000
7 7/8% Notes due 2007	100,000	100,000
7 3/8% Debentures due 2027	100,000	—
Capital leases (Note 5)	152,324	165,610
Other	<u>—</u>	<u>10</u>
	752,324	665,620
Less current maturities	121,324	12,327
Less debt discount	<u>2,894</u>	<u>3,067</u>
	<u>\$628,106</u>	<u>\$650,226</u>

On February 28, 1997, the Company issued \$100 million of senior unsecured 7 3/8% Debentures due March 1, 2027. Interest is payable semi-annually on March 1 and September 1. The Debentures may be redeemed, at the option of the Company, in whole at any time or in part from time to time, at a redemption price equal to the greater of the principal amount of the Debentures plus accrued interest at the date of redemption or the sum of the present values of the remaining scheduled payments of principal and interest thereon, discounted to the date of redemption at the comparable treasury rate plus 20 basis points, plus accrued interest at the date of redemption.

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On March 7, 1995, the Company issued \$100 million of senior unsecured 8% Notes due March 1, 2005. Interest is payable semi-annually on March 1 and September 1. The Notes are not redeemable prior to maturity.

On September 9, 1992, the Company 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 prior to maturity.

The fair values, based on quoted market prices, of these securities at December 31, 1997, were as follows:

(IN THOUSANDS)

9 1/4% Notes due 1998	\$100,350
9.4% Notes due 2001	110,150
8 3/4% Notes due 2003	111,630
8% Notes due 2005	108,920
7 7/8% Notes due 2007	109,410
7 3/8% Debentures due 2027	105,660

In addition to the credit facilities described above, Southwest has an unsecured Bank Credit Agreement with a group of banks that permits Southwest to borrow through May 6, 2002, on a revolving credit basis, up to \$475 million. Interest rates on borrowings under the Credit Agreement can be, at the option of Southwest, the greater of the agent bank's prime rate or the federal funds rate plus .5 percent, .17 percent over LIBOR, or a fixed rate offered by the banks at the time of borrowing. The commitment fee is .08 percent per annum. There were no outstanding borrowings under this agreement, or prior similar agreements, at December 31, 1997 or 1996.

5. LEASES

Total rental expense for operating leases charged to operations in 1997, 1996, and 1995 was \$297,158,000, \$280,389,000, and \$247,033,000, respectively. The majority of the Company's terminal operations space, as well as 106 aircraft, were under operating leases at December 31, 1997. The amounts applicable to capital leases included in property and equipment were:

(IN THOUSANDS)	1997	1996
Flight equipment	\$227,803	\$226,677
Less accumulated amortization	<u>122,346</u>	<u>111,815</u>
	<u>\$105,457</u>	<u>\$114,862</u>

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Future minimum lease payments under capital leases and noncancelable operating leases with initial or remaining terms in excess of one year at December 31, 1997, were:

(IN THOUSANDS)	CAPITAL LEASES	OPERATING LEASES
1998	\$32,026	\$234,828
1999	20,245	227,679
2000	16,871	224,302
2001	17,391	209,862
2002	17,561	196,410
After 2002	<u>137,799</u>	<u>2,147,915</u>
Total minimum lease payments	241,893	<u>\$3,240,996</u>
Less amount representing interest	<u>89,569</u>	
Present value of minimum lease payments	152,324	
Less current portion	<u>21,324</u>	
Long-term portion	<u>\$131,000</u>	

The aircraft leases generally can 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.

6. COMMON STOCK

The Company has one class of common stock. Holders of shares of common stock are entitled to receive dividends when and if declared by the Board of Directors and are entitled to one vote per share on all matters submitted to a vote of the shareholders.

At December 31, 1997, the Company had common stock reserved for issuance pursuant to Employee stock benefit plans (49,254,768 shares) and upon exercise of rights (270,461,851 shares) pursuant to the Common Stock Rights Agreement, as amended (Agreement).

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 \$11.11 and is exercisable only in the event of a proposed takeover, as defined by the Agreement. The Company may redeem the Rights at \$.0074 per Right prior to the time that 15 percent of the common stock has been acquired by a person or group. If the Company is acquired, as defined in the Agreement, each Right will entitle its holder to purchase for \$11.11 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, 2006.

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On September 25, 1997, the Company's Board of Directors declared a three-for-two stock split, distributing 73,577,983 shares on November 26, 1997. Unless otherwise stated, all per share data presented in the accompanying consolidated financial statements and notes thereto have been restated to give effect to the stock split.

7. STOCK PLANS

At December 31, 1997, the Company had six stock-based compensation plans and other stock options outstanding, which are described below. The Company applies APB 25 and related Interpretations in accounting for its stock-based compensation. Accordingly, no compensation expense is recognized for its fixed option plans because the exercise prices of the Company's Employee stock options equal or exceed the market prices of the underlying stock on the dates of the grants. Compensation expense for other stock options is not material.

The Company has five fixed option plans. Under the 1991 Incentive Stock Option Plan, the Company may grant options to key Employees for up to 13,500,000 shares of common stock. Under the 1991 Non-Qualified Stock Option Plan, the Company may grant options to key Employees and non-employee directors for up to 1,125,000 shares of common stock. All options granted under these plans have ten-year terms and vest and become fully exercisable at the end of three, five, or ten years of continued employment, depending upon the grant type.

Under the 1995 Southwest Airlines Pilots' Association Non-Qualified Stock Option Plan (SWAPA Plan), the Company may grant options to Pilots for up to 27,000,000 shares of common stock. An initial grant of approximately 21,750,000 shares was made on January 12, 1995, at an option price of \$13.33 per share, which exceeded the market price of the Company's stock on that date. Options granted under the initial grant vest in ten annual increments of ten percent. On September 1 of each year of the agreement beginning in 1996, additional options will be granted to Pilots that become eligible during that year. Additional options granted on September 1, 1997 and 1996, vest in seven annual increments of 14.3 percent and eight annual increments of 12.5 percent, respectively. Options under all grants must be exercised prior to January 31, 2007, or within a specified time upon retirement or termination. In the event that the Southwest Airlines Pilots' Association exercises its option to make the collective bargaining agreement amendable on September 1, 1999, any unexercised options will be canceled on December 1, 1999.

Under the 1996 Incentive Stock Option Plan, the Company may grant options to key Employees for up to 9,000,000 shares of common stock. Under the 1996 Non-Qualified Stock Option Plan, the Company may grant options to key Employees and non-employee directors for up to 862,500 shares of common stock. All options granted under these plans have ten-year terms and vest and become fully exercisable at the end of three, five, or ten years of continued employment, depending upon the grant type.

Under all fixed option plans, except the SWAPA Plan, the exercise price of each option equals the market price of the Company's stock on the date of grant. Under the SWAPA Plan, for additional options granted each September 1, the exercise price will be equal to 105 percent of the fair value of such stock on the date of the grant.

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Information regarding the Company's five fixed stock option plans, as adjusted for the three-for-two stock split on November 26, 1997, is summarized below:

	<u>Incentive Plans</u>		<u>Non-Qualified Plans</u>	
	Options	Average Exercise Price	Options	Average Exercise Price
Outstanding December 31, 1994	7,217,943	\$8.05	532,883	\$9.07
Granted — Incentive Plans	1,474,821	12.53	-	-
Granted — SWAPA Plan	-	-	21,790,575	13.33
Granted — Other Non-Qualified Plans	-	-	139,973	12.51
Exercised	(412,587)	5.67	(90,765)	10.08
Surrendered	(462,358)	8.47	(91,562)	13.07
Outstanding December 31, 1995	7,817,819	8.98	22,281,104	13.24
Granted — Incentive Plans	2,505,516	16.79	-	-
Granted — SWAPA Plan	-	-	699,300	15.88
Granted — Other Non-Qualified Plans	-	-	103,683	16.78
Exercised	(593,772)	6.85	(435,578)	11.93
Surrendered	(375,669)	13.44	(142,477)	13.33
Outstanding December 31, 1996	9,353,894	11.03	22,506,032	13.36
Granted — Incentive Plans	2,455,158	14.51	-	-
Granted — SWAPA Plan	-	-	882,000	19.79
Granted — Other Non-Qualified Plans	-	-	145,406	14.51
Exercised	(1,151,926)	9.04	(1,771,831)	13.27
Surrendered	<u>(670,013)</u>	14.58	<u>(99,212)</u>	13.59
Outstanding December 31, 1997	<u>9,987,113</u>	\$11.87	<u>21,662,395</u>	\$13.63
Exercisable December 31, 1997	2,081,222		7,132,653	
Available for granting in future periods	9,244,087		4,853,562	

The following table summarizes information about stock options outstanding under the five fixed option plans at December 31, 1997:

Range Of Exercise Prices	<u>Options Outstanding</u>			<u>Options Exercisable</u>	
	Number Outstanding At 12/31/97	Weighted-Average Remaining Contractual Life	Weighted-Average Exercise Price	Number Exercisable At 12/31/97	Weighted-Average Exercise Price
\$4.01 to \$5.21	3,084,861	3.04 yrs.	\$4.09	993,711	\$4.25
\$7.56 to \$8.04	415,464	4.03	7.97	92,589	7.83
\$11.25 to \$16.79	26,244,958	8.81	13.73	7,621,620	13.54
\$17.29 to \$24.96	<u>1,904,225</u>	7.55	19.82	<u>505,955</u>	21.85
\$4.01 to \$24.96	<u>31,649,508</u>	8.11 yrs.	\$13.08	<u>9,213,875</u>	\$12.93

The Company has granted options to purchase the Company's common stock related to employment contracts with the Company's president and chief executive officer. Depending upon the grant, these options have terms of ten years from the date of grant or ten years from the date exercisable and vest and become fully exercisable over three or four years. No options were granted in 1997 or 1995. In 1996, the Company granted 217,000 options with an exercise price of \$1.00 per share and 750,000 options with an

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exercise price of \$15.67 per share related to the 1996 employment agreement. At December 31, 1997, 1996, and 1995, total options of 2,611,000, 2,847,000, and 2,133,000 were outstanding, respectively. At December 31, 1997, total options of 2,031,000 were exercisable at exercise prices ranging from \$1.00 to \$15.67 per share. Options for 236,000, 253,000, and 101,000 shares were exercised in 1997, 1996, and 1995, respectively.

Under the 1991 Employee Stock Purchase Plan (ESPP), at December 31, 1997, the Company is authorized to issue up to a balance of 871,000 shares of common stock to Employees of the Company at a price equal to 90 percent 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 440,000 shares in 1997, 464,000 shares in 1996, and 583,000 shares in 1995 at average prices of \$16.00, \$15.37, and \$12.79, respectively.

Pro forma information regarding net income and net income per share is required by SFAS 123 and has been determined as if the Company had accounted for its Employee stock-based compensation plans and other stock options under the fair value method of SFAS 123. The fair value of each option grant is estimated on the date of grant using the Black-Scholes option pricing model with the following weighted-average assumptions used for grants under the fixed option plans in 1997, 1996, and 1995, respectively: dividend yield of .22 percent, .16 percent, and .21 percent; expected volatility of 38.23 percent, 35.37 percent, and 36.85 percent; risk-free interest rate of 5.80 percent, 5.89 percent, and 7.79 percent; and expected lives of 5.0 years for all periods. Assumptions for the stock options granted in 1996 to the Company's president and chief executive officer were the same as for the fixed option plans except for the weighted-average expected lives of 8.0 years.

The weighted-average fair value of options granted under the five fixed option plans during 1997, 1996, and 1995 was \$6.12, \$6.78, and \$5.61, respectively, for the incentive plans; \$7.67, \$6.16, and \$5.31, respectively, for the SWAPA Plan; and \$6.12, \$6.78, and \$5.61, respectively, for other non-qualified plans. The weighted-average fair value of options granted in 1996 to the Company's president and chief executive officer relative to an employment contract was \$9.32. No such options were granted in 1997 or 1995. The weighted-average fair value of each purchase right under the ESPP granted in 1997, 1996, and 1995, which is equal to the ten percent discount from the market value of the common stock at the end of each purchase period, was \$1.78, \$1.71, and \$1.43, respectively.

The Black-Scholes option valuation model was developed for use in estimating the fair value of traded options which have no vesting restrictions and are fully transferable. In addition, option valuation models require the input of highly subjective assumptions including expected stock price volatility. Because the Company's Employee stock options have characteristics significantly different from those of traded options and because changes in the subjective input assumptions can materially affect the fair value estimate, in management's opinion, the existing models do not necessarily provide a reliable single measure of the fair value of its Employee stock options.

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For purposes of pro forma disclosures, the estimated fair value of stock-based compensation plans and other options is amortized to expense primarily over the vesting period. The Company's pro forma net income and net income per share is as follows:

(IN THOUSANDS EXCEPT PER SHARE AMOUNTS)	1997	1996	1995
NET INCOME:			
As reported	\$317,772	\$207,337	\$182,626
Pro forma	\$306,553	\$196,478	\$167,907
NET INCOME PER SHARE, BASIC:			
As reported	\$1.45	\$.95	\$.85
Pro forma	\$1.40	\$.90	\$.78
NET INCOME PER SHARE, DILUTED:			
As reported	\$1.40	\$.92	\$.82
Pro forma	\$1.34	\$.89	\$.76

As required, the pro forma disclosures above include only options granted since January 1, 1995. Consequently, the effects of applying SFAS 123 for providing pro forma disclosures may not be representative of the effects on reported net income for future years until all options outstanding are included in the pro forma disclosures.

8. EMPLOYEE PROFITSHARING AND SAVINGS PLANS

Substantially all of Southwest's Employees are members of the Southwest Airlines Co. Profitsharing Plan. Total profitsharing expense charged to operations in 1997, 1996, and 1995 was \$91,256,000, \$59,927,000, and \$54,033,000, respectively.

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 1997, 1996, and 1995 were \$39,744,000, \$35,125,000, and \$28,954,000, respectively.

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9. INCOME TAXES

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, 1997 and 1996 are as follows:

(IN THOUSANDS)	1997	1996
DEFERRED TAX LIABILITIES:		
Accelerated depreciation	\$543,547	\$467,372
Scheduled airframe maintenance	33,202	30,984
Other	83,607	78,195
Total deferred tax liabilities	660,356	576,551
DEFERRED TAX ASSETS:		
Deferred gains from sale and leaseback of aircraft	112,659	114,514
Capital and operating leases	61,747	58,252
Alternative minimum tax credit carryforward	-	6,019
Other	65,812	59,339
Total deferred tax assets	<u>240,218</u>	<u>238,124</u>
Net deferred tax liability	<u>\$420,138</u>	<u>\$338,427</u>

The provision for income taxes is composed of the following:

(IN THOUSANDS)	1997	1996	1995
CURRENT:			
Federal	\$102,938	\$59,101	\$64,420
State	14,535	7,671	9,947
Total current	117,473	66,772	74,367
DEFERRED:			
Federal	75,990	60,967	44,580
State	5,721	6,286	3,567
Total deferred	<u>81,711</u>	<u>67,253</u>	<u>48,147</u>
	<u>\$199,184</u>	<u>\$134,025</u>	<u>\$122,514</u>

Southwest has received examination reports from the Internal Revenue Service (IRS) proposing certain adjustments to Southwest's income tax returns for 1989 through 1991. The adjustments relate to aircraft maintenance costs incurred 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

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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 income taxes differed from the federal income tax statutory rate for the following reasons:

(IN THOUSANDS)	1997	1996	1995
Tax at statutory			
U.S. tax rates	\$180,935	\$119,477	\$106,799
Nondeductible items	5,893	5,168	4,488
State income taxes, net of federal benefit	13,166	9,072	8,784
Other, net	(810)	308	2,443
Total income tax provision	<u>\$199,184</u>	<u>\$134,025</u>	<u>\$122,514</u>

10. NET INCOME PER SHARE

The following table sets forth the computation of basic and diluted earnings per share:

(IN THOUSANDS EXCEPT PER SHARE AMOUNTS)	1997	1996	1995
NUMERATOR:			
Net income, available to stockholders – numerator for basic and diluted earnings per share	<u>\$317,772</u>	<u>\$207,337</u>	<u>\$182,626</u>
DENOMINATOR:			
Weighted-average shares outstanding, basic	219,088	217,118	215,517
Dilutive effect of Employee stock options	<u>8,371</u>	<u>7,873</u>	<u>6,247</u>
Adjusted weighted-average shares outstanding, diluted	<u>227,459</u>	<u>224,991</u>	<u>221,764</u>
NET INCOME PER SHARE:			
Basic	<u>\$1.45</u>	<u>\$.95</u>	<u>\$.85</u>
Diluted	<u>\$1.40</u>	<u>\$.92</u>	<u>\$.82</u>

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**REPORT OF ERNST & YOUNG LLP
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, 1997 and 1996, and the related consolidated statements of income, stockholders' equity, and cash flows for each of the three years in the period ended December 31, 1997. 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, 1997 and 1996, and the consolidated results of its operations and its cash flows for each of the three years in the period ended December 31, 1997, in conformity with generally accepted accounting principles.

ERNST & YOUNG LLP

Dallas, Texas

January 23, 1998

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QUARTERLY FINANCIAL DATA (UNAUDITED)

(IN THOUSANDS EXCEPT PER SHARE AMOUNTS)	THREE MONTHS ENDED			
	March 31	June 30	Sept. 30	Dec. 31
1997				
Operating revenues	\$887,095	\$956,892	\$997,241	\$975,593
Operating income	87,203	156,407	151,770	128,856
Income before income taxes	83,401	153,823	150,387	129,345
Net income	50,874	93,832	92,511	80,555
Net income per share, basic	.23	.43	.42	.36
Net income per share, diluted	.23	.42	.41	.35
1996				
Operating revenues	\$772,529	\$910,308	\$891,492	\$831,841
Operating income	57,393	142,206	102,934	48,302
Income before income taxes	54,771	139,989	100,243	46,359
Net income	33,000	85,316	60,858	28,163
Net income per share, basic	.15	.39	.28	.13
Net income per share, diluted	.15	.38	.27	.13

COMMON STOCK PRICE RANGES AND DIVIDENDS

Southwest's common stock is listed on the New York Stock Exchange and is traded under the symbol LUV. The high and low sales prices of the common stock on the Composite Tape and the quarterly dividends per share, as adjusted for the November 1997 three-for-two stock split, were:

PERIOD	DIVIDENDS	HIGH	LOW
1997			
1st Quarter	\$.00770	\$16.67	\$14.17
2nd Quarter	.00770	18.67	14.33
3rd Quarter	.00770	22.13	17.33
4th Quarter	.01000	26.25	18.83
1996			
1st Quarter	\$.00733	\$22.00	\$14.75
2nd Quarter	.00733	22.17	17.17
3rd Quarter	.00733	19.33	14.25
4th Quarter	.00733	17.33	13.75

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TEN-YEAR SUMMARY

SELECTED CONSOLIDATED FINANCIAL DATA ⁽¹⁾

(IN THOUSANDS EXCEPT PER SHARE AMOUNTS)	1997	1996	1995	1994
Operating revenues:				
Passenger	\$3,639,193	\$3,269,238	\$2,760,756	\$2,497,765
Freight	94,758	80,005	65,825	54,419
Other	82,870	56,927	46,170	39,749
Total operating revenues	3,816,821	3,406,170	2,872,751	2,591,933
Operating expenses	3,292,585	3,055,335	2,559,220	2,275,224
Operating income	524,236	350,835	313,531	316,709
Other expenses (income), net	7,280	9,473	8,391	17,186
Income before income taxes	516,956	341,362	305,140	299,523
Provision for income taxes ⁽³⁾	199,184	134,025	122,514	120,192
Net income ⁽³⁾	<u>\$317,772</u>	<u>\$207,337</u>	<u>\$182,626</u>	<u>\$179,331</u>
Net income per share, basic ⁽³⁾	\$1.45	\$.95	\$.85	\$.84
Net income per share, diluted ⁽³⁾	\$1.40	\$.92	\$.82	\$.82
Cash dividends per common share	\$.03310	\$.02932	\$.02667	\$.02667
Total assets	\$4,246,160	\$3,723,479	\$3,256,122	\$2,823,071
Long-term debt	\$628,106	\$650,226	\$661,010	\$583,071
Stockholders' equity	\$2,009,018	\$1,648,312	\$1,427,318	\$1,238,706

CONSOLIDATED FINANCIAL RATIOS ⁽¹⁾

Return on average total assets	8.0%	5.9%	6.0%	6.6%
Return on average stockholders' equity	17.4%	13.5%	13.7%	15.6%

CONSOLIDATED OPERATING STATISTICS ⁽²⁾

Revenue passengers carried	50,399,960	49,621,504	44,785,573	42,742,602 ⁽⁹⁾
RPMs (000s)	28,355,169	27,083,483	23,327,804	21,611,266
ASMs (000s)	44,487,496	40,727,495	36,180,001	32,123,974
Load factor	63.7%	66.5%	64.5%	67.3%
Average length of passenger haul	563	546	521	506
Trips flown	786,288	748,634	685,524	624,476
Average passenger fare	\$72.21	\$65.88	\$61.64	\$58.44
Passenger revenue yield per RPM	12.84¢	12.07¢	11.83¢	11.56¢
Operating revenue yield per ASM	8.58¢	8.36¢	7.94¢	8.07¢
Operating expenses per ASM	7.40¢	7.50¢	7.07¢	7.08¢
Fuel cost per gallon (average)	62.46¢	65.47¢	55.22¢	53.92¢
Number of Employees at yearend	23,974	22,944	19,933	16,818
Size of fleet at yearend ⁽¹¹⁾	261	243	224	199

(1) The Selected Consolidated Financial Data and Consolidated Financial Ratios for 1992 through 1989 have been restated to include the financial results of Morris Air Corporation (Morris). Years prior to 1989 were immaterial for restatement purposes

(2) Prior to 1993, Morris operated as a charter carrier; therefore, no Morris statistics are included for these years

(3) Pro forma for 1992 through 1989 assuming Morris, an S-Corporation prior to 1993, was taxed at statutory rates

(4) Excludes cumulative effect of accounting changes of \$15.3 million (\$.07 per share)

(5) Excludes cumulative effect of accounting change of \$12.5 million (\$.06 per share)

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1993	1992	1991	1990	1989	1988
\$2,216,342	\$1,623,828	\$1,267,897	\$1,144,421	\$973,568	\$828,343
42,897	33,088	26,428	22,196	18,771	14,433
37,434	146,063	84,961	70,659	65,390	17,658
2,296,673	1,802,979	1,379,286	1,237,276	1,057,729	860,434
2,004,700	1,609,175	1,306,675	1,150,015	955,689	774,454
291,973	193,804	72,611	87,261	102,040	85,980
32,336	36,361	18,725	6,827 ⁽⁶⁾	(13,696) ⁽⁷⁾	620 ⁽⁸⁾
259,637	157,443	53,886	80,434	115,736	85,360
105,353	60,058	20,738	29,829	41,231	27,408
<u>\$154,284⁽⁴⁾</u>	<u>\$97,385⁽⁵⁾</u>	<u>\$33,148</u>	<u>\$50,605</u>	<u>\$74,505</u>	<u>\$57,952</u>
\$.72 ⁽⁴⁾	\$.47 ⁽⁵⁾	\$.17	\$.26	\$.36	\$.27
\$.70 ⁽⁴⁾	\$.46 ⁽⁵⁾	\$.17	\$.26	\$.36	\$.27
\$.02578	\$.02355	\$.02222	\$.02149	\$.02073	\$.01962
\$2,576,037	\$2,368,856	\$1,854,331	\$1,480,813	\$1,423,298	\$1,308,389
\$639,136	\$735,754	\$617,434	\$327,553	\$354,150	\$369,541
\$1,054,019	\$879,536	\$635,793	\$607,294	\$591,794	\$567,375
6.2% ⁽⁴⁾	4.6% ⁽⁵⁾	2.0%	3.5%	5.5%	5.1%
16.0% ⁽⁴⁾	12.9% ⁽⁵⁾	5.3%	8.4%	12.9%	10.8%
36,955,221 ⁽⁹⁾	27,839,284	22,669,942	19,830,941	17,958,263	14,876,582
18,827,288	13,787,005	11,296,183	9,958,940	9,281,992	7,676,257
27,511,000	21,366,642	18,491,003	16,411,115	14,796,732	13,309,044
68.4%	64.5%	61.1%	60.7%	62.7%	57.7%
509	495	498	502	517	516
546,297	438,184	382,752	338,108	304,673	274,859
\$59.97	\$58.33	\$55.93	\$57.71	\$54.21	\$55.68
11.77¢	11.78¢	11.22¢	11.49¢	10.49¢	10.79¢
8.35¢	7.89¢	7.10¢	7.23¢	6.86¢	6.47¢
7.25¢ ⁽¹⁰⁾	7.03¢	6.76¢	6.73¢	6.20¢	5.82¢
59.15¢	60.82¢	65.69¢	77.89¢	59.46¢	51.37¢
15,175	11,397	9,778	8,620	7,760	6,467
178	141	124	106	94	85

(6) Includes \$2.6 million gains on sales of aircraft and \$3.1 million from the sale of certain financial assets

(7) Includes \$10.8 million gains on sales of aircraft, \$5.9 million from the sale of certain financial assets, and \$2.3 million from the settlement of a contingency

(8) Includes \$5.6 million gains on sales of aircraft and \$3.6 million from the sale of certain financial assets

(9) Includes certain estimates for Morris

(10) Excludes merger expenses of \$10.8 million

(11) Includes leased aircraft

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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
10:00a.m.
on May 21, 1998, at the Southwest Airlines Corporate Headquarters, 2702 Love Field
Drive, Dallas, Texas.

FINANCIAL INFORMATION

A copy of the Company's Annual Report on Form 10-K as filed with the Securities and
Exchange Commission may be obtained without charge, as well as other financial
information, by writing or calling:

Investor Relations
Southwest Airlines Co.
P.O. Box 36611
Dallas, Texas 75235-1611
Telephone (214) 792-4908

THIS SOUTHWEST AIRLINES ANNUAL REPORT IS DEDICATED TO THE 25,000+ EMPLOYEES WHOSE NAMES ARE PERMANENTLY INSCRIBED ONBOARD TRIPLE CROWN ONE, A SIGNATURE SALUTE TO THE EMPLOYEES OF SOUTHWEST AIRLINES FOR FIVE ANNUAL TRIPLE CROWN WINS.

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Chairman of the Board, Barshop & Oles Co., Inc.,
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Audit and Compensation Committees

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Retired, Dallas, Texas;
Audit, Compensation, and Executive Committees

C. WEBB CROCKETT
Shareholder and Director, Fennemore Craig,
Attorneys at Law, Phoenix, Arizona;
Audit Committee

WILLIAM P. HOBBY
Chairman of the Board,
Hobby Communications, L.L.C.;
Former Lieutenant Governor of Texas;
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Partner, Johnson & Bowen,
Attorneys at Law, El Paso, Texas;
Audit Committee

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

ROLLIN W. KING
Retired, Dallas, Texas;
Audit and Executive Committees

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Officer, Hallmark Residential Group, 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

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and Chief Executive Officer

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Executive Vice President—Customers and Corporate Secretary

GARY A. BARRON*
Executive Vice President—Chief Operations Officer

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Executive Vice President—Corporate Services

CAROLYN R. BATES
Vice President—Reservations

ALAN S. DAVIS
Vice President—Internal Audit and Special Projects

LUKE J. GILL
Vice President—Maintenance and Engineering

MICHAEL P. GOLDEN
Vice President—Purchasing

GINGER C. HARDAGE
Vice President—Public Relations and Corporate Communications

ROBERT E. JORDAN
Controller

CAMILLE T. KEITH
Vice President—Special Marketing

GARY C. KELLY*
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Chief Financial Officer

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Treasurer

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Vice President–General Counsel

RON RICKS*
Vice President–Governmental Affairs

DAVE RIDLEY
Vice President–Marketing and Sales

JOYCE C. ROGGE*
Vice President–Advertising and Promotions

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Vice President–Fuel Management

ELIZABETH P. SARTAIN
Vice President–People

PAUL E. STERBENZ
Vice President–Flight Operations

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Vice President–Ground Operations

*Member of Executive Planning Committee

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