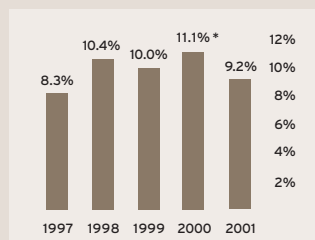


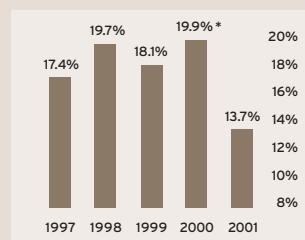
2001 marks Southwest Airlines' 30th Anniversary. For 30 years now, we have had one mission: low fares. In that respect, this year was no different. But as we all know, 2001 was a year like no other, in both our Company's and our country's history. In first quarter, we unveiled our new look for the new millennium – beautiful Canyon Blue jets with all-leather interiors. In second quarter, our Chairman, Herb Kelleher, announced that he would be sharing his responsibilities with our new Vice Chairman and CEO, Jim Parker, and our new President and COO, Colleen Barrett. The National Tragedy struck our collective hearts, minds, and lives in third quarter. In fourth quarter, our nation and our Company began the difficult process of healing together. Nothing will keep us from moving ahead. Freedom, and the Freedom to Fly, will most certainly endure.



Net Margin



Net Income Per Share, Diluted



Return On Stockholders' Equity

CONSOLIDATED HIGHLIGHTS (DOLLARS IN THOUSANDS, EXCEPT PER SHARE AMOUNTS)	2001	2000	CHANGE
Operating revenues	\$5,555,174	\$5,649,560	(1.7)%
Operating expenses	\$4,924,052	\$4,628,415	6.4%
Operating income	\$631,122	\$1,021,145	(38.2)%
Operating margin	11.4%	18.1%	(6.7)pts.
Net income	\$511,147	\$625,224*	(18.2)%
Net margin	9.2%	11.1%*	(1.9)pts.
Net income per share - basic	\$0.67	\$0.84*	(20.2)%
Net income per share - diluted	\$0.63	\$0.79*	(20.3)%
Stockholders' equity	\$4,014,053	\$3,451,320	16.3%
Return on average stockholders' equity	13.7%	19.9%*	(6.2)pts.
Stockholders' equity per common share outstanding	\$5.24	\$4.53	15.7%
Revenue passengers carried	64,446,773	63,678,261	1.2%
Revenue passenger miles {RPMs} (000s)	44,493,916	42,215,162	5.4%
Available seat miles {ASMs} (000s)	65,295,290	59,909,965	9.0%
Passenger load factor	68.1%	70.5%	(2.4)pts.
Passenger revenue yield per RPM	12.09¢	12.95¢	(6.6)%
Operating revenue yield per ASM	8.51¢	9.43¢	(9.8)%
Operating expenses per ASM	7.54¢	7.73¢	(2.5)%
Employees at yearend	31,580	29,274	7.9%

*Excludes cumulative effect of change in accounting principle of \$22.1 million (\$.03 per share)

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 2001, Southwest operated 355 Boeing 737 aircraft and provided service to 59 airports in 30 states throughout the United States. Southwest has one of the lowest operating cost structures 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.



TO OUR SHAREHOLDERS:

February 1, 2002

"Are you guys ready? Okay. Let's roll." - Todd Beamer

These heroic words, flung into the macabre face of impending tragedy, were a luminous reflection of the iron character, unquenchable spirit, and inspiring altruism of a noble team leader and player. Todd Beamer's words and actions, in the scarifying context of the horrific events of September 11, helped to galvanize America into a state of "terrible, swift resolve."

The airline industry was shut down on September 11 – and many of our planes, crews, and Customers were required to land, and thereafter stay, in unintended places. Communicating with, and taking care of, those Customers, crews, and aircraft, as well as passengers reserved on flights cancelled, was a herculean task. As the passenger carriers resumed service, reuniting planes and crews "legal to fly" into a coherent passenger schedule was another hugely complex and enormously difficult undertaking. And the FAA and the DOT, reacting swiftly and well to the crisis, were engaged in the process of issuing a veritable cascade of new Security Directives profoundly changing the manner in which Customers, luggage, and airplanes were protected and cleared for flight, thus compelling probably 1,000,000 airline employees to learn, and apply, new security procedures on a daily and, sometimes, hourly basis. Meanwhile, much of our industry was simultaneously and furiously absorbed in: (i) borrowing as much cash as quickly as it could; (ii) deferring or canceling scheduled new aircraft deliveries; (iii) determining how many flights it should cut and how many employees it should lay off, furlough, or put on unpaid leave; (iv) speculating how low its fares might have to be in order to induce passengers to fly, in the aftermath of a devastating terrorist attack occurring in the midst of a recession; and (v) pondering the imponderables of: (a) what new business models it might adopt in radically changed circumstances; (b) the vagaries of Chapter 11 proceedings; and (c) how long its tenuous future might be. For the airline industry, this was not merely Dante's purgatory. It was, indeed, Dante's pure "hell," created in one amazing and tragic day.

Southwest was well poised, financially, to withstand the potentially devastating hammer blow of September 11. Why? Because for several decades our leadership philosophy has been: we manage in good times so that our Company, and our People, can be job secure and prosper through bad times. This philosophy served our People and our Company well during the holocaustic economic catastrophe that afflicted the airline industry from 1990 - 94, when the industry, as a totality, lost a cumulative \$13 billion and furloughed approximately 120,000 of its employees, while, during that same 1990 - 94 period, Southwest remained 100 percent job secure and produced profits and Profitsharing for our Employees and Shareholders. Once again, after September 11, our philosophy of managing in good times so as to do well in bad times proved a marvelous prophylactic for our Employees and our Shareholders:

1. On September 11, Southwest had \$1.0 billion in cash and cash equivalents on hand, enabling us to withstand the severe cash flow drain suffered by all passenger airlines upon recommencement of air service post September 11. Liquidity is good, not bad!
2. On September 11, Southwest had the strongest balance sheet and the highest credit ratings in the American airline industry. As a consequence, we were able to quickly borrow, at reasonable rates, \$1.1 billion in order to ensure that we had enough cash on hand to pay our bills; pay our Employees; fund our Employee Profitsharing commitments; make contractually obligated capital expenditures; and guarantee the longevity of our Company and, thus, of our People's livelihoods. A conservative balance sheet and high credit ratings are good, not bad!
3. On September 11, Southwest had the lowest cost per Available Seat Mile (ASM) flown of any major passenger air carrier. In the sparse ridership, very low-fare airline industry environment subsequent to September 11, our low costs enabled us to compete effectively by offering extremely low fares, while simultaneously reestablishing a positive cash flow (more cash coming in than going out) and, ultimately, even fourth quarter 2001 profitability. Low costs for producing an ASM are good, not bad!

On September 11, our Company had the financial wherewithal to withstand and overcome the dire economic emergency with which it, and our nation, were threatened. But what about our Southwest People, as a whole? How would they respond in an atmosphere of incredulity, fear, sadness, uncertainty, and grave economic jeopardy for themselves and their Company? Here is how they responded:

"Are you guys ready? Okay. LET'S ROLL."

While still grieving over the events and losses of September 11, our People returned to work with tears in their eyes but resolve in their hearts. They speedily reassembled our airline, after it had been shut down, and got it flowing smoothly again. In a national and Company emergency, they put aside petty complaints and miniscule concerns and both learned, and endured, the multitude of complicated new security measures and procedures mandated by our federal government. And despite the stress and strain of the post September 11 airline industry environment, they smiled, and cared, for their internal and external Customers, while providing superb Customer Service in their usual spirited, joyful, open, warm-hearted, and humanitarian way.



The combination of farsighted, rather than nearsighted, Company philosophies and policies and of the Southwest People, who are strong, resolved, dedicated, empathetic, resilient, and also farsighted, rather than nearsighted, in their thoughts and actions, brought about the following proud results for Southwest in the post September 11 period:

1. Southwest operated 100 percent of its aircraft capacity and provided 100 percent job security, with no loss of pay for its People from layoffs, furloughs, or unpaid leaves and with no fear by its People of having to reduce their pay or benefits;
2. Southwest was able to fund its year 2000 Employee Profitsharing and fourth quarter 2001 Employee savings plan obligations in the amount of \$197.5 million;
3. Southwest inaugurated service to Southern Virginia through Norfolk;
4. Southwest announced additional nonstop service between the following cities, utilizing two previously deferred new aircraft deliveries: Baltimore/Washington to Manchester, Orlando, and Ft. Lauderdale; and Long Island/Islip to Orlando and Ft. Lauderdale;
5. Southwest prepared to implement its first nonstop flights between Chicago's Midway Airport and both Seattle and Oakland, utilizing four previously deferred new aircraft deliveries;
6. Year over year, Southwest's fourth quarter 2001 ASM capacity increased by 6.4 percent;
7. Southwest's Revenue Passenger Mile (RPM) share of the U.S. domestic air passenger market increased by about 2.0 percent in fourth quarter 2001;
8. Excluding fuel costs (which dropped) and despite greatly increased expenses for added security measures and insurance coverage, Southwest reduced its fourth quarter operating expenses per ASM by 2.5 percent;
9. Southwest reported a profit of \$511.1 million for the year 2001 (including federal grants and special charges) or \$412.9 million (excluding federal grants, special charges, and their related effects), and amended its Profitsharing Plan in order to pay all of its qualified Employees Profitsharing calculated on the higher (\$511.1 million), rather than the lower (\$412.9 million), profit figure;
10. Southwest actually reported a profit of \$63.5 million for fourth quarter 2001 (including federal grants and special charges) or \$32.4 million (excluding federal grants, special charges, and their related effects); and
11. Based upon all of the above occurrences and the market's concomitant faith in a prosperous future for Southwest Airlines, the price of our stock rose, rather than fell, subsequent to September 11.

Including federal grants and special charges, our annual net income declined 18.2 percent to \$511.1 million in 2001 (before the cumulative effect of a change in accounting principle in 2000), and excluding such grants, charges, and their related effects, our net income declined 34.0 percent to \$412.9 million. Seldom does such a significant decline in earnings provide cause for rejoicing on the part of Employees and Shareholders, but, in the case of 2001, it both does and should. Including federal grants and special charges, the other major carriers lost a cumulative total of \$7.8 billion in all of 2001 and a cumulative total of \$3.3 billion in fourth quarter 2001 alone, reputedly also "furloughing" up to 100,000 employees without pay.

The year 2002 will, in the words of Winston Churchill, demand the expenditure of "blood, toil, tears, and sweat" as our airline and our nation endeavor to recover from the heartrending catastrophe of September 11, which also deepened an already existing domestic economic recession and resulted in the imposition of additional security costs upon our industry as well as enhanced airport processing time upon our industry's Customers.

We are prepared, and our valorous, good-hearted, and united People are determined that, together, as one, we shall overcome any obstacle and conquer every adversity, and that our magnificent Canyon Blue Boeings will fly at the forefront of our industry as it recovers from the ravages of 2001.

For 2002, our wonderful People's brave hearts will be both informed and inspired by Todd Beamer's brave words – and his devotion to the concept of duty with honor:

"LET'S ROLL."

Most sincerely,

Herbert D. Kelleher
Chairman of the Board



James F. Parker
Vice Chairman of the Board
and Chief Executive Officer



Colleen C. Barrett
President and
Chief Operating Officer





BE PREPARED!

This motto is a governing principle of Southwest Airlines.

The way we put it is this: We manage in good times so that our Employees (many of whom are our Shareholders) and our Shareholders (many of whom are our Employees) will do well in bad times.

Throughout the Arab oil embargo of 1973 and its aftereffects, the sharp spike in jet fuel prices in 1979 - 1980, the recession of the early 1980s, the airline industry "depression" of 1990 - 1994, and the recession and terrorist-plagued year of 2001:

1. Southwest has provided total job security, with no unpaid furloughs or reductions in pay and benefits, for its Employees;
2. Southwest has expanded its fleet and the amount of service it provides, furnishing new jobs for new hires and enhanced seniority and the opportunity to move both around and up to its existing Employees;
3. Southwest has provided Profitsharing and funded 401(k) plans for its Employees; and
4. Southwest's earnings have consistently followed a rising trend, propelling our stock price and total market value upward for the benefit of our Shareholders (many of whom are our Employees).

The airline business is capital intensive (e.g., year 2001 Southwest expenditures for equipment and property - \$1.0 billion); fuel intensive (e.g., year 2001 Southwest expenses for fuel and oil - \$770 million); People intensive (e.g., year 2001 Southwest expenses for salaries, wages, and benefits - \$1.9 billion); and intensely cyclical (e.g., airline industry losses 1990 - 1994 - \$13.0 billion; airline industry loss 2001 - \$7.3 billion, after receipt of government grants). It is widely stated that in the 98 years since the Wright brothers flew their first flight, the commercial passenger airline industry has, in the aggregate, produced a net loss, rather than a net profit. During that same 98-year period, innumerable airlines have ceased operations and perished, causing millions of people to lose their jobs.

In a business long noted among analysts and economists for its financial misfortunes and frequent vicissitudes, Southwest, which flew its first full year in 1972, has achieved:

1. Twenty-nine consecutive years of profitability and Profitsharing, while expanding our ASMs flown by 24,651 percent (a record unmatched in the history of the airline industry);
2. Thirty consecutive years of 100 percent job security while the number of our Employees has grown from 183 to 31,580 (a record unmatched in the history of the airline industry);
3. An increase in the market value of our stock (of which our Employees, as a group, are the largest owners) of 138,656 percent (a record unmatched in the history of the airline industry); and
4. Year in and year out, the best Customer Satisfaction statistics (a record unmatched in the history of the airline industry).

How was Southwest able to achieve these admirable and unprecedented airline industry records for the benefit of our People (many of whom are our Shareholders), our Shareholders (many of whom are our People), and the American public? By adhering to the motto:

BE PREPARED!

On September 11, Southwest had the lowest cost per available seat mile of any of the major air carriers; the strongest balance sheet in the American airline industry; plenty of cash on hand; ample credit available; and the strongest, most resilient, adaptable, united, Customer-focused, and willing Employees in the airline industry.

Southwest was prepared and, once again, that preparedness protected our Employees' jobs, livelihoods, benefits, and Profitsharing; that preparedness protected the investments of our Shareholders (including Employee Shareholders) in Southwest's stock; and that preparedness protected the American traveler as Southwest continued to operate 100 percent of its flights post September 11.

Economic crises in the American airline industry occur at least once per decade. They always have and they always will. The analysts and the economists are correct - the airline business, as a whole, is fraught with economic peril. It always has been, and it always will be.

Southwest has surmounted each such crisis during the past 30 years by being prepared for it. We pledge to our Employees and to our Shareholders that, for their benefit, their continued wellbeing, and their secure, prosperous futures, we will always:

BE PREPARED!



LOW-FARE COMMITMENT.

America's freedom was threatened on September 11, 2001. However, Southwest's resolve to Keep America Flying has not changed. We have been successful over the past 30 years because we have not strayed from our commitment to offer affordable fares and high-quality Customer Service. Southwest provides 90 percent of the low-fare competition in the U.S. and our fares are consistently the lowest and simplest in the domestic airline industry. We keep our fares low which, in turn, gives our Customers the Freedom to Fly.

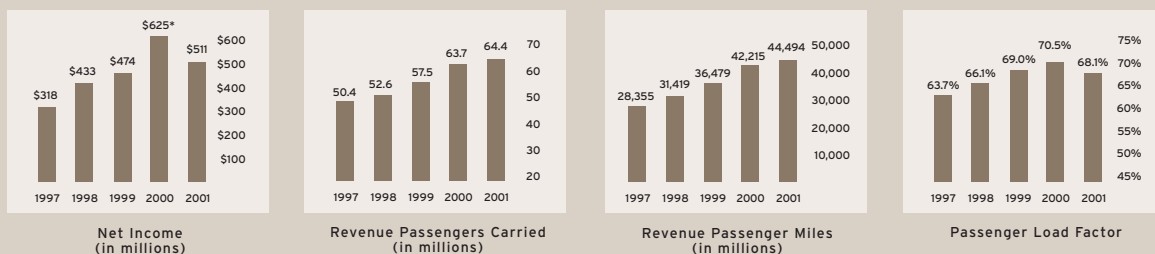
We have been profitable for 29 consecutive years and were the only U.S. major carrier to post a profit, with or without the federal grant, during the fourth quarter 2001 and for the full year 2001. We have a proven and flexible business model, which allows us to generate ample profits even though we offer low fares. Of course, the secret is low costs, and the key ingredients to our low-cost formula are our unique operating strategy and our amazing Culture.

Southwest has been able to continually achieve the highest productivity of any major U.S. airline, and, therefore, the lowest cost of any major U.S. airline. One of the primary reasons for our productivity advantage is our dedication to the low-fare, point-to-point market niche. This market focus allows us to operate a single aircraft type, the Boeing 737, which significantly simplifies scheduling, operations, and maintenance and, thus, minimizes costs. Southwest also has a very effective and efficient distribution system with over 45 percent of our revenue currently being generated through our award-winning web site at southwest.com. Our web site is easy to use and provides one-stop travel convenience for our Customers. Over 85 percent of our seats sold in 2001 were Ticketless, which eliminates significant processing costs. We offer the most generous frequent flyer program, which was designed to reward our Customers based on trips rather than miles. After purchasing and flying only eight roundtrips on Southwest, Customers receive a roundtrip ticket, good for travel anywhere on our system for up to a year.

We schedule our aircraft on a point-to-point, not hub-and-spoke, basis and focus on local, not through or connecting, traffic. As a result, over 70 percent of our Customers fly nonstop. Our point-to-point route system, as compared to hub-and-spoke, provides for more direct nonstop routings for our Customers and, therefore, minimizes stops, connections, delays and total trip time. We serve many conveniently located satellite or downtown airports such as Baltimore/Washington, Chicago Midway, Dallas Love Field, Houston Hobby, Long Island/Islip, Oakland, and Providence. Although we have successful operations at major hub airports such as Los Angeles (LAX), we prefer, if possible, to avoid congested hub airports, which enhances our ability to sustain high productivity and reliable ontime performance.

We schedule our aircraft to minimize the amount of time at the gate, which is why we continually achieve the highest aircraft utilization and Employee productivity of any major U.S. airline. Because our aircraft are generally at the gate less than 25 minutes, we require fewer aircraft and gate facilities than otherwise would be needed.

Although we have experienced higher costs in certain areas due to the events of September 11, we managed to achieve our low-cost objective in fourth quarter 2001 through lower fuel costs and our companywide cost reduction efforts. Among other things, Southwest recently changed its travel agency policy to pay commissions of five percent (with no cap). Although lower fuel costs contributed to our decline in unit costs for both fourth quarter and full year 2001, our Employees also reduced our unit costs, excluding fuel, by 2.5 percent in fourth quarter 2001, despite significant increases in security and insurance costs. This is a remarkable feat for our Employees and a testament to our desire to keep fares low and America Flying.



*Excludes cumulative effect of change in accounting principle of \$22.1 million (\$.03 per share)



Although enhanced security measures have not diminished our aircraft productivity or ontime performance, they have resulted in longer checkin lines, at times, for our Customers. We understand how important convenience is to all of our Customers and we have been working tirelessly to reduce wait times. We have made significant facility changes (where possible); have added new screening devices; and are hiring Employees to help our Customers with the new security procedures. As a result, we have been able to streamline Customer processing and have already seen a reduction in Customer lines. Although this remains a challenge, we are committed to meeting the challenge as we continue to explore new methods and technology that will, hopefully, continue this positive trend. We will also work diligently with the federal government as it begins assuming responsibility for airport security on February 17, 2002.

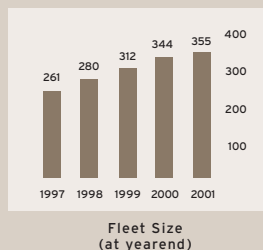
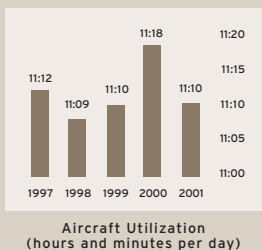
Although this change will undoubtedly present new challenges, Southwest has demonstrated that our Employees are adaptable to change and our business strategy is flexible under difficult operating conditions. Following September 11, our Employees quickly restored operations, operating our normal full schedule of approximately 2,800 daily flights with exceptional ontime performance and reliability. For the year 2001, Southwest had the best Ontime Performance and Highest Customer Satisfaction record of all major airlines, based on statistics published in Department of Transportation consumer reports.

Our business strategy has served us well during what has been the most difficult period in airline history. And while we are proud of our progress since September 11, we will continue to work hard to improve Customer convenience and maintain our low costs so that we can continue to bring the Freedom to Fly to America for many generations to come.

MOVING AHEAD.

As we, along with our nation, continue to recover from September 11, we are prepared to move ahead. We took a number of significant steps immediately following the terrorist attacks to stabilize cash and protect our strong financial position. As a result of the extraordinary efforts of our Employees, we quickly restored operations with exceptional ontime performance and reliability. Although demand for air travel dramatically declined following the terrorist attacks, we chose not to reduce our total flights or postpone our new Norfolk, Virginia, service. This decision protected our 30-year history of complete job security for our Employees and now places Southwest in a competitively strong position as we move ahead. To preserve cash following the terrorist attacks, we temporarily deferred placing new aircraft deliveries into service, and with The Boeing Company's greatly appreciated cooperation, we arranged for a preferred new aircraft delivery schedule (as set forth in the accompanying table).

Although we are still in a recovery mode, we believe our overall performance has been strong enough to begin cautiously resuming our growth plans. In February, we will add flights between the following cities, utilizing two previously deferred aircraft deliveries: Baltimore/Washington to Manchester, Orlando, and Ft. Lauderdale; and Long Island/Islip to Orlando and Ft. Lauderdale. In addition, we accelerated delivery of four more previously deferred aircraft into March and April to initiate our first nonstop flights between Chicago's Midway Airport and both Seattle and Oakland. We will also add an additional flight between Chicago Midway and Phoenix in March.



Type	2002	2003	2004	2005	2006	2007	2008	2009-2012	Total
Firm Orders	11	21	23	24	22	25	6	-	132
Options	-	-	13	20	20	9	25	-	87
Purchase Rights	-	-	-	-	-	20	20	177	217
Total	11	21	36	44	42	54	51	177	436

Boeing 737-700 Firm Orders and Options



Including these six aircraft, we will have accepted delivery of nine of the 11 737-700 aircraft scheduled for delivery in 2002. We will retire three older 737-200s in 2002, which results in a minimum capacity increase of 3.5 percent for the year. In total, the number of firm orders, purchase rights, and options, through 2012, of 436 (including 2002) remains unchanged from pre-September 11. Also we have the flexibility to accelerate delivery of up to eight of the 2003 deliveries into 2002. As we phase out our older 737-200 aircraft from our all-Boeing 737 fleet, we plan to retire the remaining 27 -200s by the end of 2005. All of our new Boeing 737s will be delivered in our new "Canyon Blue" exterior color scheme and "Saddle Tan" all-leather seating configuration to symbolize our renewed 30-year commitment to provide the Freedom to Fly to America.

As the economy recovers and America continues to return to the skies, we are well-positioned both competitively and financially to take advantage of growth opportunities as they arise. At yearend, we served 58 cities (59 airports) in 30 states and provided less than ten percent of total domestic capacity. Due to the devastating events of September 11, we do not currently plan to add any new cities to our route system for 2002. However, as the economy recovers and overall air travel demand returns, we believe there will be ample opportunities to add new markets over the longer term. In addition, we continue to have numerous expansion opportunities within our current route system, which now spans from coast to coast. In fact, for the past several years, roughly 75 percent of our aircraft additions were deployed in our existing system by adding frequencies between markets already served and by providing new nonstop service in existing markets.

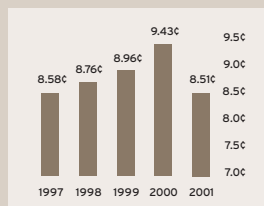
Our capacity is spread throughout the U.S., with 45 percent in the West; 27 percent in the East; 15 percent in the Midwest; and 13 percent in the Heartland region (Texas and surrounding states). As a result, we have a diverse revenue base, with an average of 47 departures per airport. Our low fares generate substantial demand, which allows us to offer lots of convenient flights. For example, our top ten cities' daily departures are currently Phoenix, 183; Las Vegas, 170; Houston Hobby, 143; Baltimore/Washington, 134; Dallas Love Field, 131; Oakland, 120; Chicago Midway, 119; Los Angeles (LAX), 114; Nashville, 87; and San Diego, 77.

While our new city focus over the past few years has been in the eastern region of the U.S., we have numerous expansion opportunities in our more mature regions, as evidenced by our upcoming additions from Chicago's Midway Airport. As a result of the combination of our low fares, high frequencies, convenience, and high-quality Customer Service, Southwest tends to dominate the majority of the markets it serves. Southwest consistently ranks first in market share in approximately 80 to 90 percent of our top 100 city pairs and, in the aggregate, holds 60 to 65 percent of total market share in those markets. Based on the most recent second quarter 2001 Department of Transportation data available, Southwest held 73 percent of the total intra-Texas market; intra-California, 59 percent; intra-Florida, 52 percent; Baltimore, 36 percent; Las Vegas, 34 percent; and Phoenix, 33 percent. Southwest also carries the most passengers in the top 100 U.S. markets despite serving only 42 of them.

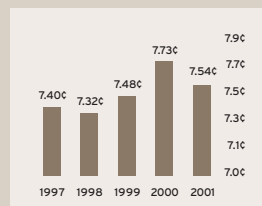
While the economic impact of September 11 was devastating for the airline industry as a whole, Southwest was financially well-prepared and is able to move ahead from a relative position of strength. Our commitment to bring low fares to people across America is stronger than ever and numerous opportunities to accelerate our growth currently exist. We will add incremental aircraft capacity in a manner that does not jeopardize our financial stability and safety, nor impair our excellent Customer Service record.



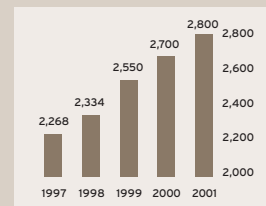
Operating Revenue (in millions)



Operating Revenues Per Available Seat Mile



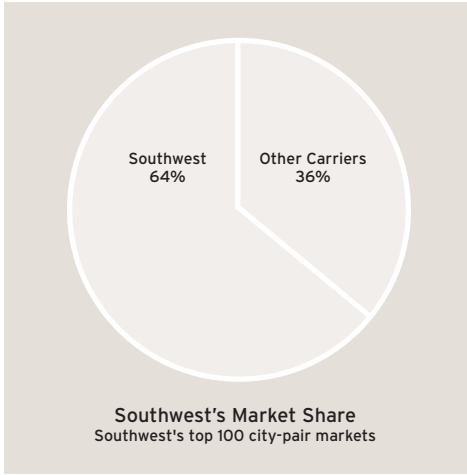
Operating Expenses Per Available Seat Mile



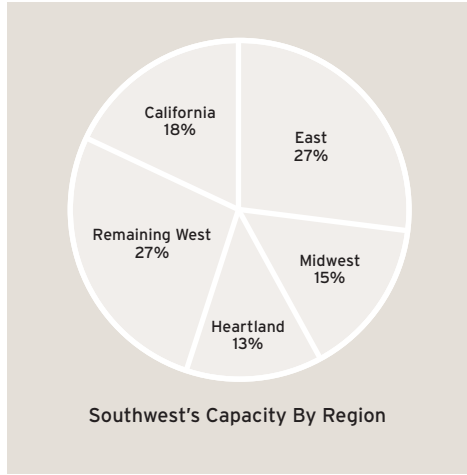
Average Daily Departures



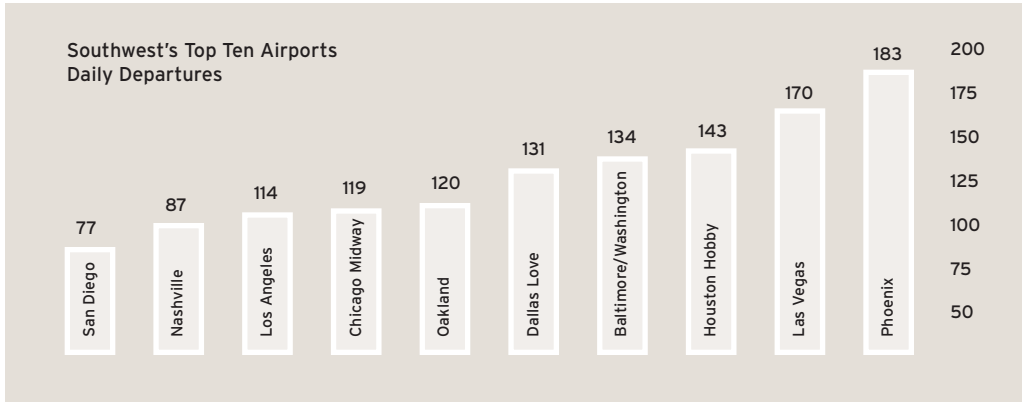
Southwest System Map



Southwest's Market Share
Southwest's top 100 city-pair markets



Southwest's Capacity By Region



Southwest's Top Ten Airports
Daily Departures



SOUTHWEST AIRLINES CO. 2001 ANNUAL REPORT FINANCIAL REVIEW

Management's Discussion and Analysis	F2
Consolidated Financial Statements	F8
Notes to Consolidated Financial Statements	F12
Report of Independent Auditors	F20
Quarterly Financial Data	F21
Common Stock Price Ranges and Dividends	F21
Ten-Year Summary	F22
Corporate Data	F24
Directors and Officers	F24



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

YEAR IN REVIEW

In 2001, Southwest posted a profit for the 29th consecutive year in one of the most challenging operating environments the air travel industry has ever faced. During the year, Southwest also increased our domestic market share, made enhancements that will improve our Customer Service, and ended the year with more Employees and aircraft than we had when we began the year. Despite the onset of a recession early in 2001 and the September 11, 2001, terrorist attacks against the United States (the terrorist attacks), Southwest was profitable in each quarter of the year, including the third and fourth quarters after excluding federal grants recognized in these quarters under the Air Transportation Safety and System Stabilization Act (the Act). (See Note 3 to the Consolidated Financial Statements for further details on the terrorist attacks and the Act.) Although we were unable to match some of the Company's record-setting performance levels reached in 2000, our business strategy – primarily shorthaul, high frequency, low-fare, point-to-point, high-quality Customer Service – continued to serve us well during some difficult times in 2001.

In 2001, we continued to maintain our cost advantage over our industry while the recession and events of September 11 put downward pressure on revenues. In response to uncertainties following September 11 and the precipitous drop in demand for air travel, Southwest amended its agreement with The Boeing Company to defer aircraft deliveries (see Note 4 to the Consolidated Financial Statements) but did not ground airplanes, reduce service, or furlough Employees. Following the temporary FAA shutdown of U.S. air space after the terrorist attacks, load factors have steadily improved to somewhat normal, average historical levels. However, these load factors have resulted from significant fare discounting, which continues to result in year-over-year declines in passenger revenue yields per RPM (passenger yields) and operating revenue yields per ASM.

As we begin 2002, in addition to the difficult revenue environment for commercial airlines, the Company is faced with increased war risk insurance and passenger security costs resulting from continually evolving security laws and directives. In response to the terrorist attacks, the airline industry has worked diligently with Congress, the DOT, the FAA, and law enforcement officials to enhance security. During fourth quarter 2001, the Company was able to offset these additional costs because of lower jet fuel prices and through internal cost reduction initiatives implemented following the terrorist attacks. However, there can be no assurance the Company will be able to continue to offset future cost increases resulting from the changing commercial airline environment. (The immediately preceding sentence is a forward-looking statement that involves uncertainties that could result in actual results differing materially from expected results. Some significant factors include, but may not be limited to, additional laws or directives that could increase the Company's costs or result in changes to the Company's operations, etc.)

During 2001, we began service to two new cities, West Palm Beach, Florida, and Norfolk, Virginia, while also discontinuing service to San Francisco International Airport due to airport congestion. We have been pleased with the initial results in both of the new Southwest cities. Prior to September 11, the Company also continued to add flights between cities already served. Southwest ended 2001 serving 58 cities in 30 states. Immediately following the terrorist attacks, Southwest suspended fleet growth. However, by the end of the year, Southwest had announced plans for modest growth to resume in early 2002.

Currently, available seat mile (ASM) capacity is expected to grow approximately 3.5 percent in 2002 with the planned net addition of at least eight aircraft. The Company will place in service at least 11 new Boeing 737-700s scheduled for delivery during the year and will retire three of the Company's older 737-200s. (The immediately preceding sentences are forward-looking statements that involve uncertainties that could result in actual results differing materially from expected results. Some significant factors include, but may not be limited to, future capacity decisions made by the Company, demand for air travel, changes in the Company's aircraft retirement schedule, etc.)

RESULTS OF OPERATIONS

2001 COMPARED WITH 2000 The Company's consolidated net income for 2001 was \$511.1 million (\$.63 per share, diluted), as compared to 2000 net income, before the cumulative effect of change in accounting principle, of \$625.2 million (\$.79 per share, diluted), a decrease of 18.2 percent. The prior years' net income per share amounts have been restated for the 2001 three-for-two stock split (see Note 11 to the Consolidated Financial Statements). Consolidated results for 2001 included \$235 million in gains that the Company recognized from grants under the Act and special pre-tax charges of approximately \$48 million arising from the terrorist attacks (see Note 3 to the Consolidated Financial Statements). Excluding the grant and special charges related to the terrorist attacks, net income for 2001 was \$412.9 million (\$.51 per share, diluted). The cumulative effect of change in accounting principle for 2000 was \$22.1 million, net of taxes of \$14.0 million (see Note 2 to the Consolidated Financial Statements). Net income and net income per share, diluted, after the cumulative change in accounting principle, for 2000 were \$603.1 million and \$.76, respectively. Operating income for 2001 was \$631.1 million, a decrease of 38.2 percent compared to 2000.

Following the terrorist attacks, all U.S. commercial flight operations were suspended for approximately three days. However, the Company continued to incur nearly all of its normal operating expenses (with the exception of certain direct trip-related expenditures such as fuel, landing fees, etc.). The Company cancelled approximately 9,000 flights before resuming flight operations on September 14, although we did not resume our normal pre-September 11 flight schedule until September 18, 2001. Once the Company did resume operations, load factors and passenger yields were severely impacted, and ticket refund activity increased. The Company estimates that from September 11 through September 30, it incurred operating losses in excess of \$130 million.

The effects of the terrorist attacks continued to be felt throughout fourth quarter 2001. The Company's operating income during fourth quarter 2001 was \$37.1 million, a decrease of 85.2 percent compared to fourth quarter 2000. Without consideration of any federal grant under the Act the Company expects to recognize (see Note 3 to the Consolidated Financial Statements), it is not yet known whether the Company will be profitable in first quarter 2002, due to uncertain economic conditions and the difficult airline industry revenue environment.

OPERATING REVENUES Consolidated operating revenues decreased 1.7 percent primarily due to a 1.6 percent decrease in passenger revenues. The decrease in passenger revenues was a direct result of the terrorist attacks. Because of the terrorist attacks, fluctuations in passenger revenue can best be explained by discussing the year in two distinct time periods: January through August 2001, and September through December 2001.

From January through August 2001, passenger revenues were approximately 8.7 percent higher than the same period in 2000 due



primarily to an increase in capacity, as measured by ASMs, of 11.6 percent. The capacity increase was due to the addition of 14 aircraft during 2001 (all prior to September 11) and was partially offset by a decrease of 1.9 percent in passenger yield. Passenger yields decreased as a result of fare discounting by the Company and the airline industry in general as the United States economy weakened throughout the year. The Company's load factor (RPMs divided by ASMs) over this time period was 71.2 percent, compared to 71.7 percent for the same period in 2000.

From September through December 2001, passenger revenues were approximately 21.7 percent lower than the same period of 2000. Capacity increased 4.0 percent and the Company's load factor fell to 62.0 percent, compared to 68.2 percent during the same period of 2000. Passenger yields were 17.2 percent lower during this period versus the same period of 2000 due to aggressive fare sales following the terrorist attacks.

For the full year, the Company experienced a 1.2 percent increase in revenue passengers carried, a 5.4 percent increase in revenue passenger miles (RPMs), and a 9.0 percent increase in ASMs. The Company's load factor for 2001 was off 2.4 points to 68.1 percent and there was a 6.6 percent decrease in 2001 passenger yield.

Load factors in January 2002 continued to trail those experienced in January 2001. Additionally, passenger yields remain significantly below prior year levels. As a result, the Company expects first quarter 2002 revenue per available seat mile to continue to fall below first quarter 2001 levels. (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, additional incidents that could cause the public to question the safety and/or efficiency of air travel, competitive pressure such as fare sales and capacity changes by other carriers, general economic conditions, operational disruptions as a result of bad weather, the impact of labor issues, and variations in advance booking trends.) See Note 1 to the Consolidated Financial Statements for further information on the Company's revenue recognition policy.

As a result of weak economic conditions throughout 2001, consolidated freight revenues decreased 17.6 percent. There were decreases in both the number of freight shipments and revenue per shipment. Following the September 11, 2001, terrorist attacks, the United States Postal Service made the decision to shift a portion of the mail that commercial carriers had previously carried to freight carriers. As a result of this decision, the Company expects to experience a decrease in freight revenues during at least the first half of 2002 when compared to 2001. (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, general economic conditions, subsequent shifts in business by the United States Postal Service, and capacity changes by other carriers.) Other revenues increased 20.3 percent primarily due to an increase in commissions earned from programs the Company sponsors with certain business partners, such as the Company-sponsored First USA Visa card.

OPERATING EXPENSES Consolidated operating expenses for 2001 increased 6.4 percent, compared to the 9.0 percent increase in capacity. Operating expenses per ASM decreased 2.5 percent to \$.0754, compared to \$.0773 in 2000, primarily due to a decrease in average jet fuel prices. The average fuel cost per gallon in 2001 was \$.7086, 10.0 percent lower than the average cost per gallon in 2000 of \$.7869. Excluding fuel expense, operating expenses per ASM decreased .3 percent.

Operating expenses per ASM for 2001 and 2000 were as follows:

OPERATING EXPENSES PER ASM

	2001	2000	INCREASE (DECREASE)	PERCENT CHANGE
Salaries, wages, and benefits	2.51¢	2.41¢	.10¢	4.1%
Employee retirement plans	.33	.40	(.07)	(17.5)
Fuel and oil	1.18	1.34	(.16)	(11.9)
Maintenance materials and repairs	.61	.63	(.02)	(3.2)
Agency commissions	.16	.27	(.11)	(40.7)
Aircraft rentals	.29	.33	(.04)	(12.1)
Landing fees and other rentals	.48	.44	.04	9.1
Depreciation	.49	.47	.02	4.3
Other	1.49	1.44	.05	3.5
Total	7.54¢	7.73¢	(.19)¢	(2.5)%

Approximately 59 percent of the increase in Salaries, wages, and benefits per ASM was due to increases in salaries and wages from higher average wage rates within certain workgroups and increased headcount due, in part, to the increased security requirements following the September terrorist attacks. The remaining 41 percent of the increase in Salaries, wages, and benefits per ASM was due to higher benefits costs, primarily health care.

The Company's Ramp, Operations, and Provisioning Agents are subject to an agreement with the Transport Workers Union of America (TWU), which became amendable in December 2000. The Company reached an agreement with the TWU, which was ratified by its membership in June 2001. The new contract becomes amendable in June 2006.

The Company's Mechanics are subject to an agreement with the International Brotherhood of Teamsters (the Teamsters), which became amendable in August 2001. Southwest is currently in negotiations with the Teamsters for a new contract.

The Company's Flight Attendants are subject to an agreement with the TWU, which becomes amendable in June 2002. The Company's Customer Service and Reservations Agents are subject to an agreement with the International Association of Machinists and Aerospace Workers, which becomes amendable in November 2002.

Employee retirement plans expense per ASM decreased 17.5 percent, primarily due to the decrease in Company earnings available for profitsharing. The decrease in earnings more than offset an increase in expense due to a fourth quarter amendment made to the Company's profitsharing plan. This amendment enabled the Company to take into consideration federal grants under the Act and special charges resulting from the terrorist attacks in the calculation of profitsharing.

Fuel and oil expense per ASM decreased 11.9 percent, primarily due to a 10.0 percent decrease in the average jet fuel cost per gallon. The average cost per gallon of jet fuel in 2001 was \$.7086 compared to \$.7869 in 2000, including the effects of hedging activities. The Company's 2001 and 2000 average jet fuel prices are net of



approximately \$79.9 million and \$113.5 million in gains from hedging activities, respectively. The Company's 2001 hedging gains were calculated according to the requirements of Statement of Financial Accounting Standards No. 133, as amended (SFAS 133), which the Company adopted January 1, 2001. See Note 2 and Note 9 to the Consolidated Financial Statements. As detailed in Note 9 to the Consolidated Financial Statements, the Company has hedges in place for approximately 60 percent of its anticipated fuel consumption in 2002. Considering current market prices and the continued effectiveness of the Company's fuel hedges, we are forecasting our first quarter 2002 average fuel cost per gallon to be below first quarter 2001's average fuel cost per gallon of \$.7853. The majority of the Company's near term hedge positions are in the form of option contracts, which should enable the Company to continue to benefit to a large extent from a decline in jet fuel prices. (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, the continued effectiveness of the Company's fuel hedges, and changes in the Company's overall fuel hedging strategy.)

Maintenance materials and repairs per ASM decreased 3.2 percent. This decrease was primarily due to the Company's capacity growth exceeding the increase in expense. Virtually all of the Company's 2001 capacity growth versus the prior year was accomplished with new aircraft, most of which have not yet begun to incur any meaningful repair costs. The decrease in engine expense was partially offset by an increase in expense for airframe inspections and repairs. In addition to an increase in the number of airframe inspections and repairs, the cost per event increased compared to 2000. Currently, the Company expects an increase in maintenance materials and repairs expense per ASM in first quarter 2002 versus first quarter 2001. (The immediately preceding sentence is a forward-looking statement involving uncertainties that could result in actual results differing materially from expected results. Such uncertainties include, but may not be limited to, any unscheduled required aircraft airframe or engine repairs and regulatory requirements.)

Agency commissions per ASM decreased 40.7 percent, primarily due to a change in the Company's commission rate policy. Effective January 1, 2001, the Company reduced the commission rate paid to travel agents from ten percent to eight percent for Ticketless bookings, and from ten percent to five percent for paper ticket bookings. Effective October 15, 2001, the Company reduced the commission paid to travel agents to five percent (with no cap), regardless of the type of ticket sold. Due to this most recent commission policy change in October 2001, we expect agency commissions to show a year-over-year decrease in first quarter 2002 on a per-ASM basis. (The immediately preceding sentence is a forward-looking statement involving uncertainties that could result in actual results differing materially from expected results. Such uncertainties include, but may not be limited to, changes in consumer ticket purchasing habits.)

Aircraft rentals per ASM decreased 12.1 percent primarily due to a lower percentage of the aircraft fleet being leased. Approximately 25.9 percent of the Company's aircraft were under operating lease at December 31, 2001, compared to 27.3 percent at December 31, 2000. Based on the Company's current new aircraft delivery schedule and scheduled aircraft retirements for 2001, we expect a decline in aircraft rental expense per ASM in 2002. (The immediately preceding sentence is a forward-looking statement involving uncertainties that could result in actual results differing materially from expected results. Such uncertainties include, but may not be limited to, changes in the Company's current schedule for purchase and/or retirement of aircraft.)

Landing fees and other rentals per ASM increased 9.1 percent primarily as a result of the Company's expansion of facilities at several airports, including Baltimore/Washington International Airport and Chicago Midway Airport. As a result of the terrorist attacks, most other major airlines have reduced their flight schedules and/or have retired aircraft early due to the decrease in demand for air travel. Since Southwest has not reduced the number of flights it offers, the Company expects that the airport costs it shares with other airlines on the basis of relative flights landed or passengers carried, such as landing fees and common space rentals, will increase on a per-ASM basis in future periods. In fourth quarter 2001, landing fees and other rentals per ASM increased 21.4 percent. The Company currently expects a similar year-over-year increase in first quarter 2002. (The immediately preceding sentence is a forward-looking statement involving uncertainties that could result in actual results differing materially from expected results. Such uncertainties include, but may not be limited to, changes in competitors' flight schedules, demand for air travel, etc.)

Depreciation expense per ASM increased 4.3 percent primarily due to the growth in the Company's aircraft fleet prior to the September 11, 2001, terrorist attacks. The Company had received delivery of 14 new 737-700 aircraft prior to September 11, bringing the percentage of owned aircraft in the Company's fleet to 74.1 percent by the end of 2001 compared to 72.7 percent at the end of 2000.

Other operating expenses per ASM increased 3.5 percent primarily due to a significant increase in passenger liability, aircraft hull, and third-party liability insurance costs following the terrorist attacks. The Company's insurance carriers cancelled their war risk and terrorism insurance policies following the terrorist attacks and reinstated such coverage at significantly higher rates than before. Although the Company was reimbursed for a portion of the higher rates by the federal government for one month during fourth quarter 2001, we have assumed no further reimbursements. As a result, the Company currently expects continued year-over-year increases in insurance costs for the near future, including first quarter 2002. (The immediately preceding sentence is a forward-looking statement involving uncertainties that could result in actual results differing materially from expected results. Such uncertainties include, but may not be limited to, the financial stability of companies offering insurance policies to the airline industry, the level of competition within the insurance industry, etc.)

OTHER "Other expenses (income)" included interest expense, capitalized interest, interest income, and other gains and losses. Interest expense was flat compared to the prior year. Following the terrorist attacks, the Company borrowed the full \$475 million available under its revolving credit facility and issued \$614.3 million in long-term debt in the form of Pass-Through Certificates (see Note 7 to the Consolidated Financial Statements). The increase in expense caused by these borrowings was offset by a decrease in interest rates on the Company's floating rate debt and the July 2001 redemption of \$100 million of unsecured notes. Based on the Company's recent borrowings, we expect interest expense to be higher on a year-over-year basis in first quarter 2002. (The immediately preceding sentence is a forward-looking statement involving uncertainties that could result in actual results differing materially from expected results. Such uncertainties include, but may not be limited to, subsequent financing decisions made by the Company.) Capitalized interest decreased 25.3 percent primarily as a result of lower 2001 progress payment balances for scheduled future aircraft deliveries compared to 2000. The lower progress payments were due in part to the deferral of Boeing 737 aircraft



firm orders and options following the terrorist attacks. Interest income increased 6.2 percent primarily due to higher invested cash balances, partially offset by lower rates of return. Other gains in 2001 primarily resulted from \$235 million received as the Company's share of government grant funds under the Act provided to offset the Company's direct and incremental losses following the terrorist attacks through the end of 2001. The Company expects to receive up to an additional \$50 million in 2002, but determined that due to some uncertainties regarding the amount to be received, accrual of any amounts in 2001 as a receivable was not proper. (The immediately preceding sentence is a forward-looking statement involving uncertainties that could result in actual results differing materially from expected results. Such uncertainties include, but may not be limited to, subsequent modifications or amendments to the Act, interpretations of the meaning of direct and incremental losses, and changes in the government's expected schedule of distributing grant funds, etc.) See Note 3 to the Company's Consolidated Financial Statements for further discussion of the Act and grants from the government.

INCOME TAXES The provision for income taxes, as a percentage of income before taxes, decreased slightly to 38.24 percent in 2001 from 38.54 percent in 2000. The decrease primarily resulted from lower effective state tax rates in 2001.

2000 COMPARED WITH 1999 The Company's consolidated net income for 2000 before the cumulative effect of a change in accounting principle was \$625.2 million (\$.79 per share, diluted), an increase of 31.8 percent. The cumulative change in accounting principle, related to the adoption of SEC Staff Accounting Bulletin No. 101, was \$22.1 million, net of taxes of \$14.0 million (see Note 2 to the Consolidated Financial Statements). Net income, after the cumulative change in accounting principle, was \$603.1 million. Net income per share, diluted, after consideration of the accounting change, was \$.76 compared to \$.59 in 1999. Operating income was \$1,021.1 million, an increase of 30.7 percent compared to 1999.

OPERATING REVENUES Consolidated operating revenues increased 19.3 percent primarily due to a 19.8 percent increase in passenger revenues. The increase in passenger revenues primarily resulted from the Company's increased capacity, strong demand for commercial air travel, and excellent marketing and revenue management. The Company experienced a 10.7 percent increase in revenue passengers carried, a 15.7 percent increase in RPMs, and a 3.6 percent increase in passenger yield. The increase in passenger yield primarily was due to an 8.2 percent increase in average passenger fare, partially offset by a 4.6 percent increase in average length of passenger haul. The increase in average passenger fare primarily was due to modest fare increases combined with a higher mix of full-fare passengers.

The increase in RPMs exceeded a 13.3 percent increase in ASMs resulting in a load factor of 70.5 percent, or 1.5 points above the prior year. The increase in ASMs primarily resulted from the net addition of 32 aircraft during the year.

Freight revenues increased 7.5 percent primarily due to an increase in capacity. Other revenues, which consist primarily of charter revenues, increased 1.2 percent. This increase was less than the Company's increase in capacity primarily due to the Company's decision to utilize more of its aircraft to satisfy the strong demand for scheduled service, resulting in fewer aircraft available for charters.

OPERATING EXPENSES Consolidated operating expenses for 2000 increased 17.1 percent, compared to the 13.3 percent increase in capacity. Operating expenses per ASM increased 3.3 percent to \$.0773, compared to \$.0748 in 1999, primarily due to an increase in average jet fuel prices. The average fuel cost per gallon in 2000 was \$.7869, which was the highest annual average fuel cost per gallon experienced by the Company since 1984. Excluding fuel expense, operating expenses per ASM decreased 2.6 percent.

Salaries, wages, and benefits per ASM increased slightly, as increases in productivity in several of the Company's operational areas were more than offset by higher benefits costs, primarily workers' compensation expense, and increases in average wage rates within certain workgroups.

Employee retirement plans expense per ASM increased 11.1 percent, primarily due to the increase in Company earnings available for profitsharing.

Fuel and oil expense per ASM increased 44.1 percent, primarily due to a 49.3 percent increase in the average jet fuel cost per gallon. The average price per gallon of jet fuel in 2000 was \$.7869 compared to \$.5271 in 1999, including the effects of hedging activities. The Company's 2000 and 1999 average jet fuel prices are net of approximately \$113.5 million and \$14.8 million in gains from hedging activities, respectively.

Maintenance materials and repairs per ASM decreased 10.0 percent primarily because of a decrease in engine maintenance expense for the Company's 737-200 aircraft fleet as 1999 was an unusually high period for engine maintenance on these aircraft. Engine repairs for the Company's 737-200 aircraft are expensed on a time and materials basis. These engine repairs represented approximately 75 percent of the total decrease, while a decrease in airframe inspections and repairs per ASM represented the majority of the remaining decrease. The decrease in airframe inspections and repairs primarily was due to a greater amount of this work being performed internally versus 1999, when a large portion of this type of work was outsourced. Therefore, in 2000, a larger portion of the cost of these repairs was reflected in salaries and wages.

Agency commissions per ASM decreased 10.0 percent, primarily due to a decrease in commissionable revenue. Approximately 31 percent of the Company's 2000 revenues were attributable to direct bookings through the Company's Internet site compared to approximately 19 percent in the prior year. The increase in Internet revenues contributed to the Company's percentage of commissionable revenues decreasing from 34.6 percent in 1999 to 29.1 percent in 2000.

Aircraft rentals decreased 13.2 percent primarily due to a lower percentage of the aircraft fleet being leased. Approximately 27.3 percent of the Company's aircraft were under operating lease at December 31, 2000, compared to 30.8 percent at December 31, 1999.

Landing fees and other rentals per ASM decreased 4.3 percent primarily as a result of a decrease in landing fees per ASM of 6.7 percent, partially offset by a slight increase in other rentals. Although landing fees declined on a per-ASM basis, they were basically flat on a per-trip basis. The growth in ASMs exceeded the trip growth primarily due to a 5.8 percent increase in stage length (the average distance per aircraft trip flown).

Other operating expenses per ASM decreased 3.4 percent primarily due to Company-wide cost reduction efforts. The Company also reduced its advertising expense 9.5 percent per ASM, taking advantage of our national presence, increasing brand awareness, and strong Customer demand.



OTHER "Other expenses (income)" included interest expense, capitalized interest, interest income, and other gains and losses. Interest expense increased 29.1 percent primarily due to the Company's issuance of \$256 million of long-term debt in fourth quarter 1999. Capitalized interest decreased 11.9 percent primarily as a result of lower 2000 progress payment balances for scheduled future aircraft deliveries compared to 1999. Interest income increased 59.0 percent primarily due to higher invested cash balances and higher rates of return. Other losses in 1999 resulted primarily from a write-down associated with the consolidation of certain software development projects.

INCOME TAXES The provision for income taxes, as a percentage of income before taxes, decreased slightly to 38.54 percent in 2000 from 38.68 percent in 1999.

LIQUIDITY AND CAPITAL RESOURCES

Net cash provided by operating activities was \$1.5 billion in 2001 compared to \$1.3 billion in 2000. The increase in operating cash flows primarily was due to the deferral of approximately \$186 million in tax payments until January 2002, as provided for in the Act, which more than offset the decrease in net income. Net cash provided by financing activities was \$1.3 billion in 2001 compared to a net use of \$59.5 million in 2000. Financing cash flows were generated from borrowings the Company made from its \$475 million revolving credit facility and the issuance of \$614.3 million in long-term debt. These borrowings were partially offset by the redemption of \$100 million unsecured notes in 2001. See Note 6 and Note 7 to the Consolidated Financial Statements for more information on these financing activities. Cash generated in

2001 primarily was used to finance aircraft-related capital expenditures and provide working capital.

During 2001, net capital expenditures were \$1.0 billion, which primarily related to the purchase of 14 new 737-700 aircraft delivered to the Company, 11 new 737-700 aircraft the Company has effectively purchased via a special purpose trust (the Trust), and progress payments for future aircraft deliveries. See Note 4 to the Consolidated Financial Statements for more information on the Trust. The Company's contractual commitments consist primarily of scheduled aircraft acquisitions. As a result of the terrorist attacks, the Company was able to modify its future aircraft delivery dates through the amendment of our purchase contract with The Boeing Company and through the creation of the Trust. Through the Trust, as of December 31, 2001, Southwest will take delivery and place in service 11 new 737-700 aircraft in 2002 and eight new 737-700 aircraft in 2003. Excluding aircraft scheduled to be delivered from the Trust, as of December 31, 2001, the Company has no new 737-700 aircraft deliveries scheduled for 2002, 13 in 2003, 23 in 2004, 24 in 2005, 22 in 2006, 25 in 2007, and six in 2008. The Company also has a total of 87 purchase options for new 737-700 aircraft for years 2004 through 2008 and purchase rights for an additional 217 737-700s during 2007 - 2012. In total, Southwest's Trust deliveries, firm orders, options, and purchase rights through 2012 are at 436 aircraft. 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 737-700s. The following table provides details regarding the Company's contractual cash obligations subsequent to December 31, 2001:

	Contractual cash obligations by year (in millions)						
	2002	2003	2004	2005	2006	Beyond 5 years	Total
Long-term debt ⁽¹⁾	\$ 40	\$ 130	\$ 232	\$ 142	\$ 541	\$ 291	\$1,376
Short-term borrowings	475	-	-	-	-	-	475
Operating lease commitments	290	275	243	217	185	1,590	2,800
Aircraft purchase commitments ⁽²⁾	319	689	685	719	641	622	3,675
Total contractual cash obligations	\$1,124	\$1,094	\$1,160	\$1,078	\$1,367	\$2,503	\$8,326

(1) Includes amounts classified as interest for capital lease obligations

(2) Includes amounts payable to the Trust - see Note 4 to the Consolidated Financial Statements

The Company has various options available to meet its capital and operating commitments, including cash on hand at December 31, 2001, of \$2.28 billion and internally generated funds. In addition, the Company will also consider various borrowing or leasing options to maximize earnings and supplement cash requirements. The Company believes it has access to a wide variety of financing arrangements because of its excellent credit ratings and modest leverage.

The Company currently has outstanding shelf registrations for the issuance of \$704 million of public debt securities, which it may utilize for aircraft financings in 2002 and 2003.

On September 23, 1999, the Company announced its Board of Directors had authorized the repurchase of up to \$250 million of the Company's common stock. Repurchases are made in accordance with applicable securities laws in the open market or in private transactions

from time to time, depending on market conditions, and may be discontinued at any time. As of December 31, 2001, in aggregate, 18.3 million shares had been repurchased at a total cost of \$199.2 million, of which \$108.7 million was completed in 2000. No shares were repurchased in 2001.

QUALITATIVE AND QUANTITATIVE DISCLOSURES ABOUT MARKET RISK

Southwest has interest rate risk in that it holds floating rate debt instruments and has commodity price risk in that it must purchase jet fuel to operate its aircraft fleet. The Company purchases jet fuel at prevailing market prices, but seeks to minimize its average jet fuel cost through execution of a documented hedging strategy. Southwest has market sensitive instruments in the form of fixed rate debt instruments



and derivative instruments used to hedge its exposure to jet fuel price increases. The Company also operates 99 aircraft under operating and capital leases. However, leases are not considered market sensitive financial instruments and, therefore, are not included in the interest rate sensitivity analysis below. Commitments related to leases are disclosed in Note 8 to the Consolidated Financial Statements. The Company does not purchase or hold any derivative financial instruments for trading purposes. See Note 2 to the Consolidated Financial Statements for information on the Company's accounting for its hedging program and Note 9 to the Consolidated Financial Statements for further details on the Company's financial derivative instruments.

The fair values of outstanding financial derivative instruments related to the Company's jet fuel market price risk at December 31, 2001, were a net liability of approximately \$19.4 million, which is classified in accrued liabilities in the Consolidated Balance Sheet. The fair values of the derivative instruments, depending on the type of instrument, were determined by the use of present value methods or standard option value models with assumptions about commodity prices based on those observed in underlying markets. An immediate ten percent increase or decrease in underlying fuel-related commodity prices from the December 31, 2001, prices would correspondingly change the fair value of the commodity derivative instruments in place by approximately \$55 million. Changes in the related commodity derivative instrument cash flows may change by more or less than this amount based upon further fluctuations in futures prices as well as related income tax effects. This sensitivity analysis uses industry standard valuation models and holds all inputs constant at December 31, 2001, levels, except underlying futures prices.

Airline operators are inherently capital intensive as the vast majority of the Company's assets are expensive aircraft, which are long-lived. The Company's strategy is to capitalize conservatively and grow capacity steadily and profitably. While the Company uses financial leverage, it has maintained a strong balance sheet and an "A" credit rating on its senior unsecured fixed-rate debt with Standard & Poor's and Fitch ratings agencies, and a "Baa1" credit rating with Moody's rating agency. The Company's Aircraft Secured Notes and French Credit Agreements do not give rise to significant fair value risk but do give rise to interest rate risk because these borrowings are floating-rate debt. Although there is interest rate risk associated with these secured borrowings, the risk is somewhat mitigated by the fact that the Company may prepay this debt on any of the semi-annual principal and interest payment dates. See Note 7 to the Consolidated Financial Statements for more information on these borrowings.

As disclosed in Note 7 to the Consolidated Financial Statements, the Company had outstanding senior unsecured notes totaling \$400 million at December 31, 2001. Also, as disclosed in Note 7, the Company issued \$614.3 million in long-term debt in November 2001 in the form of Pass-Through Certificates (Certificates), which are secured by aircraft the Company owns. The total of the Company's long-term unsecured notes represented only 6.2 percent of total noncurrent assets at December 31, 2001. The unsecured long-term debt currently has a weighted-average maturity of 9.0 years at fixed rates averaging 7.6 percent at December 31, 2001, which is comparable to average rates prevailing over the last ten years. The Certificates bear interest at a combined weighted-average rate of 5.5 percent. The Company does not have significant exposure to changing interest rates on its unsecured long-term debt or its Certificates because the interest rates are fixed and the financial leverage is modest.

The Company also has some risk associated with changing interest rates due to the short-term nature of its invested cash, which was \$2.28 billion at December 31, 2001. The Company invests available cash in certificates of deposit and investment grade commercial paper that generally have maturities of three months or less; therefore, the returns earned on these investments parallel closely with floating interest rates. The Company has not undertaken any additional actions to cover interest rate market risk and is not a party to any other material interest rate market risk management activities.

A hypothetical ten percent change in market interest rates as of December 31, 2001, would not have a material effect on the fair value of the Company's fixed rate debt instruments. See Note 9 to the Consolidated Financial Statements for further information on the fair value of the Company's financial instruments. A change in market interest rates could, however, have a corresponding effect on the Company's earnings and cash flows associated with its Aircraft Secured Notes, French Credit Agreements, and invested cash because of the floating-rate nature of these items. Assuming floating market rates in effect as of December 31, 2001, were held constant throughout a 12-month period, a hypothetical ten percent change in those rates would correspondingly change the Company's net earnings and cash flows associated with these items by approximately \$2.1 million. However, a ten percent change in market rates would not impact the Company's earnings or cash flow associated with the Company's publicly traded fixed-rate debt, or its Certificates.



SOUTHWEST AIRLINES CO. CONSOLIDATED BALANCE SHEET

(in thousands, except per share amounts)	DECEMBER 31,	
	2001	2000
ASSETS		
Current assets:		
Cash and cash equivalents	\$ 2,279,861	\$ 522,995
Accounts and other receivables	71,283	138,070
Inventories of parts and supplies, at cost	70,561	80,564
Deferred income taxes	46,400	28,005
Prepaid expenses and other current assets	52,114	61,902
Total current assets	2,520,219	831,536
Property and equipment, at cost:		
Flight equipment	7,534,119	6,831,913
Ground property and equipment	899,421	800,718
Deposits on flight equipment purchase contracts	468,154	335,164
	8,901,694	7,967,795
Less allowance for depreciation	2,456,207	2,148,070
	6,445,487	5,819,725
Other assets	31,435	18,311
	<u>\$ 8,997,141</u>	<u>\$ 6,669,572</u>
LIABILITIES AND STOCKHOLDERS' EQUITY		
Current liabilities:		
Accounts payable	\$ 504,831	\$ 312,716
Accrued liabilities	547,540	499,874
Air traffic liability	450,407	377,061
Aircraft purchase obligations	221,840	-
Short-term borrowings	475,000	-
Current maturities of long-term debt	39,567	108,752
Total current liabilities	2,239,185	1,298,403
Long-term debt less current maturities	1,327,158	760,992
Deferred income taxes	1,058,143	852,865
Deferred gains from sale and leaseback of aircraft	192,342	207,522
Other deferred liabilities	166,260	98,470
Commitments and contingencies		
Stockholders' equity:		
Common stock, \$1.00 par value: 2,000,000 shares authorized; 766,774 and 507,897 shares issued in 2001 and 2000, respectively	766,774	507,897
Capital in excess of par value	50,409	103,780
Retained earnings	3,228,408	2,902,007
Accumulated other comprehensive income (loss)	(31,538)	-
Treasury stock, at cost: 3,735 shares in 2000	-	(62,364)
Total stockholders' equity	4,014,053	3,451,320
	<u>\$ 8,997,141</u>	<u>\$ 6,669,572</u>

See accompanying notes.



SOUTHWEST AIRLINES CO. CONSOLIDATED STATEMENT OF INCOME

(in thousands, except per share amounts)	YEARS ENDED DECEMBER 31,		
	2001	2000	1999
OPERATING REVENUES:			
Passenger	\$ 5,378,702	\$ 5,467,965	\$ 4,562,616
Freight	91,270	110,742	102,990
Other	85,202	70,853	69,981
Total operating revenues	5,555,174	5,649,560	4,735,587
OPERATING EXPENSES:			
Salaries, wages, and benefits	1,856,288	1,683,689	1,455,237
Fuel and oil	770,515	804,426	492,415
Maintenance materials and repairs	397,505	378,470	367,606
Agency commissions	103,014	159,309	156,419
Aircraft rentals	192,110	196,328	199,740
Landing fees and other rentals	311,017	265,106	242,002
Depreciation	317,831	281,276	248,660
Other operating expenses	975,772	859,811	791,932
Total operating expenses	4,924,052	4,628,415	3,954,011
OPERATING INCOME	631,122	1,021,145	781,576
OTHER EXPENSES (INCOME):			
Interest expense	69,827	69,889	54,145
Capitalized interest	(20,576)	(27,551)	(31,262)
Interest income	(42,562)	(40,072)	(25,200)
Other (gains) losses, net	(203,226)	1,515	10,282
Total other expenses (income)	(196,537)	3,781	7,965
INCOME BEFORE INCOME TAXES AND CUMULATIVE EFFECT OF CHANGE IN ACCOUNTING PRINCIPLE	827,659	1,017,364	773,611
PROVISION FOR INCOME TAXES	316,512	392,140	299,233
INCOME BEFORE CUMULATIVE EFFECT OF CHANGE IN ACCOUNTING PRINCIPLE	511,147	625,224	474,378
CUMULATIVE EFFECT OF CHANGE IN ACCOUNTING PRINCIPLE, NET OF INCOME TAXES	-	(22,131)	-
NET INCOME	\$ 511,147	\$ 603,093	\$ 474,378
NET INCOME PER SHARE, BASIC BEFORE CUMULATIVE EFFECT OF CHANGE IN ACCOUNTING PRINCIPLE	\$.67	\$.84	\$.63
CUMULATIVE EFFECT OF CHANGE IN ACCOUNTING PRINCIPLE	-	(.03)	-
NET INCOME PER SHARE, BASIC	\$.67	\$.81	\$.63
NET INCOME PER SHARE, DILUTED BEFORE CUMULATIVE EFFECT OF CHANGE IN ACCOUNTING PRINCIPLE	\$.63	\$.79	\$.59
CUMULATIVE EFFECT OF CHANGE IN ACCOUNTING PRINCIPLE	-	(.03)	-
NET INCOME PER SHARE, DILUTED	\$.63	\$.76	\$.59

See accompanying notes.



SOUTHWEST AIRLINES CO. CONSOLIDATED STATEMENT OF STOCKHOLDERS' EQUITY

YEARS ENDED DECEMBER 31, 2001, 2000, AND 1999

(in thousands, except per share amounts)	COMMON STOCK	CAPITAL IN EXCESS OF PAR VALUE	RETAINED EARNINGS	ACCUMULATED OTHER COMPREHENSIVE INCOME (LOSS)	TREASURY STOCK	TOTAL
Balance at December 31, 1998	\$ 335,904	\$ 89,820	\$ 2,044,975	\$ -	\$ (72,781)	\$ 2,397,918
Three-for-two stock split	167,954	(89,878)	(78,076)	-	-	-
Purchase of shares of treasury stock	-	-	-	-	(90,507)	(90,507)
Issuance of common and treasury stock						
pursuant to Employee stock plans	1,147	7,811	(45,134)	-	72,781	36,605
Tax benefit of options exercised	-	27,683	-	-	-	27,683
Cash dividends, \$.0143 per share	-	-	(10,289)	-	-	(10,289)
Net income - 1999	-	-	474,378	-	-	474,378
Balance at December 31, 1999	505,005	35,436	2,385,854	-	(90,507)	2,835,788
Purchase of shares of treasury stock	-	-	-	-	(108,674)	(108,674)
Issuance of common and treasury stock						
pursuant to Employee stock plans	2,892	6,667	(75,952)	-	136,817	70,424
Tax benefit of options exercised	-	61,677	-	-	-	61,677
Cash dividends, \$.0147 per share	-	-	(10,988)	-	-	(10,988)
Net income - 2000	-	-	603,093	-	-	603,093
Balance at December 31, 2000	507,897	103,780	2,902,007	-	(62,364)	3,451,320
Three-for-two stock split	253,929	(136,044)	(117,885)	-	-	-
Issuance of common and treasury stock						
pursuant to Employee stock plans	4,948	28,982	(52,753)	-	62,364	43,541
Tax benefit of options exercised	-	53,691	-	-	-	53,691
Cash dividends, \$.0180 per share	-	-	(14,108)	-	-	(14,108)
Net income - 2001	-	-	511,147	-	-	511,147
Other						
comprehensive income (loss) - 2001	-	-	-	(31,538)	-	(31,538)
Balance at December 31, 2001	\$ 766,774	\$ 50,409	\$ 3,228,408	\$ (31,538)	\$ -	\$ 4,014,053

See accompanying notes.

**SOUTHWEST AIRLINES CO.
CONSOLIDATED STATEMENT OF CASH FLOWS**

(in thousands)	YEARS ENDED DECEMBER 31,		
	2001	2000	1999
CASH FLOWS FROM OPERATING ACTIVITIES:			
Net income	\$ 511,147	\$ 603,093	\$ 474,378
Adjustments to reconcile net income to net cash provided by operating activities:			
Depreciation	317,831	281,276	248,660
Deferred income taxes	207,922	153,447	142,940
Amortization of deferred gains on sale and leaseback of aircraft	(15,180)	(15,178)	(15,172)
Amortization of scheduled airframe inspections and repairs	43,121	36,328	28,949
Income tax benefit from Employee stock option exercises	53,691	61,677	27,683
Changes in certain assets and liabilities:			
Accounts and other receivables	66,787	(63,032)	13,831
Other current assets	(9,027)	(24,657)	(31,698)
Accounts payable and accrued liabilities	202,506	129,438	66,081
Air traffic liability	73,346	120,119	56,864
Other	32,464	15,775	16,877
Net cash provided by operating activities	1,484,608	1,298,286	1,029,393
CASH FLOWS FROM INVESTING ACTIVITIES:			
Purchases of property and equipment	(997,843)	(1,134,644)	(1,167,834)
Net cash used in investing activities	(997,843)	(1,134,644)	(1,167,834)
CASH FLOWS FROM FINANCING ACTIVITIES:			
Issuance of long-term debt	614,250	-	255,600
Payments of long-term debt and capital lease obligations	(110,600)	(10,238)	(12,107)
Payments of cash dividends	(13,440)	(10,978)	(10,842)
Proceeds from revolving credit facility	475,000	-	-
Proceeds from trust arrangement	266,053	-	-
Proceeds from Employee stock plans	43,541	70,424	36,605
Repurchases of common stock	-	(108,674)	(90,507)
Other, net	(4,703)	-	-
Net cash provided by (used in) financing activities	1,270,101	(59,466)	178,749
NET INCREASE (DECREASE) IN CASH AND CASH EQUIVALENTS			
	1,756,866	104,176	40,308
CASH AND CASH EQUIVALENTS AT BEGINNING OF PERIOD			
	522,995	418,819	378,511
CASH AND CASH EQUIVALENTS AT END OF PERIOD	\$2,279,861	\$ 522,995	\$ 418,819
CASH PAYMENTS FOR:			
Interest, net of amount capitalized	\$ 47,682	\$ 36,946	\$ 26,604
Income taxes	\$ 65,905	\$ 150,000	\$ 131,968

See accompanying notes.



NOTES TO CONSOLIDATED FINANCIAL STATEMENTS December 31, 2001

1. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

BASIS OF PRESENTATION Southwest Airlines Co. (Southwest) is a major domestic airline that provides primarily 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 accounting principles generally accepted in the United States 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 restated to conform to the current year presentation.

CASH AND CASH EQUIVALENTS Cash equivalents consist of certificates of deposit and investment grade commercial paper issued by major corporations and financial institutions. Cash and cash equivalents are highly liquid and generally 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 generally charged to expense when issued for use.

PROPERTY AND EQUIPMENT Depreciation is provided by the straight-line method to estimated residual values over periods ranging from 20 to 25 years for flight equipment and 3 to 30 years for ground property and equipment. See Note 2 for further information on aircraft depreciation. 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 scheduled engine inspections and repairs and routine maintenance costs for aircraft and engines are charged to maintenance expense as incurred. Scheduled airframe inspections and repairs, known as "D" checks, are generally performed every ten years. Costs related to "D" checks are capitalized and amortized over the estimated period benefited, presently the least of ten years, the time until the next "D" check, or the remaining life of the aircraft. 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 Tickets sold are initially deferred as "Air traffic liability." Passenger revenue is recognized when transportation is provided. "Air traffic liability" primarily represents tickets sold for future travel dates and estimated refunds, or exchanges, of tickets sold for past travel dates. Estimated refunds and exchanges, including

the underlying assumptions, are evaluated each reporting period with resulting adjustments included in "Passenger revenue." Factors which may affect estimated refunds include, but may not be limited to, the Company's refund policy, the mix of refundable and nonrefundable fares, and fare sale activity. The Company's estimation techniques have been consistently applied from year to year; however, as with any estimates, actual refund and exchange activity may vary from estimated amounts. The Company believes it is unlikely that materially different estimates would be reported under different assumptions or conditions.

FREQUENT FLYER PROGRAM The Company accrues the estimated incremental cost of providing free travel for awards earned under its Rapid Rewards frequent flyer program. The Company also sells flight segment credits and related services to companies participating in its Rapid Rewards frequent flyer program. Prior to 2000, revenue from the sale of flight segment credits was recognized when the credits were sold. However, beginning January 1, 2000, funds received from the sale of flight segment credits and associated with future travel are deferred and recognized as "Passenger revenue" when the ultimate free travel awards are flown or the credits expire unused. See Note 2.

ADVERTISING The Company expenses the costs of advertising as incurred. Advertising expense for the years ended December 31, 2001, 2000, and 1999 was \$147.6 million, \$141.3 million, and \$137.7 million, 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. See Note 12.

FINANCIAL DERIVATIVE INSTRUMENTS The Company utilizes a variety of derivative instruments, including both crude oil and heating oil based derivatives, to hedge a portion of its exposure to jet fuel price increases. These instruments primarily consist of purchased call options, collar structures, and fixed price swap agreements. Prior to 2001, the net cost paid for option premiums and gains and losses on all financial derivative instruments, including those terminated or settled early, were deferred and charged or credited to fuel expense in the same month that the underlying jet fuel being hedged was used. However, beginning January 1, 2001, the Company adopted Statement of Financial Accounting Standards No. 133 (SFAS 133), "Accounting for Derivative Instruments and Hedging Activities," as amended, which changed the way it accounts for financial derivative instruments. See Note 2 and Note 9.

RECENT ACCOUNTING DEVELOPMENTS During 2001, the Financial Accounting Standards Board (FASB) issued SFAS No. 143, "Accounting for Asset Retirement Obligations," which is effective for financial statements issued for fiscal years beginning after June 15, 2002. The pronouncement addresses the recognition and remeasurement of obligations associated with the retirement of tangible long-lived assets. On October 3, 2001, the FASB issued SFAS No. 144, "Accounting for the Impairment or Disposal of Long-Lived Assets," which is effective for financial statements issued for fiscal years beginning after December 15, 2001. SFAS No. 144 supersedes SFAS No. 121, "Accounting for the Impairment of Long-Lived Assets and for Long-Lived Assets to Be



Disposed Of," and applies to all long-lived assets (including discontinued operations). The Company does not expect these standards to have a material impact on future financial statements or results of operations.

2. ACCOUNTING CHANGES

Effective January 1, 2001, the Company adopted SFAS 133. SFAS 133 requires the Company to record all financial derivative instruments on its balance sheet at fair value. Derivatives that are not designated as hedges must be adjusted to fair value through income. If a derivative is designated as a hedge, depending on the nature of the hedge, changes in its fair value that are considered to be effective, as defined, either offset the change in fair value of the hedged assets, liabilities, or firm commitments through earnings or are recorded in "Accumulated other comprehensive income (loss)" until the hedged item is recorded in earnings. Any portion of a change in a derivative's fair value that is considered to be ineffective, as defined, is recorded immediately in "Other (gains) losses, net" in the Consolidated Statement of Income. Any portion of a change in a derivative's fair value that the Company elects to exclude from its measurement of effectiveness is required to be recorded immediately in earnings.

Under the rules established by SFAS 133, the Company has alternatives in accounting for its financial derivative instruments. The Company primarily uses financial derivative instruments to hedge its exposure to jet fuel price increases and accounts for these derivatives as cash flow hedges, as defined. In accordance with SFAS 133, the Company must comply with detailed rules and strict documentation requirements prior to beginning hedge accounting. As required by SFAS 133, the Company assesses the effectiveness of each of its individual hedges on a quarterly basis. The Company also examines the effectiveness of its entire hedging program on a quarterly basis utilizing statistical analysis. This analysis involves utilizing regression and other statistical analysis which compare changes in the price of jet fuel to changes in the prices of the commodities used for hedging purposes (crude oil and heating oil). If these statistical techniques do not produce results within certain predetermined confidence levels, the Company could lose its ability to utilize hedge accounting, which could cause the Company to recognize all gains and losses on financial derivative instruments in earnings in the periods following the determination that the Company no longer qualified for hedge accounting. This could, in turn, depending on the materiality of periodic changes in derivative fair values, increase the volatility of the Company's future earnings.

Upon adoption of SFAS 133, the Company recorded the fair value of its fuel derivative instruments in the Consolidated Balance Sheet and a deferred gain of \$46.1 million, net of tax, in "Accumulated other comprehensive income (loss)." See Note 10 for further information on comprehensive income. During 2001, the Company recognized approximately \$8.2 million as a net expense in "Other (gains) losses, net," related to the ineffectiveness of its hedges. During 2001, the Company recognized approximately \$17.5 million of net expense, related to amounts excluded from the Company's measurements of hedge effectiveness, in "Other (gains) losses, net." The 2001 adoption of SFAS 133 has resulted in more volatility in the Company's financial statements than in the past due to the changes in market values of its derivative instruments and some ineffectiveness that has been experienced in its fuel hedges. See Note 9 for further information on the Company's derivative instruments.

Effective January 1, 2000, the Company adopted Staff Accounting Bulletin 101 (SAB 101) issued by the Securities and Exchange Commission in December 1999. As a result of adopting SAB 101, the Company changed the way it recognizes revenue from the sale of flight

segment credits to companies participating in its Rapid Rewards frequent flyer program. Prior to the issuance of SAB 101, the Company recorded revenue in "Other revenue" when flight segment credits were sold, consistent with most other major airlines. Beginning January 1, 2000, the Company recognizes Passenger revenue when free travel awards resulting from the flight segment credits sold are flown or credits expire unused. Due to this change, the Company recorded a cumulative effect charge in first quarter 2000 of \$22.1 million (net of income taxes of \$14.0 million) or \$.03 per share, basic and diluted. Adopting this method of accounting for 1999 would have reduced the Company's Net income by \$3.9 million or \$.01 per basic share. Net income per share, diluted, would not have changed.

Effective January 1, 1999, the Company revised the estimated useful lives of its 737-300 and -500 aircraft from 20 years to 23 years. This change was the result of the Company's assessment of the remaining useful lives of the aircraft based on the manufacturer's design lives, the Company's increased average aircraft stage (trip) length, and the Company's previous experience. The effect of this change was to reduce depreciation expense approximately \$25.7 million and increase net income per share, diluted, by \$.02 for the year ended December 31, 1999.

3. FEDERAL GRANTS AND SPECIAL CHARGES RELATED TO TERRORIST ATTACKS

On September 11, 2001, terrorists hijacked and used two American Airlines, Inc. aircraft and two United Air Lines, Inc. aircraft in terrorist attacks on the United States (terrorist attacks). As a result of these terrorist attacks, the Federal Aviation Administration (FAA) immediately suspended all commercial airline flights on the morning of September 11. The Company resumed flight activity on September 14 and was operating its normal pre-September 11 flight schedule by September 18, 2001. From September 11 until the Company resumed flight operations on September 14, Southwest cancelled approximately 9,000 flights.

On September 22, 2001, President Bush signed into law the Air Transportation Safety and System Stabilization Act (the Act). The Act provides for up to \$5 billion in cash grants to qualifying U.S. airlines and freight carriers to compensate for direct and incremental losses, as defined in the Act, from September 11, 2001 through December 31, 2001, associated with the terrorist attacks. Each airline's total eligible grant is being determined based on that airline's percentage of ASMs during August 2001 to total eligible carriers' ASMs for August 2001, less an undetermined amount set aside for eligible carriers that provide services not measured by ASMs. The Department of Transportation (DOT) will make the final determination of the amount of eligible direct and incremental losses incurred by each airline. Direct and incremental losses, while defined generally in the Act, are subject to interpretation by the DOT. Lastly, final applications for grants must be accompanied by Agreed Upon Procedures reports from independent accountants and may be subject to additional audit or review by the DOT and Congress.

During third quarter and fourth quarter 2001, the Company recognized in "Other gains" approximately \$235 million from grants under the Act. The Company believes its actual direct and incremental losses related to the September 11 terrorist attacks will exceed the total amount for which the Company will be ultimately eligible. The Company may recognize up to approximately \$50 million in additional amounts during 2002 from the Act upon completion and approval of the final application based on the DOT's final interpretations of the Act. However, due to many uncertainties regarding the interpretation of the Act, the Company believed that recognizing gains in excess of the \$235 million in 2001 was not appropriate.



In addition, the Company recorded special charges of \$48 million in 2001 arising from the terrorist attacks. Total special charges included a \$30 million reduction in "Passenger revenue" resulting from refunds of nonrefundable fares, \$13 million in charges to "Other operating expenses" for write-downs of various assets due to impairment, and other charges that are included in "Other (gains) losses, net."

4. COMMITMENTS

In response to the decrease in demand for air travel since the terrorist attacks, the Company modified its schedule for future aircraft deliveries and the timing of its future capital expenditure commitments. In November 2001, Southwest entered into a trust arrangement with a special purpose entity (the Trust) and assigned its purchase agreement with Boeing to the Trust with respect to 19 Boeing 737-700 aircraft originally scheduled to be delivered from September 2001 through April 2002. Southwest subsequently entered into a purchase agreement with the Trust to purchase the aircraft at new delivery dates from January 2002 through April 2003. As of December 31, 2001, the Trust has purchased a total of 11 completed aircraft, and the remaining eight aircraft will be purchased by the Trust from Boeing when the aircraft are completed in 2002. Southwest has the option to accelerate purchases from the Trust at any time.

Although Southwest does not have legal title to the assets of the Trust and has not guaranteed the liabilities of the Trust, Southwest does exercise certain rights of ownership over the Trust assets. Consequently, the assets (i.e., "Flight equipment" and "Deposits on flight equipment purchase contracts") and associated liabilities (i.e., "Aircraft purchase obligations") of the Trust have been recorded in the accompanying Consolidated Balance Sheet as of December 31, 2001.

The Company's contractual purchase commitments consist primarily of scheduled aircraft acquisitions. Excluding the aircraft acquired or to be acquired by the Trust, the Company has contractual purchase commitments with Boeing for no 737-700 aircraft deliveries in 2002, 13 scheduled for delivery in 2003, 23 in 2004, 24 in 2005, 22 in 2006, and 31 thereafter. In addition, the Company has options to purchase up to 87 737-700s during 2004 - 2008 and purchase rights for an additional 217 737-700s during 2007 - 2012. 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 737-700s. Including the amounts associated with the Trust that are included as liabilities in the Company's Consolidated Balance Sheet as of December 31, 2001, aggregate funding needed for firm commitments is approximately \$3.7 billion, subject to adjustments for inflation, due as follows: \$319 million in 2002, \$689 million in 2003, \$685 million in 2004, \$719 million in 2005, \$641 million in 2006, and \$622 million thereafter.

5. ACCRUED LIABILITIES

(in thousands)	2001	2000
Retirement plans (Note 13)	\$ 147,110	\$ 180,340
Aircraft rentals	120,554	117,302
Vacation pay	83,105	72,115
Other	196,771	130,117
	<u>\$ 547,540</u>	<u>\$ 499,874</u>

6. SHORT-TERM BORROWINGS

In September 2001, the Company borrowed the full \$475 million available under its unsecured revolving credit line with a group of

banks. Borrowings under the credit line bear interest at six-month LIBOR plus 17 basis points and amounts are repayable on or before May 6, 2002. The interest rate (approximately 3.26 percent as of December 31, 2001), however, may change based on changes in the Company's credit rating. The Company intends to repay the borrowings in full prior to the due date with either cash on hand or proceeds from the issuance of long-term debt securities. The full \$475 million is classified as a current liability in the Consolidated Balance Sheet at December 31, 2001. There were no outstanding borrowings under this agreement at December 31, 2000.

7. LONG-TERM DEBT

(in thousands)	2001	2000
9.4% Notes due 2001	\$ -	\$ 100,000
8 3/4% Notes due 2003	100,000	100,000
Aircraft Secured Notes		
due 2004	200,000	200,000
8% Notes due 2005	100,000	100,000
Pass Through Certificates	614,250	-
7 7/8% Notes due 2007	100,000	100,000
French Credit Agreements	52,310	54,243
7 3/8% Debentures due 2027	100,000	100,000
Capital leases (Note 8)	109,268	117,083
	<u>1,375,828</u>	<u>871,326</u>
Less current maturities	39,567	108,752
Less debt discount and		
issue costs	9,103	1,582
	<u>\$ 1,327,158</u>	<u>\$ 760,992</u>

On October 30, 2001, the Company issued \$614.3 million Pass Through Certificates consisting of \$150.0 million 5.1% Class A-1 certificates, \$375.0 million 5.5% Class A-2 certificates, and \$89.3 million 6.1% Class B certificates. A separate trust was established for each class of certificates. The trusts used the proceeds from the sale of certificates to acquire equipment notes, which were issued by Southwest on a full recourse basis. Payments on the equipment notes held in each trust will be passed through to the holders of certificates of such trust. The equipment notes were issued for each of 29 Boeing 737-700 aircraft owned by Southwest and are secured by a mortgage on such aircraft. Interest on the equipment notes held for the certificates is payable semi-annually, beginning May 1, 2002. Beginning May 1, 2002, principal payments on the equipment notes held for the Class A-1 certificates are due semi-annually until the balance of the certificates mature on May 1, 2006. The entire principal of the equipment notes for the Class A-2 and Class B certificates are scheduled for payment on November 1, 2006.

In July 2001, the Company redeemed \$100 million of senior unsecured 9.4% Notes originally issued in 1991.

In fourth quarter 1999, the Company issued \$200 million of floating rate Aircraft Secured Notes (the Notes), due 2004. The Notes are funded by a bank through a commercial paper conduit program and are secured by eight aircraft. Interest rates on the Notes are based on the conduit's actual commercial paper rate, plus fees, for each period and



are expected to average approximately LIBOR plus 36 basis points over the term of the Notes. Interest is payable monthly and the Company can prepay the Notes in whole or in part prior to maturity.

Also in fourth quarter 1999, the Company entered into two identical 13-year floating rate financing arrangements, whereby it effectively borrowed a total of \$56 million from French banking partnerships. For presentation purposes, the Company has classified these identical borrowings as one \$56 million transaction. The effective rate of interest over the 13-year term of the loans is LIBOR plus 32 basis points. Principal and interest are payable semi-annually on June 30 and December 31 for each of the loans and the Company may terminate the arrangements in any year on either of those dates, with certain conditions. The Company has pledged two aircraft as collateral for the entire transaction.

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.

During 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.

During 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 8 3/4% Notes due October 15, 2003. Interest on the Notes is payable semi-annually. The Notes are not redeemable prior to maturity.

The net book value of the assets pledged as collateral for the Company's secured borrowings, primarily aircraft and engines, was \$958.0 million at December 31, 2001.

As of December 31, 2001, aggregate annual principal maturities for the five-year period ending December 31, 2006, were \$40 million in 2002, \$130 million in 2003, \$232 million in 2004, \$142 million in 2005, \$541 million in 2006, and \$291 million thereafter.

8. LEASES

Total rental expense for operating leases charged to operations in 2001, 2000, and 1999 was \$358.6 million, \$330.7 million, and \$318.2 million, respectively. The majority of the Company's terminal operations space, as well as 92 aircraft, were under operating leases at December 31, 2001. The amounts applicable to capital leases included in property and equipment were:

(in thousands)	2001	2000
Flight equipment	\$ 165,085	\$ 164,909
Less accumulated depreciation	99,801	92,763
	\$ 65,284	\$ 72,146

Future minimum lease payments under capital leases and noncancelable operating leases with initial or remaining terms in excess of one year at December 31, 2001, were:

(in thousands)	CAPITAL LEASES	OPERATING LEASES
2002	\$ 17,562	\$ 290,378
2003	17,751	275,013
2004	17,651	242,483
2005	23,509	217,170
2006	13,379	185,125
After 2006	65,395	1,589,559
Total minimum		
lease payments	155,247	\$ 2,799,728
Less amount		
representing interest	45,979	
Present value of minimum		
lease payments	109,268	
Less current portion	8,692	
Long-term portion	\$ 100,576	

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, generally limited to a stated percentage of the lessor's defined cost of the aircraft.

9. DERIVATIVE AND FINANCIAL INSTRUMENTS

Airline operators are inherently dependent upon energy to operate and, therefore, are impacted by changes in jet fuel prices. Jet fuel and oil consumed in 2001, 2000, and 1999 represented approximately 15.6 percent, 17.4 percent, and 12.5 percent of Southwest's operating expenses, respectively. The Company endeavors to acquire jet fuel at the lowest possible prices. Because jet fuel is not traded on an organized futures exchange, liquidity for hedging is limited. However, the Company has found that both crude oil and heating oil contracts are effective commodities for hedging jet fuel. The Company has financial derivative instruments in the form of the types of hedges it utilizes to decrease its exposure to jet fuel price increases. The Company does not purchase or hold any derivative financial instruments for trading purposes.

The Company utilizes financial derivative instruments for both short-term and long-term time frames when it appears the Company can take advantage of market conditions. At December 31, 2001, the Company had a mixture of purchased call options, collar structures, and fixed price swap agreements in place to hedge approximately 60 percent of its 2002 total anticipated jet fuel requirements, approximately 47 percent of its 2003 total anticipated jet fuel requirements, and a small portion of its 2004 - 2005 total anticipated jet fuel requirements. As of December 31, 2001, the majority of the Company's 2002 hedges are effectively heating oil-based positions in the form of option contracts. All remaining hedge positions are crude oil-based positions.

During 2001, 2000, and 1999, the Company recognized gains in "Fuel and oil" expense of \$79.9 million, \$113.5 million, and \$14.8 million,



respectively, from hedging activities. At December 31, 2001 and 2000, approximately \$8.2 million and \$49.9 million, respectively, were due from third parties from expired derivative contracts, and accordingly, are included in "Accounts and other receivables" in the accompanying Consolidated Balance Sheet. The Company accounts for its fuel hedge derivative instruments as cash flow hedges, as defined. Therefore, all changes in fair value that are considered to be effective are recorded in "Accumulated other comprehensive income (loss)" until the underlying jet fuel is consumed. The fair value of the Company's financial derivative instruments at December 31, 2001, was a net liability of approximately \$19.4 million and is classified as "Accrued liabilities" in the Consolidated Balance Sheet. The fair value of the derivative instruments, depending on the type of instrument, was determined by the use of present value methods or standard option value models with assumptions about commodity prices based on those observed in underlying markets.

As of December 31, 2001, the Company had approximately \$31.1 million in unrealized losses, net of tax, in "Accumulated other comprehensive income (loss)" related to fuel hedges. Included in this total are approximately \$22.2 million in net unrealized losses that are expected to be realized in earnings during 2002. Upon the adoption of SFAS 133 on January 1, 2001, the Company recorded unrealized fuel hedge gains of \$46.1 million, net of tax, of which \$45.5 million was realized in earnings during 2001.

Outstanding financial derivative instruments expose the Company to credit loss in the event of nonperformance by the counterparties to the agreements. However, the Company does not expect any of the counterparties to fail to meet their obligations. The credit exposure related to these financial instruments is represented by the fair value of contracts with a positive fair value at the reporting date. To manage credit risk, the Company selects and periodically reviews counterparties based on credit ratings, limits its exposure to a single counterparty, and monitors the market position of the program and its relative market position with each counterparty. At December 31, 2001, the Company had agreements with five counterparties containing early termination rights and/or bilateral collateral provisions whereby security is required if market risk exposure exceeds a specified threshold amount or credit rating falls below certain levels. Neither the Company nor the counterparties exceeded such threshold amounts at December 31, 2001. The Company is in the process of negotiating similar agreements with other counterparties.

The carrying amounts and estimated fair values of the Company's long-term debt at December 31, 2001, were as follows:

(in thousands)	CARRYING VALUE	FAIR VALUE
8 3/4% Notes due 2003	\$ 100,000	\$ 106,954
Aircraft Secured Notes		
due 2004	200,000	200,000
8% Notes due 2005	100,000	107,602
Pass Through Certificates	614,250	605,839
7 7/8% Notes due 2007	100,000	108,455
French Credit Agreements	52,310	52,310
7 3/8% Debentures due 2027	100,000	96,150

The estimated fair values of the Company's long-term debt were based on quoted market prices. The carrying values of all other financial instruments approximate their fair value.

10. COMPREHENSIVE INCOME

Comprehensive income includes changes in the fair value of certain financial derivative instruments, which qualify for hedge accounting, and unrealized gains and losses on certain investments. Comprehensive income totaled \$479.6 million for 2001. The difference between Net income and Comprehensive income for 2001 is as follows:

(in thousands)	2001
Net income	\$ 511,147
Unrealized (loss) on derivative instruments, net of deferred taxes of (\$20,719)	(31,063)
Other, net of deferred taxes of (\$320)	(475)
Total other comprehensive income (loss)	(31,538)
Comprehensive income	\$ 479,609

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

(in thousands)	FUEL HEDGE DERIVATIVES	OTHER	ACCUMULATED OTHER COMPREHENSIVE INCOME (LOSS)
Balance at			
December 31, 2000	\$ -	\$ -	\$ -
January 1, 2001			
transition adjustment	46,089	-	46,089
2001 changes in			
fair value	(31,665)	(475)	(32,140)
Reclassification			
to earnings	(45,487)	-	(45,487)
Balance at			
December 31, 2001	\$ (31,063)	\$ (475)	\$ (31,538)

11. 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, 2001, the Company had common stock reserved for issuance pursuant to Employee stock benefit plans (140.3 million shares authorized of which 40.2 million shares have not yet been granted) and upon exercise of rights (323.0 million shares) pursuant to the Common Share Purchase 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 is exercisable only in the event of a proposed takeover, as defined by the Agreement. The Company may redeem the Rights at \$.0022 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 \$3.29 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.

On May 20, 1999, the Company's Board of Directors declared a three-for-two stock split, distributing 168.0 million shares on July 19, 1999. On January 18, 2001, the Company's Board of Directors declared a three-for-two stock split, distributing 253.9 million shares on February 15, 2001. Unless otherwise stated, all share and per share data presented in the accompanying consolidated financial statements and notes thereto have been restated to give effect to these stock splits.

On September 23, 1999, the Company's Board of Directors authorized the repurchase of up to \$250 million of its outstanding common stock. This program to date has resulted in the repurchase of 18.3 million shares at an average cost of \$10.85 per share between October 1999 and December 2000. No shares were repurchased in 2001. All of these acquired shares were subsequently reissued under Employee stock plans.

12. STOCK PLANS

At December 31, 2001, the Company had 12 stock-based compensation plans, excluding a plan covering the Company's Board of Directors and plans related to employment contracts with certain Executive Officers of the Company. 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 grant. Compensation expense for other stock options is not material.

Of the Company's 12 stock-based compensation plans, 11 are fixed option plans that cover various Employee groups. Under these plans, the Company may grant up to 141 million shares of common stock, of which 32.4 million shares were available for granting in future periods as of December 31, 2001. Under plans covered by collective bargaining agreements, options granted to Employees generally have terms similar to the term of, and vest in annual increments over the remaining life of, the respective collective bargaining agreement. Options granted to Employees not covered by collective bargaining agreements have ten-year terms and vest and become fully exercisable over three, five, or ten years of continued employment, depending upon the grant type.

Aggregated information regarding the Company's 11 fixed stock option plans, as adjusted for stock splits, is summarized below:

(in thousands, except exercise prices)	COLLECTIVE BARGAINING PLANS		OTHER EMPLOYEE PLANS	
	OPTIONS	AVERAGE EXERCISE PRICE	OPTIONS	AVERAGE EXERCISE PRICE
Outstanding December 31, 1998	68,909	\$ 4.30	34,919	\$ 4.40
Granted	2,304	11.70	5,051	12.19
Exercised	(3,327)	4.13	(4,938)	3.11
Surrendered	(612)	4.33	(1,701)	5.56
Outstanding December 31, 1999	67,274	4.32	33,331	4.61
Granted	4,707	18.23	11,904	13.86
Exercised	(7,895)	4.47	(7,416)	3.47
Surrendered	(686)	5.15	(1,461)	8.67
Outstanding December 31, 2000	63,400	5.59	36,358	8.66
Granted	1,665	19.05	4,022	18.75
Exercised	(4,166)	4.48	(4,135)	4.77
Surrendered	(349)	8.71	(1,394)	10.87
Outstanding December 31, 2001	60,550	\$ 6.05	34,851	\$ 10.20
Exercisable December 31, 2001	38,483	\$ 5.15	10,696	\$ 9.20
Available for granting in future periods	10,741		21,634	



The following table summarizes information about stock options outstanding under the 11 fixed option plans at December 31, 2001:

RANGE OF EXERCISE PRICES	OPTIONS OUTSTANDING			OPTIONS EXERCISABLE	
	OPTIONS OUTSTANDING AT 12/31/01 (000s)	WTD-AVERAGE REMAINING CONTRACTUAL LIFE	WTD-AVERAGE EXERCISE PRICE	OPTIONS EXERCISABLE AT 12/31/01 (000s)	WTD-AVERAGE EXERCISE PRICE
\$2.23 to \$3.35	79	.8 yrs	\$ 2.40	70	\$ 2.42
\$3.71 to \$5.38	59,035	4.9 yrs	4.08	36,973	4.04
\$5.85 to \$8.73	9,850	6.1 yrs	7.64	4,554	7.47
\$10.10 to \$15.07	8,829	7.2 yrs	11.32	3,023	11.46
\$15.25 to \$22.81	17,556	8.0 yrs	17.36	4,553	17.23
\$23.92 to \$23.93	52	10.3 yrs	23.93	6	23.93
\$2.23 to \$23.93	<u>95,401</u>	5.7 yrs	\$ 7.57	<u>49,179</u>	\$ 6.03

Under the amended 1991 Employee Stock Purchase Plan (ESPP), at December 31, 2001, the Company is authorized to issue up to a remaining balance of 7.8 million 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 1,025,000 shares in 2001, 1,029,000 shares in 2000, and 974,000 shares in 1999 at average prices of \$16.42, \$13.34, and \$10.83, 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 2001, 2000, and 1999, respectively: dividend yield of .065 percent, .10 percent, and .12 percent; expected volatility of 34.80 percent, 34.87 percent, and 35.66 percent; risk-free interest rate of 4.46 percent, 5.04 percent, and 6.68 percent; and expected lives ranging from 5 years to 6 years, depending upon the type of grant.

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.

The fair value of options granted under the fixed option plans during 2001 ranged from \$5.69 to \$9.11. The fair value of options granted under the fixed option plans during 2000 ranged from \$4.47 to \$9.79. The fair value of options granted under the fixed option plans during 1999 ranged from \$4.17 to \$5.87. The weighted-average fair value of each purchase right under the ESPP granted in 2001, 2000, and 1999, which is equal to the ten percent discount from the market value of the common stock at the end of each purchase period, was \$1.82, \$1.48, and \$1.17, respectively.

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 are as follows:

(in thousands, except per share amounts)	2001	2000	1999
NET INCOME:			
As reported	\$ 511,147	\$ 603,093	\$ 474,378
Pro forma	\$ 485,946	\$ 583,707	\$ 461,875
NET INCOME PER SHARE, BASIC:			
As reported	\$.67	\$.81	\$.63
Pro forma	\$.64	\$.78	\$.61
NET INCOME PER SHARE, DILUTED:			
As reported	\$.63	\$.76	\$.59
Pro forma	\$.61	\$.74	\$.58

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.

13. EMPLOYEE RETIREMENT PLANS

The Company has defined contribution plans covering substantially all of Southwest's Employees. The Southwest Airlines Co. Profitsharing Plan is a money purchase defined contribution plan and Employee stock purchase plan. The Company also sponsors Employee savings plans under section 401(k) of the Internal Revenue Code, which include Company matching contributions. The 401(k) plans cover substantially all Employees. Contributions under all defined contribution plans are based primarily on Employee compensation and performance of the Company.

Company contributions to all retirement plans expensed in 2001, 2000, and 1999 were \$214.6 million, \$241.5 million, and \$192.0 million, respectively.

**14. 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, 2001 and 2000, are as follows:

(in thousands)	2001	2000
DEFERRED TAX LIABILITIES:		
Accelerated depreciation	\$1,246,009	\$1,049,791
Scheduled airframe maintenance	89,292	71,519
Other	31,770	23,805
Total deferred tax liabilities	1,367,071	1,145,115
DEFERRED TAX ASSETS:		
Deferred gains from sale and leaseback of aircraft	101,755	107,686
Capital and operating leases	76,990	77,151
Accrued employee benefits	83,450	80,050
State taxes	37,715	28,843
Other	55,418	26,525
Total deferred tax assets	355,328	320,255
Net deferred tax liability	\$1,011,743	\$ 824,860

The provision for income taxes is composed of the following:

(in thousands)	2001	2000	1999
CURRENT:			
Federal	\$ 98,378	\$ 197,875	\$ 137,393
State	10,212	26,671	18,900
Total current	108,590	224,546	156,293
DEFERRED:			
Federal	187,296	151,694	128,984
State	20,626	15,900	13,956
Total deferred	207,922	167,594	142,940
	<u>\$ 316,512</u>	<u>\$ 392,140</u>	<u>\$ 299,233</u>

The Company received a statutory notice of deficiency from the Internal Revenue Service (IRS) in July 1995 in which the IRS proposed to disallow deductions claimed by the Company on its federal income tax returns for the taxable years 1989 through 1991 for the costs of certain aircraft inspection and maintenance procedures. In response to the statutory notice of deficiency, the Company filed a petition in the United States Tax Court on October 30, 1997, seeking a determination that the IRS erred in disallowing the deductions claimed by the Company and there is no deficiency in the Company's tax liability for the taxable years in issue. On December 21, 2000, the national office of the IRS published a revenue ruling in which it concluded that aircraft

inspection and maintenance is currently deductible as an ordinary and necessary business expense. In accordance with the revenue ruling, the IRS conceded the proposed adjustments to the deductions claimed by the Company for aircraft inspection and maintenance expense, and on June 1, 2001, a decision was entered by the Tax Court holding that there is no deficiency in income tax for the taxable years 1989 through 1991.

The IRS similarly proposed to disallow deductions claimed by the Company on its federal income tax returns for the taxable years 1992 through 1994 primarily related to the costs of certain aircraft inspection and maintenance expenses. During 2001, the IRS conceded the proposed adjustments to the deductions claimed for aircraft inspection and maintenance expenses. Management believes the final resolution of this controversy will not have a material adverse effect upon the financial position or results of operations of the Company.

The effective tax rate on income before income taxes differed from the federal income tax statutory rate for the following reasons:

(in thousands)	2001	2000	1999
Tax at statutory			
U.S. tax rates	\$289,681	\$356,077	\$270,764
Nondeductible items	7,318	6,801	6,664
State income taxes,			
net of federal benefit	20,045	27,671	21,356
Other, net	(532)	1,591	449
Total income			
tax provision	<u>\$316,512</u>	<u>\$392,140</u>	<u>\$299,233</u>



15. NET INCOME PER SHARE

The following table sets forth the computation of net income per share, basic and diluted:

(in thousands, except per share amounts)	2001	2000	1999
NUMERATOR:			
Net income before cumulative effect of change in accounting principle	\$ 511,147	\$ 625,224	\$ 474,378
Cumulative effect of change in accounting principle	-	(22,131)	-
Net income	<u>\$ 511,147</u>	<u>\$ 603,093</u>	<u>\$ 474,378</u>
DENOMINATOR:			
Weighted-average shares outstanding, basic	762,973	748,617	754,598
Dilutive effect of Employee stock options	44,142	47,699	49,293
Adjusted weighted-average shares outstanding, diluted	<u>807,115</u>	<u>796,316</u>	<u>803,891</u>
NET INCOME PER SHARE:			
Basic before cumulative effect of change in accounting principle	\$.67	\$.84	\$.63
Cumulative effect of change in accounting principle	-	(.03)	-
Net income per share, basic	<u>\$.67</u>	<u>\$.81</u>	<u>\$.63</u>
Diluted before cumulative effect of change in accounting principle	\$.63	\$.79	\$.59
Cumulative effect of change in accounting principle	-	(.03)	-
Net income per share, diluted	<u>\$.63</u>	<u>\$.76</u>	<u>\$.59</u>

The Company has excluded 5.7 million, 11.7 million, and 6.7 million shares from its calculations of net income per share, diluted, in 2001, 2000, and 1999, respectively, as they represent antidilutive stock options for the respective periods presented.

REPORT OF 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, 2001 and 2000, and the related consolidated statements of income, stockholders' equity, and cash flows for each of the three years in the period ended December 31, 2001. 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 auditing standards generally accepted in the United States. 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, 2001 and 2000, and the consolidated results of its operations and its cash flows for each of the three years in the period ended December 31, 2001, in conformity with accounting principles generally accepted in the United States.

As discussed in Note 2 to the financial statements, in 2001 the Company changed its method of accounting for derivative financial instruments and in 2000 the Company changed its method of accounting for the sale of flight segment credits.

Ernst & Young LLP

Dallas, Texas
January 16, 2002

**QUARTERLY FINANCIAL DATA (UNAUDITED)**

(in thousands, except per share amounts)	THREE MONTHS ENDED			
	MARCH 31	JUNE 30	SEPTEMBER 30	DECEMBER 31
2001				
Operating revenues	\$ 1,428,617	\$ 1,553,785	\$ 1,335,125	\$ 1,237,647
Operating income	210,157	290,862	92,986	37,117
Income before income taxes	196,502	287,451	245,870	97,836
Net income	121,045	175,633	150,964	63,505
Net income per share, basic	.16	.23	.20	.08
Net income per share, diluted	.15	.22	.19	.08
2000				
Operating revenues	\$ 1,242,647	\$ 1,460,675	\$ 1,478,834	\$ 1,467,404
Operating income	155,408	314,558	300,109	251,070
Income before income taxes	155,973	310,865	301,073	249,453
Net income	95,643*	190,622	184,298	154,661
Net income per share, basic	.13*	.26	.25	.21
Net income per share, diluted	.12*	.24	.23	.19

*Excludes cumulative effect of change in accounting principle of \$22.1 million (\$.03 per share, basic and diluted)

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 February 2001 three-for-two stock split, were:

PERIOD	DIVIDENDS	HIGH	LOW
2001			
1st Quarter	\$ 0.00450	\$ 23.27	\$ 16.00
2nd Quarter	0.00450	20.03	16.55
3rd Quarter	0.00450	20.23	11.25
4th Quarter	0.00450	20.00	14.52
2000			
1st Quarter	\$ 0.00367	\$ 13.92	\$ 10.00
2nd Quarter	0.00367	15.17	12.38
3rd Quarter	0.00367	16.67	12.75
4th Quarter	0.00367	23.33	15.75



TEN-YEAR SUMMARY

SELECTED CONSOLIDATED FINANCIAL DATA ⁽¹⁾

(in thousands, except per share amounts)	2001	2000	1999	1998
Operating revenues:				
Passenger ⁽⁹⁾	\$ 5,378,702	\$ 5,467,965	\$ 4,562,616	\$ 4,010,029
Freight	91,270	110,742	102,990	98,500
Other ⁽⁹⁾	85,202	70,853	69,981	55,451
Total operating revenues	5,555,174	5,649,560	4,735,587	4,163,980
Operating expenses	4,924,052	4,628,415	3,954,011	3,480,369
Operating income	631,122	1,021,145	781,576	683,611
Other expenses (income), net	(196,537)	3,781	7,965	(21,501)
Income before income taxes	827,659	1,017,364	773,611	705,112
Provision for income taxes ⁽³⁾	316,512	392,140	299,233	271,681
Net income ⁽³⁾	\$ 511,147	\$ 625,224 ⁽¹⁰⁾	\$ 474,378	\$ 433,431
Net income per share, basic ⁽³⁾	\$.67	\$.84 ⁽¹⁰⁾	\$.63	\$.58
Net income per share, diluted ⁽³⁾	\$.63	\$.79 ⁽¹⁰⁾	\$.59	\$.55
Cash dividends per common share	\$.0180	\$.0147	\$.0143	\$.0126
Total assets	\$ 8,997,141	\$ 6,669,572	5,653,703	\$ 4,715,996
Long-term debt	\$ 1,327,158	\$ 760,992	\$ 871,717	\$ 623,309
Stockholders' equity	\$ 4,014,053	\$ 3,451,320	\$ 2,835,788	\$ 2,397,918

CONSOLIDATED FINANCIAL RATIOS ⁽¹⁾

Return on average total assets	6.5%	10.1% ⁽¹⁰⁾	9.2%	9.7%
Return on average stockholders' equity	13.7%	19.9% ⁽¹⁰⁾	18.1%	19.7%

CONSOLIDATED OPERATING STATISTICS ⁽²⁾

Revenue passengers carried	64,446,773	63,678,261	57,500,213	52,586,400
RPMs (000s)	44,493,916	42,215,162	36,479,322	31,419,110
ASMs (000s)	65,295,290	59,909,965	52,855,467	47,543,515
Passenger load factor	68.1%	70.5%	69.0%	66.1%
Average length of passenger haul	690	663	634	597
Trips flown	940,426	903,754	846,823	806,822
Average passenger fare ⁽⁹⁾	\$83.46	\$85.87	\$79.35	\$76.26
Passenger revenue yield per RPM ⁽⁹⁾	12.09¢	12.95¢	12.51¢	12.76¢
Operating revenue yield per ASM	8.51¢	9.43¢	8.96¢	8.76¢
Operating expenses per ASM	7.54¢	7.73¢	7.48¢	7.32¢
Fuel cost per gallon (average)	70.86¢	78.69¢	52.71¢	45.67¢
Number of Employees at yearend	31,580	29,274	27,653	25,844
Size of fleet at yearend ⁽⁸⁾	355	344	312	280

(1) The Selected Consolidated Financial Data and Consolidated Financial Ratios for 1992 have been restated to include the financial results of Morris Air Corporation (Morris)

(2) Prior to 1993, Morris operated as a charter carrier; therefore, no Morris statistics are included for 1992

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

(4) Excludes cumulative effect of accounting changes of \$15.3 million (\$.02 per share)

(5) Excludes cumulative effect of accounting change of \$12.5 million (\$.02 per share)



1997	1996	1995	1994	1993	1992
\$ 3,669,821	\$ 3,285,178	\$ 2,767,835	\$ 2,497,765	\$ 2,216,342	\$ 1,623,828
94,758	80,005	65,825	54,419	42,897	33,088
52,242	40,987	39,091	39,749	37,434	146,063
3,816,821	3,406,170	2,872,751	2,591,933	2,296,673	1,802,979
3,292,585	3,055,335	2,559,220	2,275,224	2,004,700	1,609,175
524,236	350,835	313,531	316,709	291,973	193,804
7,280	9,473	8,391	17,186	32,336	36,361
516,956	341,362	305,140	299,523	259,637	157,443
199,184	134,025	122,514	120,192	105,353	60,058
\$ 317,772	\$ 207,337	\$ 182,626	\$ 179,331	\$ 154,284 ⁽⁴⁾	\$ 97,385 ⁽⁵⁾
\$.43	\$.28	\$.25	\$.25	\$.21 ⁽⁴⁾	\$.14 ⁽⁵⁾
\$.41	\$.27	\$.24	\$.24	\$.21 ⁽⁴⁾	\$.13 ⁽⁵⁾
\$.0098	\$.0087	\$.0079	\$.0079	\$.0076	\$.0070
\$ 4,246,160	\$ 3,723,479	\$ 3,256,122	\$ 2,823,071	\$ 2,576,037	\$ 2,368,856
\$ 628,106	\$ 650,226	\$ 661,010	\$ 583,071	\$ 639,136	\$ 735,754
\$ 2,009,018	\$ 1,648,312	\$ 1,427,318	\$ 1,238,706	\$ 1,054,019	\$ 879,536
8.0%	5.9%	6.0%	6.6%	6.2% ⁽⁴⁾	4.6% ⁽⁵⁾
17.4%	13.5%	13.7%	15.6%	16.0% ⁽⁴⁾	12.9% ⁽⁵⁾
50,399,960	49,621,504	44,785,573	42,742,602 ⁽⁶⁾	36,955,221 ⁽⁶⁾	27,839,284
28,355,169	27,083,483	23,327,804	21,611,266	18,827,288	13,787,005
44,487,496	40,727,495	36,180,001	32,123,974	27,511,000	21,366,642
63.7%	66.5%	64.5%	67.3%	68.4%	64.5%
563	546	521	506	509	495
786,288	748,634	685,524	624,476	546,297	438,184
\$72.81	\$66.20	\$61.80	\$58.44	\$59.97	\$58.33
12.94¢	12.13¢	11.86¢	11.56¢	11.77¢	11.78¢
8.58¢	8.36¢	7.94¢	8.07¢	8.35¢	7.89¢
7.40¢	7.50¢	7.07¢	7.08¢	7.25¢ ⁽⁷⁾	7.03¢
62.46¢	65.47¢	55.22¢	53.92¢	59.15¢	60.82¢
23,974	22,944	19,933	16,818	15,175	11,397
261	243	224	199	178	141

(6) Includes certain estimates for Morris

(7) Excludes merger expenses of \$10.8 million

(8) Includes leased aircraft

(9) Includes effect of reclassification of revenue reported in 1999 through 1995 related to the sale of flight segment credits from Other to Passenger due to the accounting change implementation in 2000

(10) Excludes cumulative effect of accounting change of \$22.1 million (\$.03 per share)



CORPORATE DATA

TRANSFER AGENT AND REGISTRAR

Registered shareholder inquiries regarding stock transfers, address changes, lost stock certificates, dividend payments, or account consolidation should be directed to:

Continental Stock Transfer & Trust Company
17 Battery Place
New York, New York 10004
(212) 509-4000

STOCK EXCHANGE LISTING

New York Stock Exchange
Ticker Symbol: LUV

INDEPENDENT AUDITORS

Ernst & Young LLP
Dallas, Texas

GENERAL OFFICES

P.O. Box 36611
Dallas, Texas 75235-1611

ANNUAL MEETING

The Annual Meeting of Shareholders of Southwest Airlines Co. will be held at 10:00 a.m. on May 15, 2002, 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 U.S. Securities and Exchange Commission (SEC) and other financial information can be found on Southwest's web site (southwest.com) or may be obtained without charge by writing or calling:

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

DIRECTORS

COLLEEN C. BARRETT
President and Chief Operating Officer
Southwest Airlines Co., Dallas, Texas

SAMUEL E. BARSHOP
Chairman of the Board, Barshop & Oles Co., Inc.,
San Antonio, Texas;
Audit and Compensation (Chairman) Committees

GENE H. BISHOP
Retired, Dallas, Texas;
Audit, Compensation, and Executive Committees

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

WILLIAM H. CUNNINGHAM, Ph.D.
James L. Bayless Professor of Marketing
University of Texas School of Business
Former Chancellor of
The University of Texas System, Austin, Texas;
Audit and Nominating Committees

WILLIAM P. HOBBY
Chairman of the Board,
Hobby Communications, L.L.C.;
Former Lieutenant Governor of Texas;
Houston, Texas;
Audit, Nominating, and Compensation Committees

TRAVIS C. JOHNSON
Attorney at Law, El Paso, Texas;
Audit (Chairman) and Nominating Committees

HERBERT D. KELLEHER
Chairman of the Board, Southwest Airlines Co.,
Dallas, Texas; Executive Committee

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

JUNE M. MORRIS
Founder and former Chief Executive Officer
of Morris Air Corporation, Salt Lake City, Utah;
Audit and Nominating Committees

JAMES F. PARKER
Vice Chairman and Chief Executive Officer
of Southwest Airlines Co., Dallas, Texas

OFFICERS

JAMES F. PARKER*
Vice Chairman and Chief Executive Officer

COLLEEN C. BARRETT*
President and Chief Operating Officer
Corporate Secretary

DONNA D. CONOVER*
Executive Vice President – Customer Service

GARY C. KELLY*
Executive Vice President and Chief Financial Officer

JAMES C. WIMBERLY*
Executive Vice President and Chief of Operations

JOYCE C. ROGGE*
Senior Vice President – Marketing

DEBORAH ACKERMAN
Vice President – General Counsel

BEVERLY CARMICHAEL
Vice President – People Department

GREGORY N. CRUM
Vice President – Flight Operations

GINGER C. HARDAGE
Vice President – Corporate Communications

ROBERT E. JORDAN
Vice President – Purchasing

CAMILLE T. KEITH
Vice President – Special Marketing

DARYL KRAUSE
Vice President – Provisioning

KEVIN M. KRONE
Vice President – Interactive Marketing

PETE MCGLADE
Vice President – Schedule Planning

BOB MONTGOMERY
Vice President – Properties and Facilities

RON RICKS*
Vice President – Governmental Affairs

DAVE RIDLEY*
Vice President – Ground Operations

JAMES A. RUPPEL
Vice President – Customer Relations and
Rapid Rewards

ROGER W. SAARI
Vice President – Fuel Management

JIM SOKOL
Vice President – Maintenance and Engineering

KEITH L. TAYLOR
Vice President – Revenue Management

ELLEN TORBERT
Vice President – Reservations

MICHAEL G. VAN DE VEN
Vice President – Financial Planning and Analysis

TAMMYE WALKER-JONES
Vice President – Inflight

GREG WELLS
Vice President – Safety, Security, and
Flight Dispatch

STEVEN P. WHALEY
Controller

LAURA H. WRIGHT
Vice President – Finance and Treasurer

*Member of Executive Planning Committee