

SECURITIES AND EXCHANGE COMMISSION
Washington, D.C. 20549

FORM 10-Q

(Mark One)

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

For the quarterly period ended March 31, 2001 or

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

For the transition period from _____ to _____

Commission file No. 1-7259

Southwest Airlines Co.

(Exact name of registrant as specified in its charter)

TEXAS

74-1563240

(State or other jurisdiction of
incorporation or organization)

(I.R.S. Employer
Identification No.)

P.O. Box 36611, Dallas, Texas

75235-1611

(Address of principal executive offices)

(Zip Code)

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

Indicate by check mark whether the registrant (1) has filed all reports
required to be filed by Section 13 or 15(d) of the Securities Exchange
Act of 1934 during the preceding 12 months (or for such shorter period
that the registrant was required to file such reports), and (2) has
been subject to such filing requirements for the past 90 days.

Yes ☒ No ☐

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

Number of shares of Common Stock outstanding as of the close of
business on April 27, 2001:

761,643,359

SOUTHWEST AIRLINES CO.

FORM 10-Q

Part I - FINANCIAL INFORMATION

Item 1. Financial Statements

Southwest Airlines Co.

CONDENSED CONSOLIDATED BALANCE SHEETS

(in thousands)

(unaudited)

March 31, 2001 December 31, 2000

ASSETS

Current assets:

Cash and cash equivalents	\$684,678	\$522,995
Accounts and other receivables	144,467	138,070
Inventories of parts and supplies, at cost	78,817	80,564

Deferred income taxes	28,132	28,005
Fuel hedge contracts	63,773	22,515
Prepaid expenses and other		
current assets	44,547	39,387
Total current assets	1,044,414	831,536
Property and equipment:		
Flight equipment	7,108,197	6,831,913
Ground property and equipment	823,835	800,718
Deposits on flight equipment		
purchase contracts	286,969	335,164
	8,219,001	7,967,795
Less allowance for depreciation	2,232,500	2,148,070
	5,986,501	5,819,725
Other assets	34,938	18,311
	\$7,065,853	\$6,669,572

LIABILITIES AND STOCKHOLDERS' EQUITY

Current liabilities:		
Accounts payable	\$316,112	\$312,716
Accrued liabilities	537,755	499,874
Air traffic liability	504,846	377,061
Income taxes payable	19,572	-
Current maturities of long-term debt	110,136	108,752
Total current liabilities	1,488,421	1,298,403
Long-term debt less current maturities	754,686	760,992
Deferred income taxes	891,186	852,865
Deferred gains from sale and leaseback		
of aircraft	203,728	207,522
Other deferred liabilities	85,726	98,470
Stockholders' equity:		
Common stock	761,826	507,897
Capital in excess of par value	-	103,780
Retained earnings	2,858,932	2,902,007
Accumulated other comprehensive		
income	35,795	-
Treasury stock at cost	(14,447)	(62,364)
Total stockholders' equity	3,642,106	3,451,320
	\$7,065,853	\$6,669,572

See accompanying notes.

Southwest Airlines Co. CONDENSED CONSOLIDATED STATEMENTS OF INCOME (in thousands, except per share amounts) (unaudited)

	Three months ended March 31,	
	2001	2000
OPERATING REVENUES:		
Passenger	\$1,381,276	\$1,199,885
Freight	25,781	27,066
Other	21,560	15,696
Total operating revenues	1,428,617	1,242,647
OPERATING EXPENSES:		
Salaries, wages, and benefits	447,431	381,489
Fuel and oil	209,584	197,071
Maintenance materials and repairs	98,524	93,565
Agency commissions	30,494	37,216
Aircraft rentals	48,045	49,347
Landing fees and other rentals	70,018	65,019
Depreciation	77,692	66,698
Other operating expenses	236,672	196,834
Total operating expenses	1,218,460	1,087,239
OPERATING INCOME	210,157	155,408
OTHER EXPENSES (INCOME):		
Interest expense	17,012	17,223
Capitalized interest	(6,199)	(7,001)
Interest income	(8,882)	(6,649)
Other (gains) losses, net	11,724	(4,138)
Total other expenses (income)	13,655	(565)
INCOME BEFORE INCOME TAXES AND CUMULATIVE		
EFFECT OF CHANGE IN ACCOUNTING PRINCIPLE	196,502	155,973
PROVISION FOR INCOME TAXES	75,457	60,330
NET INCOME BEFORE CUMULATIVE EFFECT OF		
CHANGE IN ACCOUNTING PRINCIPLE	121,045	95,643

CUMULATIVE EFFECT OF CHANGE IN ACCOUNTING PRINCIPLE (Net of Income Taxes of \$14.0 million)	-	(22,131)
NET INCOME	\$121,045	\$73,512
NET INCOME PER SHARE, BASIC BEFORE CUMULATIVE EFFECT OF CHANGE IN ACCOUNTING PRINCIPLE	\$.16	\$.13
CUMULATIVE EFFECT OF CHANGE IN ACCOUNTING PRINCIPLE	-	(.03)
NET INCOME PER SHARE, BASIC	\$.16	\$.10
NET INCOME PER SHARE, DILUTED BEFORE CUMULATIVE EFFECT OF CHANGE IN ACCOUNTING PRINCIPLE	\$.15	\$.12
CUMULATIVE EFFECT OF CHANGE IN ACCOUNTING PRINCIPLE	-	(.03)
NET INCOME PER SHARE, DILUTED	\$.15	\$.09
WEIGHTED AVERAGE SHARES OUTSTANDING:		
Basic	760,225	745,736
Diluted	807,744	789,534

See accompanying notes.

Southwest Airlines Co.
CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS
(in thousands)
(unaudited)

	Three months ended March 31, 2001	2000
NET CASH PROVIDED BY OPERATING ACTIVITIES	\$420,598	\$415,565
INVESTING ACTIVITIES:		
Net purchases of property and equipment	(254,328)	(191,810)
FINANCING ACTIVITIES:		
Payments of long-term debt and capital lease obligations	(5,019)	(4,411)
Payments of cash dividends	(6,570)	(5,510)
Proceeds from Employee stock plans	7,002	11,271
Repurchases of common stock	-	(101,363)
NET CASH (USED IN) FINANCING ACTIVITIES	(4,587)	(100,013)
NET INCREASE IN CASH AND CASH EQUIVALENTS	161,683	123,742
CASH AND CASH EQUIVALENTS AT BEGINNING OF PERIOD	522,995	418,819
CASH AND CASH EQUIVALENTS AT END OF PERIOD	\$684,678	\$542,561
CASH PAYMENTS FOR:		
Interest, net of amount capitalized	\$18,086	\$12,453
Income taxes	\$3,109	\$621

See accompanying notes.

SOUTHWEST AIRLINES CO.
Notes to Condensed Consolidated Financial Statements
(unaudited)

1. Basis of presentation - The accompanying unaudited condensed consolidated financial statements of Southwest Airlines Co. (Company) have been prepared in accordance with accounting principles generally accepted in the United States for interim financial information and with the instructions to Form 10-Q and Article 10 of Regulation S-X. Accordingly, they do not include all of the information and footnotes required by accounting principles generally accepted in the United States for complete financial statements. The condensed consolidated financial

statements for the interim periods ended March 31, 2001 and 2000 include all adjustments (which include only normal recurring adjustments) which are, in the opinion of management, necessary for a fair presentation of the results for the interim periods. The Condensed Consolidated Balance Sheet as of December 31, 2000 has been derived from the Company's audited financial statements as of that date but does not include all of the information and footnotes required by Generally Accepted Accounting Principles for complete financial statements. Operating results for the three months ended March 31, 2001 are not necessarily indicative of the results that may be expected for the year ended December 31, 2001. For further information, refer to the consolidated financial statements and footnotes thereto included in the Southwest Airlines Co. Annual Report on Form 10-K for the year ended December 31, 2000.

2. Dividends - During the three month period ended March 31, 2001, dividends of \$.0045 per share were declared on the 760.7 million shares of common stock then outstanding. During the three month period ended March 31, 2000, dividends of \$.0037 per share were declared on the 745.7 million shares of common stock then outstanding.

3. Common stock - 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. All share and per share data presented in the accompanying unaudited condensed consolidated financial statements and notes thereto have been restated for the stock split.

4. Reclassifications - Certain prior year amounts have been reclassified to conform to the current year presentation.

5. Net income per share - The following table sets forth the computation of basic and diluted net income per share (in thousands except per share amounts) (unaudited):

	Three months ended March 31,	
	2001	2000
NUMERATOR:		
Net income before cumulative effect of change in accounting principle	\$121,045	\$95,643
Cumulative effect of change in accounting principle	-	(22,131)
Net income available to common stockholders	\$121,045	\$73,512
DENOMINATOR:		
Weighted-average shares outstanding, basic	760,225	745,736
Dilutive effect of Employee stock options	47,519	43,798
Adjusted weighted-average shares outstanding, diluted	807,744	789,534
NET INCOME PER SHARE:		
Basic, before cumulative effect of change in accounting principle	\$.16	\$.13
Cumulative effect of change in accounting principle	-	(.03)
Basic	\$.16	\$.10
Diluted, before cumulative effect of change in accounting principle	\$.15	\$.12
Cumulative effect of change in accounting principle	-	(.03)
Diluted	\$.15	\$.09

6. Accounting changes - Effective January 1, 2001, the Company adopted Statement of Financial Accounting Standards No. 133, Accounting for Derivative Instruments and Hedging Activities, as amended (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 the derivative is designated as a hedge, depending on the nature of the hedge, changes in the fair value of derivatives 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 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 in the Condensed Consolidated Statement of Income. Any portion of a change in a derivative's fair value that the Company has elected to exclude from its measurement of effectiveness, such as the change in time value of option contracts, is recorded immediately in Other (gains)/losses in the Condensed Consolidated Statement of Income.

Airline operators are inherently dependent upon energy to operate and, therefore, are impacted by changes in jet fuel prices. The Company endeavors to acquire jet fuel at the lowest prevailing prices possible. Because jet fuel is not traded on an organized futures exchange, liquidity for hedging is limited. However, the Company has found that crude oil contracts 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 March 31, 2001, the Company had a mixture of purchased call options, collar structures, and fixed price swap agreements in place to hedge approximately 80 percent of its remaining 2001 total anticipated jet fuel requirements, approximately 27 percent of its 2002 total anticipated jet fuel requirements, and a small portion of its 2005 total anticipated jet fuel requirements. As of March 31, 2001, nearly all of the Company's remaining 2001 hedges, and the majority of its 2002 hedges, are effectively heating oil-based positions. All remaining hedge positions are crude oil-based positions.

The Company accounts for its fuel hedge derivative instruments as cash flow hedges, as defined. Upon adoption of SFAS 133, the Company recorded the fair value of its fuel derivative instruments in the Condensed Consolidated Balance Sheet and a deferred gain of \$46.1 million, net of tax, in accumulated other comprehensive income. The portion of the transition adjustment in "Accumulated other comprehensive income" that was recognized in earnings during first quarter 2001 was a gain of \$16.8 million, net of tax. During first quarter 2001, the Company recognized approximately \$2.5 million of net expense, related to the ineffectiveness of its hedges, in Other losses on the Condensed Consolidated Statement of Income. During first quarter 2001, the Company recognized approximately \$8.4 million of net expense, related to the change in time value of hedge instruments, in Other (gains)/losses on the Condensed Consolidated Statement of Income. The Company believes the adoption of SFAS 133 will result in more volatility in its financial statements than in the past.

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 to "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 earned and flown or credits expire unused. Due to this change, the Company recorded a cumulative adjustment in first quarter 2000 of \$22.1 million (net of income taxes of \$14.0 million) or \$.03 per share, basic and diluted.

7. 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. For the three months ended March 31, 2001, comprehensive income totaled \$156.8 million. The difference between net income and comprehensive income for the three months ended March 31, 2001 is as follows (in thousands):

	Three months ended March 31, 2001
Net income	\$121,045
Unrealized gain (loss) on Derivative instruments, net of deferred taxes of \$23,575	36,494
Other, net of deferred taxes of (\$452)	(699)
Total other comprehensive income	35,795
Comprehensive income	\$156,840

As of March 31, 2001, the Company had approximately \$36.5 million in unrealized gains, net of tax, in accumulated other comprehensive income related to fuel hedges, of which approximately \$32.9 million is

expected to be realized in earnings over the next twelve months following March 31, 2001. 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 approximately \$45.1 million is expected to be realized in earnings over the twelve months following January 1, 2001. A rollforward of the amounts included in Accumulated other comprehensive income, net of taxes, is shown below (in thousands):

	Fuel hedge derivatives	Other	Accumulated other comprehensive income
Balance at December 31, 2000	-	-	-
January 1, 2001 transition adjustment	\$ 46,089	-	\$ 46,089
Current-period changes in value	4,279	(\$699)	3,580
Reclassification to earnings	(13,874)	-	(13,874)
Balance at March 31, 2001	\$ 36,494	(\$699)	\$ 35,795

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

Comparative Consolidated Operating Statistics

Relevant operating statistics for the three months ended March 31, 2001 and 2000 are as follows:

SOUTHWEST AIRLINES CO. COMPARATIVE CONSOLIDATED OPERATING STATISTICS

	Three months ended March 31,		
	2001	2000	Change
Revenue passengers carried	15,716,020	14,389,276	9.2%
Revenue passenger miles (RPMs) (000s)	10,662,391	9,453,201	12.8%
Available seat miles (ASMs) (000s)	15,852,999	14,153,959	12.0%
Load factor	67.3%	66.8%	.5 pts.
Average length of passenger haul	678	657	3.2%
Trips flown	231,793	218,615	6.0%
Average passenger fare	\$87.89	\$83.39	5.4%
Passenger revenue yield per RPM (cents)	12.95	12.69	2.0%
Operating revenue yield per ASM (cents)	9.01	8.78	2.6%
Operating expenses per ASM (cents)	7.69	7.68	0.1%
Operating expenses per ASM, excluding fuel (cents)	6.36	6.29	1.1%
Fuel costs per gallon, excluding fuel tax (cents)	78.53	81.98	(4.2)%
Number of Employees at period-end	29,563	27,911	5.9%
Size of fleet at period-end	352	315	11.7%

Material Changes in Results of Operations

Consolidated net income for first quarter 2001 was \$121.0 million (\$.15 per share, diluted), as compared to first quarter 2000 net income, before the cumulative effect of change in accounting principle, of \$95.6 million (\$.12 per share, diluted), an increase of 26.6 percent. The prior year's net income per share amounts have been restated for the 2001 three-for-two stock split (see Note 3 to the unaudited Condensed Consolidated

Financial Statements). The cumulative effect of change in accounting principle for first quarter 2000 was \$22.1 million, net of taxes of \$14.0 million (see Note 6 to the unaudited Condensed Consolidated Financial Statements). Net income and diluted net income per share, after the cumulative change in accounting principle, for first quarter 2000 were \$73.5 million and \$.09, respectively. Operating income for first quarter 2001 was \$210.2 million, an increase of 35.2 percent compared to 2000.

Consolidated operating revenues increased 15.0 percent primarily due to a 15.1 percent increase in passenger revenues. The increase in passenger revenues primarily resulted from the Company's increased capacity. The Company experienced a 9.2 percent increase in revenue passengers carried, a 12.8 percent increase in RPMs, and a 2.0 percent increase in passenger revenue yield per RPM (passenger yield). The increase in RPMs exceeded a 12.0 percent increase in ASMs resulting in a load factor of 67.3 percent, or .5 points above the same prior year period. The increase in ASMs resulted primarily from the net addition of 37 aircraft since first quarter 2000, which represents an 11.7 percent increase in the Company's fleet size. The increase in passenger yield is primarily due to a 5.4 percent increase in average passenger fare, partially offset by a 3.2 percent increase in average length of passenger haul.

Based on current traffic and booking trends thus far in April and considering an estimated increase in available seat miles of 11.6 percent for second quarter 2001, the Company's second quarter 2001 load factor is forecasted to be lower than second quarter 2000's load factor of 74.3 percent. The April 2001 load factor is expected to fall below April 2000's load factor by approximately 2.0 points. RPM yields for April 2001 are expected to be in line with year ago levels. As a result of the weakening economy and industry environment, RPM yields may continue to soften. (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, competitive pressure such as fare sales and capacity changes by other carriers, general economic conditions, and variations in advance booking trends.)

Consolidated freight revenues decreased 4.7 percent primarily due to the recent U.S. economic decline experienced throughout first quarter 2001. Other revenues increased 37.4 percent. Approximately 51.1 percent of the increase in other revenues was from an increase in commissions earned from programs the Company sponsors with certain business partners, such as the Company sponsored First USA Visa card, while 27.5 percent of the increase was due to an increase in charter revenues.

Operating expenses per ASM were \$.0769, compared to \$.0768 for 2000. Excluding fuel expense, operating expenses per ASM increased 1.1 percent to \$.0636. As in first quarter 2001, the Company currently expects that, excluding fuel, operating expenses per ASM in second quarter 2001 will continue to experience a moderate year-over-year increase compared to second quarter 2000. (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, wage and productivity pressures from within the Company's work force and general economic conditions)

Southwest Airlines Co.
Operating Expenses per ASM
(in cents except percent change)

	Three months ended March 31,			
	2001	2000	Inc/ (Dec)	Percent Change
Salaries, wages, and benefits	2.49	2.40	.09	3.8
Employee retirement plans	.33	.29	.04	13.8
Fuel and oil	1.32	1.39	(.07)	(5.0)
Maintenance materials and repairs	.62	.66	(.04)	(6.1)
Agency commissions	.19	.26	(.07)	(26.9)
Aircraft rentals	.30	.35	(.05)	(14.3)
Landing fees and other rentals	.44	.46	(.02)	(4.3)
Depreciation	.49	.47	.02	4.3
Other operating expenses	1.51	1.40	.11	7.9
Total	7.69	7.68	.01	.1

Salaries, wages, and benefits per ASM increased 3.8 percent. Approximately 63.3 percent of the increase was due to an increase in salaries, and approximately 28.9 percent of the increase was due to an increase in health benefits expense.

Employee retirement plans expense per ASM increased 13.8 percent, primarily due to the increase in Company earnings available for profitsharing.

Fuel and oil expense per ASM decreased 5.0 percent due to a 4.2 percent decrease in the average jet fuel cost per gallon compared to 2000. The average jet fuel cost per gallon in first quarter 2001 was \$.7853 compared to \$.8198 in first quarter 2000, including the effects of hedging activities. The Company's first quarter 2001 average jet fuel cost is net of approximately \$24.4 million in "effective" hedging gains, as defined. See Note 6 to the Condensed Consolidated Financial Statements. The Company's first quarter 2000 average jet fuel cost is net of approximately \$3.2 million in gains from hedging activities. As of March 31, 2001, the Company had hedges in place for approximately 80 percent of its anticipated jet fuel requirements for the remainder of 2001 at prices below market prices as of March 31, 2001. Including estimated hedging gains and considering current market prices and the continued effectiveness of the Company's fuel hedges, we are forecasting our second quarter 2001 average fuel price per gallon to be at or below second quarter 2000's average fuel cost per gallon of \$.78. The Company's fuel hedging strategy could result in the Company not fully benefiting from certain jet fuel price declines. (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.)

Maintenance materials and repairs per ASM decreased 6.1 percent primarily due to a decrease in engine repair expense.

Agency commissions per ASM decreased 26.9 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. The percentage of commissionable revenues decreased from approximately 31 percent in first quarter 2000 to approximately 28 percent in first quarter 2001. Due to the Company's commission policy change in 2001, we expect agency commissions to continue to show year-over-year decreases throughout 2001 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 14.3 percent compared to first quarter 2000 due to a lower percentage of the aircraft fleet being leased. Approximately 26.7 percent of the Company's aircraft fleet was under operating lease at March 31, 2001, compared to 30.5 percent at March 31, 2000. Based on the Company's current new aircraft delivery schedule and scheduled aircraft retirements for 2001, we expect to continue to have year-over-year decreases throughout 2001 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 the Company's current schedule for purchase and/or retirement of aircraft.)

Landing fees and other rentals per ASM decreased 4.3 percent primarily as a result of a decrease in landing fees per ASM of 5.6 percent. 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 an increase in the average distance per aircraft trip flown.

Depreciation expense per ASM increased 4.3 percent primarily due to a higher percentage of owned aircraft. All of the 39 aircraft added to the Company's fleet over the past twelve months have been purchased. This, combined with the retirement of two leased aircraft, has increased the Company's percentage of aircraft owned or on capital lease from 69.5 percent at March 31, 2000 to 73.3 percent at March 31, 2001.

Other operating expenses per ASM increased 7.9 percent primarily due to an increase in advertising costs.

Other expenses (income) include interest expense, capitalized interest, interest income, and other gains and losses. Interest expense decreased 1.2 percent primarily due to a reduction in interest rates on the Company's floating rate debt. Capitalized interest decreased 11.5 percent primarily due to a reduction in progress payment

balances for future aircraft deliveries. Interest income increased 33.6 percent primarily due to higher invested cash balances. Other losses in first quarter 2001 resulted primarily from the reduction in the time value portion of financial derivative instruments, such as premiums paid for option contracts, used in the Company's fuel hedging program. The Company excludes this change in time value from its tests of effectiveness, as defined by SFAS 133, and thus records the changes in other gains and losses. See Note 6 to the Condensed Consolidated Financial Statements. Other gains in first quarter 2000 were primarily due to proceeds received from the favorable conclusion of a lawsuit.

Liquidity and Capital Resources

Net cash provided by operating activities was \$420.6 million for the three months ended March 31, 2001 and \$1,303.3 million for the 12 months then ended. Cash generated for the 12 months ended March 31, 2001 was primarily used to finance aircraft-related capital expenditures and provide working capital.

During the 12 months ended March 31, 2001, net capital expenditures were \$1,197.2 million, which primarily related to the purchase of 39 new 737-700 aircraft, and progress payments for future aircraft deliveries.

The Company's contractual commitments consist primarily of scheduled aircraft acquisitions. As of March 31, 2001, 17 737-700s are scheduled for delivery in the remainder of 2001, 27 in 2002, 13 in 2003, 29 in 2004, five in 2005, and 47 thereafter. In addition, the Company has options to purchase up to 87 737-700s during 2003-2008 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 scheduled subsequent to 2002. Aggregate funding needed for fixed commitments at March 31, 2001 was approximately \$3,800 million due as follows: \$473 million in 2001; \$766 million in 2002; \$472 million in 2003; \$641 million in 2004; \$379 million in 2005; and \$1,069 million thereafter.

The Company has various options available to meet its capital and operating commitments, including cash on hand at March 31, 2001 of \$684.7 million, internally generated funds, and a revolving credit line with a group of banks of up to \$475 million (none of which had been drawn at March 31, 2001). In addition, the Company will also consider various borrowing or leasing options to maximize earnings and supplement cash requirements.

The Company currently has outstanding shelf registrations for the issuance of \$318.8 million in public debt securities which it may utilize for aircraft financing during 2001 and 2002.

In January 2001, the Company began new service to Palm Beach International Airport in West Palm Beach, Florida, with daily nonstop service to Tampa Bay, Orlando, Nashville, and Baltimore/Washington.

Item 3. Quantitative and Qualitative Disclosures About Market Risk

See Item 7A. Quantitative and Qualitative Disclosures About Market Risk in the Company's Annual Report on Form 10-K for the year ended December 31, 2000.

PART II. OTHER INFORMATION

Item 1. Legal Proceedings

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. The IRS has proposed similar adjustments to the tax returns of numerous other members of the airline industry. 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, substantially

the same as that in issue in the Company's Tax Court suit, is currently deductible as an ordinary and necessary business expense. Counsel for the Company and the IRS are in discussions in an attempt to resolve the controversy in conformity with the IRS revenue ruling and without the necessity of further litigation. 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.

Item 2. Changes in Securities and Use of Proceeds

Recent Sales of Unregistered Securities

During the first quarter of 2001, Herbert D. Kelleher exercised unregistered options to purchase Southwest Airlines Co. Common Stock as follows:

Number of Shares Purchased	Option Price	Date of Exercise
893,427	\$1.00	1/2/2001

The number of shares shown has not been adjusted for the February 15, 2001 3-for-2 stock split. The issuance of the above shares to Mr. Kelleher were exempt from the registration provisions of the Securities Act of 1933, as amended (the "Act"), by reason of the provision of Section 4(2) of the Act because, among other things, of the limited number of participants in such transactions and the agreement and representation of Mr. Kelleher that he was acquiring such securities for investment and not with a view to distribution thereof. The certificates representing the shares issued to Mr. Kelleher contain a legend to the effect that such shares are not registered under the Act and may not be transferred except pursuant to a registration statement which has become effective under the Act or to an exemption from such registration. The issuance of such shares was not underwritten.

Item 3. Defaults upon Senior Securities

None

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

None

Item 5. Other Information

None

Item 6. Exhibits and Reports on Form 8-K

a) Exhibits

(10) 2001 Employment Contract between Southwest and Herbert D. Kelleher dated as of January 1, 2001

b) Reports on Form 8-K

None

SIGNATURES

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

SOUTHWEST AIRLINES CO.

May 1, 2001

By /s/ Gary C. Kelly

Gary C. Kelly
Vice President - Finance and
Chief Financial Officer
(Principal Financial and

Accounting Officer)

EMPLOYMENT CONTRACT

THIS EMPLOYMENT CONTRACT (hereinafter referred to as this "Agreement"), dated as of January 1, 2001, by and between HERBERT D. KELLEHER (hereinafter referred to as the "Employee"), a resident of Dallas, Texas, and SOUTHWEST AIRLINES CO. (hereinafter referred to as "Southwest", which term shall include its subsidiary companies where the context so admits), a Texas corporation,

W I T N E S S E T H:

WHEREAS the Employee has served as permanent President and Chief Executive Officer of Southwest since February 1, 1982, initially pursuant to an Employment Contract dated as of February 1, 1982, later pursuant to Employment Contracts dated as of January 1, 1985, as amended, January 1, 1988 and January 1, 1992 and most recently pursuant to an Employment Contract dated as of January 1, 1996 (such Employment Contracts being referred to collectively as the "Old Contracts"); and

WHEREAS the Employee and Southwest desire to enter into a successor agreement for the continuing services of the Employee;

NOW, THEREFORE, for and in consideration of the premises and the mutual covenants and promises contained herein, Southwest and the Employee agree as follows:

I. POSITION, DUTIES AND AUTHORITY

A. POSITIONS. The Employee shall perform such corporate duties and discharge such corporate responsibilities as are designated by the Board of Directors and, for so long as he shall be elected to the Board of Directors of Southwest, he shall serve as both Chairman of the Board and Chairman of the Executive Committee of the Board without additional compensation hereunder.

B. DUTIES. The Employee's duties shall include responsibility for overseeing the implementation of Southwest's current and long range business policies and programs and handling such other functions or segments of Southwest's business as may be directed from time to time by the Board of Directors.

C. AUTHORITY. The Employee shall be vested with all authority reasonably necessary to carry out his duties and responsibilities as set forth in this Article I.

D. NECESSARY SUPPORT AND ENVIRONMENT. The Employee shall be provided with the secretarial and other support personnel (including a full-time administrative assistant) and general working environment (including a private, furnished office) reasonably necessary for him to carry out his duties and responsibilities as set forth in this Article I.

II. EMPLOYEE'S OBLIGATIONS

A. TIME AND EFFORTS. During the term of his employment hereunder, the Employee shall devote such time and effort as is required to discharge his duties hereunder.

B. NON-COMPETITION. The Employee recognizes and understands that in performing the duties and responsibilities of his employment as outlined in this Agreement and pursuant to his employment at Southwest prior to the execution of this Agreement, the Employee has occupied and will occupy a position of trust and confidence, pursuant to which the Employee has developed and acquired and will develop and acquire experience and knowledge with respect to various aspects of the business of Southwest and the manner in which such business is conducted. It is the expressed intent and agreement of the Employee and Southwest that such knowledge and experience shall be used in the furtherance of the business interests of Southwest and not in any manner which would be detrimental to such business interests of Southwest. The Employee therefore agrees that, so long as the Employee is employed pursuant to this Agreement, unless he first secures the consent of the Board of Directors of Southwest, the Employee will not invest, engage or participate in any manner whatsoever, either personally or in any status or capacity (other than as a shareholder of less than one percent [1%] of the capital stock of a publicly owned corporation), in any business or other entity organized for profit engaged in significant competition with Southwest in the conduct of its air carrier operations anywhere in the States of Texas, Louisiana, Oklahoma, New Mexico, Missouri, Arizona, Nevada, California, Arkansas, Alabama, Tennessee, Kentucky, Michigan, Indiana, Ohio, Maryland, Illinois, Utah, Washington, Oregon, Nebraska, Florida, Idaho, Mississippi, New Hampshire, New York, Rhode Island, Connecticut and North Carolina. Although the Employee and Southwest regard such restrictions as reasonable for the purpose of

preserving Southwest and its proprietary rights, in the event that the provisions of this Paragraph II-B should ever be deemed to exceed the time or geographic limitations permitted by applicable laws, then such provisions shall be reformed to the maximum time or geographic limitations permitted by applicable laws.

III. TERM

A. TERM. This Agreement and the Employee's employment hereunder shall commence and become effective on and as of January 1, 2001. The term of such employment shall expire on December 31, 2003, unless extended by consent of the parties hereto or earlier terminated pursuant to the provisions of Article V.

IV. EMPLOYEE'S COMPENSATION

A. BASE SALARY. The Employee's annual Base Salary for the years ending December 31, 2001, 2002 and 2003 shall be \$450,000 or such greater amount as shall be determined by the Board of Director of Southwest. The Employee's Base Salary shall be payable to the Employee in equal semi-monthly installments and shall be subject to such payroll and withholding deductions as may be required by law.

B. PERFORMANCE BONUS. The Board of Directors of Southwest (or the Compensation Committee thereof) may grant a Performance Bonus to the Employee, in addition to his Base Salary, at such times and in such amounts as such Board (or Committee) may determine.

C. DEFERRED COMPENSATION. In addition to the Base Salary provided for in Paragraph IV-A above, Southwest shall continue to set aside on its books, as provided in Paragraph IV-C of each of the Old Contracts, a special ledger Deferred Compensation Account (the "Account") for the Employee, and shall credit thereto Deferred Compensation determined as hereinafter provided. (Southwest at its election may fund the payment of Deferred Compensation by setting aside and investing such funds as Southwest may from time to time determine. Neither the establishment of the Account, the crediting of Deferred Compensation thereto, nor the setting aside of any funds shall be deemed to create a trust. Legal and equitable title to any funds set aside shall remain in Southwest, and the Employee shall have no security or other interest in such funds. Any funds so set aside or invested shall remain subject to the claims of the creditors of Southwest, present and future.) For each full or partial calendar year as the Employee shall remain in the employment of Southwest under this Agreement, Deferred Compensation shall accumulate in an amount equal to any contributions (including forfeitures but excluding any elective deferrals actually returned to the Employee) which would otherwise have been made by Southwest on behalf of the Employee to the Southwest Airlines Co. Money Purchase Plan but which exceed maximum annual additions under such Plan on his behalf under federal tax law. If such employment shall terminate prior to December 31 in any calendar year, then Deferred Compensation shall accumulate and be calculated as provided under the terms of Southwest's Money Purchase Plan. The Deferred Compensation credited to the Account (including the Interest hereinafter provided) shall be paid to the Employee (or to the executors or administrators of his estate) at the rate of \$100,000 per calendar year (subject to such payroll and withholding deductions as may be required by law), commencing with the calendar year following the year in which (i) the Employee shall become seventy-two (72) or (ii) the Employee's employment with Southwest shall terminate (whether such termination is under this Agreement or otherwise and whether it is before, on or after the expiration of the initial term set forth in Paragraph III-A above, and irrespective of the cause thereof), whichever shall occur later, and continuing until the entire amount of Deferred Compensation and Interest credited to the Account shall have been paid. Although the total amount of Deferred Compensation ultimately payable to the Employee hereunder shall be computed in accordance with the provisions set forth above, there shall be accrued and credited to the Account, beginning on January 1, 2001 and continuing annually thereafter, amounts equal to simple interest at the rate of ten percent (10%) per annum, compounded annually ("Interest"), on the accrued and unpaid balance of the Deferred Compensation credited to the Account as of the preceding December 31. The Deferred Compensation and Interest to be paid in any one calendar year shall be paid on the first business day of such calendar year. Notwithstanding the foregoing, in the event of the Employee's death, Southwest, in its sole discretion, shall have the right to pay the unpaid balance of the Deferred Compensation (together with any accrued Interest thereon) to the executors or administrators of the Employee's estate in cash in one lump sum on the first business day of the calendar year next following the calendar year in which the Employee shall have died. No right, title, interest or benefit under this Paragraph IV-C shall ever be liable for or charged with any of the torts or obligations of the Employee or any person claiming under him, or be subject to seizure by any creditor of the Employee or any person claiming under him. Neither the Employee nor any person claiming under him shall have the power to anticipate or dispose of any right, title, interest or benefit under

this Paragraph IV-C in any manner until the same shall have been actually distributed by Southwest.

D. DISABILITY INSURANCE. Southwest shall provide long term disability insurance providing for payment, in the event of disability of the Employee, of \$8,000 per month to age seventy-three (73). Except as to amounts payable, the terms and conditions of such policy shall be identical, or substantially similar, to the disability insurance provided by Southwest for its other officers as of the date of this Agreement.

E. MEDICAL AND DENTAL EXPENSES. During the term of this Agreement, Southwest shall reimburse the Employee (i) for all medical and dental expenses incurred by the Employee and his spouse and (ii) for all medical and dental expenses paid by the Employee in excess of \$10,000 per calendar year and incurred by his children, their spouses and the Employee's grandchildren. Expenses for medical care shall be deemed to include all amounts paid with respect to hospital bills, doctor and dental bills and drugs which are not compensated by insurance or otherwise.

F. STOCK OPTION GRANT AND AMENDMENTS. Southwest shall grant to the Employee, effective as of the date hereof but subject to shareholder approval, ten-year options to purchase 300,000 shares of its common stock at \$33.53 per share in accordance with the Stock Option Plan and Agreement of even date herewith, a form of which is attached as Exhibit A hereto, and ten-year options to purchase 70,563 such shares at \$1 per share in accordance with the Stock Option Plan and Agreement of even date herewith, a form of which is attached as Exhibit B hereto. Failing shareholder approval of each such Stock Option Plan and Agreement at the 2001 Annual Meeting of Shareholders (including any adjournment thereof), such grant shall be null and void ab initio, and thereupon Southwest and the Employee shall negotiate alternative compensation of equivalent value to the Employee.

G. OTHER BENEFITS. The Employee shall be eligible to continue to participate in all employee pension, profit-sharing, stock purchase, group insurance and other benefit plans or programs in effect for Southwest managerial employees generally to the extent of and in accordance with the rules and agreements governing such plans or programs, so long as same shall be in effect, with full service credit where relevant for the Employee's prior employment by Southwest. Southwest shall reimburse the Employee for reasonable expenses incurred by him in the performance of his duties and responsibilities hereunder. The Employee shall be entitled to vacation of three (3) weeks per year or such longer period as may be established from time to time by Southwest for its managerial employees generally.

V. TERMINATION PROVISIONS

A. EXPIRATION OR DEATH. The Employee's employment hereunder shall terminate on December 31, 2003 (or such later date to which the term of this Agreement may be extended by consent of the parties hereto, in either case without prejudice to the Employee's privilege to remain an employee of Southwest thereafter), or upon the Employee's death, whichever shall first occur, without further obligation or liability of either party hereunder, except for Southwest's obligation to pay Deferred Compensation as provided in Paragraph IV-C of this Agreement.

B. TERMINATION FOR CAUSE. Southwest may terminate the Employee's employment hereunder upon the determination by a majority of its whole Board of Directors that the Employee has willfully failed and refused to perform his duties and to discharge his responsibilities hereunder. Such determination shall be final and conclusive. If the Board of Directors of Southwest makes such determination, Southwest may (a) terminate the Employee's employment, effective immediately or at a subsequent date, or (b) condition his continued employment upon the circumstances and place a reasonable limitation upon the time within which the Employee shall comply with such considerations or requirements. If termination is so effected, Southwest shall have no further liability to the Employee hereunder except for the obligation to pay Deferred Compensation as provided in Paragraph IV-C hereof.

C. TERMINATION FOR DISABILITY. Southwest may terminate the Employee's employment hereunder on account of any disabling illness, hereby defined to include any emotional or mental disorders, physical diseases or injuries as a result of which the Employee is, for a continuous period of ninety (90) days, unable to perform his duties hereunder. Southwest shall give to the Employee thirty (30) days' notice of its intention to effect such termination pursuant to this Paragraph V-C. If, within such notice period, the Employee shall have recovered from his disability sufficiently well to resume performance of his duties (although still undergoing treatment or rehabilitation), Southwest shall not have the right to effect such termination. If such disabling illness occurs as a result of a job-related cause, Southwest shall continue to pay the

Employee regular installments of his Base Salary in effect at the time of such termination for the remainder of the term of this Agreement. It is expressly understood and agreed, however, that any obligation of Southwest to continue to pay the Employee his Base Salary pursuant to this Paragraph V-C shall be reduced by the amount of any proceeds of long-term disability insurance provided for the Employee pursuant to Paragraph IV-D above, and shall also be reduced by the amount of the proceeds of any worker's compensation or other benefits which the Employee receives as a result of or growing out of his disabling illness.

D. CHANGE OF CONTROL TERMINATION. In the event of any change of control of Southwest, the Employee may, at his option, terminate his employment hereunder by giving to Southwest notice thereof no later than sixty (60) days after the Employee shall have determined or ascertained that such change has occurred, irrespective whether Southwest shall have purported to terminate this Agreement after such event but prior to receipt of such notice. If termination is so effected, no later than the date of such termination Southwest shall pay the Employee as "severance pay" a lump sum equal to (i) \$750,000 plus (ii) an amount equal to the unpaid installments of his Base Salary in effect at the time of such termination for the remaining term of this Agreement. If termination is so effected, Southwest shall have no other further liability to the Employee hereunder except for its obligation to pay Deferred Compensation as provided in Paragraph IV-C above. For purposes of this Paragraph V-D, a "change of control of Southwest" shall be deemed to occur if (i) a third person, including a "group" as determined in accordance with Section 13(d)(3) of the Securities Exchange Act of 1934, becomes the beneficial owner of shares of Southwest having twenty percent (20%) or more of the total number of votes that may be cast for the election of directors of Southwest, or (ii) as a result of, or in connection with, any cash tender or exchange offer, merger or other business combination, sale of assets or contested election, or any combination of the foregoing transactions (herein called a "Transaction"), the persons who were directors of Southwest before the Transaction shall cease to constitute a majority of the Board of Directors of Southwest or any successor to Southwest.

E. VOLUNTARY TERMINATION. The Employee's employment hereunder shall terminate forthwith upon his resignation and its acceptance by Southwest, without further obligation or liability of either party hereunder, except for Southwest's obligation to pay Deferred Compensation as provided in Paragraph IV-C above.

VI. MISCELLANEOUS

A. ASSIGNABILITY, ETC. The rights and obligations of Southwest hereunder shall inure to the benefit of and shall be binding upon the successors and assigns of Southwest; provided, however, Southwest's obligations hereunder may not be assigned without the prior approval of the Employee. This Agreement is personal to the Employee and may not be assigned by him.

B. NO WAIVERS. Failure to insist upon strict compliance with any provision hereof shall not be deemed a waiver of such provision or any other provision hereof.

C. AMENDMENTS. This Agreement may not be modified except by an agreement in writing executed by the parties hereto.

D. NOTICES. Any notice required or permitted to be given under this Agreement shall be in writing and shall be deemed to have been given to the person affected by such notice when personally delivered or when deposited in the United States mail, certified mail, return receipt requested and postage prepaid, and addressed to the party affected by such notice at the address indicated on the signature page hereof.

E. SEVERABILITY. The invalidity or unenforceability of any provision hereof shall not affect the validity or enforceability of any other provision hereof.

F. COUNTERPARTS. This Agreement may be executed in multiple counterparts, each of which shall be deemed an original but all of which taken together shall constitute a single instrument.

G. ENTIRE AGREEMENT. This Agreement contains all of the terms and conditions agreed upon by the parties hereto respecting the subject matter hereof, and all other prior agreements, oral or otherwise, regarding the subject matter of this Agreement shall be deemed to be superseded as of the date of this Agreement and not to bind either of the parties hereto.

H. GOVERNING LAW. This Agreement shall be subject to and governed by the laws of the State of Texas.

IN WITNESS WHEREOF, the Employee has set his hand hereto and Southwest has caused this Agreement to be signed in its corporate name and behalf by one of its officers thereunto duly authorized, and its corporate seal to be affixed hereunto, all as of the day and year first above written.

SOUTHWEST AIRLINES CO.

By: ___/s/ James F. Parker
James F. Parker
Vice President and General Counsel

ATTEST:

/s/ Colleen C. Barrett
Colleen C. Barrett
Secretary

THE EMPLOYEE

_____/s/ Herbert D. Kelleher
Herbert D. Kelleher

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

STOCK OPTION PLAN AND AGREEMENT

THIS STOCK OPTION PLAN AND AGREEMENT ("Agreement"), made as of the 1st day of January 2001, between SOUTHWEST AIRLINES CO., a Texas corporation (the "Company"), and HERBERT D. KELLEHER ("Employee"),

W I T N E S S E T H:

To carry out the purpose of Paragraph IV-F of the Employment Contract (herein so called) of even date herewith between the Company and Employee by affording Employee the opportunity to purchase shares of the \$1.00 par value common stock of the Company ("Stock"), the Company Employee hereby agrees as follows:

1. Grant of Option. Subject to shareholder approval as provided in Paragraph IV-F of the Employment Contract, the Company hereby irrevocably grants to Employee the right and option ("Option") to purchase all or part of an aggregate of 300,000 shares of Stock, on the terms and conditions set forth herein. This Option is not intended to constitute an incentive stock option within the meaning of section 422A(b) of the Internal Revenue Code of 1986, as amended (the "Code").

2. Purchase Price. The purchase price of Stock purchased pursuant to the exercise of this Option shall be \$33.53 per share, which represents the New York Stock Exchange-Composite Tape closing sales price of the Stock on December 29, 2000, the last trading day prior to the date of grant of this Option.

3. Exercise of Option. Subject to the earlier expiration of this Option as herein provided, this Option may be exercised, by written notice to the Company (addressed to its principal executive offices), at any time and from time to time after the date of grant hereof, in equal annual increments of 100,000 shares each beginning January 1, 2001, with all of such options being exercisable on and after January 1, 2003. Notwithstanding the foregoing, in the event of any change of control of the Company (as defined in Paragraph V-D of the Employment Contract), then this Option shall become exercisable in full. This Option is not transferable by Employee otherwise than by will or the laws of descent and distribution, and may be exercised only by Employee during his lifetime and while he remains an employee of the Company, except that:

(a) If Employee's employment with the Company terminates other than by death (whether by resignation, retirement, dismissal or otherwise),

Employee may exercise this Option at any time during the period of five years following the date of such termination, but only as to the number of shares Employee was entitled to purchase hereunder as of the date his employment so terminates.

(b) If Employee dies while in the employ of the Company or within the five-year period specified in (a) above, his estate, or the person who acquires this option by bequest or inheritance or by reason of the death of Employee, may exercise this Option at any time during the period of three years following the date of Employee's death, but only as to the number of shares Employee was entitled to purchase hereunder as of the date of his death.

(c) Employee may transfer this Option or a part thereof to a Family Member of Employee. For purposes of this Agreement, "Family Member" includes any child, stepchild, grandchild, parent, stepparent, grandparent, spouse, former spouse, sibling, niece, nephew, mother-in-law, father-in-law, son-in-law, daughter-in-law, brother-in-law, or sister-in-law, including adoptive relationships, of the Employee, any person sharing the Employee's household (other than a tenant or employee), a trust of which the Employee is a trustee or in which these persons have a beneficial interest, a foundation in which these persons (or the Employee) control the management of assets, and any other entity in which these persons (or the Employee) own more than fifty percent of the voting interests. Such Family Member may exercise the transferred Option, or part thereof, at any time during the three-year period following the date of transfer, but only as to the number of shares Employee was entitled to purchase hereunder as of the date of the transfer.

In any event, this Option shall not be exercisable as to any shares of Stock offered hereby after the expiration of ten years from the date this Option shall first become exercisable with respect to such shares. The purchase price of shares of Stock as to which this Option is exercised shall be paid in full at the time of exercise (a) in cash (including check, bank draft or money order payable to the order of the Company), or (b) by delivery to the Company of shares of Stock having a fair market value equal to the purchase price, or (c) by a combination of cash and Stock; provided that the fair market value of Stock so delivered shall be the mean of the reported high and low sales price of Stock on the New York Stock Exchange - Composite Tape on the date on which this Option is exercised or, if no prices are so reported on such day, on the next preceding day on which such prices of Stock are so reported. All references in this Agreement to "Employee" shall be deemed to include, unless the context otherwise requires, any Family Member to whom Employee has transferred this Option, or any part thereof, and any person permitted to exercise this Option in the event of Employee's death. Unless and until a certificate for such shares shall have been issued by the Company to him, Employee shall not be or have any of the rights or privileges of a shareholder of the Company with respect to shares acquirable upon an exercise of this Option.

4. Shares Subject to the Option. The aggregate number of shares of Stock which may be issued under this Option is 300,000. Such shares may consist of authorized but unissued shares of Stock or previously issued shares reacquired by the Company. Any of such shares which remains unissued at the termination of this Option shall cease to be subject thereto, but until termination of this Option the Company shall at all times make available a sufficient number of shares to meet the requirements of this Option. The aggregate number of shares issuable under this Option shall be adjusted to reflect a change in capitalization of the Company, such as a stock dividend or stock split, as provided in Paragraph 5 of this Agreement.

5. Recapitalization or Reorganization.

(a) The existence of this Option shall not affect in any way the right or power of the Board of Directors or the shareholders of the Company to make or authorize any adjustment, recapitalization, reorganization or other change in the Company's capital structure or its business, any merger or consolidation of the Company, any issue of bonds, debentures, warrants, preferred or prior preference stocks ahead of or affecting Stock or the rights thereof, the dissolution or liquidation of the Company or any sale or transfer of all or any part of its assets or business, or any other corporate act or proceeding.

(b) The shares offered by this Option are shares of Stock as presently constituted, but if, and whenever, prior to the expiration of this Option, the Company shall effect a subdivision or consolidation of shares of Stock or the payment of a stock dividend on Stock without receipt of consideration by the Company, the number of shares of Stock with respect to which this Option may thereafter be exercised (i) in the event of an increase in the number of outstanding shares shall be proportionately increased, and the purchase price per share shall be proportionately reduced (but in no event to less than the par value of

the Stock), and (ii) in the event of a reduction in the number of outstanding shares shall be proportionately reduced, and the purchase price per share shall be proportionately increased.

(c) If the Company recapitalizes or merges or engages in a compulsory share exchange with one or more other entities and the Company shall be the surviving or acquiring corporation, thereafter upon any exercise of this Option, Employee shall be entitled to purchase under this Option, in lieu of the number of shares of Stock as to which this Option shall then be exercisable, the number and class of shares of stock and other securities or other property to which Employee would have been entitled pursuant to the terms of the recapitalization or plan of merger or exchange if, immediately prior to the effective time of such recapitalization or merger or share exchange, Employee had been the holder of record of the number of shares of Stock as to which such Option is then exercisable. If the Company shall not be the surviving or acquiring corporation in any merger or share exchange, or if the Company is to be dissolved or liquidated, then unless a surviving or acquiring entity assumes or substitutes new options for this Option, (i) the time at which this Option may be exercised shall be accelerated and this Option shall become exercisable in full on or before a date fixed by the Company prior to the effective date of such merger or share exchange or such dissolution or liquidation, and (ii) upon such effective date this Option shall expire.

(d) Except as hereinbefore expressly provided, the issuance by the Company of shares of stock of any class or securities convertible into shares of stock of any class, for cash, property, labor or services, upon direct sale, upon the exercise of rights or warrants to subscribe therefore, or upon conversion of shares or obligations of the Company convertible into such shares or other securities, in any case whether or not for fair value, shall not affect, and no adjustment by reason thereof shall be made with respect to, the number of shares of Stock subject to this Option or the purchase price per share.

6. Administration. To the extent necessary for the administration of elections made pursuant to Paragraph 7 hereof, this Option shall be administered by the Stock Option Committee which administers the 1996 Incentive Stock Option Plan of the Company; or, at the direction of the Board of Directors of the Company, such other committee (together with such Stock Option Committee, the "Committee") of two or more directors of the Company, each of whom is a Non-Employee Director, appointed by the Board of Directors of the Company. The Committee is authorized to interpret this Option and may from time to time adopt such rules and regulations, consistent with the provisions of this Option, as it may deem advisable to carry out this Option. For purposes of this Option, the term "Non-Employee Director" shall have the meaning provided for by Rule 16b-3 promulgated under the Securities Exchange Act of 1934, as amended.

7. Withholding of Tax. To the extent that the exercise of this Option or the disposition of shares of Stock acquired by exercise of this Option results in compensation income to Employee for federal or state income tax purposes, except as hereinafter provided, Employee shall deliver to the Company at the time of such exercise or disposition such amount of money as the Company may require to meet its obligation under applicable tax laws or regulations. Employee may elect with respect to this Option to surrender or authorize the Company to withhold shares of Stock (valued at their fair market value on the date of surrender or withholding of such shares) in satisfaction of any such withholding obligation (a "Stock Surrender Withholding Election"); provided, however, that any Stock Surrender Withholding Election shall be made in accordance with the rules and regulations adopted by the Committee for implementation of the tax withholding provisions of this Paragraph 7. If Employee fails to deliver such money or make a Stock Surrender Withholding Election pursuant to this Paragraph 7, the Company is authorized to withhold from any cash or Stock remuneration then or thereafter payable to Employee any tax required to be withheld.

8. Status of Stock. The Company does not presently intend to register for issue under the Securities Act of 1933, as amended (the "Act"), the shares of Stock acquirable upon exercise of this Option, and instead proposes to rely on the private offering exemption from the registration requirements of the Act afforded by Section 4(2) thereof. In order to assure that exemption from registration under the Act is available upon an exercise of this Option, Employee, if requested by the Company to do so, will execute and deliver to the Company in writing an agreement containing such provisions as the Company may reasonably require to assure compliance with applicable securities laws. No sale or disposition of shares of Stock acquired upon exercise of this Option shall be made in the absence of a registration statement being on file with respect to such shares under the Act unless an opinion of counsel satisfactory to the Company that such sale or disposition will not constitute a

violation of the Act or any other applicable securities laws is first obtained. The certificates representing shares of Stock acquired under this Option may bear such legend as the Company deems appropriate, referring to the provisions of this Paragraph 8.

9. Registration Rights. With respect to any shares of Stock which are issued and delivered upon exercise of (i) this Option or (ii) any options granted to Employee pursuant to any of his prior Employment Contracts (the "Shares"):

(a) Upon written request made by Employee at any time before January 1, 2014, the Company shall take such steps as may be necessary promptly to register (but not more than once), at the Company's sole expense (save for any underwriting commissions or discounts applicable to any Shares and Employee's counsel fees), such of the Shares under the Act (and under regulations of the Securities and Exchange Commission under the Act or under any similar federal act or acts then in effect and under the so-called "Blue Sky" laws of the several states and regulations thereunder then in effect), as Employee may by written request given to the Company within 15 days following such initial request, desire to have so registered. The Company will cause such a registration statement to be filed within 90 days after the initial request is made. The Company will use its best efforts to cause any such registration statement to become and to remain effective and current for such period (not to exceed 120 days) as Employee may request.

(b) In connection with any registration under this Paragraph 9, the parties agree to indemnify each other in the customary manner, and, in the case of an organized secondary or primary underwritten offering, the Company agrees to indemnify Employee and the underwriters and Employee agrees to indemnify the Company, in the manner and to the extent as is customary in secondary or primary underwritten offerings.

(c) The Company shall have the sole right to designate the underwriters to be employed in any organized secondary or primary underwritten offering under this Section 9.

(d) In connection with any registration under this Section 9, Employee shall furnish to the Company such information regarding the Shares and such other information as the Company may reasonably request.

10. Employment Relationship. Employee shall be considered to be in the employment of the Company as long as he remains an employee of either the Company, a parent or subsidiary corporation (as defined in Section 424 of the Code), or a corporation or a parent or subsidiary of such corporation assuming or substituting a new option for this Option. Any questions as to whether or when there has been a termination of such employment, and the cause of such termination, shall be determined by the Board of Directors of the employing corporation, and its determination shall be final. No obligation as to length of Employee's employment with any such corporation shall be implied from the terms of this Agreement, and this Agreement in no way modifies, alters, amends or impairs the provisions of the Employment Contract.

11. Binding Effect. This Agreement shall be binding upon and inure to the benefit of any successors to the Company and all persons lawfully claiming under Employee.

IN WITNESS WHEREOF, the Company has caused this Agreement to be duly executed by its officer thereunto duly authorized and its corporate seal to be affixed hereunto, and Employee has executed this Agreement, all as of the day and year first above written.

ATTEST: SOUTHWEST AIRLINES CO.

Colleen C. Barrett
Secretary

By: James F. Parker
Vice President and General Counsel

EMPLOYEE

Herbert D. Kelleher

STOCK OPTION PLAN AND AGREEMENT

THIS STOCK OPTION PLAN AND AGREEMENT ("Agreement"), made as of the 1st day of January 2001, between SOUTHWEST AIRLINES CO., a Texas corporation (the "Company"), and HERBERT D. KELLEHER ("Employee"),

W I T N E S S E T H:

To carry out the purpose of Paragraph IV-F of the Employment Contract (herein so called) of even date herewith between the Company and Employee by affording Employee the opportunity to purchase shares of the \$1.00 par value common stock of the Company ("Stock"), the Company and Employee hereby agree as follows:

1. Grant of Option. Subject to shareholder approval as provided in Paragraph IV-F of the Employment Contract, the Company hereby irrevocably grants to Employee the right and Option ("Option") to purchase all or part of an aggregate of 70,563 shares of Stock, on the terms and conditions set forth herein.

2. Purchase Price. The purchase price of Stock purchased pursuant to the exercise of this Option shall be \$1 per share.

3. Exercise of Option. Subject to the earlier expiration of this Option as herein provided, this Option may be exercised, by written notice to the Company (addressed to its principal executive offices), at any time and from time to time after the date of grant hereof, in equal annual increments of 23,521 shares each, beginning January 1, 2001, with all of such options being exercisable on and after January 1, 2003. Notwithstanding the foregoing, in the event of any change of control of the Company (as defined in Paragraph V-D of the Employment Contract), then this Option shall become exercisable in full. This Option is not transferable by Employee otherwise than by will or the laws of descent and distribution, and may be exercised only by Employee during his lifetime and while he remains an employee of the Company, except that:

(a) If Employee's employment with the Company terminates other than by death (whether by resignation, retirement, dismissal or otherwise), Employee may exercise this Option at any time during the period of five years following the date of such termination, but only as to the number of shares Employee was entitled to purchase hereunder as of the date his employment so terminates.

(b) If Employee dies while in the employ of the Company or within the five-year period specified in (a) above, his estate, or the person who acquires this Option by bequest or inheritance or by reason of the death of Employee, may exercise this Option at any time during the period of three years following the date of Employee's death, but only as to the number of shares Employee was entitled to purchase hereunder as of the date of his death.

(c) Employee may transfer this Option or any part thereof to a Family Member of Employee. For purposes of this Agreement, "Family Member" includes any child, stepchild, grandchild, parent, stepparent, grandparent, spouse, former spouse, sibling, niece, nephew, mother-in-law, father-in-law, son-in-law, daughter-in-law, brother-in-law, or sister-in-law, including adoptive relationships, of the Employee, any person sharing the Employee's household (other than a tenant or employee), a trust of which the Employee is a trustee or in which these persons have a beneficial interest, a foundation in which these persons (or the Employee) control the management of assets, and any other entity in which these persons (or the Employee) own more than fifty percent of the voting interests. Such Family Member may exercise the transferred Option, or part thereof, at any time during the three-year period following the date of transfer, but only as to the number of shares Employee was entitled to purchase hereunder as of the date of the transfer.

In any event, this Option shall not be exercisable as to any shares of Stock offered hereby after the expiration of ten years from the date this Option shall first become exercisable with respect to such shares. The purchase price of shares of Stock as to which this Option is exercised shall be paid in full at the time of exercise (a) in cash (including check, bank draft or money order payable to the order of the Company), or (b) by delivery to the Company of shares of Stock having a fair market value equal to the purchase price, or (c) by a combination of cash and Stock; provided that the fair market value of Stock so delivered shall be the mean of the reported high and low sales price of

Stock on the New York Stock Exchange - Composite Tape on the date on which this Option is exercised or, if no prices are so reported on such day, on the next preceding day on which such prices of Stock are so reported. All references in this Agreement to "Employee" shall be deemed to include, unless the context otherwise requires, any Family Member to whom Employee has transferred this Option, or any part thereof, and any person permitted to exercise this Option in the event of Employee's death. Unless and until a certificate for such shares shall have been issued by the Company to him, Employee shall not be or have any of the rights or privileges of a shareholder of the Company with respect to shares acquirable upon an exercise of this Option.

4. Shares Subject to the Option. The aggregate number of shares of Stock which may be issued under this Option is 70,563. Such shares may consist of authorized but unissued shares of Stock or previously issued shares reacquired by the Company. Any of such shares which remains unissued at the termination of this Option shall cease to be subject thereto, but until termination of this Option the Company shall at all times make available a sufficient number of shares to meet the requirements, of this Option. The aggregate number of shares issuable under this Option shall be adjusted to reflect a change in capitalization of the Company, such as a stock dividend or stock split, as provided in Paragraph 5 of this Agreement.

5. Recapitalization or Reorganization.

(a) The existence of this Option shall not affect in any way the right or power of the Board of Directors or the shareholders of the Company to make or authorize any adjustment, recapitalization, reorganization or other change in the Company's capital structure or its business, any merger or consolidation of the Company, any issue of bonds, debentures, warrants, preferred or prior preference stocks ahead of or affecting Stock or the rights thereof, the dissolution or liquidation of the Company or any sale or transfer of all or any part of its assets or business, or any other corporate act or proceeding.

(b) The shares offered by this Option are shares of Stock as presently constituted, but if, and whenever, prior to the expiration of this Option, the Company shall effect a subdivision or consolidation of shares of Stock or the payment of a stock dividend on Stock without receipt of consideration by the Company, the number of shares of Stock with respect to which this Option may thereafter be exercised (i) in the event of an increase in the number of outstanding shares shall be proportionately increased, and the purchase price per share shall be proportionately reduced (but in no event to less than the par value of the Stock), and (ii) in the event of a reduction in the number of outstanding shares shall be proportionately reduced, and the purchase price per share shall be proportionately increased.

(c) If the Company recapitalizes or merges or engages in a compulsory share exchange with one or more other entities and the Company shall be the surviving or acquiring corporation, thereafter upon any exercise of this Option, Employee shall be entitled to purchase under this Option, in lieu of the number of shares of Stock as to which this Option shall then be exercisable, the number and class of shares of stock and other securities or other property to which Employee would have been entitled pursuant to the terms of the recapitalization or plan of merger or exchange if, immediately prior to the effective time of such recapitalization or merger or share exchange, Employee had been the holder of record of the number of shares of Stock as to which such Option is then exercisable. If the Company shall not be the surviving or acquiring corporation in any merger or share exchange, or if the Company is to be dissolved or liquidated, then unless a surviving or acquiring entity assumes or substitutes new options for this Option, (i) the time at which this Option may be exercised shall be accelerated and this Option shall become exercisable in full on or before a date fixed by the Company prior to the effective date of such merger or share exchange or such dissolution or liquidation, and (ii) upon such effective date this Option shall expire.

(d) Except as hereinbefore expressly provided, the issuance by the Company of shares of stock of any class or securities convertible into shares of stock of any class, for cash, property, labor or services, upon direct sale, upon the exercise of rights or warrants to subscribe therefor, or upon conversion of shares or obligations of the Company convertible into such shares or other securities, and in any case whether or not for fair value, shall not affect, and no adjustment by reason thereof shall be made with respect to, the number of shares of Stock subject to this Option or the purchase price per share.

6. Administration. To the extent necessary for the administration of elections made pursuant to Paragraph 7 hereof, this Option shall be administered by the Stock Option Committee which administers the 1996 Incentive Stock Option Plan of the Company; or, at the direction of the Board of Directors of the Company, such other committee (together with such Stock Option Committee, the "Committee") of two or more directors

of the Company, each of whom is a Non-Employee Director, appointed by the Board of Directors of the Company. The Committee is further authorized to interpret this Option and may from time to time adopt such rules and regulations, consistent with the provisions of this Option, as it may deem advisable to carry out this Option. For purposes of this Option, the term "Non-Employee Director" shall have the meaning provided for by Rule 16b-3 promulgated under the Securities Exchange Act of 1934, as amended.

7. Withholding of Tax. To the extent that the exercise of this Option or the disposition of shares of Stock acquired by exercise of this Option results in compensation income to Employee for federal or state income tax purposes, except as hereinafter provided, Employee shall deliver to the Company at the time of such exercise or disposition such amount of money as the Company may require to meet its obligation under applicable tax laws or regulations. Employee may elect with respect to this Option to surrender or authorize the Company to withhold shares of Stock (valued at their fair market value on the date of surrender or withholding of such shares) in satisfaction of any such withholding obligation (a "Stock Surrender Withholding Election"); provided, however, that any Stock Surrender Withholding Election shall be made in accordance with the rules and regulations adopted by the Committee for implementation of the tax withholding provisions of this Paragraph 7. If Employee fails to deliver such money or make a Stock Surrender Withholding Election pursuant to this Paragraph 7, the Company is authorized to withhold from any cash or Stock remuneration then or thereafter payable to Employee any tax required to be withheld.

8. Status of Stock. The Company does not presently intend to register for issue under the Securities Act of 1933, as amended (the "Act"), the shares of Stock acquirable upon exercise of this Option, and instead proposes to rely on the private offering exemption from the registration requirements of the Act afforded by Section 4(2) thereof. In order to assure that exemption from registration under the Act is available upon an exercise of this Option, Employee, if requested by the Company to do so, will execute and deliver to the Company in writing an agreement containing such provisions as the Company may reasonably require to assure compliance with applicable securities laws. No sale or disposition of shares of Stock acquired upon exercise of this Option shall be made in the absence of a registration statement being on file with respect to such shares under the Act unless an opinion of counsel satisfactory to the Company that such sale or disposition will not constitute a violation of the Act or any other applicable securities laws is first obtained. The certificates representing shares of Stock acquired under this Option may bear such legend as the Company deems appropriate, referring to the provisions of this Paragraph 8.

9. Registration Rights. With respect to any shares of Stock which are issued and delivered upon exercise of (i) this Option and (ii) any options granted to Employee pursuant to any of his prior Employment Contracts (the "Shares"):

(a) Upon written request made by Employee at any time before January 1, 2014, the Company shall take such steps as may be necessary promptly to register (but not more than once), at the Company's sole expense (save for any underwriting commissions or discounts applicable to any Shares and Employee's counsel fees), such of the Shares under the Act (and under regulations of the Securities and Exchange Commission under the Act or under any similar federal act or acts then in effect and under the so-called "Blue Sky" laws of the several states and regulations thereunder then in effect), as Employee may by written request give to the Company within 15 days following such initial request, desire to have so registered. The Company will cause such a registration statement to be filed within 90 days after the initial request is made. The Company will use its best efforts to cause any such registration statement to become and to remain effective and current for such period (not to exceed 120 days) as Employee may request.

(b) In connection with any registration under this Paragraph 9, the parties agree to indemnify each other in the customary manner, and, in the case of an organized secondary or primary underwritten offering, the Company agrees to indemnify Employee and the underwriters and Employee agrees to indemnify the Company, in the manner and to the extent as is customary in secondary or primary underwritten offerings.

(c) The Company shall have the sole right to designate the underwriters to be employed in any organized secondary or primary underwritten offering under this Section 9.

(d) In connection with any registration under this Section 9, Employee shall furnish to the Company such information regarding the Shares and such other information as the Company may reasonably request.

10. Employment Relationship. Employee shall be considered to be in the employment of the Company as long as he remains an employee of

either the Company, a parent or subsidiary corporation (as defined in Section 424 of the Internal Revenue Code of 1986, as amended), or a corporation or a parent or subsidiary of such corporation assuming or substituting a new option for this Option. Any questions as to whether and when there has been a termination of such employment, and the cause of such termination, shall be determined by the Board of Directors of the employing corporation, and its determination shall be final. No obligation as to the length of the Employee's employment with any such corporation shall be implied from the terms of this Agreement, and this Agreement in no way modifies, alters, amends or impairs the provisions of the Employment Contract.

11. Binding Effect. This Agreement shall be binding upon and inure to the benefit of any successors to the Company and all persons lawfully claiming under Employee.

IN WITNESS WHEREOF, the Company has caused this Agreement to be duly executed by its officer thereunto duly authorized and its corporate seal to be affixed hereunto, and Employee has executed this Agreement, all as of the day and year first above written.

ATTEST: SOUTHWEST AIRLINES CO.

Colleen C. Barrett By: James F. Parker
Secretary Vice President and General Counsel

EMPLOYEE

Herbert D. Kelleher

Exhibit 10.DOC