

UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
WASHINGTON, D.C. 20549

FORM 8-K

CURRENT REPORT

Pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934

Date of Report (Date of Earliest Event Reported): August 11, 2006



Southwest Airlines Co.

(Exact name of registrant as specified in its charter)

Texas

1-7259

74-1563240

(State or other jurisdiction
of incorporation)

(Commission
File Number)

(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

Not Applicable

Former name or former address, if changed since last report

Check the appropriate box below if the Form 8-K filing is intended to simultaneously satisfy the filing obligation of the registrant under any of the following provisions:

- ☐ Written communications pursuant to Rule 425 under the Securities Act (17 CFR 230.425)
 - ☐ Soliciting material pursuant to Rule 14a-12 under the Exchange Act (17 CFR 240.14a-12)
 - ☐ Pre-commencement communications pursuant to Rule 14d-2(b) under the Exchange Act (17 CFR 240.14d-2(b))
 - ☐ Pre-commencement communications pursuant to Rule 13e-4(c) under the Exchange Act (17 CFR 240.13e-4(c))
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As disclosed in its Quarterly Report on Form 10-Q for the quarter ended March 31, 2006, Southwest Airlines Co. ("the Company") adopted the Financial Accounting Standards Board (FASB) SFAS 123R, "Share-Based Payment" (SFAS 123R) effective January 1, 2006 which requires that all stock-based compensation, including grants of Employee stock options, be accounted for using a fair-value-based method. The Company elected to adopt SFAS 123R using the modified retrospective method under which prior years' results have been revised to give effect to the value of options granted in fiscal years beginning on or after January 1, 1995.

In addition, in first quarter 2006, the Company began transitioning the maintenance program for performing planned airframe maintenance on its fleet of 737-300 and 737-500 aircraft. Due to the change in the nature of the maintenance activities performed, the Company changed its method of accounting for scheduled airframe and inspection repairs for 737-300 and 737-500 aircraft from the deferral method to the direct expense method, effective January 1, 2006. Under the deferral method, scheduled airframe and inspection repairs were capitalized and amortized as a component of Maintenance, materials and repairs expense in the Consolidated Statement of Income; under the direct expense method, scheduled airframe and inspection repairs are expensed as incurred. The Company recorded the change in accounting in accordance with Statement of Financial Accounting Standards No. 154, Accounting Changes and Error Corrections (SFAS 154), which was effective for calendar year companies on January 1, 2006. SFAS 154 requires that all elective accounting changes be made on a retrospective basis.

The Company is providing this Form 8-K to present only those sections in its Form 10-K filing for the fiscal year ended December 31, 2005, that are conformed for the adoption of the accounting changes described above. For reference, the Company has included the entire text of the affected sections. Other than as presented here, the sections of the Form 10-K for year ended December 31, 2005 remain as previously filed. This Form 8-K does not purport to provide an update or a discussion of any other developments at the Company subsequent to the original Form 10-K filing.

These financial statements, conformed for the changes, will become the historical financial statements of Southwest Airlines Co. for currently open and future filings with the Securities and Exchange Commission.

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 hereunto duly authorized.

SOUTHWEST AIRLINES CO.

August 11, 2006

By /s/ Laura Wright

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

Exhibit Index

Exhibit No.	Description
99.1	Management's Discussion and Analysis of Financial Condition and Results of Operations.
99.2	Financial Statements and Supplementary Data.
99.3	Selected Financial Data.
99.4	Consent of Independent Registered Public Accounting Firm.
99.5	Condensed Consolidated Third and Fourth Quarter 2005 Statement of Income (as adjusted).

ITEM 7. MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS

As disclosed in its Quarterly Report on Form 10-Q for the period ended March 31, 2006, Southwest adopted Statement of Financial Accounting Standards (SFAS) No. 123R, "Share-Based Payment" (SFAS 123R) effective January 1, 2006, using the modified retrospective transition method. SFAS 123R requires that all stock-based compensation, including grants of employee stock options, be accounted for using a fair-value-based method. Under the modified retrospective method, prior years' results were retrospectively adjusted to give effect to the value of options granted in fiscal years beginning on or after January 1, 1995.

In addition, in first quarter 2006, the Company began transitioning the maintenance program for performing planned airframe maintenance on its fleet of 737-300 and 737-500 aircraft. Due to the change in the nature of the maintenance activities performed, the Company changed its method of accounting for scheduled airframe and inspection repairs for 737-300 and 737-500 aircraft from the deferral method to the direct expense method, effective January 1, 2006. The Company recorded the change in accounting in accordance with Statement of Financial Accounting Standards No. 154, *Accounting Changes and Error Corrections* (SFAS 154), which was effective for calendar year companies on January 1, 2006. SFAS 154 requires that all elective accounting changes be made on a retrospective basis.

A summary of the changes in the Company's financial statements as a result of adopting SFAS No. 123(R) and changing its method of accounting for airframe maintenance is provided in Note 1 to the Consolidated Financial Statements. This MD&A has been updated to reflect the Company's results adjusted to conform to the adoption of SFAS No. 123(R) and the change in airframe maintenance accounting. As part of this update, the Company has deleted the majority of forward-looking statements made in its original Annual Report on Form 10-K for 2005. For current forward-looking statements related to the Company's business, along with more current information on trends and other factors affecting our business, refer to the Company's Quarterly Report on Form 10-Q for the quarter ended June 30, 2006.

YEAR IN REVIEW

In 2005, Southwest posted a profit for its 33rd consecutive year, and also extended its number of consecutive profitable quarters to 59. Southwest's 2005 profit was \$484 million, representing a 125.1% increase compared to our 2004 profit of \$215 million. This performance was driven primarily by strong revenue growth, as the Company grew capacity, and effective cost control measures, including a successful fuel hedge program. For the fifth consecutive year, the airline industry as a whole is expected to suffer a substantial net loss, as additional carriers filed for bankruptcy protection and many underwent or continued massive efforts to restructure or merge their businesses, gain wage concessions from their employees, and slash costs.

The revenue environment in the airline industry strengthened considerably throughout 2005. As a result of the extensive restructuring in the domestic airline industry in 2004 and 2005, several carriers reduced domestic capacity. Industry capacity reductions and strong demand resulted in high load factors for many airlines. In fact, Southwest set new monthly load-factor records for four separate months during 2005, and recorded a Company-record load factor of 70.7 percent for the full year. The Company was also able to modestly raise its fares over the course of the year, resulting in an increase in passenger revenue yield per RPM (passenger revenues divided by revenue passenger miles) of 2.8 percent compared to 2004. Unit revenue (total revenue divided by ASMs) also increased a healthy 4.7 percent compared to 2004 levels, as a result of the higher load factors and higher RPM yields.

The Company once again benefited from a strong fuel hedge and an intense focus on controlling non-fuel costs. As reflected in the Consolidated Statement of Income, the Company's fuel hedging program resulted in a reduction to "Fuel and oil expense" during 2005 of \$892 million. The Company's hedge program also resulted in earnings variability throughout 2005, primarily due to unrealized gains and losses relating to fuel contracts settling in future periods, recorded in accordance with Statement of Financial Accounting Standard 133 (SFAS 133), *Accounting for Derivative Instruments and Hedging Activities*, as amended. For 2005, these amounts total a net gain of \$110 million, and are reflected in "Other (gains) losses, net," in the Consolidated Statement of Income.

Although the Company's fuel hedge in place for 2006 is not as strong as that in 2005, absent a significant decrease from the current level of market energy prices the Company will continue to have a considerable competitive advantage compared to airlines that have not hedged fuel. The Company hopes to overcome the impact of higher anticipated 2006 fuel prices through improved revenue management and control of non-fuel costs. In 2005, the Company benefited from cost-control efforts instituted over the past 3 years. These efforts, combined with unit cost reductions in share-based compensation expense and maintenance materials and repairs, resulted in a reduction in non-fuel unit costs (cost per ASM) of 2.8 percent in 2005 compared to 2004. The Company's Employees again increased their productivity and improved the overall efficiency of the Company's operations. The Company's headcount per aircraft decreased from 74 at December 31, 2004, to 71 at December 31, 2005. Furthermore, from the end of 2003 to the end of 2005, the Company's headcount per aircraft decreased 16.5 percent.

The Company moves forward into 2006 with a focused and measured growth plan. The Company's low-cost competitive advantage, protective fuel hedging position, and excellent Employees will allow Southwest to continue to react quickly to market opportunities. The Company added Pittsburgh, Pennsylvania, and Fort Myers, Florida, to its route system in 2005, and continued to grow its Chicago Midway service. The Company has increased its capacity at Chicago Midway Airport nearly 60 percent since third quarter 2004 and plans to continue to add service to this market. The Company began service to Denver, Colorado, in January 2006, and has already announced plans to add service and destinations in 2006. Denver represents the 62nd city to which the Company flies.

In December 2005, we completed a transaction with ATA Airlines, Inc. (ATA), as a part of ATA's bankruptcy proceedings, acquiring the leasehold rights to four additional gates at Chicago Midway in exchange for a \$20 million reduction in our outstanding debtor-in-possession loan. The codeshare agreement with ATA was recently expanded to include ATA flights from DFW International Airport to Chicago Midway. The Company also recently announced an additional codeshare expansion to include connecting service through Houston Hobby and Oakland, beginning April 2006. See Note 2 to the Consolidated Financial Statements for further information on the Company's relationship and recent transactions with ATA.

During 2005, the Company added 33 new 737-700 aircraft to its fleet and retired its remaining five 737-200 aircraft, resulting in a net available seat mile (ASM) capacity increase of 10.8 percent. This brought the Company's all-737 fleet to 445 aircraft at the end of 2005. ASM capacity currently is expected to grow approximately 8 percent in 2006 with the planned addition of 33 new Boeing 737-700 aircraft.

RESULTS OF OPERATIONS

2005 COMPARED WITH 2004 The Company's consolidated net income for 2005 was \$484 million (\$.60 per share, diluted), as compared to 2004 net income of \$215 million (\$.27 per share, diluted), an increase of \$269 million or 125.1 percent. Operating income for 2005 was \$725 million, an increase of \$321 million, or 79.5 percent, compared to 2004. The increase in operating income primarily was due to higher revenues from the Company's fleet growth, improved load factors, and higher fares, which more than offset a significant increase in the cost of jet fuel. The larger percentage increase in net income compared to operating income primarily was due to variability in Other (gains) losses, net, due to unrealized 2005 gains resulting from the Company's fuel hedging activities, in accordance with SFAS 133.

OPERATING REVENUES Consolidated operating revenues increased \$1.1 billion, or 16.1 percent, primarily due to a \$1.0 billion, or 15.9 percent, increase in passenger revenues. The increase in passenger revenues primarily was due to an increase in capacity, an increase in RPM yield, and an increase in load factor. Holding other factors constant (such as yields and load factor), almost 70 percent of the increase in passenger revenue was due to the Company's 10.8 percent increase in available seat miles compared to 2004. The Company increased available seat miles as a result of the net addition of 28 aircraft (33 new 737-700 aircraft net of five 737-200 aircraft retirements). Approximately 18 percent of the increase in passenger revenue was due to the 2.8 percent increase in passenger yields. Average passenger fares increased 5.8 percent compared to 2004, primarily due to lower fare discounting because of the strong demand for air travel coupled with the availability of fewer seats from industrywide domestic capacity reductions. The remainder of the passenger revenue increase primarily was due to the 1.2 point increase in the Company's load factor compared to 2004. The 70.7 percent load factor for 2005 represented the highest annual load factor in the Company's history.

The Company continues to be encouraged by the airline revenue environment. Although the Company significantly downsized its New Orleans operations following Hurricane Katrina during third quarter 2005, some of those flights have been added back as demand has increased to that city. In addition, because of strong industry demand, the Company was able to quickly re-deploy available aircraft from the New Orleans reduction in service to meet service needs in other cities within the Company's network. The outlook for first quarter 2006 is favorable as the Company continues to enjoy strong revenue momentum and benefit from reductions in competitive capacity.

Consolidated freight revenues increased \$16 million, or 13.7 percent. Approximately 65 percent of the increase was due to an increase in freight and cargo revenues, primarily due to higher rates charged on shipments. The remaining 35 percent of the increase was due to higher mail revenues. The U.S. Postal Service periodically reallocates the amount of mail business given to commercial and freight air carriers and, during 2005, shifted more business to commercial carriers. Other revenues increased \$39 million, or 29.3 percent, compared to 2004. Approximately 35 percent of the increase was from commissions earned from programs the Company sponsors with certain business partners, such as the Company sponsored Chase® Visa card. An additional 35 percent of the increase was due to an increase in excess baggage charges, as the Company modified its fee policy related to the weight of checked baggage during second quarter 2005. Among other changes, the limit at which baggage charges apply was reduced to 50 pounds per checked bag.

OPERATING EXPENSES Consolidated operating expenses for 2005 increased \$733 million, or 12.0 percent, compared to the 10.8 percent increase in capacity. To a large extent, changes in operating expenses for airlines are driven by changes in capacity, or ASMs. The following presents Southwest's operating expenses per ASM for 2005 and 2004 followed by explanations of these changes on a per-ASM basis:

	2005	2004	Increase (decrease)	Percent change
Salaries, wages, and benefits	3.27¢	3.35¢	(.08¢)	(2.4)%
Fuel and oil	1.58	1.30	.28	21.5
Maintenance materials and repairs	.52	.61	(.09)	(14.8)
Aircraft rentals	.19	.23	(.04)	(17.4)
Landing fees and other rentals	.53	.53	-	-
Depreciation and amortization	.55	.56	(.01)	(1.8)
Other	1.41	1.39	.02	1.4
Total	8.05¢	7.97¢	.08¢	1.0%

Operating expenses per ASM increased 1.0 percent to 8.05 cents, primarily due to an increase in jet fuel prices, net of hedging gains. The Company was able to hold flat or reduce unit costs in every cost category, except fuel expense and other operating expense, through a variety of cost reduction and productivity efforts. These efforts, however, were entirely offset by the significant increase in the cost of fuel. Excluding fuel, CASM was 2.8 percent lower than 2004, at 6.48 cents.

Salaries, wages, and benefits expense per ASM decreased 2.4 percent compared to 2004, primarily due to a reduction in share-based compensation expense, the majority of which is due to stock-options granted by the Company. As a result of the timing of grants in prior years and their related vesting provisions, share-based compensation expense decreased from \$135 million in 2004 to \$80 million in 2005. Excluding the impact of share-based compensation expense, salaries, wages, and benefits decreased slightly due to productivity efforts that have enabled the Company to grow overall headcount at a rate that is less than the growth in ASMs. This decrease was partially offset by higher average wage rates, and higher profitsharing expense associated with the Company's higher earnings.

The Company's Pilots are subject to an agreement with the Southwest Airlines Pilots' Association, which becomes amendable during September 2006. The Company's Customer Service and Reservations Agents are subject to an agreement with the International Association of Machinists and Aerospace Workers ("IAM"), which becomes amendable during November 2008, but which may become amendable during 2006 at the IAM's option, under certain conditions. The Company's Ramp, Operations, and Provisioning and Freight Agents are subject to an agreement with the Transportation Workers of America, AFL-CIO ("TWU"), which becomes amendable during November 2008, but which may become amendable during 2006 at the TWU's option, under certain conditions. The Company is currently unable to predict whether its contracts with the IAM and TWU will become amendable during 2006.

Fuel and oil expense per ASM increased 21.5 percent, primarily due to a 24.8 percent increase in the average jet fuel cost per gallon, net of hedging gains. The average cost per gallon of jet fuel in 2005 was \$1.03 compared to 82.8 cents in 2004, excluding fuel-related taxes and net of hedging gains. The Company's 2005 and 2004 average jet fuel costs are net of approximately \$892 million and \$455 million in gains from hedging activities, respectively. See Note 9 to the Consolidated Financial Statements. The increase in fuel prices was partially offset by steps the Company has taken to improve the fuel efficiency of its aircraft. These steps primarily included the addition of blended winglets to all of the Company's 737-700 aircraft, and the upgrade of certain engine components on many aircraft. The Company estimates that these and other efficiency gains saved the Company approximately \$70 million during 2005, at average unhedged market jet fuel prices.

Maintenance materials and repairs per ASM decreased 14.8 percent compared to 2004, primarily due to a decrease in repair events for aircraft engines.

Aircraft rentals per ASM decreased 17.4 percent. Of the 33 aircraft the Company acquired during 2005, all are owned. In addition, during 2005, the Company renegotiated the leases on four aircraft, and, as a result, reclassified these aircraft from operating leases to capital leases. These transactions have increased the Company's percentage of aircraft owned or on capital lease to 81 percent at December 31, 2005, from 79 percent at December 31, 2004.

Depreciation expense per ASM decreased 1.8 percent. An increase in depreciation expense per ASM from 33 new 737-700 aircraft purchased during 2005 and the higher percentage of owned aircraft, was more than offset by lower expense associated with the Company's retirement of its 737-200 fleet and all 737-200 remaining spare parts by the end of January 2005.

Other operating expenses per ASM increased 1.4 percent compared to 2004. Approximately 75 percent of the increase relates to higher 2005 security fees in the form of a \$24 million retroactive assessment the Company received from the Transportation Security Administration in January 2006. The Company intends to vigorously contest this assessment; however, if it is unsuccessful in reversing or modifying it, 2006 security fees will be at similar levels. The remainder of the increase primarily related to higher fuel taxes as a result of the substantial increase in fuel prices compared to 2004.

OTHER "Other expenses (income)" included interest expense, capitalized interest, interest income, and other gains and losses. Interest expense increased by \$34 million, or 38.6 percent, primarily due to an increase in floating interest rates. The majority of the Company's long-term debt is at floating rates. Excluding the effect of any new debt offerings the Company may execute during 2006, the Company expects an increase in interest expense compared to 2005, due to higher expected floating interest rates, partially offset by the borrowings due to be repaid in 2006 on their redemption dates. See Note 9 to the Consolidated Financial Statements for more information. Capitalized interest was flat compared to 2004 as lower 2005 progress payment balances for scheduled future aircraft deliveries were offset by higher interest rates. Interest income increased \$26 million, or 123.8 percent, primarily due to an increase in rates earned on cash and investments. "Other (gains) losses, net" primarily includes amounts recorded in accordance with SFAS 133. See Note 9 to the Consolidated Financial Statements for more information on the Company's hedging activities. During 2005, the Company recognized approximately \$35 million of expense related to amounts excluded from the Company's measurements of hedge effectiveness. Also during 2005, the Company recognized approximately \$110 million of additional income in "Other (gains) losses, net," related to the ineffectiveness of its hedges and the loss of hedge accounting for certain hedges. Of this additional income, approximately \$77 million was unrealized, mark-to-market changes in the fair value of derivatives due to the discontinuation of hedge accounting for certain contracts that will settle in future periods, approximately \$9 million was unrealized ineffectiveness associated with hedges designated for future periods, and \$24 million was ineffectiveness and mark-to-market gains related to contracts that settled during 2005. For 2004, the Company recognized approximately \$24 million of expense related to amounts excluded from the Company's measurements of hedge effectiveness and \$13 million in expense related to the ineffectiveness of its hedges and unrealized mark-to-market changes in the fair value of certain derivative contracts.

INCOME TAXES The provision for income taxes, as a percentage of income before taxes, increased to 37.88 percent in 2005 from 36.54 percent in 2004. The 2004 rate was favorably impacted by an adjustment related to the ultimate resolution of an airline industry-wide issue regarding the tax treatment of certain aircraft engine maintenance costs, and lower state income taxes. The adoption of SFAS 123R will make it more difficult to forecast future effective income tax rates due to the difference in treatment of certain types of stock options for tax purposes. See Note 12 to the Consolidated Financial Statements for further information.

2004 COMPARED WITH 2003 The Company's consolidated net income for 2004 was \$215 million (\$.27 per share, diluted), as compared to 2003 net income of \$372 million (\$.46 per share, diluted), a decrease of \$157 million or 42.2 percent. Operating income for 2004 was \$404 million, an increase of \$26 million, or 6.9 percent compared to 2003.

As disclosed in Note 16 to the Consolidated Financial Statements, results for 2003 included \$271 million as "Other gains" from the Emergency Wartime Supplemental Appropriations Act (Wartime Act). The Company believes that excluding the impact of this special item enhances comparative analysis of results. The grant was made to stabilize and support the airline industry as a result of the 2003 war with Iraq. Financial results including the grant were not indicative of the Company's operating performance for 2003, nor should they be considered in developing trend analysis for future periods. There were no special items in 2004. The following table reconciles and compares results reported in accordance with Generally Accepted Accounting Principles (GAAP) for 2004 and 2003 with results excluding the impact of the government grant received in 2003:

(in millions, except per share and per ASM amounts)	2004	2003
Operating expenses, as reported	\$ 6,126	\$ 5,559
Profitsharing impact of government grant	-	(40)
Operating expenses, excluding grant impact	<u>\$ 6,126</u>	<u>\$ 5,519</u>
Operating expenses per ASM, as reported	\$.0797	\$.0774
Profitsharing impact of government grant	-	(.0006)
Operating expenses per ASM, excluding grant impact	<u>\$.0797</u>	<u>\$.0768</u>
Operating income, as reported	\$ 404	\$ 378
Profitsharing impact of government grant	-	40
Operating income, excluding impact of government grants	<u>\$ 404</u>	<u>\$ 418</u>
Net income, as reported	\$ 215	\$ 372
Government grant, net of income taxes and profitsharing	-	(144)
Net income, excluding government grants	<u>\$ 215</u>	<u>\$ 228</u>
Net income per share, diluted, as reported	\$.27	\$.46
Government grant, net of income taxes and profitsharing	-	(.18)
Net income per share, diluted, excluding government grants	<u>\$.27</u>	<u>\$.28</u>

Excluding the government grant received, consolidated net income for 2004 decreased \$13 million, or 5.7 percent, compared to 2003 net income of \$228 million. The decrease primarily was due to higher share-based compensation expense, partially offset by higher revenues from the Company's fleet growth and addition of capacity. Excluding the impact of the 2003 government grant, 2004 operating income decreased \$14 million, or 3.3 percent, compared to 2003.

OPERATING REVENUES Consolidated operating revenues increased \$593 million, or 10.0 percent, primarily due to a \$539 million, or 9.4 percent, increase in passenger revenues. The increase in passenger revenues primarily was due to an 11.4 percent increase in RPMs flown, driven by the Company's growth and a 2.7 point increase in the Company's load factor compared to 2003.

The Company increased ASMs by 7.1 percent compared to 2003, primarily as a result of the net addition of 29 aircraft during 2004 (47 new aircraft, net of 18 aircraft retirements). The Company's load factor for 2004 (RPMs divided by ASMs) was 69.5 percent, compared to 66.8 percent for 2003. Although this represented a strong load factor performance for the Company, passenger yields for 2004 (passenger revenue divided by RPMs) remained under considerable pressure due to significant capacity increases by a large majority of carriers. Passenger yields for 2004 declined to \$.1176, compared to \$.1197 in 2003, a decrease of 1.8 percent, because of heavy fare discounting arising as a result of the glut in industry seats available.

Consolidated freight revenues increased \$23 million, or 24.5 percent. Approximately 70 percent of the increase was due to an increase in freight and cargo revenues, primarily due to more units shipped. The remaining 30 percent of the increase was due to higher mail revenues, as the U.S. Postal Service shifted more business to commercial carriers. Other revenues increased \$31 million, or 30.4 percent, primarily due to an increase in commissions earned from programs the Company sponsors with certain business partners, such as the Company-sponsored Chase® Visa card.

OPERATING EXPENSES Consolidated operating expenses for 2004 increased \$567 million, or 10.2 percent, compared to the 7.1 percent increase in capacity. To a large extent, changes in operating expenses for airlines are driven by changes in capacity, or ASMs. The following presents Southwest's operating expenses per ASM for 2004 and 2003 followed by explanations of these changes on a per-ASM basis:

	2004	2003	Increase (decrease)	Percent change
Salaries, wages, and benefits	3.35¢	3.25¢	.10¢	3.1%
Fuel and oil	1.30	1.16	.14	12.1
Maintenance materials and repairs	.61	.60	.01	1.7
Aircraft rentals	.23	.25	(.02)	(8.0)
Landing fees and other rentals	.53	.52	.01	1.9
Depreciation and amortization	.56	.53	.03	5.7
Other	1.39	1.43	(.04)	(2.8)
Total	7.97¢	7.74¢	.23¢	3.0%

Operating expenses per ASM increased 3.0 percent to \$.0797, primarily due to an increase in jet fuel prices, net of hedging gains, and an increase in salaries, wages, and benefits. These increases were partially offset by the Company's elimination of commissions paid to travel agents, which was effective December 15, 2003.

Salaries, wages, and benefits expense per ASM increased 3.1 percent, inclusive of \$40 million in additional expense from the profitsharing impact of the 2003 government grant. Excluding the profitsharing impact of the 2003 government grant, approximately 60 percent of the increase per ASM was due to higher salaries expense, primarily from higher average wage rates, and 20 percent was due to higher benefits costs, primarily health care and workers' compensation.

During second quarter 2004, the Company and the Transport Workers Union Local 556 reached a tentative labor agreement for the Company's Flight Attendants, which included both pay increases and the issuance of stock options. During July 2004, a majority of the Company's Flight Attendants ratified the labor agreement, which is for the period from June 1, 2002, to May 31, 2008.

During third quarter 2004, the Company and the Aircraft Mechanics Fraternal Association, representing the Company's Mechanics, agreed to extend the date the current agreement becomes amendable to August 2008. The extension included both pay raises and the issuance of stock options, and was ratified by a majority of the Company's Mechanics.

During third quarter 2004, the Company and the International Brotherhood of Teamsters, representing the Company's Flight Simulator Technicians, agreed to extend the date the current agreement becomes amendable to November 2011. The extension included both pay raises and the issuance of stock options, and was ratified by a majority of the Company's Simulator Technicians.

Fuel and oil expense per ASM increased 12.1 percent, primarily due to a 14.5 percent increase in the average jet fuel cost per gallon, net of hedging gains. The average cost per gallon of jet fuel in 2004 was 82.8 cents compared to 72.3 cents in 2003, excluding fuel-related taxes but including the effects of hedging activities. The Company's 2004 and 2003 average jet fuel costs are net of approximately \$455 million and \$171 million in gains from hedging activities, respectively. See Note 9 to the Consolidated Financial Statements. The increase in fuel prices was partially offset by steps the Company took to improve the fuel efficiency of its aircraft. These steps primarily included the addition of blended winglets to 177 of the Company's 737-700 aircraft as of December 31, 2004, and the upgrade of certain engine components on many aircraft. The Company estimates that these and other efficiency gains saved the Company approximately \$28 million in 2004, at average unhedged market jet fuel prices.

Aircraft rentals per ASM and depreciation and amortization expense per ASM were both impacted by a higher percentage of the aircraft fleet being owned. Aircraft rentals per ASM decreased 8.0 percent while depreciation and amortization expense per ASM increased 5.7 percent. Of the 47 aircraft the Company acquired during 2004, 46 are owned and one is on operating lease. This, along with the retirement of 16 owned and two leased aircraft, increased the Company's percentage of aircraft owned or on capital lease to 79 percent at December 31, 2004, from 77 percent at December 31, 2003.

Landing fees and other rentals per ASM increased 1.9 percent primarily due to the Company's expansion of gate and counter space at several airports across our system.

Other operating expenses per ASM decreased 2.8 percent compared to 2003 primarily due to the elimination of commissions paid to travel agents, effective December 15, 2003. In addition to this change, an increase in expense from higher fuel taxes as a result of the substantial increase in fuel prices was mostly offset by lower advertising expense.

OTHER "Other expenses (income)" included interest expense, capitalized interest, interest income, and other gains and losses. Interest expense decreased by \$3 million, or 3.3 percent, primarily due to the Company's October 2003 redemption of \$100 million of senior unsecured 8 ³/₄% Notes originally issued in 1991. This decrease was partially offset by the Company's September 2004 issuance of \$350 million 5.25% senior unsecured notes and the fourth quarter 2004 issuance of \$112 million in floating-rate financing. Concurrently with the September 2004 issuance, the Company entered into an interest-rate swap agreement to convert this fixed-rate debt to floating rate. See Note 9 to the Consolidated Financial Statements for more information on the interest-rate swap agreement. Capitalized interest increased \$6 million, or 18.2 percent, primarily as a result of higher 2004 progress payment balances for scheduled future aircraft deliveries, compared to 2003. Interest income decreased \$3 million, or 12.5 percent, primarily due to a decrease in average invested cash balances. Other gains in 2003 primarily resulted from the government grant of \$271 million received pursuant to the Wartime Act. See Note 16 to the Consolidated Financial Statements for further discussion of the grant. Other losses in 2004 primarily include amounts recorded in accordance with SFAS 133. See Note 9 to the Consolidated Financial Statements for more information on the Company's hedging activities. During 2004, the Company recognized approximately \$24 million of expense related to amounts excluded from the Company's measurements of hedge effectiveness and \$13 million in expense related to the ineffectiveness of its hedges and unrealized mark-to-market changes in the fair value of certain derivative contracts.

INCOME TAXES The provision for income taxes, as a percentage of income before taxes, decreased to 36.54 percent in 2004 from 38.35 percent in 2003. Approximately half of the rate reduction was due to lower effective state income tax rates. The remainder of the decrease primarily was due to a favorable adjustment related to the ultimate resolution of an airline industry-wide issue regarding the tax treatment of certain aircraft engine maintenance costs.

LIQUIDITY AND CAPITAL RESOURCES

Net cash provided by operating activities was \$2.1 billion in 2005 compared to \$1.1 billion in 2004. For the Company, operating cash inflows primarily are derived from providing air transportation for Customers. The vast majority of tickets are purchased prior to the day on which travel is provided and, in some cases, several months before the anticipated travel date. Operating cash outflows primarily are related to the recurring expenses of operating the airline. For 2005, the increase in operating cash flows primarily was due to an increase in "Accounts payable and accrued liabilities" and higher net income in 2005 versus 2004. There was a \$1.0 billion increase in accrued liabilities, primarily related to a \$620 million increase in counterparty deposits associated with the Company's fuel hedging program. For further information on the Company's hedging program and counterparty deposits, see Note 9 to the Consolidated Financial Statements, and Item 7A. Qualitative and Quantitative Disclosures about Market Risk, respectively. Cash generated in 2005 and in 2004 primarily was used to finance aircraft-related capital expenditures and to provide working capital.

Cash flows used in investing activities in 2005 totaled \$1.1 billion compared to \$1.7 billion in 2004. Investing activities in both years primarily consisted of payments for new 737-700 aircraft delivered to the Company and progress payments for future aircraft deliveries. The Company purchased 33 new 737-700 aircraft in 2005 versus the purchase of 46 new 737-700s in 2004. In addition, progress payments for future deliveries were higher in 2004 than 2005. See Note 3 to the Consolidated Financial Statements. Investing activities for 2004 were also reduced \$124 million by a change in the balance of the Company's short-term investments, namely auction rate securities. Also, 2005 and 2004 included payments of \$6 million and \$34 million, respectively, for certain ATA assets. See Note 2 to the Consolidated Financial Statements for further information on the Company's transaction with ATA.

Net cash provided by financing activities was \$260 million in 2005, primarily from the issuance of \$300 million senior unsecured 5.125% notes in February 2005, net of the redemption of the Company's \$100 million senior unsecured 8% notes in March 2005. During 2005, the Company also received proceeds of \$132 million from Employee exercises of stock options under its stock plans and repurchased \$55 million of its common stock. In 2004, net cash provided by financing activities was \$156 million, primarily from the issuance of \$520 million in long-term debt. The majority of the debt issuance was the \$350 million senior unsecured notes issued in September 2004, and the fourth quarter 2004 issuance of \$112 million in floating-rate financing. The largest 2004 cash outflows in financing activities were from the Company's repurchase of \$246 million of its common stock during 2004, and the redemption of long-term debt, primarily the \$175 million Aircraft Secured Notes that came due in November 2004. See Note 6 to the Consolidated Financial Statements for more information on the issuance and redemption of long-term debt.

The Company has various options available to meet its 2006 capital and operating commitments, including cash on hand and short-term investments at December 31, 2005, of \$2.5 billion, internally generated funds, and a \$600 million bank revolving line of credit. 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, unencumbered assets, modest leverage, and consistent profitability.

The Company currently has outstanding shelf registrations for the issuance of up to \$1.3 billion in public debt securities and pass through certificates, which it may utilize for aircraft financings or other purposes in the future. The Company may issue a portion of these securities in 2006, primarily to replace debt that is coming due and to fund current fleet growth plans.

OFF-BALANCE SHEET ARRANGEMENTS, CONTRACTUAL OBLIGATIONS, AND CONTINGENT LIABILITIES AND COMMITMENTS

Southwest has contractual obligations and commitments primarily with regard to future purchases of aircraft, payment of debt, and lease arrangements. Along with the receipt of 33 new 737-700 aircraft in 2005, the Company has exercised its remaining options for aircraft to be delivered in 2006, and some of its options for aircraft to be delivered in 2007. As of January 2006, the Company had firm orders for 33 737-700 aircraft in 2006, 29 in 2007, and six in 2008. The Company also had options for seven 737-700 aircraft in 2007, 25 in 2008, and an additional 217 purchase rights for 737-700 aircraft for the years 2007 through 2012. The Company has the option to substitute 737-600s or -800s for the -700s. This option is applicable to aircraft ordered from the manufacturer and must be exercised two years prior to the contractual delivery date.

The Company has engaged in off-balance sheet arrangements in the leasing of aircraft. The leasing of aircraft provides flexibility to the Company effectively as a source of financing. Although the Company is responsible for all maintenance, insurance, and expense associated with operating the aircraft, and retains the risk of loss for leased aircraft, it has not made any guarantees to the lessors regarding the residual value (or market value) of the aircraft at the end of the lease terms.

As shown in Item 2., and as disclosed in Note 7 to the Consolidated Financial Statements, the Company operates 93 aircraft leased from third parties, of which 84 are operating leases. As prescribed by GAAP, assets and obligations under operating leases are not included in the Company's Consolidated Balance Sheet. Disclosure of the contractual obligations associated with the Company's leased aircraft are included below as well as in Note 7 to the Consolidated Financial Statements.

The following table aggregates the Company's material expected contractual obligations and commitments as of December 31, 2005:

	Obligations by period (in millions)				
	2006	2007 - 2008	2009 - 2010	Beyond 2010	Total
Contractual obligations					
Long-term debt (1)	\$ 596	\$ 123	\$ 28	\$ 1,222	\$ 1,969
Interest commitments (2)	37	51	45	214	347
Capital lease commitments (3)	16	32	31	12	91
Operating lease commitments	332	583	454	1,164	2,533
Aircraft purchase commitments (4)	740	538	-	-	1,278
Other purchase commitments	44	26	24	11	105
Total contractual obligations	\$ 1,765	\$ 1,353	\$ 582	\$ 2,623	\$ 6,323

(1) Includes current maturities, but excludes amounts associated with interest rate swap agreements

(2) Related to fixed-rate debt

(3) Includes amounts classified as interest

(4) Firm orders from the manufacturer

The Company may issue a portion of its \$1.3 billion in outstanding shelf registrations as public debt securities during 2006.

There were no outstanding borrowings under the revolving credit facility at December 31, 2005. See Note 5 to the Consolidated Financial Statements for more information on the Company's revolving credit facility.

In January 2004, the Company's Board of Directors authorized the repurchase of up to \$300 million of the Company's common stock, utilizing present and anticipated proceeds from the exercise of Employee stock options. Repurchases were made in accordance with applicable securities laws in the open market or in private transactions from time to time, depending on market conditions. This program was completed during first quarter 2005, resulting in the total repurchase of approximately 20.9 million of its common shares.

In January 2006, the Company's Board of Directors authorized the repurchase of up to \$300 million of the Company's common stock. Repurchases will be made in accordance with applicable securities laws in the open market or in private transactions from time to time, depending on market conditions.

CRITICAL ACCOUNTING POLICIES AND ESTIMATES

The Company's Consolidated Financial Statements have been prepared in accordance with United States GAAP. The Company's significant accounting policies are described in Note 1 to the Consolidated Financial Statements. The preparation of financial statements in accordance with GAAP requires the Company's management to make estimates and assumptions that affect the amounts reported in the Consolidated Financial Statements and accompanying footnotes. The Company's estimates and assumptions are based on historical experience and changes in the business environment. However, actual results may differ from estimates under different conditions, sometimes materially. Critical accounting policies and estimates are defined as those that are both most important to the portrayal of the Company's financial condition and results and require management's most subjective judgments. The Company's most critical accounting policies and estimates are described below.

Revenue Recognition

As described in Note 1 to the Consolidated Financial Statements, tickets sold for passenger air travel are initially deferred as "Air traffic liability." Passenger revenue is recognized and air traffic liability is reduced when the service is provided (i.e., when the flight takes place). "Air traffic liability" represents tickets sold for future travel dates and estimated future refunds and exchanges of tickets sold for past travel dates. The balance in "Air traffic liability" fluctuates throughout the year based on seasonal travel patterns and fare sale activity. The Company's "Air traffic liability" balance at December 31, 2005 was \$649 million, compared to \$529 million as of December 31, 2004.

Estimating the amount of tickets that will be refunded, exchanged, or forfeited involves some level of subjectivity and judgment. The majority of the Company's tickets sold are nonrefundable, which is the primary source of forfeited tickets. According to the Company's "Contract of Carriage", tickets that are sold but not flown on the travel date can be reused for another flight, up to a year from the date of sale, or can be refunded (if the ticket is refundable). A small percentage of tickets (or partial tickets) expire unused. Fully refundable tickets are rarely forfeited. "Air traffic liability" includes an estimate of the amount of future refunds and exchanges, net of forfeitures, for all unused tickets once the flight date has passed. These estimates are based on historical experience over many years. The Company and members of the airline industry have consistently applied this accounting method to estimate revenue from forfeited tickets at the date travel is provided. Estimated future refunds and exchanges included in the air traffic liability account are constantly evaluated based on subsequent refund and exchange activity to validate the accuracy of the Company's estimates with respect to forfeited tickets. Holding other factors constant, a ten-percent change in the Company's estimate of the amount of refunded, exchanged, or forfeited tickets for 2005 would have resulted in a \$13 million change in Passenger revenues recognized for that period.

Events and circumstances outside of historical fare sale activity or historical Customer travel patterns, as noted, can result in actual refunds, exchanges, or forfeited tickets differing significantly from estimates. The Company evaluates its estimates within a narrow range of acceptable amounts. If actual refunds, exchanges, or forfeiture experience results in an amount outside of this range, estimates and assumptions are reviewed and adjustments to "Air traffic liability" and to "Passenger revenue" are recorded, as necessary. Additional factors that may affect estimated refunds and exchanges include, but may not be limited to, the Company's refund and exchange policy, the mix of refundable and nonrefundable fares, and promotional fare activity. The Company's estimation techniques have been consistently applied from year to year; however, as with any estimates, actual refund, exchange, and forfeiture activity may vary from estimated amounts. No material adjustments were recorded for years 2003, 2004, or 2005.

The Company believes it is unlikely that materially different estimates for future refunds, exchanges, and forfeited tickets would be reported based on other reasonable assumptions or conditions suggested by actual historical experience and other data available at the time estimates were made.

Accounting for Long-Lived Assets

As of December 31, 2005, the Company had approximately \$12.5 billion (at cost) of long-lived assets, including \$10.6 billion (at cost) in flight equipment and related assets. Flight equipment primarily relates to the 361 Boeing 737 aircraft in the Company's fleet at December 31, 2005, which are either owned or on capital lease. The remaining 84 Boeing 737 aircraft in the Company's fleet at December 31, 2005, are on operating lease. In accounting for long-lived assets, the Company must make estimates about the expected useful lives of the assets, the expected residual values of the assets, and the potential for impairment based on the fair value of the assets and the cash flows they generate.

The following table shows a breakdown of the Company's long-lived asset groups along with information about estimated useful lives and residual values of these groups:

	Estimated Useful Life	Estimated Residual value
Aircraft and engines	23 to 25 years	15%
Aircraft parts	Fleet life	4%
Ground property and equipment	5 to 30 years	0%-10%
Leasehold improvements	5 years or lease term	0%

In estimating the lives and expected residual values of its aircraft, the Company primarily has relied upon actual experience with the same or similar aircraft types and recommendations from Boeing, the manufacturer of the Company's aircraft. Aircraft estimated useful lives are based on the number of "cycles" flown (one take-off and landing). The Company has made a conversion of cycles into years based on both its historical and anticipated future utilization of the aircraft. Subsequent revisions to these estimates, which can be significant, could be caused by changes to the Company's maintenance program, changes in utilization of the aircraft (actual cycles during a given period of time), governmental regulations on aging aircraft, and changing market prices of new and used aircraft of the same or similar types. The Company evaluates its estimates and assumptions each reporting period and, when warranted, adjusts these estimates and assumptions. Generally, these adjustments are accounted for on a prospective basis through depreciation and amortization expense, as required by GAAP.

When appropriate, the Company evaluates its long-lived assets for impairment. Factors that would indicate potential impairment may include, but are not limited to, significant decreases in the market value of the long-lived asset(s), a significant change in the long-lived asset's physical condition, and operating or cash flow losses associated with the use of the long-lived asset. While the airline industry as a whole has experienced many of these indicators, Southwest has continued to operate all of its aircraft, generate positive cash flow, and produce profits. Consequently, the Company has not identified any impairments related to its existing aircraft fleet. The Company will continue to monitor its long-lived assets and the airline operating environment.

The Company believes it unlikely that materially different estimates for expected lives, expected residual values, and impairment evaluations would be made or reported based on other reasonable assumptions or conditions suggested by actual historical experience and other data available at the time estimates were made.

Financial Derivative Instruments

The Company utilizes financial derivative instruments primarily to manage its risk associated with changing jet fuel prices, and accounts for them under Statement of Financial Accounting Standards No. 133, "Accounting for Derivative Instruments and Hedging Activities", as amended (SFAS 133). See "Qualitative and Quantitative Disclosures about Market Risk" for more information on these risk management activities and see Note 9 to the Consolidated Financial Statements for more information on SFAS 133, the Company's fuel hedging program, and financial derivative instruments.

SFAS 133 requires that all derivatives be marked to market (fair value) and recorded on the Consolidated Balance Sheet. At December 31, 2005, the Company was a party to over 400 financial derivative instruments, related to fuel hedging, for year 2006 and beyond. The fair value of the Company's fuel hedging financial derivative instruments recorded on the Company's Consolidated Balance Sheet as of December 31, 2005, was \$1.7 billion, compared to \$796 million at December 31, 2004. The large increase in fair value primarily was due to the dramatic increase in energy prices throughout 2005, and the Company's addition of derivative instruments to increase its hedge positions in future years. Changes in the fair values of these instruments can vary dramatically, as was evident during 2005, based on changes in the underlying commodity prices. Market price changes can be driven by factors such as supply and demand, inventory levels, weather events, refinery capacity, political agendas, and general economic conditions, among other items. The financial derivative instruments utilized by the Company primarily are a combination of collars, purchased call options, and fixed price swap agreements. The Company does not purchase or hold any derivative instruments for trading purposes.

The Company enters into financial derivative instruments with third party institutions in "over-the-counter" markets. Since the majority of the Company's financial derivative instruments are not traded on a market exchange, the Company estimates their fair values. Depending on the type of instrument, the values are 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. Also, since there is not a reliable forward market for jet fuel, the Company must estimate the future prices of jet fuel in order to measure the effectiveness of the hedging instruments in offsetting changes to those prices, as required by SFAS 133. Forward jet fuel prices are estimated through the observation of similar commodity futures prices (such as crude oil, heating oil, and unleaded gasoline) and adjusted based on historical variations to those like commodities.

Fair values for financial derivative instruments and forward jet fuel prices are both estimated prior to the time that the financial derivative instruments settle, and the time that jet fuel is purchased and consumed, respectively. However, once settlement of the financial derivative instruments occurs and the hedged jet fuel is purchased and consumed, all values and prices are known and are recognized in the financial statements. Based on these actual results once all values and prices become known, the Company's estimates have proved to be materially accurate.

Estimating the fair value of these fuel hedging derivatives and forward prices for jet fuel will also result in changes in their values from period to period and thus determine how they are accounted for under SFAS 133. To the extent that the total change in the estimated fair value of a fuel hedging instrument differs from the change in the estimated price of the associated jet fuel to be purchased, both on a cumulative and a period-to-period basis, ineffectiveness of the fuel hedge can result, as defined by SFAS 133. This could result in the immediate recording of noncash charges or income, even though the derivative instrument may not expire until a future period. Likewise, if a cash flow hedge ceases to qualify for hedge accounting, those periodic changes in the fair value of derivative instruments are recorded to "Other gains and losses" in the income statement in the period of the change.

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

SFAS 133 is a complex accounting standard with stringent requirements, including the documentation of a Company hedging strategy, statistical analysis to qualify a commodity for hedge accounting both on a historical and a prospective basis, and strict contemporaneous documentation that is required at the time each hedge is executed by the Company. 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 analyses that compare changes in the price of jet fuel to changes in the prices of the commodities used for hedging purposes (crude oil, heating oil, and unleaded gasoline).

The Company continually looks for better and more accurate methodologies in forecasting future cash flows relating to its jet fuel hedging program. These estimates are used in the measurement of effectiveness for the Company's fuel hedges, as required by SFAS 133. Any changes to the Company's methodology for estimating future cash flows (i.e., jet fuel prices) will be applied prospectively, in accordance with SFAS 133. While the Company would expect that a change in the methodology for estimating future cash flows would result in more effective hedges over the long-term, such a change could result in more ineffectiveness, as defined, in the short-term, due to the prospective nature of enacting the change.

The Company also utilizes financial derivative instruments in the form of interest rate swap agreements. The primary objective for the Company's use of interest rate hedges is to reduce the volatility of net interest income by better matching the repricing of its assets and liabilities. Concurrently, the Company's interest rate hedges are also intended to take advantage of market conditions in which short-term rates are significantly lower than the fixed longer term rates on the Company's long-term debt. During 2003, the Company entered into interest rate swap agreements relating to its \$385 million 6.5% senior unsecured notes due 2012, and \$375 million 5.496% Class A-2 pass-through certificates due 2006. The floating rate paid under each agreement sets in arrears. Under the first agreement, the Company pays the London InterBank Offered Rate (LIBOR) plus a margin every six months and receives 6.5% every six months on a notional amount of \$385 million until 2012. The average floating rate paid under this agreement during 2005 is estimated to be 6.46 percent based on actual and forward rates at December 31, 2005. Under the second agreement, the Company pays LIBOR plus a margin every six months and receives 5.496% every six months on a notional amount of \$375 million until November 1, 2006. Based on actual and forward rates at December 31, 2005, the average floating rate paid under this agreement during 2005 is estimated to be 6.73 percent.

During 2004, the Company also entered into an interest rate swap agreement relating to its \$350 million 5.25% senior unsecured notes due 2014. Under this agreement, the Company pays LIBOR plus a margin every six months and receives 5.25% every six months on a notional amount of \$350 million until 2014. The floating rate is set in advance. The average floating rate paid under this agreement during 2005 was 3.82 percent.

The Company's interest rate swap agreements qualify as fair value hedges, as defined by SFAS 133. In addition, these interest rate swap agreements qualify for the "shortcut" method of accounting for hedges, as defined by SFAS 133. Under the "shortcut" method, the hedges are assumed to be perfectly effective, and, thus, there is no ineffectiveness to be recorded in earnings. The fair value of the interest rate swap agreements, which are adjusted regularly, are recorded in the Consolidated Balance Sheet, as necessary, with a corresponding adjustment to the carrying value of the long-term debt. The fair value of the interest rate swap agreements, excluding accrued interest, at December 31, 2005, was a liability of approximately \$31 million. The comparable fair value of these same agreements at December 31, 2004, was a liability of \$16 million. The long-term portion of these amounts are recorded in "Other deferred liabilities" in the Consolidated Balance Sheet for each respective year and the current portion is reflected in "Accrued liabilities." In accordance with fair value hedging, the offsetting entry is an adjustment to decrease the carrying value of long-term debt. See Note 9 to the Consolidated Financial Statements.

The Company believes it is unlikely that materially different estimates for the fair value of financial derivative instruments, and forward jet fuel prices, would be made or reported based on other reasonable assumptions or conditions suggested by actual historical experience and other data available at the time estimates were made.

Share-Based Compensation

The Company has share-based compensation plans covering the majority of its Employee groups, including plans adopted via collective bargaining, a plan covering the Company's Board of Directors, and plans related to employment contracts with one Executive Officer of the Company. Effective January 1, 2006, the Company adopted the fair value recognition provisions of SFAS No. 123R, "Share-Based Payment" using the modified retrospective transition method. Among other items, SFAS 123R eliminates the use of APB 25 and the intrinsic value method of accounting, and requires companies to recognize the cost of Employee services received in exchange for awards of equity instruments, based on the grant date fair value of those awards, in the financial statements. See Notes 1 and 12 to the Consolidated Financial Statements.

Under the modified retrospective method, compensation cost is recognized in the financial statements beginning with the effective date, based on the requirements of SFAS 123R for all share-based payments granted after that date, and based on the requirements of SFAS 123 for all unvested awards granted prior to the effective date of SFAS 123R. In addition, results for prior periods have been retroactively adjusted utilizing the pro forma disclosures in those prior financial statements, except as noted. As part of this revision, the Company recorded cumulative share-based compensation expense of \$409 million for the period 1995-2005, resulting in a reduction to Retained earnings in the accompanying Consolidated Balance Sheet as of December 31, 2005. This adjustment, along with the creation of a net Deferred income tax asset in the amount of \$130 million, resulted in an offsetting increase to Capital in excess of par value in the amount of \$539 million in the accompanying Consolidated Balance Sheet as of December 31, 2005. The Deferred tax asset represents the portion of the cumulative expense related to stock options that will result in a future tax deduction.

The Consolidated Statement of Income for 2005, 2004, and 2003 reflects share-based compensation cost of \$80 million, \$135 million, and \$107 million, respectively. The total tax benefit recognized from share-based compensation arrangements for 2005, 2004, and 2003 was \$25 million, \$46 million, and \$36 million, respectively. For 2005, 2004, and 2003, the Company's net earnings were reduced by \$55 million, \$89 million, and \$71 million, respectively, compared to the previous accounting method under APB 25. For 2005, 2004, and 2003, net income per share, basic was reduced by \$.08, \$.12, and \$.09, respectively, compared to the previous accounting under APB 25. For 2005, 2004, and 2003, net income per share, diluted was reduced by \$.06, \$.10, and \$.08, respectively, compared to the previous accounting under APB 25.

The Company estimates the fair value of stock option awards on the date of grant utilizing a modified Black-Scholes option pricing model. The Black-Scholes option valuation model was developed for use in estimating the fair value of short-term traded options that have no vesting restrictions and are fully transferable. However, certain assumptions used in the Black-Scholes model, such as expected term and expected stock price volatility, can be adjusted to incorporate the unique characteristics of the Company's stock option awards. Prior to 2005, the Company relied exclusively on historical volatility as an input for determining the estimated fair value of stock options. For 2005, the Company relied on observations of both historical volatility trends as well as implied future volatility observations as determined by independent third parties. For 2005 stock option grants, the Company utilized expected volatility based on the expected life of the option, but within a range of 25% to 27%. In determining the expected life of the option grants, the Company has observed the actual terms of prior grants with similar characteristics, the actual vesting schedule of the grant, and assessed the expected risk tolerance of different optionee groups.

Other assumptions required for estimating fair value with the Black-Scholes model are the expected risk-free interest rate and expected dividend yield of the Company's stock. The risk-free interest rates used, which were actual U.S. Treasury zero-coupon rates for bonds matching the expected term of the option as of the option grant date, ranged from 3.37% to 4.47% for 2005, 2.16% to 4.62% for 2004, and 1.82% to 4.10% for 2003. The expected dividend yield of the Company's common stock over the expected term of the option on the date of grant was estimated based on the Company's current dividend yield, and adjusted for anticipated future changes.

The fair value of options granted under the fixed option plans during 2005 ranged from \$2.90 to \$6.79, with a weighted-average fair value of \$4.49. The fair value of options granted under the fixed option plans during 2004 ranged from \$3.45 to \$7.83, with a weighted-average fair value of \$4.49. The fair value of options granted under the fixed option plans during 2003 ranged from \$3.33 to \$8.17, with a weighted-average fair value of \$4.28

Vesting terms for the Company's stock option plans differ based on the type of grant made and the group to which the options are granted. For grants made to Employees under collective bargaining plans, vesting has ranged in length from immediate vesting to vesting periods in accordance with the period covered by the respective collective bargaining agreement. For "Other Employee Plans", options vest and become fully exercisable over three, five, or ten years of continued employment, depending upon the grant type. For grants in any of the Company's plans that are subject to graded vesting over a service period, we recognize expense on a straight-line basis over the requisite service period for the entire award. None of the Company's grants include performance-based or market-based vesting conditions, as defined.

As of December 31, 2005, the Company has \$148 million in remaining unrecognized compensation cost related to past grants of stock options, which is expected to be recognized over a weighted-average period of 2.0 years. The total recognition period for the remaining unrecognized compensation cost is approximately ten years; however, the majority of this cost will be recognized over the next two years, in accordance with vesting provisions.

The Company believes it is unlikely that materially different estimates for the assumptions used in estimating the fair value of stock options granted would be made based on the conditions suggested by actual historical experience and other data available at the time estimates were made.

FORWARD-LOOKING STATEMENTS

Some statements in this Form 10-K (or otherwise made by the Company or on the Company's behalf from time to time in other reports, filings with the Securities and Exchange Commission, news releases, conferences, World Wide Web postings or otherwise) which are not historical facts, may be "forward-looking statements" within the meaning of Section 21E of the Securities Exchange Act of 1934 and the Private Securities Litigation Reform Act of 1995. Forward-looking statements include statements about Southwest's estimates, expectations, beliefs, intentions or strategies for the future, and the assumptions underlying these forward-looking statements. Southwest uses the words "anticipates," "believes," "estimates," "expects," "intends," "forecasts," "may," "will," "should," and similar expressions to identify these forward-looking statements. Forward-looking statements involve risks and uncertainties that could cause actual results to differ materially from historical experience or the Company's present expectations. Factors that could cause these differences include, but are not limited to, those set forth under Item 1A—Risk Factors.

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

ITEM 7A. QUALITATIVE AND QUANTITATIVE DISCLOSURES ABOUT MARKET RISK

Southwest has interest rate risk in its floating rate debt obligations and interest rate swaps, and has commodity price risk in jet fuel required to operate its aircraft fleet. The Company purchases jet fuel at prevailing market prices, but seeks to manage market risk through execution of a documented hedging strategy. Southwest has market sensitive instruments in the form of fixed rate debt instruments and financial derivative instruments used to hedge its exposure to jet fuel price increases. The Company also operates 93 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 7 to the Consolidated Financial Statements. The Company does not purchase or hold any derivative financial instruments for trading purposes. See Note 9 to the Consolidated Financial Statements for information on the Company's accounting for its hedging program and for further details on the Company's financial derivative instruments.

Fuel hedging. The Company utilizes its fuel hedges, on both a short-term and a long-term basis, as a form of insurance against significant increases in fuel prices. The Company believes there is significant risk in not hedging against the possibility of such fuel price increases. The Company expects to consume approximately 1.4 billion gallons of jet fuel in 2006. Based on this usage, a change in jet fuel prices of just one cent per gallon would impact the Company's "Fuel and oil expense" by approximately \$14 million per year, excluding any impact of the Company's fuel hedges.

The fair values of outstanding financial derivative instruments related to the Company's jet fuel market price risk at December 31, 2005, were net assets of \$1.7 billion. The current portion of these financial derivative instruments, or \$640 million, is classified as "Fuel hedge contracts" in the Consolidated Balance Sheet. The long-term portion of these financial derivative instruments, or \$1.0 billion, is included in "Other assets." The fair values of the derivative instruments, depending on the type of instrument, were determined by 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, 2005, prices would correspondingly change the fair value of the commodity derivative instruments in place by approximately \$420 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, 2005, levels, except underlying futures prices.

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 will periodically review 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, 2005, the Company had agreements with seven counterparties containing early termination rights and/or bilateral collateral provisions whereby security is required if market risk exposure exceeds a specified threshold amount or credit ratings fall below certain levels. At December 31, 2005, the Company held \$950 million in cash collateral deposits under these bilateral collateral provisions. These collateral deposits serve to decrease, but not totally eliminate, the credit risk associated with the Company's hedging program. The deposits are included in "Accrued liabilities" on the Consolidated Balance Sheet. See also Note 9 to the Consolidated Financial Statements.

Financial market risk. The vast majority of the Company's assets are aircraft, which are long-lived. The Company's strategy is to maintain a conservative balance sheet 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 1999 and 2004 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. In addition, as disclosed in Note 9 to the Consolidated Financial Statements, the Company has converted certain of its long-term debt to floating rate debt by entering into interest rate swap agreements. This includes the Company's \$385 million 6.5% senior unsecured notes due 2012, the \$375 million 5.496% Class A-2 pass-through certificates due 2006, and the \$350 million 5.25% senior unsecured notes due 2014. Although there is interest rate risk associated with these floating rate borrowings, the risk for the 1999 and 2004 French Credit Agreements is somewhat mitigated by the fact that the Company may prepay this debt under certain conditions. See Notes 5 and 6 to the Consolidated Financial Statements for more information on the material terms of the Company's short-term and long-term debt.

Excluding the \$385 million 6.5% senior unsecured notes, and the \$350 million 5.25% senior unsecured notes that were converted to a floating rate as previously noted, the Company had outstanding senior unsecured notes totaling \$500 million at December 31, 2005. These senior unsecured notes currently have a weighted-average maturity of 11.3 years at fixed rates averaging 6.125 percent at December 31, 2005, which is comparable to average rates prevailing for similar debt instruments over the last ten years. The fixed-rate portion of the Company's pass-through certificates consists of its Class A certificates and Class B certificates, which totaled \$154 million at December 31, 2005. These Class A and Class B certificates had fixed rates averaging 5.7 percent at December 31, 2005 and mature during 2006. The carrying value of the Company's floating rate debt totaled \$1.2 billion, and this debt had a weighted-average maturity of 6.0 years at floating rates averaging 6.27 percent at December 31, 2005. In total, the Company's fixed rate debt and floating rate debt represented 6.2 percent and 11.6 percent, respectively, of total noncurrent assets at December 31, 2005.

The Company also has some risk associated with changing interest rates due to the short-term nature of its invested cash, which totaled \$2.3 billion, and short-term investments, which totaled \$251 million, at December 31, 2005. The Company invests available cash in certificates of deposit, highly rated money market instruments, investment grade commercial paper, auction rate securities, and other highly rated financial instruments. Because of the short-term nature of these investments, the returns earned parallel closely with short-term 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 market interest rate risk management activities.

A hypothetical ten percent change in market interest rates as of December 31, 2005, 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 floating rate debt, invested cash, and short-term investments because of the floating-rate nature of these items. Assuming floating market rates in effect as of December 31, 2005, 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 less than \$2 million. Utilizing these assumptions and considering the Company's cash balance, short-term investments, and floating-rate debt outstanding at December 31, 2005, an increase in rates would have a net positive effect on the Company's earnings and cash flows, while a decrease in rates would have a net negative effect on the Company's earnings and cash flows. 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.

The Company is also subject to various financial covenants included in its credit card transaction processing agreement, the revolving credit facility, and outstanding debt agreements. Covenants include the maintenance of minimum credit ratings. For the revolving credit facility, the Company shall also maintain, at all times, a Coverage Ratio, as defined in the agreement, of not less than 1.25 to 1.0. The Company met or exceeded the minimum standards set forth in these agreements as of December 31, 2005. However, if conditions change and the Company fails to meet the minimum standards set forth in the agreements, it could reduce the availability of cash under the agreements or increase the costs to keep these agreements intact as written.

ITEM 8. FINANCIAL STATEMENTS AND SUPPLEMENTARY DATA
SOUTHWEST AIRLINES CO.
CONSOLIDATED BALANCE SHEET
(In millions, except share data)

	DECEMBER 31,	
	2005	2004
ASSETS		
Current assets:		
Cash and cash equivalents	\$ 2,280	\$ 1,048
Short-term investments	251	257
Accounts and other receivables	258	248
Inventories of parts and supplies, at cost	150	137
Fuel hedge contracts	641	428
Prepaid expenses and other current assets	40	54
Total current assets	3,620	2,172
Property and equipment, at cost:		
Flight equipment	10,592	9,635
Ground property and equipment	1,256	1,202
Deposits on flight equipment purchase contracts	660	682
	12,508	11,519
Less allowance for depreciation and amortization	3,296	2,996
	9,212	8,523
Other assets		
	1,171	442
	\$ 14,003	\$ 11,137
LIABILITIES AND STOCKHOLDERS' EQUITY		
Current liabilities:		
Accounts payable	\$ 524	\$ 420
Accrued liabilities	2,074	1,047
Air traffic liability	649	529
Current maturities of long-term debt	601	146
Total current liabilities	3,848	2,142
Long-term debt less current maturities		
	1,394	1,700
Deferred income taxes	1,681	1,407
Deferred gains from sale and leaseback of aircraft	136	152
Other deferred liabilities	269	209
Commitments and contingencies		
Stockholders' equity:		
Common stock, \$1.00 par value: 2,000,000,000 shares authorized; 801,641,645 and 790,181,982 shares issued in 2005 and 2004, respectively	802	790
Capital in excess of par value	963	777
Retained earnings	4,018	3,614
Accumulated other comprehensive income	892	417
Treasury stock, at cost: 5,199,192 shares in 2004	-	(71)
Total stockholders' equity	6,675	5,527
	\$ 14,003	\$ 11,137
See accompanying notes.		

SOUTHWEST AIRLINES CO.
CONSOLIDATED STATEMENT OF INCOME

(In millions, except per share amounts)

	YEARS ENDED DECEMBER 31,		
	2005	2004	2003
OPERATING REVENUES:			
Passenger	\$ 7,279	\$ 6,280	\$ 5,741
Freight	133	117	94
Other	172	133	102
Total operating revenues	7,584	6,530	5,937
OPERATING EXPENSES:			
Salaries, wages, and benefits	2,782	2,578	2,330
Fuel and oil	1,341	1,000	830
Maintenance materials and repairs	446	472	429
Aircraft rentals	163	179	183
Landing fees and other rentals	454	408	372
Depreciation and amortization	469	431	384
Other operating expenses	1,204	1,058	1,031
Total operating expenses	6,859	6,126	5,559
OPERATING INCOME	725	404	378
OTHER EXPENSES (INCOME):			
Interest expense	122	88	91
Capitalized interest	(39)	(39)	(33)
Interest income	(47)	(21)	(24)
Other (gains) losses, net	(90)	37	(259)
Total other expenses (income)	(54)	65	(225)
INCOME BEFORE INCOME TAXES	779	339	603
PROVISION FOR INCOME TAXES	295	124	231
NET INCOME	\$ 484	\$ 215	\$ 372
NET INCOME PER SHARE, BASIC	\$.61	\$.27	\$.48
NET INCOME PER SHARE, DILUTED	\$.60	\$.27	\$.46

See accompanying notes.

SOUTHWEST AIRLINES CO.
CONSOLIDATED STATEMENT OF STOCKHOLDERS' EQUITY

YEARS ENDED DECEMBER 31, 2005, 2004, AND 2003

(In millions, 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, 2002	\$ 777	\$ 395	\$ 3,148	\$ 54	\$ -	4,374
Issuance of common stock pursuant to Employee stock plans	12	81	-	-	-	93
Tax benefit of options exercised	-	29	-	-	-	29
Share-based compensation	-	107	-	-	-	107
Cash dividends, \$.018 per share	-	-	(14)	-	-	(14)
Comprehensive income (loss)						
Net income	-	-	372	-	-	372
Unrealized gain on derivative instruments	-	-	-	66	-	66
Other	-	-	-	2	-	2
Total comprehensive income						440
Balance at December 31, 2003	\$ 789	\$ 612	\$ 3,506	\$ 122	\$ -	5,029
Purchase of shares of treasury stock	-	-	-	-	(246)	(246)
Issuance of common and treasury stock pursuant to Employee stock plans	1	7	(93)	-	175	90
Tax benefit of options exercised	-	23	-	-	-	23
Share-based compensation	-	135	-	-	-	135
Cash dividends, \$.018 per share	-	-	(14)	-	-	(14)
Comprehensive income (loss)						
Net income	-	-	215	-	-	215
Unrealized gain on derivative instruments	-	-	-	293	-	293
Other	-	-	-	2	-	2
Total comprehensive income						510
Balance at December 31, 2004	\$ 790	\$ 777	\$ 3,614	\$ 417	\$ (71)	5,527
Purchase of shares of treasury stock	-	-	-	-	(55)	(55)
Issuance of common and treasury stock pursuant to Employee stock plans	12	59	(66)	-	126	131
Tax benefit of options exercised	-	47	-	-	-	47
Share-based compensation	-	80	-	-	-	80
Cash dividends, \$.018 per share	-	-	(14)	-	-	(14)
Comprehensive income (loss)						
Net income	-	-	484	-	-	484
Unrealized gain on derivative instruments	-	-	-	474	-	474
Other	-	-	-	1	-	1
Total comprehensive income						959
Balance at December 31, 2005	\$ 802	\$ 963	\$ 4,018	\$ 892	\$ -	6,675

See accompanying notes.

SOUTHWEST AIRLINES CO.
CONSOLIDATED STATEMENT OF CASH FLOWS

(In millions)

	YEARS ENDED DECEMBER 31,		
	2005	2004	2003
CASH FLOWS FROM OPERATING ACTIVITIES:			
Net income	\$ 484	\$ 215	\$ 372
Adjustments to reconcile net income to net cash provided by operating activities:			
Depreciation and amortization	469	431	384
Deferred income taxes	291	166	190
Amortization of deferred gains on sale and leaseback of aircraft	(16)	(16)	(16)
Share-based compensation expense	80	135	107
Excess tax benefits from share-based compensation expense	(47)	(23)	(29)
Changes in certain assets and liabilities:			
Accounts and other receivables	(9)	(75)	43
Other current assets	(59)	(44)	(19)
Accounts payable and accrued liabilities	855	231	129
Air traffic liability	120	68	50
Other	(50)	(22)	50
Net cash provided by operating activities	2,118	1,066	1,261
CASH FLOWS FROM INVESTING ACTIVITIES:			
Purchases of property and equipment, net	(1,146)	(1,707)	(1,192)
Change in short-term investments, net	6	124	(381)
Payment for assets of ATA Airlines, Inc.	(6)	(34)	-
Debtor in possession loan to ATA Airlines, Inc.	-	(40)	-
Other	-	(1)	-
Net cash used in investing activities	(1,146)	(1,658)	(1,573)
CASH FLOWS FROM FINANCING ACTIVITIES:			
Issuance of long-term debt	300	520	-
Proceeds from Employee stock plans	132	88	93
Payments of long-term debt and capital lease obligations	(149)	(207)	(130)
Payments of cash dividends	(14)	(14)	(14)
Repurchase of common stock	(55)	(246)	-
Excess tax benefits from share-based compensation arrangements	47	23	29
Other, net	(1)	(8)	3
Net cash provided by (used in) financing activities	260	156	(19)
NET INCREASE (DECREASE) IN CASH AND CASH EQUIVALENTS			
	1,232	(436)	(331)
CASH AND CASH EQUIVALENTS AT BEGINNING OF PERIOD			
	1,048	1,484	1,815
CASH AND CASH EQUIVALENTS AT END OF PERIOD	\$ 2,280	\$ 1,048	\$ 1,484
SUPPLEMENTAL DISCLOSURES			
Cash payments for:			
Interest, net of amount capitalized	\$ 71	\$ 38	\$ 62
Income taxes	\$ 8	\$ 2	\$ 51
Noncash rights to airport gates acquired through reduction in debtor in possession loan to ATA Airlines, Inc.	\$ 20	\$ -	\$ -
See accompanying notes.			

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
DECEMBER 31, 2005

1. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

Changes in Accounting

Effective January 1, 2006, Southwest adopted Statement of Financial Accounting Standards (SFAS) No. 123R, "Share-Based Payment" (SFAS 123R) using the modified retrospective transition method. SFAS 123R requires that all stock-based compensation, including grants of employee stock options, be accounted for using a fair-value-based method. Under the modified retrospective method, prior years' results were retrospectively adjusted to give effect to the value of options granted in fiscal years beginning on or after January 1, 1995.

Stock-based compensation expense reported under SFAS 123R in the accompanying financial statements does not exactly match the pro forma results disclosed in the footnotes to previous years' financial statements. We have adjusted the amounts reported in prior period pro forma results primarily to exclude a previous assumption that if stock-based compensation expense were recorded in the financial statements in prior periods, the Company's profitsharing contributions would be impacted by that expense. The amount of this adjustment related to 2005 was \$12 million, the amount related to 2004 was \$20 million, and the amount related to 2003 was \$16 million. On a per share basis for 2005, the \$12 million profitsharing amount resulted in a difference of \$.02, both basic and diluted, compared to previously disclosed pro forma amounts. On a per share basis for 2004, the \$20 million profitsharing amount resulted in a difference of \$.03, basic and \$.02, diluted, compared to previously disclosed pro forma amounts. On a per share basis for 2003, the \$16 million profitsharing amount resulted in a difference of \$.02, both basic and diluted, compared to previously disclosed pro forma amounts. These adjustments had no impact on our balance sheets, statements of operations, cash flows, or stockholders' equity as reported in prior periods.

In addition, in first quarter 2006, the Company began transitioning the maintenance program for performing planned airframe maintenance on its fleet of 737-300 and 737-500 aircraft. Due to the change in the nature of the maintenance activities performed, the Company changed its method of accounting for scheduled airframe and inspection repairs for 737-300 and 737-500 aircraft from the deferral method to the direct expense method, effective January 1, 2006. Under the deferral method, scheduled airframe and inspection repairs were capitalized and amortized as a component of Maintenance, materials and repairs expense in the Consolidated Statement of Income; under the direct expense method, scheduled airframe and inspection repairs are expensed as incurred. The Company recorded the change in accounting in accordance with Statement of Financial Accounting Standards No. 154, *Accounting Changes and Error Corrections* (SFAS 154), which was effective for calendar year companies on January 1, 2006. SFAS 154 requires that all elective accounting changes be made on a retrospective basis.

The following table summarizes the impact of these accounting changes on the Consolidated Statement of Earnings for the years ended December 31, 2005, 2004 and 2003:

(in millions, except per share amounts)	Year ended Dec 31 2005	Year ended Dec 31 2004	Year ended Dec 31 2003
Net income, as previously reported	\$ 548	\$ 313	\$ 442
Less: impact of SFAS 123R			
(Salaries, wages and benefits)	(80)	(135)	(107)
Less: impact of change in maintenance accounting			
(Maintenance materials and repairs)	(15)	(15)	3
Add: Income tax benefit from accounting changes	31	52	34
Net income - As retrospectively adjusted	<u>\$ 484</u>	<u>\$ 215</u>	<u>\$ 372</u>
Weighted-average shares outstanding, diluted, as previously reported	814	815	822
Less: impact of SFAS 123R	(8)	(11)	(12)
Weighted-average shares outstanding, diluted - As retrospectively adjusted	<u>806</u>	<u>804</u>	<u>810</u>
Net income per share, basic, as previously reported	\$.70	\$.40	\$.56
Less: impact of SFAS 123R, net of tax	(.08)	(.12)	(.09)
Less: impact of maintenance accounting change, net of tax	(.01)	(.01)	.01
Net income per share, basic - As retrospectively adjusted	<u>\$.61</u>	<u>\$.27</u>	<u>\$.48</u>
Net income per share, diluted, as previously reported	\$.67	\$.38	\$.54
Less: impact of SFAS 123R, net of tax	(.06)	(.10)	(.08)
Less: impact of maintenance accounting change, net of tax	(.01)	(.01)	-
Net income per share, diluted - As retrospectively adjusted	<u>\$.60</u>	<u>\$.27</u>	<u>\$.46</u>

The Statement of Cash Flows has been retrospectively revised to reclassify the cash inflows related to excess tax benefits for employee exercise of options from operating activities to financing activities.

As a result of these accounting changes, we revised the following notes (numbering is as filed in the Company's original filing of our Annual Report on Form 10-K):

- Note 1, Summary of Significant Accounting Policies - The pro forma disclosure of stock-based compensation expense has been eliminated and the discussion of Aircraft and engine maintenance has been updated based on the change in accounting for airframes.

- Note 2, Accounting changes - The discussion of the planned 2006 accounting changes has been eliminated.

- Note 10, Derivative and financial instruments - Disclosures have been revised to reflect the accounting changes. Derivative and financial instruments is now Note 9.

- Note 11, Comprehensive income - Disclosures have been revised to reflect the accounting changes. Comprehensive income is now Note 10.
- Note 13, Stock Plans - Disclosures have been revised to reflect the adoption of SFAS 123R. Stock plans is now Note 12.
- Note 15, Income Taxes - Income tax disclosures have been revised to reflect the accounting changes and the related income tax effects. Income taxes is now Note 14.
- Note 16, Net income per share - Disclosures have been revised to reflect the accounting changes. Net income per share is now Note 15.

Other than the revised numbering compared to the Company's original filing of our Annual Report on Form 10-K, the notes have not been updated for any other subsequent developments. See our quarterly report on Form 10-Q for the quarter ended June 30, 2006, for the most current information.

BASIS OF PRESENTATION Southwest Airlines Co. (Southwest) is a major domestic airline that provides 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 (GAAP) 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 period amounts have been reclassified to conform to the current presentation. In the Consolidated Balance Sheet as of December 31, 2004, the Company has reclassified certain amounts as "Short-term investments", that were previously classified as "Cash and cash equivalents." In the Consolidated Statement of Cash Flows for 2004 and 2003, changes in the amounts of "Short-term investments" are classified as cash flows from investing activities. In the Consolidated Statement of Income for 2004 and 2003, amounts previously classified as "Agency commissions" are now classified in "Other operating expenses."

CASH AND CASH EQUIVALENTS Cash in excess of that necessary for operating requirements is invested in short-term, highly liquid, income-producing investments. Investments with maturities of three months or less are classified as cash and cash equivalents, which primarily consist of certificates of deposit, money market funds, and investment grade commercial paper issued by major corporations and financial institutions. Cash and cash equivalents are stated at cost, which approximates market value.

SHORT-TERM INVESTMENTS Short-term investments consist of auction rate securities with auction reset periods of less than 12 months. These investments are classified as available-for-sale securities and are stated at fair value. Unrealized gains and losses, net of tax, are recognized in "Accumulated other comprehensive income (loss)" in the accompanying Consolidated Balance Sheet. Realized gains and losses are reflected in "Interest income" in the accompanying Consolidated Income Statement.

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 generally ranging from 23 to 25 years for flight equipment and 5 to 30 years for ground property and equipment once the asset is placed in service. Residual values estimated for aircraft are 15 percent and for ground property and equipment range from zero to 10 percent. 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.

In estimating the lives and expected residual values of its aircraft, the Company primarily has relied upon actual experience with the same or similar aircraft types and recommendations from Boeing, the manufacturer of the Company's aircraft. Subsequent revisions to these estimates, which can be significant, could be caused by changes to the Company's maintenance program, modifications or improvements to the aircraft, changes in utilization of the aircraft (actual flight hours or cycles during a given period of time), governmental regulations on aging aircraft, changing market prices of new and used aircraft of the same or similar types, etc. The Company evaluates its estimates and assumptions each reporting period and, when warranted, adjusts these estimates and assumptions. Generally, these adjustments are accounted for on a prospective basis through depreciation and amortization expense, as required by GAAP.

When appropriate, the Company evaluates its long-lived assets used in operations for impairment. Impairment losses would be recorded when events and circumstances indicate that an asset might be impaired and the undiscounted cash flows to be generated by that asset are less than the carrying amounts of the asset. Factors that would indicate potential impairment include, but are not limited to, significant decreases in the market value of the long-lived asset(s), a significant change in the long-lived asset's physical condition, operating or cash flow losses associated with the use of the long-lived asset, etc. While the airline industry as a whole has experienced many of these indicators, Southwest has continued to operate all of its aircraft and continues to experience positive cash flow.

AIRCRAFT AND ENGINE MAINTENANCE The cost of scheduled inspections and repairs and routine maintenance costs for all aircraft and engines are charged to maintenance expense as incurred. 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.

INTANGIBLE ASSETS Intangible assets primarily consist of leasehold rights to airport owned gates acquired by the Company during 2004 and 2005. These assets are amortized on a straight-line basis over the expected useful life of the lease, approximately 20 years. The accumulated amortization related to the Company's intangible assets at December 31, 2004, and 2005, was not material. The Company periodically assesses its intangible assets for impairment in accordance with SFAS 142, *Goodwill and Other Intangible Assets*; however, no impairments have been noted.

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 and exchanges of tickets sold for past travel dates. The majority of the Company's tickets sold are nonrefundable. Tickets that are sold but not flown on the travel date can be reused for another flight, up to a year from the date of sale, or refunded (if the ticket is refundable). A small percentage of tickets (or partial tickets) expire unused. The Company estimates the amount of future refunds and exchanges, net of forfeitures, for all unused tickets once the flight date has passed. These estimates are based on historical experience over many years. The Company and members of the airline industry have consistently applied this accounting method to estimate revenue from forfeited tickets at the date travel is provided. Estimated future refunds and exchanges included in the air traffic liability account are constantly evaluated based on subsequent refund and exchange activity to validate the accuracy of the Company's revenue recognition method with respect to forfeited tickets.

Events and circumstances outside of historical fare sale activity or historical Customer travel patterns can result in actual refunds, exchanges or forfeited tickets differing significantly from estimates; however, these differences have historically not been material. Additional factors that may affect estimated refunds, exchanges, and forfeitures include, but may not be limited to, the Company's refund and exchange 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.

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 frequent flyer credits and related services to companies participating in its Rapid Rewards frequent flyer program. Funds received from the sale of flight segment credits are accounted for under the residual value method. The portion of those funds associated with future travel are deferred and recognized as "Passenger revenue" when the ultimate free travel awards are flown or the credits expire unused. The portion of the funds not associated with future travel are recognized in "Other revenue" in the period earned.

ADVERTISING The Company expenses the costs of advertising as incurred. Advertising expense for the years ended December 31, 2005, 2004, and 2003 was \$173 million, \$158 million, and \$155 million, respectively.

STOCK-BASED EMPLOYEE COMPENSATION The Company has stock-based compensation plans covering the majority of its Employee groups, including a plan covering the Company's Board of Directors and plans related to employment contracts with certain Executive Officers of the Company. The Company accounts for stock-based compensation utilizing the fair value recognition provisions of SFAS No. 123R, "Share-Based Payment".

See Note 12 for further discussion of the Company's stock-based Employee compensation.

FINANCIAL DERIVATIVE INSTRUMENTS The Company accounts for financial derivative instruments utilizing Statement of Financial Accounting Standards No. 133 (SFAS 133), "Accounting for Derivative Instruments and Hedging Activities", as amended. The Company utilizes various derivative instruments, including crude oil, unleaded gasoline, 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, and are accounted for as cash-flow hedges, as defined by SFAS 133. The Company has also entered into interest rate swap agreements to convert a portion of its fixed-rate debt to floating rates. These interest rate hedges are accounted for as fair value hedges, as defined by SFAS 133.

Since the majority of the Company's financial derivative instruments are not traded on a market exchange, the Company estimates their fair values. Depending on the type of instrument, the values are 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. Also, since there is not a reliable forward market for jet fuel, the Company must estimate the future prices of jet fuel in order to measure the effectiveness of the hedging instruments in offsetting changes to those prices, as required by SFAS 133. Forward jet fuel prices are estimated through the observation of similar commodity futures prices (such as crude oil, heating oil, and unleaded gasoline) and adjusted based on historical variations to those like commodities. See Note 9 for further information on SFAS 133 and financial derivative instruments.

INCOME TAXES The Company accounts for deferred income taxes utilizing Statement of Financial Accounting Standards No. 109 (SFAS 109), "Accounting for Income Taxes", as amended. SFAS 109 requires an asset and liability method, whereby deferred tax assets and liabilities are recognized based on the tax effects of temporary differences between the financial statements and the tax bases of assets and liabilities, as measured by current enacted tax rates. When appropriate, in accordance with SFAS 109, the Company evaluates the need for a valuation allowance to reduce deferred tax assets.

2. ACQUISITION OF CERTAIN ASSETS

In fourth quarter 2004, Southwest was selected as the winning bidder at a bankruptcy-court approved auction for certain ATA Airlines, Inc. (ATA) assets. As part of the transaction, which was approved in December 2004, Southwest agreed to pay \$40 million for certain ATA assets, consisting of the leasehold rights to six of ATA's leased Chicago Midway Airport gates and the rights to a leased aircraft maintenance hangar at Chicago Midway Airport. In addition, Southwest provided ATA with \$40 million in debtor-in-possession financing while ATA remains in bankruptcy, and also guaranteed the repayment of an ATA construction loan to the City of Chicago for \$7 million. As part of this original transaction, Southwest also committed, upon ATA's emergence from bankruptcy, to convert the debtor-in-possession financing to a term loan, payable over five years, and to invest \$30 million in cash into ATA convertible preferred stock.

During fourth quarter 2005, ATA, although still in bankruptcy, entered into an agreement in which an investor, MatlinPatterson Global Opportunities Partners II ("MatlinPatterson") would provide financing to enable ATA to emerge from bankruptcy in early 2006. As part of this transaction, Southwest entered into an agreement with ATA to acquire the leasehold rights to four additional leased gates at Chicago Midway Airport in exchange for a \$20 million reduction in the Company's debtor-in-possession loan. This resulted in a \$20 million increase to intangible assets, classified in Other assets, and a corresponding \$20 million decrease in Accounts and other receivables on the Consolidated Balance Sheet. Since this transaction was non-cash, it is not reflected in the Consolidated Statement of Cash Flows. Upon ATA's emergence from bankruptcy, it will repay the remaining \$20 million balance of the debtor-in-possession financing, and will provide a letter of credit to support Southwest's obligation under the construction loan to the City of Chicago. In addition, as part of the 2005 agreement, Southwest has also been relieved of its commitment to purchase ATA convertible preferred stock. The 2005 agreement is subject to certain conditions including ATA's successful emergence from bankruptcy on or before February 28, 2006.

Southwest and ATA agreed on a code share arrangement, which was approved by the Department of Transportation in January 2005. Under the agreement, which has since been expanded, each carrier can exchange passengers on certain designated flights. Sales of the code share flights began January 16, 2005, with travel dates beginning February 4, 2005. As part of the December 2005 agreement with ATA, Southwest has enhanced its codeshare arrangement with ATA, subject to certain conditions, including ATA's confirmation of a Plan of Reorganization, which must be fulfilled by February 28, 2006.

3. COMMITMENTS

The Company's contractual purchase commitments primarily consist of scheduled aircraft acquisitions from Boeing. As of December 31, 2005, the Company had contractual purchase commitments with Boeing for 33 737-700 aircraft deliveries in 2006, 28 scheduled for delivery in 2007, and six in 2008. During January 2006, the Company exercised an additional option for 2007 to bring our commitment to 29 aircraft for that year. In addition, the Company has options and purchase rights for an additional 249 737-700s that it may acquire during 2007-2012, following the January 2006 option exercise. 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. As of December 31, 2005, aggregate funding needed for firm commitments is approximately \$1.3 billion, subject to adjustments for inflation, due as follows: \$740 million in 2006, \$458 million in 2007, and \$80 million in 2008.

4. ACCRUED LIABILITIES

(In millions)	2005	2004
Retirement plans (Note 14)	\$ 142	\$ 89
Aircraft rentals	116	127
Vacation pay	135	120
Advances and deposits	955	334
Deferred income taxes	489	218
Other	237	159
Accrued liabilities	<u>\$ 2,074</u>	<u>\$ 1,047</u>

5. REVOLVING CREDIT FACILITY

The Company has a revolving credit facility under which it can borrow up to \$600 million from a group of banks. The facility expires in August 2010 and is unsecured. At the Company's option, interest on the facility can be calculated on one of several different bases. For most borrowings, Southwest would anticipate choosing a floating rate based upon LIBOR. If fully drawn, the spread over LIBOR would be 62.5 basis points given Southwest's credit rating at December 31, 2005. The facility also contains a financial covenant requiring a minimum coverage ratio of adjusted pretax income to fixed obligations, as defined. As of December 31, 2005, the Company is in compliance with this covenant, and there are no outstanding amounts borrowed under this facility.

6. LONG-TERM DEBT

(In millions)	2005	2004
8% Notes due 2005	\$ -	\$ 100
Zero coupon Notes due 2006	58	58
Pass Through Certificates	523	544
7 7/8% Notes due 2007	100	100
French Credit Agreements due 2012	41	44
6 1/2% Notes due 2012	370	377
5 1/4% Notes due 2014	340	348
5 1/8% Notes due 2017	300	-
French Credit Agreements due 2017	106	111
7 3/8% Debentures due 2027	100	100
Capital leases (Note 8)	74	80
	<u>2,012</u>	<u>1,862</u>
Less current maturities	601	146
Less debt discount and issue costs	17	16
	<u>\$ 1,394</u>	<u>\$ 1,700</u>

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

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

In fourth quarter 2004, the Company entered into four identical 13-year floating-rate financing arrangements, whereby it borrowed a total of \$112 million from French banking partnerships. Although the interest on the borrowings are at floating rates, the Company estimates that, considering the full effect of the “net present value benefits” included in the transactions, the effective economic yield over the 13-year term of the loans will be approximately LIBOR minus 45 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 pledged four aircraft as collateral for the transactions.

In September 2004, the Company issued \$350 million senior unsecured Notes due 2014. The notes bear interest at 5.25 percent, payable semi-annually in arrears, on April 1 and October 1. Concurrently, the Company entered into an interest-rate swap agreement to convert this fixed-rate debt to a floating rate. See Note 9 for more information on the interest-rate swap agreement. Southwest used the net proceeds from the issuance of the notes, approximately \$346 million, for general corporate purposes.

In February 2004 and April 2004, the Company issued two separate \$29 million two-year notes, each secured by one new 737-700 aircraft. Both of the notes are non-interest bearing and accrete to face value at maturity at annual rates of 2.9 percent and 3.4 percent, respectively. The proceeds of these borrowings were used to fund the individual aircraft purchases.

On March 1, 2002, the Company issued \$385 million senior unsecured Notes due March 1, 2012. The notes bear interest at 6.5 percent, payable semi-annually on March 1 and September 1. Southwest used the net proceeds from the issuance of the notes, approximately \$380 million, for general corporate purposes. During 2003, the Company entered into an interest rate swap agreement relating to these notes. See Note 9 for further information.

On October 30, 2001, the Company issued \$614 million Pass Through Certificates consisting of \$150 million 5.1% Class A-1 certificates, \$375 million 5.5% Class A-2 certificates, and \$89 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 semiannually, on May 1 and November 1. Beginning May 1, 2002, principal payments on the equipment notes held for the Class A-1 certificates are due semiannually 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. During 2003, the Company entered into an interest rate swap agreement relating to the \$375 million 5.5% Class A-2 certificates. See Note 9 for further information.

In fourth quarter 1999, the Company entered into two identical 13-year floating rate financing arrangements, whereby it borrowed a total of \$56 million from French banking partnerships. Although the interest on the borrowings are at floating rates, the Company estimates that, considering the full effect of the “net present value benefits” included in the transactions, the effective economic yield over the 13-year term of the loans will be approximately LIBOR minus 67 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 pledged two aircraft as collateral for the transactions.

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 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.

The net book value of the assets pledged as collateral for the Company's secured borrowings, primarily aircraft and engines, was \$856 million at December 31, 2005.

As of December 31, 2005, aggregate annual principal maturities (not including amounts associated with interest rate swap agreements, and interest on capital leases) for the five-year period ending December 31, 2010, were \$612 million in 2006, \$127 million in 2007, \$28 million in 2008, \$29 million in 2009, \$30 million in 2010, and \$1.2 billion thereafter.

7. LEASES

The Company had nine aircraft classified as capital leases at December 31, 2005. The amounts applicable to these aircraft included in property and equipment were:

(In millions)	2005	2004
Flight equipment	\$ 164	\$ 173
Less accumulated depreciation	113	126
	<u>\$ 51</u>	<u>\$ 47</u>

Total rental expense for operating leases, both aircraft and other, charged to operations in 2005, 2004, and 2003 was \$409 million, \$403 million, and \$386 million, respectively. The majority of the Company's terminal operations space, as well as 84 aircraft, were under operating leases at December 31, 2005. Future minimum lease payments under capital leases and noncancelable operating leases with initial or remaining terms in excess of one year at December 31, 2005, were:

(In millions)	Capital leases	Operating leases
2006	\$ 16	\$ 332
2007	16	309
2008	16	274
2009	16	235
2010	15	219
After 2010	12	1,164
Total minimum lease payments	91	<u>\$ 2,533</u>
Less amount representing interest	17	
Present value of minimum lease payments	74	
Less current portion	11	
Long-term portion	<u>\$ 63</u>	

The aircraft leases generally can be renewed at rates based on fair market value at the end of the lease term for one to five years. Most aircraft leases have purchase options at or near the end of the lease term at fair market value, generally limited to a stated percentage of the lessor's defined cost of the aircraft.

8. CONSOLIDATION OF RESERVATIONS CENTERS

In November 2003, the Company announced the consolidation of its nine Reservations Centers into six, effective February 28, 2004. This decision was made in response to the established shift by Customers to the internet as a preferred way of booking travel. The Company's website, www.southwest.com, now accounts for almost 70 percent of ticket bookings and, as a consequence, demand for phone contact has dramatically decreased. During first quarter 2004, the Company closed its Reservations Centers located in Dallas, Texas, Salt Lake City, Utah, and Little Rock, Arkansas. The Company provided the 1,900 affected Employees at these locations the opportunity to relocate to another of the Company's remaining six centers. Those Employees choosing not to relocate, approximately 55% of the total affected, were offered support packages, which included severance pay, flight benefits, medical coverage, and job-search assistance, depending on length of service with the Company. The total cost associated with the Reservations Center consolidation, recognized in first quarter 2004, was approximately \$18 million. Employee severance and benefit costs were reflected in "Salaries, wages, and benefits," and the majority of other costs in "Other operating expenses" in the Consolidated Statement of Income. The total remaining amount accrued (not yet paid) was immaterial at December 31, 2005.

9. DERIVATIVE AND FINANCIAL INSTRUMENTS

Fuel contracts

Airline operators are inherently dependent upon energy to operate and, therefore, are impacted by changes in jet fuel prices. Jet fuel and oil consumed in 2005, 2004, and 2003 represented approximately 19.6 percent, 16.3 percent, and 14.9 percent of Southwest's operating expenses, respectively. The Company endeavors to acquire jet fuel at the lowest possible cost. Because jet fuel is not traded on an organized futures exchange, liquidity for hedging is limited. However, the Company has found commodities for effective hedging of jet fuel costs, primarily crude oil, and refined products such as heating oil and unleaded gasoline. The Company utilizes financial derivative instruments as hedges to decrease its exposure to jet fuel price increases. The Company does not purchase or hold any derivative financial instruments for trading purposes.

The Company has utilized financial derivative instruments for both short-term and long-term time frames. In addition to the significant hedging positions the Company had in place during 2005, the Company also has significant future hedging positions. At December 31, 2005, the Company had a mixture of purchased call options, collar structures, and fixed price swap agreements in place to hedge over 70 percent of its 2006 total anticipated jet fuel requirements at average crude oil equivalent prices of approximately \$36 per barrel, and had also hedged the refinery margins on most of those positions.

The Company accounts for its fuel hedge derivative instruments as cash flow hedges, as defined in Statement of Financial Accounting Standards No. 133, *Accounting for Derivative Instruments and Hedging Activities*, as amended (SFAS 133). Under SFAS 133, all derivatives designated as hedges that meet certain requirements are granted special hedge accounting treatment. Generally, utilizing the special hedge accounting, all periodic changes in fair value of the derivatives designated as hedges that are considered to be effective, as defined, are recorded in "Accumulated other comprehensive income" until the underlying jet fuel is consumed. See Note 10 for further information on Accumulated other comprehensive income. The Company is exposed to the risk that periodic changes will not be effective, as defined, or that the derivatives will no longer qualify for special hedge accounting. Ineffectiveness, as defined, results when the change in the total fair value of the derivative instrument does not exactly equal the change in the value of the Company's expected future cash outlay to purchase jet fuel. To the extent that the periodic changes in the fair value of the derivatives are not effective, that ineffectiveness is recorded to "Other gains and losses" in the income statement. Likewise, if a hedge ceases to qualify for hedge accounting, those periodic changes in the fair value of derivative instruments are recorded to "Other gains and losses" in the income statement in the period of the change.

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

During 2005, the Company recognized approximately \$110 million of additional income in "Other (gains) losses, net," related to the ineffectiveness of its hedges and the loss of hedge accounting for certain hedges. Of this amount, approximately \$77 million of the additional income was unrealized, mark-to-market changes in the fair value of derivatives due to the discontinuation of hedge accounting for certain contracts that will settle in future periods, approximately \$9 million was ineffectiveness associated with hedges designated for future periods, and \$24 million was ineffectiveness and mark-to-market gains related to hedges that settled during 2005. During 2004, the Company recognized approximately \$13 million of additional expense in "Other (gains) losses, net," related to the ineffectiveness of its hedges. During 2003, the Company recognized approximately \$16 million of additional income in "Other (gains) losses, net," related to the ineffectiveness of its hedges. During 2005, 2004, and 2003, the Company recognized approximately \$35 million, \$24 million, and \$29 million of net expense, respectively, related to amounts excluded from the Company's measurements of hedge effectiveness, in "Other (gains) losses, net".

During 2005, 2004, and 2003, the Company recognized gains in "Fuel and oil" expense of \$892 million, \$455 million, and \$171 million, respectively, from hedging activities. At December 31, 2005 and 2004, approximately \$83 million and \$51 million, respectively, due from third parties from expired derivative contracts, is included in "Accounts and other receivables" in the accompanying Consolidated Balance Sheet. The fair value of the Company's financial derivative instruments at December 31, 2005, was a net asset of approximately \$1.7 billion. The current portion of these financial derivative instruments, \$640 million, is classified as "Fuel hedge contracts" and the long-term portion, \$1.1 billion, is classified as "Other assets" 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, 2005, the Company had approximately \$892 million in unrealized gains, net of tax, in "Accumulated other comprehensive income (loss)" related to fuel hedges. Included in this total are approximately \$327 million in net unrealized gains that are expected to be realized in earnings during 2006.

Interest Rate Swaps

During 2003, the Company entered into interest rate swap agreements relating to its \$385 million 6.5% senior unsecured notes due 2012 and \$375 million 5.496% Class A-2 pass-through certificates due 2006. The floating rate paid under each agreement is set in arrears. Under the first agreement, the Company pays the London InterBank Offered Rate (LIBOR) plus a margin every six months and receives 6.5% every six months on a notional amount of \$385 million until 2012. The average floating rate paid under this agreement during 2005 is estimated to be 6.46 percent based on actual and forward rates at December 31, 2005. Under the second agreement, the Company pays LIBOR plus a margin every six months and receives 5.496% every six months on a notional amount of \$375 million until 2006. Based on actual and forward rates at December 31, 2005, the average floating rate paid under this agreement during 2005 is estimated to be 6.73 percent.

During 2004, the Company entered into an interest rate swap agreement relating to its \$350 million 5.25% senior unsecured notes due 2014. Under this agreement, the Company pays LIBOR plus a margin every six months and receives 5.25% every six months on a notional amount of \$350 million until 2014. The floating rate is set in advance. The average floating rate paid under this agreement during 2005 was 3.82 percent.

The primary objective for the Company's use of interest rate hedges is to reduce the volatility of net interest income by better matching the repricing of its assets and liabilities. Concurrently, the Company's interest rate hedges are also intended to take advantage of market conditions in which short-term rates are significantly lower than the fixed longer term rates on the Company's long-term debt. The Company's interest rate swap agreements qualify as fair value hedges, as defined by SFAS 133. The fair value of the interest rate swap agreements, which are adjusted regularly, are recorded in the Consolidated Balance Sheet, as necessary, with a corresponding adjustment to the carrying value of the long-term debt. The fair value of the interest rate swap agreements, excluding accrued interest, at December 31, 2005, was a liability of approximately \$31 million. The long-term portion of this amount is recorded in "Other deferred liabilities" in the Consolidated Balance Sheet and the current portion is reflected in "Accrued liabilities." In accordance with fair value hedging, the offsetting entry is an adjustment to decrease the carrying value of long-term debt. See Note 6.

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, 2005, the Company had agreements with seven counterparties containing early termination rights and/or bilateral collateral provisions whereby security is required if market risk exposure exceeds a specified threshold amount or credit ratings fall below certain levels. At December 31, 2005, the Company held \$950 million in fuel hedge related cash collateral deposits under these bilateral collateral provisions. These collateral deposits serve to decrease, but not totally eliminate, the credit risk associated with the Company's hedging program. The cash deposits, which can have a significant impact on the Company's cash balance and cash flows as of and for a particular operating period, are included in "Accrued liabilities" on the Consolidated Balance Sheet and are included as "Operating cash flows" in the Consolidated Statement of Cash Flows.

The carrying amounts and estimated fair values of the Company's long-term debt and fuel contracts at December 31, 2005 were as follows:

(In millions)	Carrying value	Estimated fair value
Zero coupon Notes due 2006	\$ 58	\$ 58
Pass Through Certificates	523	525
7 7/8% Notes due 2007	100	104
French Credit Agreements due 2012	41	41
6 1/2% Notes due 2012	370	392
5 1/4% Notes due 2014	340	332
5 1/8% Notes due 2017	300	282
French Credit Agreements due 2017	106	106
7 3/8% Debentures due 2027	100	111
Fuel contracts	1,678	1,678

The estimated fair values of the Company's publicly held 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 \$959 million, \$510 million, and \$440 million for 2005, 2004, and 2003, respectively. The differences between "Net income" and "Comprehensive income" for these years are as follows:

(In millions)	2005	2004	2003
Net income	\$ 484	\$ 215	\$ 372
Unrealized gain (loss) on derivative instruments, net of deferred taxes of \$300, \$185 and \$43	474	293	66
Other, net of deferred taxes of \$0, \$1 and \$1	1	2	2
Total other comprehensive income	475	295	68
Comprehensive income	\$ 959	\$ 510	\$ 440

A rollforward of the amounts included in "Accumulated other comprehensive income (loss)", net of taxes for 2005, 2004, and 2003, is shown below:

(In millions)	Fuel hedge derivatives	Other	Accumulated other comprehensive income (loss)
Balance at December 31, 2003	\$ 123	\$ (1)	\$ 122
2004 changes in fair value	558	2	560
Reclassification to earnings	(265)	-	(265)
Balance at December 31, 2004	416	1	417
2005 changes in fair value	999	1	1,000
Reclassification to earnings	(525)	-	(525)
Balance at December 31, 2005	<u>\$ 890</u>	<u>\$ 2</u>	<u>\$ 892</u>

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, 2005, the Company had 236 million shares of common stock reserved for issuance pursuant to Employee stock benefit plans (of which 36 million shares have not been granted.)

In January 2004, the Company's Board of Directors authorized the repurchase of up to \$300 million of the Company's common stock, utilizing proceeds from the exercise of Employee stock options. Repurchases were made in accordance with applicable securities laws in the open market or in private transactions from time to time, depending on market conditions. During first quarter 2005, the Company completed this program. In total, the Company repurchased approximately 20.9 million of its common shares during the course of the program.

In January 2006, the Company's Board of Directors authorized the repurchase of up to \$300 million of the Company's common stock. Repurchases will be made in accordance with applicable securities laws in the open market or in private transactions from time to time, depending on market conditions.

12. STOCK PLANS

The Company has stock plans covering Employees subject to collective bargaining agreements (collective bargaining plans) and stock plans covering Employees not subject to collective bargaining agreements (other Employee plans). None of the collective bargaining plans were required to be approved by shareholders. Options granted to Employees under collective bargaining plans are non-qualified, granted at or above the fair market value of the Company's common stock on the date of grant, and generally have terms ranging from six to twelve years. Neither Executive Officers nor members of the Company's Board of Directors are eligible to participate in any of these collective bargaining plans. Options granted to Employees through other Employee plans are both qualified as incentive stock options under the Internal Revenue Code of 1986 and non-qualified stock options, granted at the fair market value of the Company's common stock on the date of grant, and have ten-year terms. All of the options included under the heading of "Other Employee Plans" have been approved by shareholders, except the plan covering non-management, non-contract Employees, which had options outstanding to purchase 6.3 million shares of the Company's common stock as of December 31, 2005. Although the Company does not have a formal policy per se, upon option exercise, the Company will typically issue Treasury stock, to the extent such shares are available.

Vesting terms for the collective bargaining plans differ based on the grant made, and have ranged in length from immediate vesting to vesting periods in accordance with the period covered by the respective collective bargaining agreement. For “Other Employee Plans”, options vest and become fully exercisable over three, five, or ten years of continued employment, depending upon the grant type. For grants in any of the Company’s plans that are subject to graded vesting over a service period, we recognize expense on a straight-line basis over the requisite service period for the entire award. None of the Company’s grants include performance-based or market-based vesting conditions, as defined.

The Consolidated Statement of Income for 2005, 2004, and 2003 reflects share-based compensation cost of \$80 million, \$135 million, and \$107 million, respectively. The total tax benefit recognized from share-based compensation arrangements for 2005, 2004, and 2003 was \$25 million, \$46 million, and \$36 million, respectively. For 2005, 2004, and 2003, the Company’s net earnings were reduced by \$55 million, \$89 million, and \$71 million, respectively, compared to the previous accounting method under APB 25. For 2005, 2004, and 2003, net income per share, basic was reduced by \$.08, \$.12, and \$.09, respectively, compared to the previous accounting under APB 25. For 2005, 2004, and 2003, net income per share, diluted was reduced by \$.06, \$.10, and \$.08, respectively, compared to the previous accounting under APB 25.

Prior to the adoption of SFAS 123R, the Company was required to record benefits associated with the tax deductions in excess of recognized compensation cost as an operating cash flow. However, SFAS 123R requires that such benefits be recorded as a financing cash inflow and corresponding operating cash outflow. In the accompanying Consolidated Statement of Cash Flows for 2005, 2004, and 2003, the respective \$47 million, \$23 million, and \$29 million tax benefits classified as a financing cash flows (and corresponding operating cash outflows) were classified as an operating cash inflows prior to the adoption of SFAS 123R.

The fair value of each option grant is estimated on the date of grant using a modified Black-Scholes option pricing model. The following weighted-average assumptions were used for grants made under the fixed option plans for the current and prior year:

	2005	2004	2003
Wtd-average risk-free interest rate	4.1%	3.1%	2.6%
Expected life of option (years)	4.7	4.0	4.2
Expected stock volatility	26.2%	34.0%	34.0%
Expected dividend yield	0.09%	0.11%	0.13%

The Black-Scholes option valuation model was developed for use in estimating the fair value of short-term traded options that have no vesting restrictions and are fully transferable. In addition, option valuation models require the input of somewhat subjective assumptions including expected stock price volatility. Prior to 2005, the Company relied exclusively on historical volatility as an input for determining the estimated fair value of stock options. For 2005, the Company relied on observations of both historical volatility trends as well as implied future volatility observations as determined by independent third parties. For 2005 stock option grants, the Company utilized expected volatility based on the expected life of the option, but within a range of 25% to 27%. In determining the expected life of the option grants, the Company has observed the actual terms of prior grants with similar characteristics, the actual vesting schedule of the grant, and assessed the expected risk tolerance of different optionee groups. The risk-free interest rates used, which were actual U.S. Treasury zero-coupon rates for bonds matching the expected term of the option as of the option grant date, ranged from 3.37% to 4.47% for 2005, 2.16% to 4.62% for 2004, and 1.82% to 4.10% for 2003.

The fair value of options granted under the fixed option plans during 2005 ranged from \$2.90 to \$6.79, with a weighted-average fair value of \$4.49. The fair value of options granted under the fixed option plans during 2004 ranged from \$3.45 to \$7.83, with a weighted-average fair value of \$4.49. The fair value of options granted under the fixed option plans during 2003 ranged from \$3.33 to \$8.17, with a weighted-average fair value of \$4.28

Aggregated information regarding the Company's fixed stock option plans is summarized below:

COLLECTIVE BARGAINING PLANS				
	Options (000)	Wtd. average exercise price	Wtd. average remaining contractual term	Aggregate intrinsic value (millions)
Outstanding December 31, 2002	104,020	\$ 9.51		
Granted	26,674	13.53		
Exercised	(7,422)	6.78		
Surrendered	(3,214)	12.67		
Outstanding December 31, 2003	120,058	10.47		
Granted	14,131	14.41		
Exercised	(7,222)	6.59		
Surrendered	(6,264)	13.62		
Outstanding December 31, 2004	120,703	10.98		
Granted	1,697	14.91		
Exercised	(14,739)	6.13		
Surrendered	(2,417)	13.89		
Outstanding December 31, 2005	105,244	\$ 11.65	4.5	\$ 503
Vested or expected to vest at Dec. 31, 2005	97,957	\$ 11.47	4.5	\$ 352
Exercisable at Dec. 31, 2005	76,283	\$ 10.73	4.0	\$ 435

OTHER EMPLOYEE PLANS				
	Options (000)	Wtd. average exercise price	Wtd. average remaining contractual term	Aggregate intrinsic value (millions)
Outstanding December 31, 2002	34,152	\$ 11.47		
Granted	4,770	14.63		
Exercised	(3,318)	7.95		
Surrendered	(1,052)	13.57		
Outstanding December 31, 2003	34,552	12.21		
Granted	4,255	15.05		
Exercised	(3,133)	6.79		
Surrendered	(1,453)	14.54		
Outstanding December 31, 2004	34,221	12.94		
Granted	6,662	15.60		
Exercised	(3,800)	7.09		
Surrendered	(1,263)	15.60		
Outstanding December 31, 2005	35,820	\$ 13.96	5.8	\$ 89
Vested or expected to vest at Dec. 31, 2005	34,412	\$ 13.93	5.8	\$ 65
Exercisable at Dec. 31, 2005	20,395	\$ 13.78	5.1	\$ 54

The total aggregate intrinsic value of options exercised during 2005, 2004, and 2003 was \$179 million, \$106 million, and \$121 million, respectively. The total fair value of shares vesting during 2005, 2004, and 2003 was \$96 million, \$114 million, and \$87 million, respectively. As of December 31, 2005, there was \$148 million of total unrecognized compensation cost related to share-based compensation arrangements, which is expected to be recognized over a weighted-average period of 2.0 years. The total recognition period for the remaining unrecognized compensation cost is approximately ten years; however, the majority of this cost will be recognized over the next two years, in accordance with vesting provisions.

Employee Stock Purchase Plan

At December 31, 2005, under the amended 1991 Employee Stock Purchase Plan (ESPP), which has been approved by shareholders, the Company is authorized to issue up to a remaining balance of 2.0 million shares of common stock to Employees of the Company. These shares may be issued at a price equal to 90 percent of the market value at the end of each monthly purchase period. Common stock purchases are paid for through periodic payroll deductions. For 2005, 2004, and 2003, participants under the plan purchased 1.5 million shares, 1.5 million shares, and 1.4 million shares at average prices of \$13.19, \$13.47, and \$14.04, respectively. The weighted-average fair value of each purchase right under the ESPP granted for 2005, 2004, and 2003, which is equal to the ten percent discount from the market value of the common stock at the end of each monthly purchase period, was \$1.47, \$1.50, and \$1.56, respectively.

Non-Employee Director grants and Incentive Plan

During the term of the 1996 Non-Qualified Stock Option Plan (1996 Plan), upon initial election to the Board, non-Employee Directors receive a one-time option grant to purchase 10,000 shares of Southwest Common Stock at the fair market value of such stock on the date of the grant. The Company's 1996 Plan, which is administered by the Compensation Committee of the Board of Directors, is set to expire in second quarter 2006, after which no additional options may be granted from the plan. Outstanding stock options to the Board under the 1996 Plan become exercisable over a period of five years from the grant date and have a term of 10 years.

In 2001, the Board adopted the Southwest Airlines Co. Outside Director Incentive Plan. The purpose of the plan is to align more closely the interests of the non-Employee Directors with those of the Company's Shareholders and to provide the non-Employee Directors with retirement income. To accomplish this purpose, the plan compensates each non-Employee Director based on the performance of the Company's Common Stock and defers the receipt of such compensation until after the non-Employee Director ceases to be a Director of the Company. Pursuant to the plan, on the date of the 2002 Annual Meeting of Shareholders, the Company granted 750 non-transferable Performance Shares to each non-Employee Director who had served as a Director since at least May 2001. Thereafter, on the date of each Annual Meeting of Shareholders, the Company will grant 750 Performance Shares to each non-Employee Director who has served since the previous Annual Meeting. A Performance Share is a unit of value equal to the Fair Market Value of a share of Southwest Common Stock, based on the average closing sale price of the Common Stock as reported on the New York Stock Exchange during a specified period. On the 30th calendar day following the date a non-Employee Director ceases to serve as a Director of the Company for any reason, Southwest will pay to such non-Employee Director an amount equal to the Fair Market Value of the Common Stock during the 30 days preceding such last date of service multiplied by the number of Performance Shares then held by such Director. The plan contains provisions contemplating adjustments on changes in capitalization of the Company. The Company accounts for grants made under this plan as liability awards, as defined, and since the awards are not stock options, they are not reflected in the above tables. The fair value of the awards as of December 31, 2005, which is not material to the Company, is included in Accrued liabilities in the accompanying Consolidated Balance Sheet.

Taxes

A portion of the Company's granted options qualify as incentive stock options (ISO) for income tax purposes. As such, a tax benefit is not recorded at the time the compensation cost related to the options is recorded for book purposes due to the fact that an ISO does not ordinarily result in a tax benefit unless there is a disqualifying disposition. Stock option grants of non-qualified options result in the creation of a deferred tax asset, which is a temporary difference, until the time that the option is exercised. Due to the treatment of incentive stock options for tax purposes, the Company's effective tax rate from year to year is subject to variability.

13. EMPLOYEE RETIREMENT PLANS

Defined contribution plans

The Company has defined contribution plans covering substantially all Southwest 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 primarily based on Employee compensation and performance of the Company.

Company contributions to all retirement plans expensed in 2005, 2004, and 2003 were \$264 million, \$200 million, and \$219 million, respectively.

Postretirement benefit plans

The Company provides postretirement benefits to qualified retirees in the form of medical and dental coverage. Employees must meet minimum levels of service and age requirements as set forth by the Company, or as specified in collective bargaining agreements with specific workgroups. Employees meeting these requirements, as defined, may use accrued sick time to pay for medical and dental premiums from the age of retirement until age 65.

The following table shows the change in the Company's accumulated postretirement benefit obligation (APBO) for the years ended December 31, 2005 and 2004:

(In millions)	2005	2004
APBO at beginning of period	\$ 80	\$ 77
Service cost	12	10
Interest cost	4	5
Benefits paid	(2)	(1)
Actuarial (gain) loss	-	(11)
Plan amendments	-	-
APBO at end of period	<u>\$ 94</u>	<u>\$ 80</u>

During first quarter 2004, the Company closed its Reservations Centers located in Dallas, Texas, Salt Lake City, Utah, and Little Rock, Arkansas. In excess of 1,000 Employees at these locations did not elect to relocate to the Company's remaining centers and, instead, accepted severance packages offered by the Company. See Note 8 for further information. Also during 2004, the Company offered an early-out option to substantially all Employees, primarily in an effort to alleviate overstaffing in certain areas of the Company. As a result of the reduction in headcount associated with these events, the Company remeasured its benefit obligation, resulting in the 2004 gain.

The assumed healthcare cost trend rates have a significant effect on the amounts reported for the Company's plan. A one-percent change in all healthcare cost trend rates used in measuring the APBO at December 31, 2005, would have the following effects:

(In millions)	1% increase		1% decrease	
Increase (decrease) in total service and interest costs	\$	2	\$	(1)
Increase (decrease) in the APBO	\$	7	\$	(7)

The Company's plans are unfunded, and benefits are paid as they become due. For 2005, both benefits paid and Company contributions to the plans were each \$2 million. For 2004, both benefits paid and Company contributions to the plans were each \$1 million. Estimated future benefit payments expected to be paid for each of the next five years are \$4 million in 2006, \$6 million in 2007, \$8 million in 2008, \$10 million in 2009, \$12 million in 2010, and \$84 million for the next five years thereafter.

The following table shows the calculation of the accrued postretirement benefit cost recognized in "Other deferred liabilities" on the Company's Consolidated Balance Sheet at December 31, 2005 and 2004:

(In millions)	2005		2004	
Funded status	\$	(94)	\$	(80)
Unrecognized net actuarial loss		6		4
Unrecognized prior service cost		4		8
Cost recognized on Consolidated Balance Sheet	\$	(84)	\$	(68)

The Company's periodic postretirement benefit cost for the years ended December 31, 2005, 2004, and 2003, included the following:

(In millions)	2005		2004		2003	
Service cost	\$	12	\$	10	\$	9
Interest cost		4		5		4
Amortization of prior service cost		2		2		2
Recognized actuarial loss		-		1		1
Net periodic postretirement benefit cost	\$	18	\$	18	\$	16

Unrecognized prior service cost is expensed using a straight-line amortization of the cost over the average future service of Employees expected to receive benefits under the plan. The Company used the following actuarial assumptions to account for its postretirement benefit plans at December 31:

	2005	2004	2003
Wtd-average discount rate	5.25%	6.25%	6.75%
Assumed healthcare cost trend rate (1)	9.00%	10.00%	10.00%

(1) The assumed healthcare cost trend rate is assumed to decrease to 8.50% for 2006, then decline gradually to 5% by 2013 and remain level thereafter.

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, 2005 and 2004, are as follows:

(In millions)	2005	2004
DEFERRED TAX LIABILITIES:		
Accelerated depreciation	\$ 2,251	\$ 2,027
Fuel hedges	564	264
Other	3	11
Total deferred tax liabilities	2,818	2,302
DEFERRED TAX ASSETS:		
Deferred gains from sale and leaseback of aircraft	76	83
Capital and operating leases	70	73
Accrued employee benefits	132	110
Stock-based compensation	128	120
State taxes	57	52
Net operating loss carry forward	164	186
Other	21	53
Total deferred tax assets	648	677
Net deferred tax liability	\$ 2,170	\$ 1,625

The provision for income taxes is composed of the following:

(In millions)	2005	2004	2003
CURRENT:			
Federal	\$ 43	\$ (20)	\$ 71
State	7	-	9
Total current	50	(20)	80
DEFERRED:			
Federal	231	140	142
State	14	4	9
Total deferred	245	144	151
	\$ 295	\$ 124	\$ 231

For the year 2004, Southwest Airlines Co. had a tax net operating loss of \$616 million for federal income tax purposes. The Company carried a portion of this net operating loss back to prior periods, resulting in a \$35 million refund of federal taxes previously paid. This refund was received during 2005. The Company applied a portion of this 2004 net operating loss to the 2005 tax year, resulting in the payment of no federal taxes for this year. The \$43 million current tax provision relates to the tax benefit of stock options exercised during 2005. The remaining portion of the Company's federal net operating loss that can be carried forward to future years is estimated at \$453 million, and expires in 2024.

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

(In millions)	2005	2004	2003
Tax at statutory			
U.S. tax rates	\$ 274	\$ 123	\$ 213
Nondeductible items	8	7	7
State income taxes, net of federal benefit	14	3	12
Other, net	(1)	(9)	(1)
Total income tax provision	<u>\$ 295</u>	<u>\$ 124</u>	<u>\$ 231</u>

The Internal Revenue Service (IRS) regularly examines the Company's federal income tax returns and, in the course of which, may propose adjustments to the Company's federal income tax liability reported on such returns. It is the Company's practice to vigorously contest those proposed adjustments that it deems lacking of merit. The Company's management does not expect that the outcome of any proposed adjustments presented to date by the IRS, individually or collectively, will have a material adverse effect on the Company's financial condition, results of operations, or cash flows.

15. NET INCOME PER SHARE

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

(In millions, except per share amounts)	2005	2004	2003
Net income	\$ 484	\$ 215	\$ 372
Weighted-average shares outstanding, basic	789	783	783
Dilutive effect of Employee stock options	17	21	27
Adjusted weighted-average shares outstanding, diluted	<u>806</u>	<u>804</u>	<u>810</u>
Net income per share, basic	<u>\$.61</u>	<u>\$.27</u>	<u>\$.48</u>
Net income per share, diluted	<u>\$.60</u>	<u>\$.27</u>	<u>\$.46</u>

The Company has excluded 12 million, 31 million, and 10 million shares from its calculations of net income per share, diluted, in 2005, 2004, and 2003, respectively, as they represent antidilutive stock options for the respective periods presented.

16. FEDERAL GRANT

On April 16, 2003, as a result of the United States war with Iraq, the Emergency Wartime Supplemental Appropriations Act (Wartime Act) was signed into law. Among other items, the legislation included a \$2.3 billion government grant for airlines. Southwest received \$271 million as its proportional share of the grant during second quarter 2003. This amount is included in “Other (gains) losses” in the accompanying Consolidated Income Statement for 2003. Also as part of the Wartime Act, the Company received approximately \$5 million as a reimbursement for the direct cost of reinforcing cockpit doors on all of the Company’s aircraft. The Company accounted for this reimbursement as a reduction of capitalized property and equipment.

Report of Independent Registered Public Accounting Firm

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, 2005 and 2004, and the related consolidated statements of income, stockholders' equity, and cash flows for each of the three years in the period ended December 31, 2005. 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 the standards of the Public Company Accounting Oversight Board (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, 2005 and 2004, and the consolidated results of its operations and its cash flows for each of the three years in the period ended December 31, 2005, in conformity with U.S. generally accepted accounting principles.

As discussed in Note 1, the Company changed its method of accounting for scheduled airframe maintenance and share-based compensation.

We also have audited, in accordance with the standards of the Public Company Accounting Oversight Board (United States), the effectiveness of Southwest Airlines Co.'s internal control over financial reporting as of December 31, 2005, based on criteria established in Internal Control—Integrated Framework issued by the Committee of Sponsoring Organizations of the Treadway Commission and our report dated January 30, 2006 expressed an unqualified opinion thereon.

Dallas, Texas

January 30, 2006, except for Note 1 - "Changes in Accounting,"
as to which the date is August 9, 2006.

Years Ended December 31,

	2005	2004	2003	2002	2001
Financial Data:					
(In millions, except per share amounts)					
Operating revenues	\$ 7,584	\$ 6,530	\$ 5,937	\$ 5,522	\$ 5,555
Operating expenses	6,859	6,126	5,558	5,181	5,016
Operating income	725	404	379	341	539
Other expenses (income) net	(54)	65	(225)	24	(197)
Income before income taxes	779	339	604	317	736
Provision for income taxes	295	124	232	129	285
Net income	\$ 484	\$ 215	\$ 372	\$ 188	\$ 451
Net income per share, basic	\$.61	\$.27	\$.48	\$.24	\$.59
Net income per share, diluted	\$.60	\$.27	\$.46	\$.23	\$.56
Cash dividends per common share	\$.0180	\$.0180	\$.0180	\$.0180	\$.0180
Total assets at period-end	\$ 14,003	\$ 11,137	\$ 9,693	\$ 8,766	\$ 8,779
Long-term obligations at period-end	\$ 1,394	\$ 1,700	\$ 1,332	\$ 1,553	\$ 1,327
Stockholders' equity at period-end	\$ 6,675	\$ 5,527	\$ 5,029	\$ 4,374	\$ 3,921
Operating Data:					
Revenue passengers carried	77,693,875	70,902,773	65,673,945	63,045,988	64,446,773
Enplaned passengers	88,379,900	81,066,038	74,719,340	72,462,123	73,628,723
Revenue passenger miles (RPMs) (000s)	60,223,100	53,418,353	47,943,066	45,391,903	44,493,916
Available seat miles (ASMs) (000s)	85,172,795	76,861,296	71,790,425	68,886,546	65,295,290
Load factor ⁽¹⁾	70.7%	69.5%	66.8%	65.9%	68.1%
Average length of passenger haul (miles)	775	753	730	720	690
Average stage length (miles)	607	576	558	537	514
Trips flown	1,028,639	981,591	949,882	947,331	940,426
Average passenger fare	\$ 93.68	\$ 88.57	\$ 87.42	\$ 84.72	\$ 83.46
Passenger revenue yield per RPM	12.09¢	11.76¢	11.97¢	11.77¢	12.09¢
Operating revenue yield per ASM	8.90¢	8.50¢	8.27¢	8.02¢	8.51¢
Operating expenses per ASM	8.05¢	7.97¢	7.74¢	7.52¢	7.68¢
Operating expenses per ASM, excluding fuel	6.48¢	6.67¢	6.59¢	6.41¢	6.50¢
Fuel cost per gallon (average)	\$ 1.03	\$.83	\$.72	\$.68	\$.71
Number of Employees at year-end	31,729	31,011	32,847	33,705	31,580
Size of fleet at year-end ⁽²⁾	445	417	388	375	355

(1) Revenue passenger miles divided by available seat miles.

(2) Includes leased aircraft.

CONSENT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM

We consent to the incorporation by reference in the Registration Statements (Forms S-8 Nos. 33-20275, 33-57327, 33-40652, 33-40653, 333-64431, 333-67627, 333-67631, 333-82735, 333-89303, 333-46560, 333-52388, 333-52390, 333-53610, 333-53616, 333-57478, 333-98761, 333-100862, 333-104245, 333-117802 and Forms S-3 Nos. 333-126738 and 333-100861) of Southwest Airlines Co. and in the related Prospectuses of our report dated January 30, 2006, except for Note 1 - "Changes in Accounting", as to which the date is August 9, 2006, with respect to the consolidated financial statements of Southwest Airlines Co. included in this Current Report on Form 8-K for the year ended December 31, 2005.

Dallas, Texas
August 9, 2006

SOUTHWEST AIRLINES CO.**CONDENSED CONSOLIDATED STATEMENT OF INCOME (As adjusted--See Note)**

(in millions except per share amounts)

(unaudited)

	Three months ended Sept. 30, 2005	Three months ended Dec. 31, 2005
OPERATING REVENUES:		
Passenger	\$ 1,912	\$ 1,906
Freight	32	35
Other	45	46
Total operating revenues	1,989	1,987
OPERATING EXPENSES:		
Salaries, wages, and benefits	712	725
Fuel and oil	337	395
Maintenance materials and repairs	116	112
Aircraft rentals	36	42
Landing fees and other rentals	118	109
Depreciation and amortization	121	121
Other operating expenses	301	343
Total operating expenses	1,741	1,847
OPERATING INCOME	248	140
OTHER EXPENSES (INCOME):		
Interest expense	32	32
Capitalized interest	(10)	(11)
Interest income	(13)	(16)
Other (gains) losses, net	(104)	22
Total other expenses (income)	(95)	27
INCOME BEFORE INCOME TAXES	343	113
PROVISION FOR INCOME TAXES	133	43
NET INCOME	<u>\$ 210</u>	<u>\$ 70</u>
NET INCOME PER SHARE:		
Basic	\$.27	\$.09
Diluted	\$.26	\$.09
WEIGHTED AVERAGE SHARES OUTSTANDING:		
Basic	789	797
Diluted	802	816

NOTE:

The Company's first and second quarter 2005 adjusted statements of income have been previously published as part of the Company's first and second quarter 2006 earnings announcements. See our Form 10-Q filings related to first and second quarter 2006 for further information.

The above statements of income for third and fourth quarter 2005, as retrospectively adjusted for the Company's January 1, 2006 adoption of SFAS 123R and change in accounting for airframe maintenance, are being provided for informational purposes only and have been included in this filing only to aid in the assessment of the Company's prior year quarterly results as adjusted for the January 1, 2006 accounting changes.