SOUTHWEST AIRLINES CO
Form 10-Q
August 05, 2011

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

FORM 10-Q

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

For the quarterly period ended June 30, 2011

or

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

For the transition period from ________ to ________

Commission File No. 1-7259

Southwest Airlines Co.
(Exact name of registrant as specified in its charter)

TEXAS	74-1563240
(State or other jurisdiction of incorporation or organization)	(IRS Employer Identification No.)
P.O. Box 36611 Dallas, Texas	75235-1611
(Address of principal executive offices)	(Zip Code)

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

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

Indicate by check mark whether the registrant has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T (§232.405 of this chapter) during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files). Yes þ No ¨

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, a non-accelerated filer, or a smaller reporting company. See the definitions of "large accelerated filer," "accelerated filer" and "smaller reporting company" in Rule 12b-2 of the Exchange Act.

Large accelerated filer þ	Accelerated filer ¨
Non-accelerated filer ¨ (Do not check if a smaller reporting company)	Smaller reporting company ¨

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

Number of shares of Common Stock outstanding as of the close of business on August 3, 2011: 803,997,967

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

Item 1. Financial Statements

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

	June 30, 2011	December 31, 2010
ASSETS		
Current assets:		
Cash and cash equivalents	$ 1,595	$ 1,261
Short-term investments	2,779	2,277
Accounts and other receivables	389	195
Inventories of parts and supplies, at cost	394	243
Deferred income taxes	-	214
Prepaid expenses and other current assets	264	89
Total current assets	5,421	4,279
Property and equipment, at cost:		
Flight equipment	15,255	13,991
Ground property and equipment	2,286	2,122
Deposits on flight equipment purchase contracts	226	230
	17,767	16,343
Less allowance for depreciation and amortization	6,046	5,765
	11,721	10,578
Goodwill	971	-
Other assets	832	606
	$ 18,945	$ 15,463
LIABILITIES AND STOCKHOLDERS' EQUITY		
Current liabilities:		
Accounts payable	$ 1,049	$ 739
Accrued liabilities	1,130	863
Air traffic liability	2,149	1,198
Current maturities of long-term debt	990	505
Total current liabilities	5,318	3,305
Long-term debt less current maturities	3,242	2,875
Deferred income taxes	2,263	2,493
Deferred gains from sale and leaseback of aircraft	82	88

Other non-current liabilities	838	465
Stockholders' equity:		
Common stock	808	808
Capital in excess of par value	1,219	1,183
Retained earnings	5,398	5,399
Accumulated other comprehensive loss	(107)	(262)
Treasury stock, at cost	(116)	(891)
Total stockholders' equity	7,202	6,237
	$ 18,945	$ 15,463

See accompanying notes.

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

	Three months ended June 30,		Six months ended June 30,	
	2011	2010	2011	2010
OPERATING REVENUES:				
Passenger	$3,876	$3,016	$6,814	$5,511
Freight	36	33	67	63
Other	224	119	357	224
Total operating revenues	4,136	3,168	7,238	5,798
OPERATING EXPENSES:				
Salaries, wages, and benefits	1,125	946	2,078	1,810
Fuel and oil	1,527	933	2,565	1,754
Maintenance materials and repairs	246	194	444	360
Aircraft rentals	79	45	125	92
Landing fees and other rentals	247	206	448	396
Depreciation and amortization	176	154	332	308
Acquisition and integration	58	-	75	-
Other operating expenses	471	327	850	661
Total operating expenses	3,929	2,805	6,917	5,381
OPERATING INCOME	207	363	321	417
OTHER EXPENSES (INCOME):				
Interest expense	51	42	94	83
Capitalized interest	(2)	(5)	(5)	(10)
Interest income	(4)	(4)	(7)	(6)
Other (gains) losses, net	(113)	146	(54)	150
Total other expenses (income)	(68)	179	28	217
INCOME BEFORE INCOME TAXES	275	184	293	200
PROVISION FOR INCOME TAXES	114	72	127	77
NET INCOME	$161	$112	$166	$123
NET INCOME PER SHARE, BASIC	$0.21	$0.15	$0.22	$0.17
NET INCOME PER SHARE, DILUTED	$0.21	$0.15	$0.22	$0.17

WEIGHTED AVERAGE SHARES OUTSTANDING:				
Basic	780	745	764	744
Diluted	787	746	765	745
Cash dividends declared per common share	$0.0045	$0.0045	$0.0090	$0.0090

See accompanying notes.

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Southwest Airlines Co.
Condensed Consolidated Statement of Cash Flows
(in millions)
(unaudited)

	Three months ended June 30, 2011	Three months ended June 30, 2010	Six months ended June 30, 2011	Six months ended June 30, 2010
CASH FLOWS FROM OPERATING ACTIVITIES:				
Net income	$161	$112	$166	$123
Adjustments to reconcile net income to cash provided by operating activities:				
Depreciation and amortization	176	154	332	308
Unrealized (gain) loss on fuel derivative instruments	(129)	166	(119)	187
Deferred income taxes	95	63	123	75
Amortization of deferred gains on sale and leaseback of aircraft	(3)	(3)	(7)	(7)
Changes in certain assets and liabilities (excluding the effects of acquired business):				
Accounts and other receivables	(21)	(42)	(107)	(108)
Other current assets	(46)	5	(138)	(14)
Accounts payable and accrued liabilities	67	279	305	195
Air traffic liability	64	86	576	442
Cash collateral received from (provided to) fuel derivative counterparties	(49)	130	(20)	135
Other, net	(78)	(410)	91	(423)
Net cash provided by operating activities	237	540	1,202	913
CASH FLOWS FROM INVESTING ACTIVITIES:				
Payment to acquire AirTran, net of AirTran cash on hand	(35)	-	(35)	-
Payments for purchase of property and equipment, net	(215)	(159)	(272)	(298)
Purchases of short-term investments	(1,779)	(1,800)	(3,263)	(3,180)
Proceeds from sales of short-term investments	1,440	1,349	2,750	2,546
Net cash used in investing activities	(589)	(610)	(820)	(932)
CASH FLOWS FROM FINANCING ACTIVITIES:				
Proceeds from Employee stock plans	27	23	31	35
Proceeds from termination of interest rate derivative instrument	-	-	76	-

Payments of long-term debt and capital lease obligations	(32)	(25)	(62)	(85)
Payments of convertible debt	(81)	-	(81)	-
Payment of credit line borrowing	-	(44)	-	(44)
Payments of cash dividends	(3)	(3)	(10)	(10)
Other, net	(3)	(2)	(2)	(2)
Net cash used in financing activities	(92)	(51)	(48)	(106)
NET CHANGE IN CASH AND CASH EQUIVALENTS	(444)	(121)	334	(125)
CASH AND CASH EQUIVALENTS AT BEGINNING OF PERIOD	2,039	1,110	1,261	1,114
CASH AND CASH EQUIVALENTS AT END OF PERIOD	$1,595	$989	$1,595	$989
CASH PAYMENTS FOR:				
Interest, net of amount capitalized	$48	$33	$82	$68
Income taxes	$4	$39	$5	$39
SUPPLEMENTAL DISCLOSURE OF NONCASH TRANSACTIONS:				
Fair value of equity consideration given to acquire AirTran	$523	$-	$523	$-
Fair value of common stock issued for conversion of debt	$78	$-	$78	$-

See accompanying notes.

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

1. BASIS OF PRESENTATION

The accompanying unaudited Condensed Consolidated Financial Statements of Southwest Airlines Co. and its subsidiaries (the “Company” or “Southwest”) have been prepared in accordance with accounting principles generally accepted in the United States for interim financial information and with the instructions to Form 10-Q and Article 10 of Regulation S-X. Accordingly, they do not include all of the information and footnotes required by accounting principles generally accepted in the United States for complete financial statements. The unaudited Condensed Consolidated Financial Statements for the interim periods ended June 30, 2011 and 2010 include all adjustments which are, in the opinion of management, necessary for a fair presentation of the results for the interim periods. This includes all normal and recurring adjustments and elimination of significant intercompany transactions, but does not include all of the information and footnotes required by generally accepted accounting principles (“GAAP”) for complete financial statements. Financial results for the Company and airlines in general can be seasonal in nature. In many years, the Company’s revenues, as well as its operating income and net income, have been better in its second and third fiscal quarters than in its first and fourth fiscal quarters. Air travel is also significantly impacted by general economic conditions, the amount of disposable income available to consumers, unemployment levels, and corporate travel budgets. These and other factors, such as the price of jet fuel in some periods, the nature of the Company’s fuel hedging program, the periodic volatility of commodities used by the Company for hedging jet fuel, and the requirements related to hedge accounting, have created, and may continue to create, significant volatility in the Company’s financial results. See Note 5 for further information on fuel and the Company’s hedging program. Operating results for the three and six months ended June 30, 2011 are not necessarily indicative of the results that may be expected for the year ended December 31, 2011. For further information, refer to the Consolidated Financial Statements and footnotes thereto included in the Southwest Airlines Co. Annual Report on Form 10-K for the year ended December 31, 2010.

2. AIRTRAN ACQUISITION AND RELATED MATTERS

AirTran Holdings, Inc.
On May 2, 2011 (the “acquisition date”), the Company acquired all of the outstanding equity of AirTran Holdings, Inc. (“AirTran Holdings”), the former parent company of AirTran Airways, Inc. (“AirTran Airways”), in exchange for Southwest Airlines Co. (“Southwest Airlines”) common stock and cash. Throughout this Form 10-Q, the Company makes reference to AirTran, which is meant to be inclusive of the following: (i) for periods prior to the acquisition date, AirTran Holdings and its subsidiaries, including, among others, AirTran Airways; and (ii) for periods on and after the acquisition date, AirTran Holdings, LLC, the successor to AirTran Holdings, and its subsidiaries, including among others, AirTran Airways. AirTran Airways offers scheduled airline services, using Boeing 717-200 aircraft (B717) and Boeing 737-700 aircraft (B737), throughout the United States and to selected international locations. Approximately half of AirTran Airways’ flights originate or terminate at its largest hub in Atlanta, Georgia. AirTran Airways also serves a number of markets with non-stop service from smaller hubs in Baltimore, Maryland; Milwaukee, Wisconsin; and Orlando, Florida. The Company believes the acquisition of AirTran positions it to respond better to the economic and competitive challenges of the industry because, among other reasons: (i) it allows

the Company to offer more low-fare destinations by extending its network and diversifying into new markets, including significant opportunities to and from Atlanta, the busiest airport in the United States and the largest domestic market the Company previously did not serve, (ii) it expands the Company's presence in slot-controlled markets (New York LaGuardia/Ronald Reagan Washington National Airport), and (iii) it provides access to near-international leisure markets in the Caribbean and Mexico.

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The accompanying unaudited Condensed Consolidated Financial Statements include the results of operations and cash flows for AirTran beginning on May 2, 2011, through June 30, 2011. AirTran will be integrated into the Company’s operations and will not be considered a separate segment for financial reporting purposes. In addition, as a result of the manner in which the acquisition and related transactions were structured, AirTran’s public debt is now a direct obligation of Southwest Airlines, which eliminates the subsequent need for reporting of stand-alone AirTran financial results. Total operating revenue of $540 million and a Net loss of $27 million are attributable to AirTran and are included in the Company’s unaudited Condensed Consolidated Statement of Operations for both the three and six month periods ended June 30, 2011. These amounts exclude the effects of amortization of intangible assets and liabilities created as a result of the acquisition and certain acquisition-related expenses incurred by the Company. These amounts include $14 million (net of taxes) in certain acquisition-related expenses incurred by AirTran.

Equity transaction

Each share of AirTran Holdings common stock was exchanged for $3.75 in cash and 0.321 shares of Southwest Airlines common stock. The common stock consideration was based on the average of the Southwest Airlines closing common stock price for the 20 trading days ending April 27, 2011, which was $11.90. The transaction valued AirTran Holdings common stock at approximately $7.57 per share, or $1.0 billion in the aggregate. Stockholders of AirTran Holdings, including those holding restricted stock awards, received approximately 44 million shares of Southwest Airlines common stock, which represented approximately 5.6 percent of the Southwest Airlines common shares outstanding. Additionally, holders of AirTran Holdings equity received cash of $518 million, including $7 million in cash for the fair value of AirTran stock options and performance share units. Including existing AirTran debt (including convertible notes outstanding at the acquisition date) and capitalized aircraft operating leases, the total transaction value was approximately $3.2 billion. Subsequent to the acquisition date, a portion of the convertible notes previously held by AirTran note holders were either converted or called by the Company for an aggregate of approximately seven million shares of the Company's common stock and $81 million in cash. The equity transaction did not contain any contingent consideration arrangements.

Expenses related to the AirTran acquisition

The Company is expected to continue to incur substantial integration and transition expenses in connection with the AirTran acquisition, including the necessary costs associated with integrating the operations of the two companies. While the Company has assumed that a certain level of expenses will be incurred, there are many factors that could affect the total amount or the timing of these expenses, and many of the expenses that will be incurred are, by their nature, difficult to estimate. These expenses could, particularly in the near term, exceed the financial benefits that the Company expects to achieve from the AirTran acquisition and could continue to result in the Company taking significant charges against earnings. For the three and six month periods ended June 30, 2011, the Company incurred consolidated acquisition-related costs of $58 million and $75 million, respectively, primarily consisting of financial advisory fees and consulting, severance, and technology costs. In the Company’s unaudited Condensed Consolidated Statement of Operations, these costs are classified as Acquisition and integration expenses.

Tax matters

AirTran experienced an “ownership change” as defined in Section 382 of the Internal Revenue Code of 1986, as amended, as a result of the acquisition. Section 382 of the Code imposes an annual limitation on the amount of taxable income generated subsequent to the ownership change that may be offset with Federal net operating loss carryforwards (“NOLs”) of the corporation incurred before the ownership change. Any unused annual limitation may, subject to certain limits, be carried over to later years, and the limitation may under certain circumstances be increased by built-in gains or reduced by built-in losses in the assets held by such corporation at the time of the ownership change. The combined company's use of NOLs arising after the date of an ownership change would not be limited unless the combined company were to experience a subsequent ownership change. The Company currently expects the ownership change resulting from the AirTran acquisition will not significantly limit its ability to use AirTran's net operating loss and alternative minimum tax credit carryforwards in the carryforward period.

As of the acquisition date, AirTran had NOLs of $542 million, which expire between 2017 and 2029, available to offset future taxable income, resulting in a deferred tax asset of $190 million, which represents the expected tax benefit of the NOLs. The Company's ability to use the NOLs will also depend on the amount of taxable income generated in future periods.

Recording of assets acquired and liabilities assumed

The transaction has been accounted for using the acquisition method of accounting ("purchase accounting"), which requires, among other things, that most assets acquired and liabilities assumed be recognized at their fair values as of the acquisition date. No material assets or liabilities arose from contingencies recognized at the acquisition date. Certain estimated values are not yet finalized (see below) and are subject to change. The Company will finalize the amounts recognized as it obtains the information necessary to complete the analyses. The Company expects to finalize these amounts prior to December 31, 2011. The following table summarizes the assets acquired and liabilities assumed as of the acquisition date at estimated fair value:

(in millions)	May 2, 2011
Assets	
Cash and cash equivalents	$ 477
Restricted cash	6
Other current assets	237
Operating property and equipment	1,151
Goodwill	971
Other identified intangibles	132
Deferred income taxes	150
Other noncurrent assets	45
Liabilities	
Long-term debt and capital leases, including current portion	(1,121)
Air traffic liability	(353)
Other liabilities assumed	(654)
Net assets acquired	$ 1,041

The fair values of the assets acquired and liabilities assumed were determined using the market, income and cost approaches. The market approach, which indicates value for a subject asset based on available market pricing for comparable assets, was utilized to estimate the fair value of AirTran's aircraft and operating leases. The market approach used by the Company included prices and other relevant information generated by market transactions involving comparable assets, as well as industry pricing guides and other sources. The Company considered the current market for the aircraft, the maintenance condition of the aircraft and the expected proceeds from the sale of the assets, among other factors. The fair value of AirTran's frequent flyer program liability was estimated based on the weighted average

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equivalent ticket value of outstanding frequent flyer credits that were expected to be redeemed as of May 2, 2011. The income approach was primarily used to value intangible assets, including customer relationships and marketing agreements, noncompete agreements with certain AirTran executives, the AirTran trademark and trade name, and certain domestic airport take-off and landing slots. The income approach indicates value for a subject asset based on the present value of cash flows projected to be generated by the asset. Projected cash flows are discounted at a required market rate of return that reflects the relative risk of achieving the cash flows and the time value of money. The cost approach, which estimates value by determining the current cost of replacing an asset with another of equivalent economic utility, was used, as appropriate, for certain assets for which the market and income approaches could not be applied due to the nature of the asset. The cost to replace a given asset reflects the estimated reproduction or replacement cost for the asset, less an allowance for loss in value due to depreciation.

Intangible assets

Identifiable intangibles were created as a result of the acquisition of AirTran, which will be amortized as follows:

- Customer Relationships: Amortized based on an accelerated amortization schedule to reflect the estimated free cash flows the customer relationships are expected to provide.

- Trademarks/Trade names: Amortized based on an accelerated amortization schedule to reflect the estimated free cash flows the assets are expected to provide.

- Domestic Slots: Straight-line amortization for owned slots based on the applicable estimated useful life. Straight-line amortization for leased slots over the applicable lease term.

  - Internally developed software: Straight-line amortization over the expected useful life of the software.

  - Non-compete agreements: Straight-line amortization over the expected life of the applicable contract.

The identifiable intangibles created as a result of the acquisition have been amortized from the acquisition date. Estimated aggregate amortization expense for the remainder of 2011 and the five succeeding years and thereafter is as follows: 2011 – $26 million, 2012 – $22 million, 2013 – $16 million, 2014 – $12 million, 2015 – $10 million, 2016 – $7 million, 2017 and thereafter - $39 million. The following table is a summary of the fair value estimates of the acquired identifiable intangible assets, weighted-average useful lives, and balance of accumulated amortization as of June 30, 2011:

	Estimated fair value of asset/(liability) (in millions)	Weighted-average useful life (in years)	Accumulated amortization (in millions)
Customer relationships/marketing agreements	$ 46	4	$ 3
Trademarks/trade names	36	3	2
Domestic Slots	43	24	-
Internally developed software	2	2	-
Noncompete agreements	5	2	-
Total	$ 132	10	$ 5

Leasehold Interest

Lease fair value adjustments for operating leases were created as a result of the acquisition of AirTran. The fair value adjustments represent the net present value of the differences between contractual lease rates and the fair market lease rates for similar leased assets at the acquisition date. An asset (liability) results when the contractual lease rates are more (less) favorable than market lease terms at the valuation date. As of June 30, 2011, the lease fair value adjustments are classified within Other assets and Other non-current liabilities in the amounts of $2 million and $376 million, respectively. The lease fair value adjustments are amortized on a straight-line basis to aircraft rent expense over the individual applicable remaining lease terms, resulting in recognition of rent as if the Company had entered into the leases at market rates at the acquisition date. Estimated aggregate amortization income (reduction of expense) for the remainder of 2011 and the five succeeding years and thereafter is as follows: 2011 - $26 million, 2012 - $39 million, 2013 - $39 million, 2014 - $39 million, 2015 - $39 million, 2016 - $39 million, 2017 and thereafter - $155 million. Accumulated amortization as of June 30, 2011, was immaterial for the leasehold interest asset and $6 million for the leasehold interest liability. The weighted-average useful life for the leasehold interest asset is 9 years and for the leasehold interest liability is 10 years, for a total weighted-average leasehold useful life of 10 years.

Goodwill

Goodwill in the amount of $971 million was recorded for the acquisition of AirTran. Goodwill is calculated as the excess of the consideration transferred over the net assets recognized and represents the estimated future economic benefits arising from other assets acquired that could not be individually identified and separately recognized. Goodwill will not be amortized, but will be tested for impairment at least annually. None of the goodwill is deductible for tax purposes. Specifically, the goodwill recorded as part of the acquisition of AirTran includes:

- The expected synergies and other benefits that are expected to result from combining the operations of AirTran with the operations of the Company; and
- Any intangible assets that do not qualify for separate recognition such as the AirTran trained and assembled workforce.

The recorded amounts for assets and liabilities are provisional and subject to change. However, the Company does not expect that any future adjustments will be material. The following items are subject to change:

- Amounts for intangibles, the fair value of specific executory contracts, and deferred income taxes and liabilities, pending finalization of valuation efforts; and
- The purchase price allocable to goodwill, as a result of changes to the aforementioned items.

A single estimate of fair value results from a complex series of judgments about future events and uncertainties and relies heavily on estimates and assumptions. The Company's judgments used to determine the estimated fair value assigned to each class of assets acquired and liabilities assumed, as well as asset lives, can materially impact its results of operations.

Pro forma impact of the acquisition

The unaudited pro forma results presented below include the effects of the AirTran acquisition as if it had been consummated as of January 1, 2010. The pro forma results include the amortization associated with estimates (certain of which are preliminary) for the acquired intangible assets, fair value adjustments for deferred revenue, favorable/unfavorable leasehold interests, property and equipment, and long-term debt. In addition, the pro forma results do not include any anticipated synergies or other expected benefits of the acquisition. Accordingly, the unaudited pro forma financial information below is not necessarily indicative of either future results of operations or results that might have been achieved had the acquisition been consummated as of January 1, 2010.

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(In millions, except per share data)	Three months ended June 30, 2011	Three months ended June 30, 2010	Six months ended June 30, 2011	Six months ended June 30, 2010
Total operating revenues	$ 4,402	3,868	$ 8,171	7,105
Net income	160	109	163	109
Net income per share, basic	0.20	0.14	0.21	0.14
Net income per share, diluted	0.20	0.14	0.21	0.14

3. ACCOUNTING CHANGES AND NEW ACCOUNTING PRONOUNCEMENTS

On December 29, 2010, the Financial Accounting Standards Board ("FASB") ratified Accounting Standards Update ("ASU") No. 2010-29, "Disclosure of Supplementary Pro Forma Information for Business Combinations." This ASU specifies that when a business combination occurs, the company must only disclose revenue and earnings of the combined entity as though the business combination that occurred during the current year had occurred as of the beginning of the comparable prior annual reporting period. This ASU also expands the supplemental pro forma disclosures under Topic 805, Business Combinations, formerly Statement of Financial Accounting Standards No. 141(R), to include a description of the nature and amount of material, non-recurring pro forma adjustments directly attributable to the business combination included in the reported pro forma revenue and earnings. This ASU is effective prospectively for business combinations in which the acquisition date is on or after the beginning of the first annual reporting period beginning on or after December 15, 2010.

Because the Company acquired AirTran on May 2, 2011, the Company implemented this ASU for the interim period ended June 30, 2011. The Company has prepared pro forma disclosures to include the effects of the AirTran acquisition as if it had been consummated as of January 1, 2010. There are no non-recurring pro forma adjustments directly attributable to the business combination included in the reported pro forma revenue and earnings. See Note 2.

On May 12, 2011, the FASB ratified ASU No. 2011-04, "Fair Value Measurement (Topic 820): Amendments to Achieve Common Fair Value Measurement and Disclosure Requirements in U.S. GAAP and IFRS." This ASU establishes a global standard for measuring amounts at fair value. This ASU will not have a material effect on the Company's financial position or results of operations, but will change the Company's disclosure policies for fair value. This ASU is effective for reporting periods (including interim periods) beginning after December 15, 2011. For the Company, this ASU will first take effect for the first quarter ending March 31, 2012. Early adoption is not permissible, and this ASU must be applied prospectively.

On June 16, 2011, the FASB ratified ASU No. 2011-05, "Presentation of Comprehensive Income." This ASU eliminates the current option to report other comprehensive income and its components in the statement of changes in equity. Upon adoption, other comprehensive income must be presented either in a single continuous statement of comprehensive income or in two separate but consecutive statements. This ASU will not have a material effect on the Company's financial position or results of operations, but will change the Company's disclosure policies for other comprehensive income. This ASU is effective for fiscal years, and interim periods within those years, beginning after

December 15, 2011. This ASU must be applied retrospectively and early adoption is permitted. The Company will adopt this ASU for the interim period ending March 31, 2012.

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4. NET INCOME PER SHARE

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

	Three months ended June 30, 2011	Three months ended June 30, 2010	Six months ended June 30, 2011	Six months ended June 30, 2010
NUMERATOR:				
Net income	$ 161	$ 112	$ 166	$ 123
Incremental income effect of interest on 5.25% convertible notes	1	-	-	-
Net income after assumed conversion	$ 162	$ 112	$ 166	$ 123
DENOMINATOR:				
Weighted average shares outstanding, basic	780	745	764	744
Dilutive effect of Employee stock awards	1	-	1	-
Dilutive effect of 5.25% convertible notes	6	1	-	1
Adjusted weighted-average shares outstanding, diluted	787	746	765	745
NET INCOME PER SHARE:				
Basic	$ 0.21	$ 0.15	$ 0.22	$ 0.17
Diluted	$ 0.21	$ 0.15	$ 0.22	$ 0.17
Antidilutive stock options excluded from calculations	49	72	48	74

5. FINANCIAL DERIVATIVE INSTRUMENTS

Fuel contracts

Airline operators are inherently dependent upon energy to operate and, therefore, are impacted by changes in jet fuel prices. Furthermore, jet fuel and oil typically represent one of the largest operating expenses for airlines. The Company endeavors to acquire jet fuel at the lowest possible cost and to reduce volatility in operating expenses through its fuel hedging program. Because jet fuel is not widely traded on an organized futures exchange, there are limited opportunities to hedge directly in jet fuel. However, the Company has found that financial derivative instruments in other commodities, such as West Texas Intermediate crude oil (“WTI”), Brent crude oil (“Brent”), and refined products, such as heating oil and unleaded gasoline, can be useful in decreasing its exposure to jet fuel price volatility. The Company does not purchase or hold any financial derivative instruments for trading purposes.

The Company has used financial derivative instruments for both short-term and long-term time frames, and primarily uses a mixture of purchased call options, collar structures (which include both a purchased call option and a sold put option), call spreads (which include a purchased call option and a sold call option), and fixed price swap agreements in its portfolio.

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The Company evaluates its hedge volumes strictly from an "economic" standpoint and thus does not consider whether the hedges have qualified or will qualify for hedge accounting. The Company defines its "economic" hedge as the net volume of fuel derivative contracts held, including the impact of positions that have been offset through sold positions, regardless of whether those contracts qualify for hedge accounting. For second quarter 2011, the Company had fuel derivatives in place related to approximately 36 percent of its fuel consumption. As of June 30, 2011, the Company had fuel derivative instruments in place to provide coverage on a large portion of its remaining 2011 estimated fuel consumption at varying WTI price levels. The following table provides information about the Company's (inclusive of fuel derivative instruments acquired from Air Tran – See Note 2) volume of fuel hedging for the remainder of 2011, as well as the years 2012 through 2015.

Period (by year)	Fuel hedged as of June 30, 2011 (gallons in millions)
Second half 2011	629
2012	1,297
2013	919
2014	622
2015	239

Upon proper qualification, the Company accounts for its fuel derivative instruments as cash flow hedges. All derivatives designated as hedges that meet certain requirements are granted hedge accounting treatment. Generally, utilizing hedge accounting, all periodic changes in fair value of the derivatives designated as hedges that are considered to be effective are recorded in Accumulated other comprehensive income (loss) ("AOCI") until the underlying jet fuel is consumed. See Note 6. The Company's results are subject to the possibility that periodic changes will not be effective, as defined, or that the derivatives will no longer qualify for hedge accounting. Ineffectiveness results when the change in the fair value of the derivative instrument exceeds the change in the value of the Company's expected future cash outlay to purchase and consume jet fuel. To the extent that the periodic changes in the fair value of the derivatives are ineffective, the ineffective portion is recorded to Other (gains) losses, net in the statement of operations. Likewise, if a hedge ceases to qualify for hedge accounting, any change in the fair value of derivative instruments since the last period is recorded to Other (gains) losses, net in the statement of operations in the period of the change; however, any amounts previously recorded to AOCI would remain there until such time as the original forecasted transaction occurs, at which time these amounts would be reclassified to Fuel and oil expense. When the Company has sold derivative positions in order to effectively "close" or offset a derivative already held as part of its fuel derivative instrument portfolio, any subsequent changes in fair value of those positions are marked to market through earnings. Likewise, any changes in fair value of those positions that were offset by entering into the sold positions are concurrently marked to market through earnings. However, any changes in value related to hedges that were deferred as part of AOCI while designated as a hedge would remain until the originally forecasted transaction occurs. In a situation where it becomes probable that a hedged forecasted transaction will not occur, any gains and/or losses that have been recorded to AOCI would be required to be immediately reclassified into earnings. The Company did not have any such situations occur during 2010 or during the six months ended June 30, 2011.

Ineffectiveness is inherent in hedging jet fuel with derivative positions based in other crude oil related commodities. 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 for a specific commodity. This may result, and has resulted, in increased volatility in the Company's financial results. However, even though derivatives

may not qualify for hedge accounting, the Company continues to hold the instruments as management believes derivative instruments continue to afford the Company the opportunity to stabilize jet fuel costs.

Accounting pronouncements pertaining to derivative instruments and hedging are complex 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 designated by the Company. As required, 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.

All cash flows associated with purchasing and selling fuel derivatives are classified as Other operating cash flows in the unaudited Condensed Consolidated Statement of Cash Flows. The following table presents the location of all assets and liabilities associated with the Company's hedging instruments within the unaudited Condensed Consolidated Balance Sheet:

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

(in millions)	Balance Sheet location	Asset derivatives Fair value at 06/30/11	Asset derivatives Fair value at 12/31/10	Liability derivatives Fair value at 06/30/11	Liability derivatives Fair value at 12/31/10
Derivatives designated as hedges					
Fuel derivative contracts (gross)*	Other current assets	$226	$151	$19	$16
Fuel derivative contracts (gross)*	Other assets	794	547	102	88
Fuel derivative contracts (gross)*	Accrued liabilities	56	122	1	18
Fuel derivative contracts (gross)*	Other noncurrent liabilities	20	71	2	9
Interest rate derivative contracts	Other current assets	2	73	-	-
Interest rate derivative contracts	Other assets	32	-	-	-
Interest rate derivative contracts	Accrued liabilities	-	-	5	-
Interest rate derivative contracts	Other noncurrent liabilities	-	-	75	4
Total derivatives designated as hedges		$1,130	$964	$204	$135
Derivatives not designated as hedges					
Fuel derivative contracts (gross)*	Other current assets	$317	$164	$359	$284
Fuel derivative contracts (gross)*	Other assets	279	212	583	304
Fuel derivative contracts (gross)*	Accrued liabilities	1	40	165	222
Fuel derivative contracts (gross)*	Other noncurrent liabilities	9	33	104	257
Total derivatives not designated as hedges		$606	$449	$1,211	$1,067
Total derivatives		$1,736	$1,413	$1,415	$1,202

* Represents the position of each trade before consideration of offsetting positions with each counterparty and does not include the impact of cash collateral deposits provided to or received from counterparties. See discussion of credit risk and collateral following in this Note.

In addition, the Company also had the following amounts associated with fuel derivative instruments and hedging activities in its unaudited Condensed Consolidated Balance Sheet:

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

(in millions)	Balance Sheet location	June 30, 2011	December 31, 2010
Cash collateral deposits provided to counterparty - noncurrent	Offset against Other noncurrent liabilities	$86	$125
Cash collateral deposits provided to counterparty - current	Offset against Accrued liabilities	109	-
Cash collateral deposits held from counterparty - noncurrent	Offset against Other assets	75	60
Cash collateral deposits held from counterparty - current	Offset against Other current assets	35	-
Receivable from third parties for settled fuel contracts	Accounts and other receivables	5	1
Net unrealized (gains) losses from fuel hedges, net of tax	Accumulated other comprehensive (gain) loss	97	250

The following tables present the impact of derivative instruments and their location within the unaudited Condensed Consolidated Statement of Operations for the three and six months ended June 30, 2011 and 2010:

Derivatives in cash flow hedging relationships

	(Gain) loss recognized in AOCI on derivatives (effective portion) Three months ended June 30,				(Gain) loss reclassified from AOCI into income (effective portion)(a) Three months ended June 30,				(Gain) loss Recognized in income on derivatives (ineffective portion) (b) Three months ended June 30,	
(in millions)	2011		2010		2011		2010		2011	2010
Fuel derivative contracts	$ 196	*	$ 172	*	$ 18	*	$ 74	*	$ 8	$ 58
Interest rate derivatives	11	*	21	*	-		-		-	-
Total	$ 207		$ 193		$ 18		$ 74		$ 8	$ 58

* Net of tax

(a) Amounts related to fuel derivative contracts and interest rate derivatives are included in Fuel and oil and Interest expense, respectively.

(b) Amounts are included in Other (gains) losses, net.

Derivatives in cash flow hedging relationships

	(Gain) loss recognized in AOCI on derivatives (effective portion) Six months ended June 30,		(Gain) loss reclassified from AOCI into income (effective portion)(a) Six months ended June 30,		(Gain) loss recognized in income on derivatives (ineffective portion) (b) Six months ended June 30,	
(in millions)	2011	2010	2011	2010	2011	2010
Fuel derivative contracts	$ (119)*	$ 188 *	$ 34 *	$ 149 *	$ 42	$ 54
Interest rate derivatives	4 *	22 *	-	-	-	-
Total	$ (115)	$ 210	$ 34	$ 149	$ 42	$ 54

* Net of tax

(a) Amounts related to fuel derivative contracts and interest rate derivatives are included in Fuel and oil and Interest expense, respectively.

(b) Amounts are included in Other (gains) losses, net.

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

Derivatives not in cash flow hedging relationships

(in millions)	(Gain) loss recognized in income on derivatives Three months ended June 30, 2011	2010	Location of (gain) loss recognized in income on derivatives
Fuel derivative contracts	$(150)	$57	Other (gains) losses, net

Derivatives not in cash flow hedging relationships

(in millions)	(Gain) loss recognized in income on derivatives Six months ended June 30, 2011	2010	Location of (gain) loss recognized in income on derivatives
Fuel derivative contracts	$(155)	$34	Other (gains) losses, net

The Company also recorded expense associated with premiums paid for fuel derivative contracts that settled/expired during the three months ended June 30, 2011 and 2010 of $26 million and $30 million, respectively, and the six months ended June 30, 2011 and 2010 of $57 million and $61 million, respectively. These amounts are excluded from the Company's measurement of effectiveness for related hedges and are included as a component of Other (gains) losses, net, in the unaudited Condensed Consolidated Statement of Operations.

The fair values of the derivative instruments, depending on the type of instrument, were determined by the use of present value methods or standard option value models with assumptions about commodity prices based on those observed in underlying markets. Included in the Company's total net unrealized losses from fuel hedges as of June 30, 2011, were approximately $87 million in unrealized losses, net of taxes, which are expected to be realized in earnings during the twelve months subsequent to June 30, 2011. In addition, as of June 30, 2011, the Company had already recognized cumulative net gains due to ineffectiveness and derivatives that do not qualify for hedge accounting treatment totaling $26 million, net of taxes. These net gains were recognized in second quarter 2011 and prior periods, and are reflected in Retained earnings as of June 30, 2011, but the underlying derivative instruments will not expire/settle until third quarter 2011 or future periods.

Interest rate swaps

The Company is party to certain interest rate swap agreements that are accounted for as either fair value hedges or cash flow hedges, as defined in the applicable accounting guidance for derivative instruments and hedging. The interest rate swap agreements accounted for as fair value hedges qualify for the “shortcut” method of accounting for hedges, which dictates that the hedges are assumed to be perfectly effective, and, thus, there is no ineffectiveness to be recorded in earnings. For the Company’s interest rate swap agreements accounted for as cash flow hedges, ineffectiveness is required to be measured at each reporting period.

AirTran has also entered into a number of interest rate swap agreements, which convert a portion of AirTran’s floating-rate debt to a fixed-rate basis for the remaining life of the debt, thus reducing the impact of interest rate changes on future interest expense and cash flows. Under these agreements, which expire

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between 2016 and 2020, the Company pays fixed rates between 4.34 percent and 6.435 percent and receives either three-month or six-month USD London Interbank Offered Rate (LIBOR) on the notional values. The notional amount of outstanding debt related to interest-rate swaps as of June 30, 2011 was $462 million. These interest rate swap arrangements were designated as cash flow hedges as of the acquisition date. The ineffectiveness associated with all of the Company's interest rate cash flow hedges for all periods presented was not material.

Credit risk and collateral

Credit exposure related to fuel derivative instruments is represented by the fair value of contracts that are an asset to the Company at the reporting date. These outstanding instruments expose the Company to credit loss in the event of nonperformance by the counterparties to the agreements. However, the Company has not experienced any significant credit loss as a result of counterparty nonperformance in the past. 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 fuel hedging program and its relative market position with each counterparty. At June 30, 2011, the Company had agreements with all of its active 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. The Company also had agreements with counterparties in which cash deposits and/or pledged aircraft are required to be posted whenever the net fair value of derivatives associated with those counterparties exceeds specific thresholds. The following table provides the fair values of fuel derivatives, amounts posted as collateral, and applicable collateral posting threshold amounts as of June 30, 2011, at which such postings are triggered:

	Counterparty (CP)						
	A	B	C	D	E	Other(a)	Total
(in millions)							
Fair value of fuel derivatives	$ 213	$ (186)	$ 15	$ 102	$ 204	$ 19	$ 367
Cash collateral held from (by) CP	110	(195)	-	-	-	-	(85)
If credit rating is investment grade, fair value of fuel derivative level at which:							
Cash is provided to CP	0 to (300) or >(700)	0 to (125) or >(625)	>(50)	>(75)	>(50)		
Cash is received from CP	>40	>150	>200(c)	>125(c)	>250		
Aircraft can be pledged to CP	(300) to (700)(d)	(125) to (625)(d)	N/A	N/A	N/A		
If credit rating is non-investment grade, fair value of fuel derivative level at which:							
Cash is provided to CP	0 to (300) or >(700)	0 to (125) or >(625)	(b)	(b)	(b)		

Cash is received from CP	(b)	(b)	(b)	(b)	(b)
Aircraft can be pledged to CP	(300) to (700)	(125) to (625)	N/A	N/A	N/A

(a) Individual counterparties with fair value of fuel derivatives <$15 million.
(b) Cash collateral is provided at 100 percent of fair value of fuel derivative contracts.
(c) Thresholds may vary based on changes in credit ratings within investment grade.
(d) The Company has the option of providing cash or pledging aircraft as collateral. No aircraft were pledged as collateral as of June 30, 2011.

The Company also has agreements with each of its counterparties associated with its outstanding interest rate swap agreements in which cash collateral may be required based on the fair value of outstanding

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derivative instruments, as well as the Company's and its counterparty's credit ratings. As of June 30, 2011, $31 million had been provided to one counterparty associated with interest rate derivatives based on the Company's outstanding net liability derivative position with that counterparty. In addition, based on interest rate swaps entered into by AirTran, $21 million in collateral had been set aside as restricted cash and $6 million had been provided to a counterparty at June 30, 2011, as a result of net liability derivative positions with those counterparties. See Note 7. The outstanding interest rate net derivative positions with all other counterparties at June 30, 2011, were assets to the Company.

In the accompanying unaudited Condensed Consolidated Balance Sheet, the Company has elected to present its cash collateral utilizing a net presentation, in which cash collateral amounts held or provided have been netted against the fair value of outstanding derivative instruments. The Company's application of this policy differs depending on whether its derivative instruments are in a net asset position or a net liability position. If its fuel derivative instruments are in a net asset position with a counterparty, cash collateral amounts held are first netted against current derivative amounts (those that will settle during the twelve months following the balance sheet date) associated with that counterparty until that balance is zero, and then any remainder is applied against the fair value of noncurrent outstanding derivative instruments (those that will settle beyond one year following the balance sheet date). If the Company's fuel derivative instruments are in a net liability position with a counterparty, cash collateral amounts provided are first netted against noncurrent derivative amounts associated with that counterparty until that balance is zero, and then any remainder is applied against the fair value of current outstanding derivative instruments.

6. COMPREHENSIVE INCOME (LOSS)

Comprehensive income (loss) includes changes in the fair value of certain financial derivative instruments, that qualify for hedge accounting, unrealized gains and losses on certain investments, and actuarial gains/losses arising from the Company's postretirement benefit obligation. The differences between Net income and Comprehensive income (loss) for the three and six months ended June 30, 2011 and 2010, were as follows:

	Three months ended June 30,	
(In millions)	2011	2010
Net income	$ 161	$ 112
Unrealized (loss) on fuel derivative instruments,		
net of deferred taxes of ($111) and ($61)	(178)	(98)
Unrealized (loss) on interest rate swaps,		
net of deferred taxes of ($7) and ($13)	(11)	(21)
Other, net of deferred taxes of $2 and ($2)	3	(4)
Total other comprehensive loss	(186)	(123)
Comprehensive loss	$ (25)	$ (11)

	Six months ended June 30,	
(In millions)	2011	2010
Net income	$ 166	$ 123
Unrealized gain/(loss) on fuel derivative instruments,		

net of deferred taxes of \$96 and (\$24)	153	(39)
Unrealized (loss) on interest rate swaps,		
net of deferred taxes of (\$3) and (\$14)	(4)	(22)
Other, net of deferred taxes of \$4 and (\$1)	6	(2)
Total other comprehensive income (loss)	155	(63)
Comprehensive income	\$ 321	\$ 60

A rollforward of the amounts included in AOCI, net of taxes, is shown below for the three and six months ended June 30, 2011:

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(In millions)	Fuel hedge derivatives	Interest rate derivatives	Other	Accumulated other comprehensive income (loss)
Balance at March 31, 2011	$ 81	$ (27)	$ 25	$ 79
Changes in fair value	(196)	(11)	3	(204)
Reclassification to earnings	18	-	-	18
Balance at June 30, 2011	$ (97)	$ (38)	$ 28	$ (107)

(In millions)	Fuel hedge derivatives	Interest rate derivatives	Other	Accumulated other comprehensive income (loss)
Balance at December 31, 2010	$ (250)	$ (34)	$ 22	$ (262)
Changes in fair value	119	(4)	6	121
Reclassification to earnings	34	-	-	34
Balance at June 30, 2011	$ (97)	(38)	28	$ (107)

7. OTHER ASSETS AND LIABILITIES

(In millions)	June 30, 2011	December 31, 2010
Fuel derivatives contracts	$312	$ 307
Intangible assets	184	60
Non-current investments	89	97
Restricted cash	67	-
Maintenance deposits	60	-
Other	120	142
Other assets	$832	$ 606

(In millions)	June 30, 2011	December 31, 2010
Retirement plans	$203	$ 171
Aircraft rentals	100	27
Vacation pay	235	200
Advances and deposits	32	33
Fuel derivative contracts	5	79
Workers compensation	151	142
Deferred taxes	102	-
Other	302	211
Accrued liabilities	$1,130	$ 863

(In millions)	June 30, 2011	December 31, 2010

Postretirement obligation	$98	$ 91
Non-current leasehold interest	337	-
Construction obligation	130	86
Other	273	288
Other non-current liabilities	$838	$ 465

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8. AIRTRAN LONG-TERM DEBT

As discussed in Note 2, in connection with the acquisition of AirTran, the Company became the holder of $1.1 billion of debt previously issued by AirTran Holdings. Subsequent to the acquisition date, holders of all of the approximately $70 million (par value) in 5.5% convertible notes due 2015 converted such securities receiving $73 million in cash and 6.2 million Southwest Airlines common shares. All of the approximately $5 million (par value) of 7.0% convertible notes due 2023 were called by Southwest and fully repaid with cash. In addition, the Company terminated AirTran's $100 million combined revolving credit and letter of credit facility. As of June 30, 2011, the following debt remained outstanding (in millions):

(In millions)	June 30, 2011	
B737 Aircraft Purchase Financing Facilities:		
Floating-rate aircraft notes payable through 2020, 1.90 percent weighted-average interest rate as of June 30, 2011	$	631
Fixed-rate aircraft notes payable through 2018, 7.02 percent weighted-average interest rate as of June 30, 2011		45
Fixed-rate B717 aircraft notes payable through 2017, 10.21 percent weighted-average interest rate as of June 30, 2011		78
5.25% convertible senior notes due 2016		120
Total long-term debt		874
Less current maturities of long-term debt		(67)
Long-term debt less current maturities	$	807

As discussed further in Note 5, a portion of the above floating-rate debt has been effectively converted to a fixed rate via interest rate swap agreements which expire between 2016 and 2020.

As of June 30, 2011, aggregate principal maturities of AirTran debt and capital leases (not including amounts associated with interest rate swap agreements and interest on capital leases) were $43 million for the remainder of 2011, $69 million in 2012, $79 million in 2013, $77 million in 2014, $91 million in 2015, $188 million in 2016, and $331 million thereafter.

At June 30, 2011, the net book value of the assets pledged as collateral for the AirTran B737 and B717 aircraft notes payable, primarily aircraft and engines, was $911 million.

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B737 Aircraft purchase financing facilities

For purposes of financing the future acquisition of B737 aircraft from Boeing, AirTran has previously entered into aircraft purchase financing facilities. As of June 30, 2011, a total of 30 aircraft were financed under these debt facilities, and AirTran has debt financing commitments from a lender to finance a significant portion of the purchase price of two B737 aircraft scheduled for delivery in 2012.

As of June 30, 2011, 27 B737 aircraft were financed under floating rate facilities. Each note is secured by a first mortgage on the aircraft to which it relates. The notes bear interest at a floating rate per annum equal to a margin plus the three or six-month LIBOR in effect at the commencement of each semi-annual or three-month period, as applicable. Payments of principal and interest under the notes are payable semi-annually or every three months as applicable. As of June 30, 2011, the remaining debt outstanding may be prepaid without penalty under all aircraft loans provided under such facilities with the exception of two aircraft loans. Under the aircraft loans for such two aircraft, the right to prepay without penalty commences on the second or third anniversary of the date such loans were made. The notes mature in years 2016 to 2020.

As of June 30, 2011, three B737 aircraft were financed under a fixed rate facility. Each note is secured by a first mortgage on the aircraft to which it relates. Payments of principal and interest under the notes are payable semi-annually. The remaining debt outstanding may be prepaid without penalty. The notes mature in years 2016 to 2018.

Fixed rate B717 aircraft notes payable

As of June 30, 2011, eight B717 aircraft were pledged as collateral for the obligations related to enhanced equipment trust certificates (EETCs). Principal and interest payments on the EETCs are due semiannually through April 2017.

5.25% Convertible senior notes

In October 2009, AirTran completed a public offering of $115 million of convertible senior notes due in 2016. The net proceeds from the offering were used for general corporate purposes. Such notes bear interest at 5.25 percent payable semi-annually, in arrears, on May 1 and November 1. As a result of the acquisition, the 5.25% convertible senior notes are convertible into AirTran conversion units of 164.042 per $1,000 in principal amount of such notes. This is equal to shares of Southwest Airlines common stock at a conversion rate of 52.6575 shares and $615.16 in cash per $1,000 in principal amount of such notes. This conversion rate is subject to adjustment under certain circumstances such as: granting of stock and cash dividends, a make-whole fundamental change of ownership provision, the issuance of rights or warrants, and/or a distribution of capital stock. Subsequent to the acquisition, holders of $5 million in principal amount elected to convert their notes. Remaining holders may convert their 5.25% convertible senior notes into shares of common stock at their option at any time. The 5.25% convertible senior notes are not redeemable at the Company’s option prior to maturity. The holders of the 5.25% convertible senior notes may require the Company to repurchase such notes, in whole or in part, for cash upon the occurrence of a fundamental change, as defined in the governing supplemental indenture, at a repurchase price of 100 percent of the principal amount plus any accrued and unpaid interest.

As a result of triggering the fundamental change of ownership provision in the 5.25% convertible senior notes and as a result of the acquisition, an embedded conversion option is deemed to exist. In accordance with applicable accounting guidance, the embedded conversion option is required to be separated and accounted for as a free-standing derivative. A fair value calculation, utilizing similar market yields and the Southwest Airlines common stock price, was performed for the debt with and without the equity to measure the equity component. The conversion option estimated at $35 million meets the definition of a “significant premium” and has thus been reclassified as permanent equity during second quarter 2011. The estimated premium associated with the notes excluding the equity feature was $10 million, and is being amortized to interest expense over the remaining life of the notes.

The dilutive effect of the shares that would be issued if the convertible notes were converted is included in the Company’s dilutive net income per share calculation, unless such conversion would be considered antidilutive. See Note 4.

9. COMMITMENTS AND CONTINGENCIES

The Company is from time to time subject to various legal proceedings and claims arising in the ordinary course of business, including, but not limited to, examinations by the IRS. The Company's management does not expect that the outcome in any of its currently ongoing legal proceedings or the outcome of any adjustments presented by the IRS, individually or collectively, will have a material adverse effect on the Company's financial condition, results of operations, or cash flow.

During 2008, the City of Dallas approved the Love Field Modernization Program (“LFMP”), a project to reconstruct Dallas Love Field (“Airport”) with modern, convenient air travel facilities. Pursuant to a Program Development Agreement (“PDA”) with the City of Dallas, and the Love Field Airport Modernization Corporation (or “LFAMC,” a Texas non-profit “local government corporation” established by the City to act on the City’s behalf to facilitate the development of the LFMP), the Company is managing this project. Major construction commenced during 2010, with completion of the project scheduled for the second half of 2014. Although subject to change, at the current time the project is expected to include the renovation of the Airport airline terminals and complete replacement of gate facilities with a new 20-gate facility, including infrastructure, systems and equipment, aircraft parking apron, fueling system, roadways and terminal curbside, baggage handling systems, passenger loading bridges and support systems, and other supporting infrastructure.

It is currently expected that the total amount spent on the LFMP project will be approximately $519 million. Although the City of Dallas has received commitments from various sources that are expected to fund portions of the LFMP project, including the Federal Aviation Administration, the Transportation Security Administration, and the City’s Aviation Fund, the majority of the funds used are expected to be from the issuance of bonds. During fourth quarter 2010, $310 million of such bonds were issued by the LFAMC, and the Company has guaranteed principal and interest payments on the bonds. Depending on funding needs and the timing of these funds from other sources, an additional tranche of bonds will likely be issued prior to the completion of the LFMP project.

The Company has agreed to manage the majority of the LFMP project, and as a result, has evaluated its ongoing accounting requirements in consideration of accounting guidance provided for lessees involved in asset construction. The Company has recorded and will continue to record an asset and corresponding obligation for the cost of the LFMP project as the construction of the facility occurs. As of June 30, 2011, the Company had recorded construction cost incurred of $130 million as both an asset as a component of Ground property and equipment and a corresponding liability as a component of Other non-current liabilities, respectively, in its unaudited Condensed Consolidated Balance Sheet. Upon completion of the LFMP project, it is expected the Company would begin depreciating the assets over their estimated useful lives, and would reduce the corresponding liabilities primarily through the Company’s airport rental payments to the City of Dallas.

Restricted Cash

As of June 30, 2011, the Company had a restricted cash balance of $67 million, which is classified as a component of other assets. See Note 7. Restricted cash consists primarily of amounts escrowed related to aircraft leases, letters of credit for airports and insurance, derivative financial instruments, and cash escrowed for future interest payments.

Unsecured Revolving Credit Facility

On April 28, 2011, the Company entered into a new $800 million unsecured revolving credit facility expiring in April 2016 and terminated its previous facility, which would have expired in October 2012. Other than an increased borrowing capacity, this new facility is substantially the same as the previous facility. At the Company's option, interest on the new facility can be calculated on one of several different bases. The new facility also contains a financial covenant requiring a minimum coverage ratio of adjusted pre-tax income to fixed obligations, as defined. As of June 30, 2011, the Company was in compliance with this covenant and there were no amounts outstanding under the revolving credit facility.

10. FAIR VALUE MEASUREMENTS

Accounting standards pertaining to fair value measurements establish a three-tier fair value hierarchy, which prioritizes the inputs used in measuring fair value. These tiers include: Level 1, defined as observable inputs such as quoted prices in active markets; Level 2, defined as inputs other than quoted prices in active markets that are either directly or indirectly observable; and Level 3, defined as unobservable inputs in which little or no market data exists, therefore requiring an entity to develop its own assumptions.

As of June 30, 2011, the Company held certain items that are required to be measured at fair value on a recurring basis. These included cash equivalents, restricted cash, short-term investments (primarily treasury bills, commercial paper, and certificates of deposit), certain noncurrent investments, interest rate derivative contracts, fuel derivative contracts, and available-for-sale securities. The majority of the Company's short-term investments consist of instruments classified as Level 1. However, the Company has certificates of deposit and commercial paper that are classified as Level 2, due to the fact that the fair value for these instruments is determined utilizing observable inputs in non-active markets. Noncurrent investments consist of certain auction rate securities, primarily those collateralized by student loan portfolios, which are guaranteed by the U.S. Government and restricted cash. See Note 9. Other available-for-sale securities primarily consist of investments associated with the Company's excess benefit plan.

The Company's fuel and interest rate derivative instruments consist of over-the-counter (OTC) contracts, which are not traded on a public exchange. Fuel derivative instruments include swaps, as well as different types of option contracts, whereas interest rate derivatives consist solely of swap agreements. See Note 5 for further information on the Company's derivative instruments and hedging activities. The fair values of swap contracts are determined based on inputs that are readily available in public markets or can be derived from information available in publicly quoted markets. Therefore, the Company has categorized these swap contracts as Level 2. The Company determines the value of option contracts utilizing a standard option pricing model based on inputs that are either readily available in public markets, can be derived from information available in publicly quoted markets, or are quoted by financial institutions that trade these contracts. Because certain of the inputs used to determine the fair value of option contracts are unobservable (principally implied volatility), the Company has categorized these option contracts as Level 3. The Company also considers counterparty credit risk and its own credit risk in its determination of all estimated fair values. The Company has consistently applied these valuation techniques in all periods presented and believes it has obtained the most accurate information available for the types of derivative contracts it holds.

The Company's investments associated with its excess benefit plan consist of mutual funds that are publicly traded and for which market prices are readily available. This plan is a deferred compensation plan designed to hold Employee contributions in excess of limits established by Section 415 of the Internal Revenue Code. This plan is funded through qualifying Employee contributions and it impacts the Company's earnings through changes in the fair value of plan assets.

All of the Company's auction rate security instruments, totaling $84 million at June 30, 2011, are classified as available for sale securities and are reflected at estimated fair value in the unaudited Condensed Consolidated Balance Sheet. In periods when an auction process successfully took place every 30-35 days, quoted market prices would be readily available, which would qualify the securities as Level 1. However, due to events in credit markets beginning during first quarter 2008, the auction events for these remaining instruments failed, and have continued to fail through the current period. Therefore, the Company determines the estimated fair values of these securities utilizing a discounted cash flow analysis or other type of valuation model. The Company has performed, and routinely updates, a valuation for each of its auction rate security instruments, considering, among other items, the collateralization underlying the security investments, the expected future cash flows, including the final maturity, associated with the securities, and estimates of the next time the security is expected to have a successful auction or return to full par value.

In association with its estimate of fair value related to auction rate security instruments as of June 30, 2011, the Company has recorded a temporary unrealized decline in fair value of $12 million, with an offsetting entry to AOCI. The Company continues to believe that this decline in fair value is due entirely to market liquidity issues, because the underlying assets for the majority of these auction rate securities held by the Company are currently rated investment grade by Moody's, Standard and Poor's, and Fitch and are almost entirely backed by the U.S. Government. The range of maturities for the Company's auction rate securities are from 7 years to 36 years. Considering the relative insignificance of these securities in comparison to the Company's liquid assets and other sources of liquidity, the Company has no current intention of selling these securities nor does it expect to be required to sell these securities before a recovery in their cost basis. At the time of the first failed auctions during first quarter 2008, the Company held a total of $463 million in auction rate securities and, since that time, has been able to sell $367 million of these instruments at par value.

The Company remains in discussions with its remaining counterparties to determine whether mutually agreeable decisions can be reached regarding the effective repurchase of its remaining auction rate securities. The Company continues to earn interest on its outstanding auction rate security instruments. Any future fluctuation in fair value related to these instruments that the Company deems to be temporary, including any recoveries of previous temporary write-downs, would be recorded to AOCI. If the Company determines that any future valuation adjustment is other than temporary, it will record a charge to earnings as appropriate.

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Southwest Airlines Co.
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The following tables present the Company's assets and liabilities that are measured at fair value on a recurring basis at June 30, 2011 and December 31, 2010:

		Fair value measurements at reporting date using		
Description	June 30, 2011	Quoted prices in active markets for identical assets (Level 1)	Significant other observable inputs (Level 2)	Significant unobservable inputs (Level 3)
Assets		(in millions)		
Cash equivalents				
Cash equivalents (a)	$ 1,407	$ 1,407	$ -	$ -
Commercial paper	135	-	135	-
Certificates of deposit	53	-	53	-
Short-term investments:				
Treasury bills	2,404	2,404	-	-
Certificates of deposit	291	-	291	-
Commercial paper	84	-	84	-
Noncurrent investments (b)				
Auction rate securities	84	-	-	84
Certificates of deposit	25	-	25	-
Restricted Cash	67	67	-	-
Interest rate derivatives (see Note 5)	34	-	34	-
Fuel derivatives:				
Swap contracts (d)	283	-	283	-
Option contracts (d)	1,333	-	-	1,333
Swap contracts (c)	20	-	20	-
Option contracts (c)	66	-	-	66
Other available-for-sale securities	5	-	-	5
Total assets	$ 6,291	$ 3,878	$ 925	$ 1,488
Liabilities				
Fuel derivatives:				
Swap contracts (d)	$ (572)	$ -	$ (572)	$ -
Option contracts (d)	(491)	-	-	(491)

Swap contracts (c)	(211)	-	(211)	-
Option contracts (c)	(61)	-	-	(61)
Interest rate derivatives (see Note 5)	(80)	-	(80)	-
Total liabilities	$ (1,415)	$ -	$ (863)	$ (552)

(a) Cash equivalents is primarily composed of money market investments.

(b) Noncurrent investments are included in Other assets in the unaudited Condensed Consolidated Balance Sheet.

(c) In the unaudited Condensed Consolidated Balance Sheet, amounts are presented as a net liability, and are also net of cash collateral provided to counterparties. See Note 5.

(d) In the unaudited Condensed Consolidated Balance Sheet, amounts are presented as a net asset, and are also net of cash collateral received from or provided to counterparties. See Note 5.

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Southwest Airlines Co.
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Description	December 31, 2010	Fair value measurements at reporting date using: Quoted prices in active arkets for identical assets (Level 1)	Significant other observable inputs (Level 2)	Significant unobservable inputs (Level 3)
Assets		(in millions)		
Cash equivalents	$ 1,261	$ 1,261	$ -	$ -
Short-term investments:				
Treasury bills	2,010	2,010	-	-
Certificates of deposit	267	-	267	-
Noncurrent investments (a)	93	-	-	93
Interest rate derivatives	73	-	73	-
Fuel derivatives:				
Swap contracts (b)	33	-	33	-
Option contracts(b)	233	-	-	233
Swap contracts (c)	286	-	286	-
Option contracts(c)	788	-	-	788
Other available-for-sale securities	39	34	-	5
Total assets	$ 5,083	$ 3,305	$ 659	$ 1,119
Liabilities				
Fuel derivatives:				
Swap contracts (b)	$ (387)	$ -	$ (387)	$ -
Option contracts(b)	(119)	-	-	(119)
Swap contracts (c)	(476)	-	(476)	-
Option contracts(c)	(216)	-	-	(216)
Interest rate derivatives	(4)	-	(4)	-
Total liabilities	$ (1,202)	$ -	$ (867)	$ (335)

(a) Auction rate securities included in Other assets in the unaudited Condensed Consolidated Balance Sheet.

(b) In the unaudited Condensed Consolidated Balance Sheet, amounts are presented as a net liability, and are also net of cash collateral provided to counterparties. See Note 5.

(c) In the unaudited Condensed Consolidated Balance Sheet, amounts are presented as a net asset, and are also net of cash collateral received from counterparties. See Note 5.

The Company had no transfers of assets or liabilities between any of the above levels during the six months ended June 30, 2011. The following tables present the Company's activity for items measured at fair value on a recurring basis using significant unobservable inputs (Level 3) for the three and six months ended June 30, 2011:

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Southwest Airlines Co.
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	Fair value measurements using significant unobservable inputs (Level 3)			
(in millions)	Fuel derivatives	Auction rate securities	Other securities	Total
Balance at March 31, 2011	$1,101	$93	$5	$1,199
Total gains or (losses) (realized or unrealized)				
Included in earnings	45	-	-	45
Included in other comprehensive income	(309)	5	-	(304)
Purchases	270	-	-	270
Sales	(173)	(14)	-	(187)
Settlements	(88)	-	-	(88)
Balance at June 30, 2011	$846	$84	(a) $5	$935
The amount of total gains or (losses) for the period included in earnings attributable to the change in unrealized gains or losses relating to assets still held at June 30, 2011	$54	$-	$-	$54

(a) Included in Other assets in the unaudited Condensed Consolidated Balance Sheet.

	Fair value measurements using significant unobservable inputs (Level 3)			
(in millions)	Fuel derivatives	Auction rate securities	Other securities	Total
Balance at December 31, 2010	$686	$93	$5	$784
Total gains or (losses) (realized or unrealized)				
Included in earnings	197	-	-	197
Included in other comprehensive income	184	5	-	189

Purchases	321	-	-	321
Sales	(406)	(14)	-	(420)
Settlements	(136)	-	-	(136)
Balance at June 30, 2011	$846	$84	(a)$5	$935
The amount of total gains or (losses) for the period included in earnings attributable to the change in unrealized gains or losses relating to assets still held at June 30, 2011	$209	$-	$-	$209

(a) Included in Other assets in the unaudited Condensed Consolidated Balance Sheet.

All settlements from fuel derivative contracts that are deemed "effective" are included in Fuel and oil expense in the period the underlying fuel is consumed in operations. Any "ineffectiveness" associated with hedges, including amounts that settled in the current period (realized), and amounts that will settle in future periods (unrealized), is recorded in earnings immediately, as a component of Other (gains) losses, net. See Note 5 for further information on hedging. Any gains and losses (realized and unrealized) related to other investments are reported in Other operating expenses, and were immaterial for the three and six months ended June 30, 2011 and 2010.

The carrying amounts and estimated fair values of the Company's (including AirTran) long-term debt (including current maturities) at June 30, 2011 are contained in the below table. The estimated fair values of publicly held long-term debt were based on quoted market prices.

(In millions)	Carrying value	Estimated fair value
10.5% Notes due 2011	$ 402	$ 414
French credit agreements due 2012	11	11
6.5% Notes due 2012	394	407
5.25% Notes due 2014	350	378
5.75% Notes due 2016	314	344
5.25% Convertible notes due 2016	120	165
5.125% Notes due 2017	300	320
French credit agreements due 2017	69	69
Fixed rate B717 aircraft notes payable through 2017 - 10.21%	78	91
Fixed rate B737 aircraft notes payable through 2018 - 7.02%	45	48
Term loan agreement due 2019 - 6.64%	283	295
Term loan agreement due 2019 - 6.94%	110	120
Term loan agreement due 2020 - 5.223%	505	467
Floating rate B737 aircraft notes payable through 2020 - 1.90%	631	631
Pass through certificates due 2022	420	459
7.375% Debentures due 2027	118	127

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

Relevant Southwest comparative operating statistics for the three and six months ended June 30, 2011 and 2010 are included below. As discussed in Note 2 to the unaudited Condensed Consolidated Financial Statements, these statistics include the operations of AirTran for May and June 2011, but include the operations of Southwest only prior to May 2, 2011.

	Three months ended June 30,		
	2011	2010	Change
Revenue passengers carried	27,114,480	22,883,422	18.5%
Enplaned passengers	33,430,914	27,554,201	21.3%
Revenue passenger miles (RPMs) (000s)	25,883,849	20,206,229	28.1%
Available seat miles (ASMs) (000s)	31,457,412	25,471,845	23.5%
Load factor(1)	82.3%	79.3%	3.0pts
Average length of passenger haul (miles)	955	883	8.2%
Average aircraft stage length (miles)	685	650	5.4%
Trips flown	340,768	287,222	18.6%
Average passenger fare	$ 142.94	$ 131.82	8.4%
Passenger revenue yield per RPM (cents)	14.97	14.93	0.3%
Operating revenue per ASM (cents)	13.15	12.44	5.7%
Passenger revenue per ASM (cents)	12.32	11.84	4.1%
Operating expenses per ASM (cents)	12.49	11.01	13.4%
Operating expenses per ASM, excluding fuel (cents)(2)	7.63	7.35	3.8%
Fuel costs per gallon, including fuel tax	$ 3.30	$ 2.50	32.0%
Fuel costs per gallon, including fuel tax, economic	$ 3.28	$ 2.37	38.4%
Fuel consumed, in gallons (millions)	462	372	24.2%
Active fulltime equivalent Employees	43,805	34,636	26.5%
Aircraft in service at period-end(3)	694	544	27.6%

(1) Revenue passenger miles divided by available seat miles.
(2) See the following reconciliation of GAAP to non-GAAP financial measures.
(3) Includes leased aircraft and excludes aircraft that are not available for service or are in storage, held for sale, or for return to the lessor.

	Six months ended June 30,		
	2011	2010	Change
Revenue passengers carried	48,229,595	42,860,257	12.5%
Enplaned passengers	59,030,032	51,248,665	15.2%
Revenue passenger miles (RPMs) (000s)	45,079,735	37,367,943	20.6%
Available seat miles (ASMs) (000s)	55,963,085	48,091,305	16.4%
Load factor(1)	80.6%	77.7%	2.9pts
Average length of passenger haul (miles)	935	872	7.2%
Average aircraft stage length (miles)	672	642	4.7%
Trips flown	614,591	549,114	11.9%
Average passenger fare	$ 141.29	$ 128.60	9.9%
Passenger revenue yield per RPM (cents)	15.12	14.75	2.5%
Operating revenue per ASM (cents)	12.93	12.06	7.2%
Passenger revenue per ASM (cents)	12.18	11.46	6.3%
Operating expenses per ASM (cents)	12.36	11.19	10.5%
Operating expenses per ASM, excluding fuel (cents)(2)	7.77	7.54	3.1%

Fuel costs per gallon, including fuel tax	$ 3.13	$ 2.49	25.7%
Fuel costs per gallon, including fuel tax, economic	$ 3.14	$ 2.35	33.6%
Fuel consumed, in gallons (millions)	817	701	16.5%
Active fulltime equivalent Employees	43,805	34,636	26.5%
Aircraft in service at period-end(3)	694	544	27.6%

(1) Revenue passenger miles divided by available seat miles.
(2) See the following reconciliation of GAAP to non-GAAP financial measures.
(3) Includes leased aircraft and excludes aircraft that are not available for service or are in storage, held for sale, or for return to the lessor.

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Reconciliation of Reported Amounts to non-GAAP Financial Measures (unaudited) (in millions, except per share and per ASM amounts)

Three months ended June 30,			Six months ended June 30,		
2011	2010	Percent Change	2011	2010	Percent Change