

SOUTHWEST AIRLINES CO
Form 10-K
February 07, 2018

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

FORM 10-K

(Mark One)

ANNUAL REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934
For the fiscal year ended December 31, 2017

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 (IRS Employer
incorporation or organization) 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

Securities registered pursuant to Section 12(b) of the Act:

Title of Each Class	Name of Each Exchange on Which Registered
Common Stock (\$1.00 par value)	New York Stock Exchange

Securities registered pursuant to Section 12(g) of the Act:

None

Indicate by check mark if the registrant is a well-known seasoned issuer, as defined in Rule 405 of the Securities Act. Yes No

Indicate by check mark if the registrant is not required to file reports pursuant to Section 13 or Section 15(d) of the Act. Yes No

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

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

Indicate by check mark if disclosure of delinquent filers pursuant to Item 405 of Regulation S-K is not contained herein, and will not be contained, to the best of registrant's knowledge, in definitive proxy or information statements incorporated by reference in Part III of this Form 10-K or any amendment to this Form 10-K.

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

Large accelerated filer Accelerated filer
Non-accelerated filer Smaller reporting company
Emerging growth company

If an emerging growth company, indicate by check mark if the registrant has elected not to use the extended transition period for complying with any new or revised financial accounting standards provided pursuant to Section 13(a) of the Exchange Act.

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

The aggregate market value of the common stock held by non-affiliates of the registrant was approximately \$37,211,057,645 computed by reference to the closing sale price of the common stock on the New York Stock Exchange on June 30, 2017, the last trading day of the registrant's most recently completed second fiscal quarter. Number of shares of common stock outstanding as of the close of business on February 5, 2018: 587,950,973 shares
DOCUMENTS INCORPORATED BY REFERENCE

Portions of the Definitive Proxy Statement for the Company's Annual Meeting of Shareholders to be held May 16, 2018, are incorporated into Part III of this Annual Report on Form 10-K.

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PART I

Item 1. Business

Company Overview

Southwest Airlines Co. (the "Company" or "Southwest") operates Southwest Airlines, a major passenger airline that provides scheduled air transportation in the United States and near-international markets. For the 45th consecutive year, the Company was profitable, earning \$3.5 billion in net income.

Southwest commenced service on June 18, 1971, with three Boeing 737 aircraft serving three Texas cities: Dallas, Houston, and San Antonio. At December 31, 2017, Southwest operated a total of 706 Boeing 737 aircraft and served 100 destinations in 40 states, the District of Columbia, the Commonwealth of Puerto Rico, and ten near-international countries: Mexico, Jamaica, The Bahamas, Aruba, Dominican Republic, Costa Rica, Belize, Cuba, the Cayman Islands, and Turks and Caicos.

The Company expanded its international footprint during 2017, with the commencement of service to Owen Roberts International Airport in Grand Cayman and Providenciales International Airport in Turks and Caicos, both from Fort Lauderdale-Hollywood International Airport. The Company also commenced service to Cincinnati/Northern Kentucky International Airport in 2017, giving the Company's Customers access to a full complement of the top 50 markets across the 48 contiguous United States.

During 2017, the Company announced plans to begin selling tickets in 2018 for service to Hawaii, subject to requisite governmental approvals, including approval from the Federal Aviation Administration ("FAA") for Extended Operations ("ETOPS"), a regulatory requirement to operate between the U.S. mainland and the Hawaiian Islands. The Company further announced its decision to cease service at Bishop International Airport in Flint, Michigan, with the last day of service on June 6, 2018. In January 2018, the Company announced its intent to begin service at a new commercial aircraft facility at Paine Field in Everett, Washington, scheduled to be completed in 2018.

In 2017, the Company completed its deployment of a new single reservation system, the largest technology project in the Company's history. The new reservation system was designed to improve flight scheduling and inventory management, enable revenue enhancements, support additional international growth, and enable other foundational and operational capabilities.

Further, in 2017, the Company became the first airline in North America to offer scheduled service utilizing Boeing's new, more fuel efficient, 737 MAX 8 aircraft. The Company also retired its remaining Boeing 737-300 aircraft. Based on the most recent data available from the U.S. Department of Transportation (the "DOT"), as of September 30, 2017, Southwest was the largest domestic air carrier in the United States, as measured by the number of domestic originating passengers boarded.

Industry

The airline industry has historically been an extremely volatile industry subject to numerous challenges. Among other things, it has been cyclical, energy intensive, labor intensive, capital intensive, technology intensive, highly regulated, heavily taxed, and extremely competitive. The airline industry has also been particularly susceptible to detrimental events such as acts of terrorism, poor weather, and natural disasters.

The U.S. airline industry benefited from modest economic growth during 2017 and was further aided by a relatively stable fuel environment. In recent years, the U.S. airline industry, including Southwest, has increased available seat miles (also referred to as "capacity," an available seat mile is one seat, empty or full, flown one mile and is a measure of space available to carry passengers in a given period), and has increased the number of seats per trip (or "gauge") through slimline seat retrofits and the use of larger aircraft. Strategic capacity increases are expected to continue in 2018.

In 2017, the airline industry continued to be impacted by the significant growth of "Ultra-Low Cost Carriers" ("ULCCs"). ULCCs offer "unbundled" service offerings, which enable them to appeal to price-sensitive travelers through promotion to consumers of an extremely low relative base fare for a seat, while separately charging for related services and products. In response, certain major U.S. airlines (sometimes referred to as "legacy" or "network" carriers) have introduced new fare products, such as a "Basic Economy" product. The Basic Economy product provides for a lower

base fare to compete with a ULCC base fare, but includes significant additional restrictions on amenities such as seat assignments (including restrictions on group and family seating), order of boarding, checked baggage and use of overhead bin space, flight changes and refunds, and eligibility for upgrades. Also in response to ULCC pricing, some legacy carriers have removed their fare floors for certain routes, leading to lower fares across the industry. Conversely, some legacy carriers offer a "Premium Economy" fare that targets consumers willing to pay extra for additional amenities such as more favorable seating options in segmented aircraft.

Company Operations

Route Structure

Southwest principally provides point-to-point service, rather than the "hub-and-spoke" service provided by most major U.S. airlines. The hub-and-spoke system concentrates most of an airline's operations at a limited number of central hub cities and serves most other destinations in the system by providing one-stop or connecting service through a hub. By not concentrating operations through one or more central transfer points, Southwest's point-to-point route structure has allowed for more direct nonstop routing than hub-and-spoke service. Approximately 76 percent of the Company's Customers flew nonstop during 2017, and, as of December 31, 2017, Southwest served 675 nonstop city pairs. Southwest's point-to-point service has also enabled it to provide its markets with frequent, conveniently timed flights and low fares. For example, Southwest currently offers 19 weekday roundtrips between Dallas Love Field and Houston Hobby, 12 weekday roundtrips between Burbank and Oakland, 12 weekday roundtrips between San Diego and San Jose, eight weekday roundtrips between Denver and Chicago Midway, and 10 weekday roundtrips between Los Angeles International and Las Vegas.

Southwest complements its high-frequency short-haul routes with long-haul nonstop service between markets such as Los Angeles and Nashville, Las Vegas and Orlando, San Diego and Baltimore, Houston and New York LaGuardia, and Oakland and Baltimore. During 2017, the Company introduced the Boeing 737 Max 8 to its fleet and continued to incorporate the Boeing 737-800 aircraft into its fleet, both of which offer significantly more Customer seating capacity than the Company's other aircraft. This has enabled the Company to more economically serve long-haul routes, as well as high-demand, slot-controlled, and gate-restricted airports, by adding seats for such routes without increasing the number of flights (a "slot" is the right of an air carrier, pursuant to regulations of the FAA, to operate a takeoff or landing at a specific time at certain airports). For 2017, the Company's average aircraft trip stage length was 754 miles, with an average duration of approximately 2.0 hours, as compared with an average aircraft trip stage length of 760 miles and an average duration of approximately 2.0 hours in 2016.

The Company continued its focus on California in 2017, and continues to invest significant resources to solidify its leadership position in California, including the planned addition of new domestic and international destination options and flights for California Customers, as well as additional marketing programs, loyalty incentives, and local outreach efforts designed to retain, engage, and acquire Customers. Based on the most recent data available from the DOT, for the year ending October 31, 2017, Southwest carried more domestic Revenue Passengers to, from, and within California than any other airline.

The Company ended 2017 with international service to 14 destinations through 16 international gateway cities within the 48 contiguous United States. During 2017, the Company commenced international service out of Oakland, San Diego, Nashville, and St. Louis. In addition, the Company announced commencement in 2018 of international service out of Indianapolis, San Jose, Sacramento, Columbus, New Orleans, Pittsburgh, and Raleigh-Durham. The Company has also concentrated its service to Cuba in Havana and ceased operations during 2017 to Varadero and Santa Clara, Cuba.

In 2017, to further support its near-international operations, the Company opened a new five-gate international concourse at Fort Lauderdale-Hollywood International Airport (FLL). The Company expanded its international flight schedule for South Florida to a total of nine international nonstop destinations including Montego Bay, Jamaica; Belize City, Belize; Cancun, Mexico; Grand Cayman; Havana, Cuba; Nassau, The Bahamas; San Jose, Costa Rica; Punta Cana, Dominican Republic; and Turks and Caicos. Additional information regarding the Company's involvement with construction of the new concourse at FLL is provided below under "Management's Discussion and Analysis of Financial Condition and Results of Operations" and in Note 4 to the Consolidated Financial Statements.

Approximately \$595 million, approximately \$383 million, and approximately \$287 million of the Company's operating revenues in 2017, 2016, and 2015, respectively, were attributable to foreign operations. The remainder of the Company's operating revenues, approximately \$20.6 billion, approximately \$20.0 billion, and approximately \$19.5 billion in 2017, 2016, and 2015, respectively, were attributable to domestic operations. The Company's assets are not allocated to a geographic area because the Company's tangible assets primarily consist of flight equipment, the majority of which are interchangeable and are deployed systemwide, with no individual aircraft dedicated to any specific route or region.

Cost Structure

A key component of the Company's business strategy is its focus on cost discipline and profitably charging competitively low fares. Adjusted for stage length, the Company has lower unit costs, on average, than the majority of major domestic carriers. The Company's strategy includes the use of a single aircraft type, the Boeing 737, the Company's operationally efficient point-to-point route structure, and its highly productive Employees. Southwest's use of a single aircraft type allows for simplified scheduling, maintenance, flight operations, and training activities. Southwest's point-to-point route structure includes service to and from many secondary or downtown airports such as Dallas Love Field, Houston Hobby, Chicago Midway, Baltimore-Washington International, Burbank, Manchester, Oakland, San Jose, Providence, and Ft. Lauderdale-Hollywood. These conveniently located airports are typically less congested than other airlines' hub airports, which has contributed to Southwest's ability to achieve high asset utilization because aircraft can be scheduled to minimize the amount of time they are on the ground. This, in turn, has reduced the number of aircraft and gate facilities that would otherwise be required and allows for high Employee productivity (lower headcount per aircraft).

The Company's focus on controlling costs also includes a continued commitment to pursuing, implementing, and enhancing initiatives to reduce fuel consumption and improve fuel efficiency. Fuel and oil expense remained the Company's second largest operating cost in 2017. Although 2017 fuel prices were moderately higher than 2016 fuel prices, as evidenced by the table below, energy prices can fluctuate significantly in a relatively short amount of time. The table below shows the Company's average cost of jet fuel for each year beginning in 2003 and during each quarter of 2017.

Year	Cost (Millions)	Average Cost Per Gallon	Percentage of Operating Expenses	
2003	\$ 920	\$ 0.80	16.5	%
2004	\$ 1,106	\$ 0.92	18.1	%
2005	\$ 1,470	\$ 1.13	21.4	%
2006	\$ 2,284	\$ 1.64	28.0	%
2007	\$ 2,690	\$ 1.80	29.7	%
2008	\$ 3,713	\$ 2.44	35.1	%
2009	\$ 3,044	\$ 2.12	30.2	%
2010	\$ 3,620	\$ 2.51	32.6	%
2011	\$ 5,644	\$ 3.19	37.7	%
2012	\$ 6,120	\$ 3.30	37.2	%
2013	\$ 5,763	\$ 3.16	35.1	%
2014	\$ 5,293	\$ 2.93	32.3	%
2015	\$ 3,616	\$ 1.90	23.0	%
2016	\$ 3,647	\$ 1.82	21.9	%
2017	\$ 3,940	\$ 1.92	22.3	%
First Quarter 2017	\$ 922	\$ 1.89	21.8	%
Second Quarter 2017	\$ 990	\$ 1.84	22.0	%
Third Quarter 2017	\$ 1,003	\$ 1.92	22.6	%
Fourth Quarter 2017	\$ 1,025	\$ 2.04	22.8	%

The Company focuses on reducing fuel consumption and improving fuel efficiency through fleet modernization and other fuel initiatives. For example, during 2017, the Company continued to replace its older aircraft with newer aircraft that are less maintenance intensive and more fuel efficient. The Company retired all remaining Boeing 737-300 aircraft

from its fleet in September 2017 and began scheduled service with its first Boeing 737 MAX 8 aircraft in October 2017. The Boeing 737 MAX 8 is expected to significantly reduce fuel use and CO2 emissions, as compared with the Company's other aircraft. The Company ended 2017 with 13 Boeing 737 MAX 8 aircraft in its fleet. The Company's fleet composition and delivery schedules are discussed in more detail below under "Properties - Aircraft." The Company has also undertaken a number of other fuel conservation initiatives which are discussed in detail under "Regulation - Environmental Regulation."

To illustrate the results of the Company's efforts to reduce fuel consumption and improve fuel efficiency, the table below sets forth the Company's available seat miles produced per fuel gallon consumed over the last five years: