

SOUTHWEST AIRLINES CO  
Form 10-K  
February 05, 2019

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, 2018

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 every Interactive Data File required to be submitted 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 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,"

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"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 \$29,086,256,077 computed by reference to the closing sale price of the common stock on the New York Stock Exchange on June 30, 2018, 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 1, 2019: 552,688,849 shares

DOCUMENTS INCORPORATED BY REFERENCE

Portions of the Definitive Proxy Statement for the Company's Annual Meeting of Shareholders to be held May 15, 2019, 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. Southwest commenced service on June 18, 1971, with three Boeing 737 aircraft serving three Texas cities: Dallas, Houston, and San Antonio. At December 31, 2018, Southwest operated a total of 750 Boeing 737 aircraft and served 99 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 is continuing its efforts towards its planned inaugural service to Hawaii in 2019, subject to requisite governmental approvals, including approval from the Federal Aviation Administration (the "FAA") for Extended Operations ("ETOPS"), a regulatory requirement to operate between the U.S. mainland and the Hawaiian Islands. The Company has announced its intent to serve Honolulu International Airport, Lihue Airport, Kona International Airport at Keahole, and Kahului Airport from four initial California cities: Oakland, San Diego, San Jose, and Sacramento. In June 2018, the Company ceased service at Bishop International Airport in Flint, Michigan. The Company has further announced its decision to cease service at Benito Juárez Mexico City International Airport, with the last day of service scheduled on March 30, 2019.

Based on the most recent data available from the U.S. Department of Transportation (the "DOT"), as of June 30, 2018, 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 economic recessions, acts of terrorism, poor weather, and natural disasters.

The U.S. airline industry continued to benefit from modest economic growth during 2018, despite a very competitive domestic fare environment. The airline industry also experienced a less stable fuel environment in 2018, as compared with recent years, with year-over-year fuel prices significantly higher throughout most of 2018, before easing in fourth quarter 2018. 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 also increased the number of seats per trip through slimline seat retrofits and the use of new and larger aircraft. Despite recent fuel price volatility, strategic capacity increases are expected to continue in 2019.

In 2018, the airline industry continued to be impacted by the significant growth of "Ultra-Low Cost Carriers" ("ULCCs"). ULCCs provide "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 have introduced and have continued to expand new cabin segmentation 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 may include 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 competitive ULCC pricing, some carriers removed their fare floors for certain routes, leading to a lower fare offering across the industry. Further, to better derive revenue from customers, some 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. The Company continues to focus on adding depth to schedule offerings in certain key cities, which is expected to benefit operational efficiency and give Customers additional options to reach their final destination. Approximately 77 percent of the Company's Customers flew nonstop during 2018, and, as of December 31, 2018, Southwest served 704 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 20 weekday roundtrips between Dallas Love Field and Houston Hobby, 12 weekday roundtrips between Burbank and Oakland, 15 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 Oakland and Orlando, Los Angeles and Nashville, Las Vegas and Orlando, San Diego and Baltimore, Houston and New York LaGuardia, Los Angeles and Tampa, Oakland and Baltimore, and San Diego and Newark. During 2018, the Company continued to incorporate the Boeing 737 MAX 8 and 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). The Company plans to continue its route network and schedule optimization efforts through the addition of new markets and itineraries, while also pruning less profitable flights from its schedule. For 2018, the Company's average aircraft trip stage length was 757 miles, with an average duration of approximately 2.0 hours, as compared with an average aircraft trip stage length of 754 miles and an average duration of approximately 2.0 hours in 2017.

The Company continued its focus on California in 2018, 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 marketing programs and local outreach efforts designed to retain, engage, and acquire Customers. For example, Hawaii is an attractive leisure destination for the Company's California Customers, and the Company has announced its intent to serve Honolulu International Airport, Lihue Airport, Kona International Airport at Keahole, and Kahului Airport from four initial California cities: Oakland, San Diego, San Jose, and Sacramento. The Company is scheduled to offer a record 800 departures from California on peak flying days in the summer of 2019 and, based on the most recent data available from the DOT, for the year ended June 30, 2018, Southwest carried more California travelers to, from, and within California than any other airline.

In order to complement the Company's network, during 2018, the Company entered into an agreement with Alaska Airlines to lease 12 slots at New York's LaGuardia Airport and eight slots at Washington Reagan National Airport through 2028.

The Company ended 2018 with international service to 14 destinations through 23 international gateway cities within the 48 contiguous United States. During 2018, the Company commenced international service out of Indianapolis, San Jose, Sacramento, Columbus, New Orleans, Pittsburgh, and Raleigh-Durham. In addition, Southwest Airlines Cargo<sup>®</sup> began shipping cargo to select international destinations beginning in 2018, including Mexico City, Cancun, Cabo San Lucas/Los Cabos, Puerto Vallarta, Montego Bay, and San Jose, Costa Rica.

### 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 the largest 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-

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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 for 2018, which increased compared with 2017, primarily due to higher market jet 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 2018.

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*	\$ 3,193	\$ 2.22	31.2	%
2010*	\$ 3,755	\$ 2.61	33.4	%
2011*	\$ 5,751	\$ 3.25	38.2	%
2012*	\$ 6,156	\$ 3.32	37.3	%
2013*	\$ 5,823	\$ 3.19	35.3	%
2014*	\$ 5,355	\$ 2.97	32.6	%
2015*	\$ 3,740	\$ 1.96	23.6	%
2016*	\$ 3,801	\$ 1.90	22.7	%
2017*	\$ 4,076	\$ 1.99	23.0	%
2018	\$ 4,616	\$ 2.20	24.6	%
First Quarter 2018	\$ 1,018	\$ 2.07	23.5	%
Second Quarter 2018	\$ 1,202	\$ 2.21	25.2	%
Third Quarter 2018	\$ 1,205	\$ 2.24	25.2	%
Fourth Quarter 2018	\$ 1,192	\$ 2.25	24.4	%

\*Effective as of January 1, 2018, the Company adopted Accounting Standards Update ("ASU") No. 2017-12, Targeted Improvements to Accounting for Hedging Activities, and ASU No. 2017-07, Improving the Presentation of Net Periodic Pension Cost and Net Periodic Postretirement Benefit Cost. See Note 2 to the Consolidated Financial Statements for further information.

The Company focuses on reducing fuel consumption and improving fuel efficiency through fleet modernization and other fuel initiatives. For example, the Company previously retired all Boeing 737-300 aircraft from its fleet and has begun scheduled service with the Boeing 737 MAX 8 aircraft. The Boeing 737 MAX 8 is expected to continue to significantly reduce fuel use and CO<sup>2</sup> emissions, as compared with the Company's other aircraft. The Company added 18 Boeing 737 MAX 8 aircraft to its fleet in 2018 and ended 2018 with 31 Boeing 737 MAX 8 aircraft in its fleet. In 2019, the Company expects to continue its fleet modernization initiative through the scheduled delivery of an additional 37 Boeing 737 MAX 8 aircraft and the Company's initial delivery of seven Boeing 737 MAX 7 aircraft. 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."

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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:

	Year ended December 31,				
	2018	2017	2016	2015	2014
Available seat miles per fuel gallon consumed	76.3	75.2	74.4	73.9	72.8

The Company also enters into fuel derivative contracts to manage its risk associated with significant increases in fuel prices. The Company's fuel hedging activities, as well as the risks associated with high and/or volatile fuel prices, are discussed in more detail below under "Risk Factors," "Management's Discussion and Analysis of Financial Condition and Results of Operations," and Note 10 to the Consolidated Financial Statements.

Salaries, wages, and benefits expense constituted approximately 41 percent of the Company's operating expenses during 2018 and was the Company's largest operating cost. The Company's ability to control labor costs is limited by the terms of its collective-bargaining agreements, and increased labor costs have negatively impacted the Company's low-cost competitive position. The Company's labor costs, and risks associated therewith, are discussed in more detail below under "Risk Factors" and "Management's Discussion and Analysis of Financial Condition and Results of Operations."

#### Fare Structure

##### General

Southwest offers a relatively simple fare structure that features competitive fares and product benefits, including unrestricted fares, as well as lower fares available on a restricted basis. Southwest fare products include three major categories: "Wanna Get Away<sup>®</sup>," "Anytime," and "Business Select<sup>®</sup>," with the goal of making it easier for Customers to choose the fare they prefer. All fare products include the privilege of two free checked bags (weight and size limits apply) and complimentary soft drinks and snacks, as well as free movies-on-demand and live and on-demand television where available on WiFi-enabled aircraft. In addition, regardless of the fare product, Southwest does not charge fees for changes to flight reservations although fare differences may apply.

"Wanna Get Away" fares are generally the lowest fares and are typically subject to advance purchase requirements. They are nonrefundable, but, subject to Southwest's No Show Policy, funds may be applied to future travel on Southwest. Wanna Get Away fares earn six Rapid Rewards<sup>®</sup> points, under Southwest's Rapid Rewards loyalty program, for each dollar spent on the base fare. The Company's loyalty program is discussed below under "Rapid Rewards Loyalty Program."

"Anytime" fares are, subject to Southwest's No Show Policy, refundable if canceled, or funds may be applied towards future travel on Southwest. If this fare is purchased with nonrefundable funds, then the flight will be nonrefundable if canceled. Anytime fares earn 10 Rapid Rewards points for each dollar spent on the base fare.

"Business Select" fares are, subject to Southwest's No Show Policy, refundable if canceled, or funds may be applied towards future travel on Southwest. If this fare is purchased with nonrefundable funds, then the flight will be nonrefundable if canceled. Business Select fares also include additional perks such as priority boarding with a boarding position in the first 15 boarding positions within boarding group "A," 12 Rapid Rewards points per dollar spent on the base fare - the highest loyalty point multiplier of all Southwest fare products, "Fly By<sup>®</sup>" priority security and/or ticket counter access in participating airports, and one complimentary premium beverage coupon for the day of travel (Customers must be of legal drinking age to drink alcoholic beverages).

Southwest's No Show Policy applies if a Customer does not change or cancel a flight segment at least ten minutes prior to scheduled departure and the Customer does not travel on the scheduled flight. In such event, subject to certain exceptions, all segments associated with the reservation will be canceled, and (i) with respect to a "Wanna Get Away" fare, unused funds will be forfeited; and (ii) with respect to an "Anytime" or "Business Select" fare, unused funds will be held as travel credit for future travel by the Customer on Southwest.

##### Ancillary Services

The Company offers ancillary services such as Southwest's EarlyBird Check-In<sup>®</sup>, Upgraded Boarding, and transportation of pets and unaccompanied minors, in accordance with Southwest's respective policies.



EarlyBird Check-In provides Customers with automatic check-in and an assigned boarding position before general boarding positions become available, thereby improving Customers' seat selection options (priority boarding privileges are already a benefit of being an "A-List" tier member under the Company's Rapid Rewards Loyalty Program). During 2018, the Company implemented a variable pricing model for EarlyBird Check-In based on the length of the flight and the historical popularity of EarlyBird Check-In on the route.

When available, Southwest sells Upgraded Boarding at the airport. These are open priority boarding positions in the first 15 positions in its "A" boarding group.

Southwest's Pet Policy provides Customers an opportunity to bring a small cat or dog into the aircraft cabin. Southwest also has an unaccompanied minor travel policy to address the administrative costs and the extra care necessary to safely transport these Customers.

#### Inflight Entertainment Portal and WiFi Service

Southwest offers inflight entertainment and connectivity service on WiFi-enabled aircraft on the majority of its fleet. In 2018, Southwest refreshed its suite of complimentary offerings onboard its inflight entertainment portal to offer Free Movies and Free App Messaging while onboard any WiFi-enabled aircraft, and Free Music while onboard a majority of WiFi-enabled aircraft. The inflight entertainment service allows Customers to enjoy gate-to-gate entertainment directly on their personal wireless devices.

The free inflight entertainment offerings include approximately 30 free movies-on-demand per month and free app messaging via iMessage or WhatsApp. The Company also continues to offer free access to its live and on-demand television product on most of its flights. The television product consists of over 15 live channels and up to 75 on-demand recorded episodes from popular television series.

The Company's new collaboration with iHeartRadio brings a free digital music and live streaming radio service to Customers within the onboard entertainment portal on the majority of Southwest domestic flights. Customers can listen to hundreds of live radio stations, pick from artist radio channels, listen to selected playlists, and listen to podcasts. Customers may also use their iHeartRadio app while onboard, and existing subscribers to the All Access and Plus products have access to their entire music library and saved playlists.

Customers can also purchase satellite internet service while on WiFi-enabled aircraft. Customers do not have to purchase WiFi to access the free inflight entertainment options including Free Movies, Free App Messaging, Free Television, Free Music, weather, destination guides, a flight tracker, and connecting flights information. These onboard offerings are currently available as a limited time offer only on WiFi-enabled aircraft, where available.

#### Rapid Rewards Loyalty Program

Southwest's Rapid Rewards loyalty program enables program members ("Members") to earn points for every dollar spent on Southwest fares. The amount of points earned under the program is based on the fare and fare class purchased, with higher fare products (e.g., Business Select) earning more points than lower fare products (e.g., Wanna Get Away). Each fare class is associated with a points earning multiplier, and points for flights are calculated by multiplying the fare for the flight by the fare class multiplier. Likewise, the amount of points required to be redeemed for a flight is based on the fare purchased. Under the program (i) Members are able to redeem their points for every available seat, every day, on every flight, with no blackout dates; and (ii) points do not expire so long as the Member has points-earning activity during the most recent 24 months.

Under the program, Members continue to accumulate points until the time they decide to redeem them. As a result, the program provides Members significant flexibility and options for earning and redeeming rewards. For example, Members can earn more points (and/or achieve tiered status such as A-List and Companion Pass faster) by purchasing higher fare tickets. Members also have significant flexibility in redeeming points, such as the opportunity to book in advance to take advantage of a lower fare ticket (including many fare sales) and redeem fewer points or by being able to redeem more points and book at the last minute if seats are still available for sale. In addition to redeeming points for Southwest flights, Members are also able to redeem their points for items such as international flights on other airlines, cruises, hotel stays, rental cars, gift cards, event tickets, and more. Members can also earn points through qualifying purchases with Rapid Rewards Partners (which include, for example, car rental agencies, hotels, restaurants, and retailers), as well as by using Southwest's co-branded Chase® Visa credit card. In addition to earning points for



revenue flights and qualifying purchases with Rapid Rewards Partners, Members also have the ability to purchase, gift, and transfer points, as well as the ability to donate points to selected charities.

Southwest's Rapid Rewards loyalty program features tier and Companion Pass programs for the most active Members, including "A-List" and "A-List Preferred" status. Both A-List and A-List Preferred Members enjoy benefits such as "Fly By<sup>®</sup>" priority check-in and security lane access, where available, as well as dedicated phone lines, standby priority, and an earnings bonus on eligible revenue flights (25 percent for A-List and 100 percent for A-List Preferred). In addition, A-List Preferred Members enjoy free inflight WiFi on equipped flights. Members who attain A-List or A-List Preferred status receive priority boarding privileges for an entire year. When these Customers purchase travel at least 36 hours prior to flight time, they receive the best boarding pass number available (generally, an "A" boarding pass). During the day of travel, if an A-List or A-List Preferred Member's plans change, they have free same-day standby privileges, which allow them to fly on earlier flights between the same city pairs if space is available. Members who fly 100 qualifying one-way flights or earn 110,000 qualifying points in a calendar year automatically receive a Companion Pass, which provides for unlimited travel for the designated companion free of airline charges (does not include taxes and fees from \$5.60 one-way). The Companion Pass is valid for the remainder of the calendar year in which status was earned and for the following full calendar year to any destination available on Southwest for a designated companion of the qualifying Member. The Member and designated companion must travel together on the same flight.

Southwest's Rapid Rewards loyalty program has been designed to drive more revenue by (i) bringing in new Customers, including new Members, as well as new holders of Southwest's co-branded Chase Visa credit card; (ii) increasing business from existing Customers; and (iii) strengthening the Company's Rapid Rewards hotel, rental car, credit card, and retail partnerships.

For the Company's 2018 consolidated results, Customers of Southwest redeemed approximately 10.4 million flight awards, accounting for approximately 13.8 percent of revenue passenger miles flown. For the Company's 2017 consolidated results, Customers of Southwest redeemed approximately 9.6 million flight awards, accounting for approximately 13.8 percent of revenue passenger miles flown. For the Company's 2016 consolidated results, Customers of Southwest redeemed approximately 8.3 million flight awards, accounting for approximately 12.7 percent of revenue passenger miles flown. The Company's accounting policies with respect to its loyalty programs are discussed in more detail in Note 1 to the Consolidated Financial Statements.

Digital Customer Platforms including Southwest.com

The Company offers a broad suite of digital platforms to support Customers' needs across their travel journey including Southwest.com<sup>®</sup>, mobile.southwest.com, an iOS app, and an Android app. The digital platforms comprise the primary storefront for the Company and are designed to allow Customers to quickly learn, shop, book, and manage their Southwest air travel. The platforms also showcase and support booking for the Company's ancillary products including EarlyBird, Business Select upgrades, vacation packages, rental car reservations, hotel reservations, ridesharing, and travel activities, as well as provide self-service tools for frequently asked questions and contacting Southwest for support. The Company also offers Swabiz.com, a website tailored for business Customers, which offers businesses shared company credit cards, company activity reporting, and centralized traveler management. These digital tools are designed to help make the Customer's experience personal, intuitive, and efficient while supporting the Company's unique and low-cost focused distribution strategy.

The platforms are powered by advanced marketing tools with algorithmic learning features for detailed insight generation, testing, monitoring, and targeting capabilities. In addition, Southwest.com and Swabiz.com are available in a translated Spanish version, which provides Customers who prefer to transact in Spanish the same level of Customer Service provided by the English versions of the websites. Both websites meet Web Content Accessibility Guidelines in order to provide an optimal experience for Customers with accessibility needs.

The Company continues to invest in and improve these digital assets, with sustained investment in 2018.

Southwest.com's Air Booking, Air Manage, Low Fare Calendar, and Early Bird Booking experiences were updated with a modern and tablet-friendly experience along with a brand new architecture to increase speed to market and shopping workflow effectiveness. A new site search tool was added to help Customers find the right content, as well as better highlight Customer-generated content from the Southwest Community and social media. Rapid Rewards

Enrollment forms were updated with a modern look and feel to ease the enrollment process. Swabiz.com received

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major enhancements to offer corporate travel managers helpful tools including Unused Funds Reports, Hotel Booking, additional reporting, mobile changes, and shared confirmation receipt emails.

In 2018, the Company also continued to invest in broadening mobile capabilities for Customers. The mobile shopping and booking experiences were updated to allow Customers to book, change, and check in for international trips, as well as sign up for the Rapid Rewards credit card while making a booking. The Company also enhanced the day of travel experience with an improved multi-passenger boarding experience, more intuitive trip cards, Google Pay-enabled mobile boarding passes for Android users, and a mobile standby list. The Company added additional Customer experience enhancements with in-app ratings and review technology, personalization technology, and an iPad optimized version of the iOS application.

In 2018, the Company also invested in major updates to its messaging platforms with a complete overhaul of its e-mail experiences. All confirmation emails were updated with a new modern look and feel, including personalized information and clearer itinerary information, as well as enhanced travel tips and promotional areas. This overhaul also extended into EarlyBird, Gift Card, LUV Voucher, and SWABIZ Account notifications. Promotional messaging emails were also updated with new personalization technology designed to increase click-through rates.

For the year ended December 31, 2018, approximately 80 percent of the Company's Passenger revenues originated from its website (including revenues from SWABIZ®).

#### Marketing

During 2018, the Company continued to aggressively market and benefit from Southwest's points of differentiation from its competitors. For example, the Company's Transparency<sup>SM</sup> campaign emphasizes Southwest's approach to treating Customers fairly, honestly, and respectfully, with its low fares and no unexpected bag fees, change fees, or hidden fees.

Southwest continues to be the only major U.S. airline that offers to all ticketed Customers up to two checked bags that fly free (subject to weight and size limits). Through both its national and local marketing campaigns, Southwest has continued to aggressively promote this point of differentiation from its competitors with its "Bags Fly Free®" message. The Company believes its decision not to charge for first and second checked bags, as reinforced by the Company's related marketing, has driven an increase in the Company's market share and a resulting net increase in revenues.

Southwest also does not charge a fee on any of its fares for a Customer change in flight reservations. The Company has continued to incorporate this key point of differentiation in its marketing campaigns. The campaigns highlight the importance to Southwest of Customer Service by showing that Southwest understands plans can change and therefore does not charge a change fee. While a Customer may pay a difference in airfare, the Customer will not be charged a change fee on top of any difference in airfare.

Also unlike many of its competitors, Southwest does not impose additional fees for items such as seat selection, snacks, curbside check-in, and telephone reservations. In addition, Southwest allows each ticketed Customer to check one stroller and one car seat free of charge, in addition to the two free checked bags.

The Company also continues to promote all of the many other reasons to fly Southwest such as its low fares, network size, Customer Service, free movies-on-demand and live and on-demand television, free messaging via iMessage or WhatsApp, the iHeartRadio service, and its Rapid Rewards loyalty program.

The Company's visual expression of its brand is its Heart. The Company believes its Heart sets it apart from the industry standard. The Company's Heart symbol is purposely placed on the Company's aircraft livery, airport experience, and logo, and symbolizes the Company's care, trust, and belief in providing exceptional Hospitality and its Employees' dedication to connecting Customers with what is important in their lives. The Company's 737-800 and 737 MAX 8 aircraft include a Heart cabin interior, which gives Southwest Customers a look and feel of the future, with bold blue seats and additional seat width and legroom, an adjustable headrest, enhanced back comfort, and extra room for personal belongings. In addition, front-line Employees wear Employee-designed uniforms that highlight the Company's red, yellow, and blue Heart brand.

#### Technology Initiatives





The Company has committed significant resources to technology improvements in support of its ongoing operations and initiatives that continue to shape and guide the strategic future of the Company. The Company has completed a multi-year initiative to completely transition its reservation system to the Amadeus Altéa Passenger Service System. The new reservation system, which represented the single largest technology project in the Company's history, was designed to improve flight scheduling and inventory management, enable operational enhancements to manage flight disruptions, such as those caused by extreme weather conditions, enable revenue enhancements, support additional international growth, and enable other foundational and operational capabilities.

The Company continues to focus on the prioritization and execution of its technology investments and is in the process of continually executing an evolving multi-year plan for technology, with the goal of developing a stronger, adaptable, and more efficient technology foundation to support the Company's strategic priorities.

The Company continues to invest significantly in technology resources including, among others, the Company's systems related to (i) aircraft maintenance record keeping, (ii) flight planning and scheduling, (iii) crew scheduling, and (iv) technology infrastructure.

### Regulation

The airline industry is heavily regulated, especially by the federal government, and there are a significant number of governmental agencies and legislative bodies that have the ability to directly or indirectly affect the Company and/or the airline industry financially and/or operationally. Examples of regulations affecting the Company and/or the airline industry, imposed by several of these governmental agencies and legislative bodies, are discussed below.

### Economic and Operational Regulation

#### Consumer Protection Regulation by the U.S. Department of Transportation

The DOT regulates economic operating authority for air carriers and consumer protection for airline passengers. The FAA, an agency within the DOT, regulates aviation safety. The DOT and the FAA may impose civil penalties on air carriers for violating their regulations.

To provide passenger transportation in the United States, a domestic airline is required to hold both a Certificate of Public Convenience & Necessity from the DOT and an Air Carrier Operating Certificate from the FAA. A Certificate of Public Convenience & Necessity is unlimited in duration, and the Company's certificate generally permits it to operate among any points within the United States and its territories and possessions. Additional DOT authority, in the form of a certificate or exemption from certificate requirements, is required for a U.S. airline to serve foreign destinations either with its own aircraft or via code-sharing with another airline. Exemptions granted by the DOT to serve international markets are generally limited in duration and are subject to periodic renewal requirements. The DOT also has jurisdiction over international tariffs and pricing in certain markets. The DOT may revoke a certificate or exemption, in whole or in part, for intentional failure to comply with federal aviation statutes, regulations, orders, or the terms of the certificate itself.

The DOT's consumer protection and enforcement activities relate to areas such as unfair and deceptive practices and unfair competition by air carriers, deceptive airline advertising (concerning, e.g., fares, ontime performance, schedules, and code-sharing), and violations of rules concerning denied boarding compensation, ticket refunds, and baggage liability requirements. The DOT is also charged with prohibiting discrimination by airlines against consumers on the basis of (i) disability; and (ii) race, religion, national origin, sex, or ancestry.

Under the above-described authority, from 2008 through 2016, the DOT adopted so-called "Passenger Protection Rules," which address a wide variety of matters, including flight delays on the tarmac, chronically delayed flights, denied boarding compensation, and advertising of airfares, among others. Under the Passenger Protection Rules, U.S. passenger airlines are required to adopt contingency plans that include the following: (i) assurances that no domestic flight will remain on the airport tarmac for more than three hours before beginning to return to the gate and that no international flight will remain on the tarmac at a U.S. airport for more than four hours before beginning to return to the gate, unless the pilot-in-command determines there is a safety-related or security-related impediment to deplaning passengers, or air traffic control advises the pilot-in-command that returning to the gate or permitting passengers to

disembark elsewhere would significantly disrupt airport operations; (ii) an assurance that air carriers will provide

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adequate food and potable drinking water no later than two hours after the aircraft leaves the gate (in the case of departure) or touches down (in the case of arrival) if the aircraft remains on the tarmac, unless the pilot-in-command determines that safety or security considerations preclude such service; and (iii) an assurance of operable lavatories, as well as adequate medical attention, if needed. Air carriers are required to publish their contingency plans on their websites.

The Passenger Protection Rules also subject airlines to potential DOT enforcement action for unfair and deceptive practices in the event of chronically delayed domestic flights (i.e., domestic flights that operate at least ten times a month and arrive more than 30 minutes late more than 50 percent of the time during that month). In addition, airlines are required to (i) display ontime performance on their websites; (ii) adopt customer service plans, publish those plans on their website, and audit their own compliance with their plans; (iii) designate an employee to monitor the performance of their flights; (iv) provide information to passengers on how to file complaints; and (v) respond in a timely and substantive fashion to consumer complaints.

The Passenger Protection Rules also require airlines to (i) pay up to four times the passenger's one-way fare to their final destination that day in compensation to each passenger denied boarding involuntarily from an oversold flight; (ii) refund any checked bag fee for permanently lost luggage; (iii) prominently disclose all potential fees for optional ancillary services on their websites; and (iv) refund passenger fees paid for ancillary services if a flight cancels or oversells and a passenger is unable to take advantage of such services. The FAA Reauthorization Act of 2018, described below, directs the DOT to revise regulations to clarify there is no maximum level of compensation for involuntary denied boarding as a result of an oversold flight.

The Passenger Protection Rules also require that (i) advertised fares include all government-mandated taxes and fees; (ii) passengers be allowed to either hold a reservation for up to 24 hours without making a payment or cancel a paid reservation without penalty for 24 hours after the reservation is made, as long as the reservation is made at least seven days in advance of travel; (iii) fares may not increase after purchase; (iv) baggage fees must be disclosed to the passenger at the time of booking; (v) the same baggage allowances and fees must apply throughout a passenger's trip; (vi) baggage fees must be disclosed on e-ticket confirmations; and (vii) passengers must be promptly notified in the event of delays of more than 30 minutes or if there is a cancellation or diversion of their flight.

The DOT has expressed its intent to aggressively investigate alleged violations of its consumer protection rules. Airlines that violate any DOT regulation are subject to potential fines of up to \$33,333 per occurrence.

The Company is also monitoring other potential rulemakings that could impact its business. The DOT is preparing a proposed rule for the purpose of improving accessibility of lavatories on single-aisle aircraft and of in-flight entertainment. The proposed rule may require both short-term and long-term measures be taken to fully address the challenges persons with mobility impairments face when traveling on single-aisle aircraft, including the eventual requirement that accessible lavatories be available for individuals who use wheelchairs. The future proposed rule is also expected to address the improvement of accessibility of in-flight entertainment by requiring certain movies and shows displayed on such aircraft to be captioned to provide access to deaf and hard of hearing passengers. In addition, audio described entertainment would be available to enable people who are blind to listen to the visual narration of movies and shows.

The DOT is also contemplating a proposed rule to consider, among other things, (i) whether carriers should be required to supply in-flight medical oxygen for a fee to passengers who require it to access air transportation; and (ii) whether to broaden the scope of passengers with disabilities who must be afforded seats with extra leg room, and whether carriers should be required to provide seating accommodations with extra leg room in all classes of service. The FAA Reauthorization Act of 2018 was passed by Congress on October 3, 2018, and signed into law on October 5, 2018 (the "Reauthorization Act"). The Reauthorization Act includes various provisions requiring additional potential DOT rulemaking. For example:

the DOT has been directed to begin a rulemaking to re-define permissible "service animals" on commercial aircraft, including considering whether to adopt the same definition of "service animal" contained in the Department of Justice rules implementing the Americans with Disabilities Act, in order to reduce the likelihood of passengers falsely claiming that their pets are service animals;



the DOT has been given the authority to impose triple the maximum fines for damages to passengers' wheelchairs or other mobility aids, as well as for injury to passengers with disabilities;

the DOT has been directed to implement a rulemaking to require air carriers to promptly provide a refund for any ancillary fee paid for services a passenger does not receive; and

the Reauthorization Act makes it an unfair and deceptive practice to involuntarily deplane a revenue passenger onboard an aircraft if that passenger is traveling on a confirmed reservation and is checked-in for the relevant flight prior to the applicable check-in deadline.

#### Aviation Taxes and Fees

The statutory authority for the federal government to collect most types of aviation taxes, which are used, in part, to finance programs administered by the FAA, must be periodically reauthorized by the U.S. Congress. The Reauthorization Act extends most commercial aviation taxes for five years through September 30, 2023.

In addition to FAA-related taxes, there are additional federal taxes related to the U.S. Department of Homeland Security. These taxes do not need to be reauthorized periodically. Congress has set the Transportation Security Fee paid by passengers at \$5.60 per one-way passenger trip. In addition, inbound international passengers are subject to immigration and customs fees that are indexed to inflation. These fees are used to support the operations of U.S. Customs and Border Protection ("CBP"). Finally, the U.S. Department of Agriculture's Animal and Plant Health Inspection Service imposes an agriculture inspection fee on arriving international passengers.

In 2019, the Company expects to continue to benefit from the comprehensive U.S. tax reform legislation enacted by Congress in late 2017, which includes, among other items, a reduced federal corporate tax rate. At the same time, the legislation eliminates certain tax deductions and preferences. These changes not only impact the Company directly, but could be impacting the U.S. economy as a whole, including consumer demand.

In 2019, Congress is expected to consider legislation to boost federal spending on public infrastructure, including at airports. This legislation could result in an increase in the maximum Passenger Facility Charge, which is assessed by airports and collected by airlines, currently capped at \$4.50 per passenger enplanement (with a maximum of two Passenger Facility Charges on a one-way trip or four Passenger Facility Charges on a roundtrip, for a maximum of \$18.00 total). Conversely, this legislation could also result in an infusion of federal investment in public infrastructure that may benefit all modes of transportation.

Finally, the annual congressional budget process is another legislative vehicle by which new aviation taxes or regulations may be imposed. The annual appropriations bill funds the federal government - including the DOT, the FAA, the Transportation Security Administration (the "TSA"), and CBP. Passage of the fiscal year 2020 appropriations bill will be considered throughout 2019 and could result in an increase in one or more of the taxes and fees discussed above, as well as new mandates on the DOT to begin or complete rulemakings related to airline consumer protection.

#### Operational, Safety, and Health Regulation

The FAA has the authority to regulate safety aspects of civil aviation operations. Specifically, the Company and certain of its third-party service providers are subject to the jurisdiction of the FAA with respect to aircraft maintenance and operations, including equipment, ground facilities, dispatch, communications, training, and other matters affecting air safety. The FAA, acting through its own powers or through the appropriate U.S. Attorney, has the power to bring proceedings for the imposition and collection of civil penalties for violation of the FAA regulations. The FAA requires airlines to obtain and maintain an Air Carrier Operating Certificate, as well as other certificates, approvals, and authorities. These certificates, approvals, and authorities are subject to suspension or revocation for cause.

The FAA has rules in effect with respect to flight, duty, and rest regulations. Among other things, the rules (i) require a ten hour minimum rest period prior to a pilot's flight duty period; (ii) mandate that a pilot must have an opportunity for eight hours of uninterrupted sleep within the rest period; and (iii) impose pilot "flight time" and "duty time" limitations based upon report times, the number of scheduled flight segments, and other operational factors. The Reauthorization Act contains a provision requiring the implementation of an FAA rule mandating a rest period of at



least 10 consecutive hours prior to a flight attendant's flight duty period. The rules affect the Company's staffing flexibility, which could impact the Company's operational performance, costs, and Customer Experience.

The Reauthorization Act also contains provisions directing the FAA to issue new regulations to establish minimum dimensions for seat size that are necessary for the safety of passengers. Further, the Reauthorization Act expands human trafficking training requirements beyond flight attendants to include several public-facing Employee work groups.

In addition to its role as safety regulator, the FAA operates the nation's air traffic control system and has continued its lengthy and ongoing effort to implement a multi-faceted, air traffic control modernization program called "NextGen." The Air Traffic Organization ("ATO") is the operational arm of the FAA. The ATO is responsible for providing safe and efficient air navigation services to all of the United States and large portions of the Atlantic and Pacific Oceans and the Gulf of Mexico. The Company is subject to any operational changes imposed by the FAA/ATO as they relate to the NextGen program, as well as the day-to-day management of the air traffic control system. The Reauthorization Act directs the FAA to (i) undertake a comprehensive review and prepare a full report on NextGen implementation and (ii) annually report on NextGen progress and return on investment.

The Company is subject to various other federal, state, and local laws and regulations relating to occupational safety and health, including Occupational Safety and Health Administration and Food and Drug Administration regulations. Security Regulation

Pursuant to the Aviation and Transportation Security Act ("ATSA"), the TSA, a division of the U.S. Department of Homeland Security, is responsible for certain civil aviation security matters. ATSA and subsequent TSA regulations and procedures implementing ATSA address, among other things, (i) flight deck security; (ii) the use of federal air marshals onboard flights; (iii) airport perimeter access security; (iv) airline crew security training; (v) security screening of passengers, baggage, cargo, mail, employees, and vendors; (vi) training and qualifications of security screening personnel; (vii) provision of passenger data to CBP; and (viii) background checks.

Under ATSA, substantially all security officers at airports are federal employees, and significant other elements of airline and airport security are overseen and performed by federal employees, including federal security managers, federal law enforcement officers, and federal air marshals. TSA personnel and TSA-mandated security procedures can affect the Company's operations, costs, and Customer experience. For example, as part of its security measures, the TSA regulates the types of liquid items that can be carried onboard aircraft. In addition, as part of its Secure Flight program, the TSA requires airlines to collect a passenger's full name (as it appears on a government-issued ID), date of birth, gender, and Redress Number (if applicable). Airlines must transmit this information to Secure Flight, which uses the information to perform matching against terrorist watch lists. After matching passenger information against the watch lists, Secure Flight transmits the matching results back to airlines. This serves to identify individuals for enhanced security screening and to prevent individuals on watch lists from boarding an aircraft. It also helps prevent the misidentification of passengers who have names similar to individuals on watch lists. The TSA has also implemented enhanced security procedures as part of its enhanced, multi-layer approach to airport security, including physical pat down procedures, at security checkpoints. Such enhanced security procedures have raised privacy concerns by some air travelers, and have caused delays at screening checkpoints.

Pursuant to the Reauthorization Act, the FAA is required to issue an order requiring installation of a physical secondary cockpit barrier on each newly-manufactured aircraft for delivery to a passenger air carrier. This could impose a substantial cost on the Company.

The Company, in conjunction with the TSA, participates in TSA PreCheck™, a pre-screening initiative that allows a select group of low risk passengers to move through security checkpoints with greater efficiency and ease when traveling. Eligible passengers may use dedicated screening lanes at certain airports the Company serves for screening benefits, which include leaving on shoes, light outerwear, and belts, as well as leaving laptops and permitted liquids in carryon bags. A similar CBP-administered program, Global Entry®, allows expedited clearance for pre-approved, low-risk international travelers upon arrival in the United States.

The Company also participates in the TSA Known Crewmember® program, which is a risk-based screening system that enables TSA security officers to positively verify the identity and employment status of flight-crew members. The program expedites flight crew member access to sterile areas of airports.





The Company works collaboratively with foreign national governments and airports to provide risk-based security measures at international departure locations.

In September 2017, the Department of Homeland Security granted the Company designation coverage under the Support Anti-Terrorism by Fostering Effective Technologies Act of 2002 (the "SAFETY Act") through September 29, 2022. The designation is based on the security program utilized by the Company to protect its Employees, Customers, and assets from terrorists and other criminal activities. Designation coverage affords the Company certain limitations of liability for claims arising out of an "act of terrorism," as defined under the SAFETY Act.

The Company has also made significant investments to address the effect of security regulations, including investments in facilities, equipment, and technology to process Customers, checked baggage, and cargo efficiently; however, the Company is not able to predict the impact, if any, that various security measures or the lack of TSA resources at certain airports will have on Passenger revenues and the Company's costs, either in the short-term or the long-term.

#### Environmental Regulation

The Company is subject to various federal laws and regulations relating to the protection of the environment, including the Clean Air Act, the Resource Conservation and Recovery Act, the Clean Water Act, the Safe Drinking Water Act, and the Comprehensive Environmental Response, Compensation and Liability Act, as well as state and local laws and regulations. These laws and regulations govern aircraft drinking water, emissions, storm water discharges from operations, and the disposal of materials such as jet fuel, chemicals, hazardous waste, and aircraft deicing fluid.

Additionally, in conjunction with airport authorities, other airlines, and state and local environmental regulatory agencies, the Company, as a normal course of business, undertakes voluntary investigation or remediation of soil or groundwater contamination at various airport sites. The Company does not believe that any environmental liability associated with these airport sites will have a material adverse effect on the Company's operations, costs, or profitability, nor has it experienced any such liability in the past that has had a material adverse effect on its operations, costs, or profitability.

Further regulatory developments pertaining to the control of engine exhaust emissions from ground support equipment could increase operating costs in the airline industry. The Company does not believe, however, that pending environmental regulatory developments in this area will have a material effect on the Company's capital expenditures or otherwise materially adversely affect its operations, operating costs, or competitive position.

The federal government, as well as several state and local governments, the governments of other countries, and the United Nations' International Civil Aviation Organization ("ICAO") are considering legislative and regulatory proposals and voluntary measures to address climate change by reducing green-house gas emissions. At the federal level, in July 2016, the Environmental Protection Agency (the "EPA") issued a final endangerment finding for greenhouse gas emissions from certain types of aircraft engines, which the agency determined contribute to the pollution that causes climate change and endangers public health and the environment. Following this endangerment finding, per the federal Clean Air Act, the EPA is required to promulgate new regulations for controlling greenhouse gas emissions from aircraft, including potential new carbon-efficiency standards on aircraft and engine manufacturers. The EPA's endangerment finding preceded adoption by the ICAO Assembly of a new "global market-based measure" framework in an effort to control carbon dioxide emissions from international aviation. The focal point of this framework is a carbon offsetting system on aircraft operators designed to cap the growth of emissions related to international aviation emissions. Assuming the U.S. Government remains committed to the ICAO framework agreement and adopts terms for implementing it into U.S. law, this system is scheduled to be phased in beginning in 2021. Regardless of the method of regulation, policy changes with regard to climate change are possible, which could significantly increase operating costs in the airline industry and, as a result, adversely affect operations.

In addition to climate change, aircraft noise continues to be an environmental focus, especially as the FAA implements new flight procedures as part of its NextGen airspace modernization program discussed above. The Airport Noise and Capacity Act of 1990 gives airport operators the right, under certain circumstances, to implement local noise abatement programs, provided they do not unreasonably interfere with interstate or foreign commerce or the national air transportation system. Some airports have established airport restrictions to limit noise, including

restrictions on aircraft types to be used and limits on the number of hourly or daily operations or the time of operations. These types of

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restrictions can cause curtailments in service or increases in operating costs and can limit the ability of air carriers to expand operations at the affected airports.

At the federal level, the FAA has committed to inform and involve the public, engage with communities, and give meaningful consideration to community concerns and views when developing new flight procedures, and there is a possibility that Congress may enact legislation in 2019 to address local noise concerns at one or more commercial airports in the United States. In addition, the Reauthorization Act requires the FAA to consider community noise concerns when proposing a new navigation departure procedure or amending an existing navigation procedure that would direct aircraft over noise sensitive areas. This requirement could delay or otherwise impede the implementation or use of more efficient flight paths. In 2017, the FAA published a final rule adopting the ICAO noise standard for new type design large aircraft submitted for certification after December 31, 2017; however, this standard does not affect the Company's in-service fleet, nor does it require that manufacturers who produce existing aircraft types, such as the Boeing 737, meet the standard with respect to these types of aircraft.

The Company remains steadfast in its desire to pursue, implement, and enhance initiatives that will reduce fuel consumption and improve fuel efficiency. During 2018, the Company continued its efforts at more efficient flight planning and flight operation, while also benefitting from the continued addition of Boeing 737 MAX 8 aircraft to the Company's fleet. In addition, over the years, the Company has undertaken a number of other fuel conservation and carbon emission reduction initiatives such as the following:

- installation of blended winglets, which reduce drag and increase fuel efficiency, on all aircraft in the Company's fleet;
- upgrading of the Company's 737-800 fleet with designed, split scimitar winglets;
- periodic engine washes;
- use of electric ground power for aircraft air and power at the gate and for ground support equipment at select locations;
- deployment of auto-throttle and vertical navigation to maintain optimum cruising speeds;
- implementation of engine start procedures to support the Company's single engine taxi procedures;
- adjustment of the timing of auxiliary power unit starts on originating flights to reduce auxiliary power unit usage;
- implementation of fuel planning initiatives to safely reduce loading of excess fuel;
- aircraft cabin interior retrofitting to reduce weight;
- reduction of aircraft engine idle speed while on the ground, which also increases engine life;
- galley refreshes with dry goods weight reduction;
- Company-optimized routes (flying the best wind routes to take advantage of tailwinds or to minimize headwinds);
- improvements in flight planning algorithms to better match the Company's aircraft flight management system and thereby enabling the Company to fly at the most efficient altitudes;
- substitution of Pilot and Flight Attendant flight bags with lighter Electronic Flight Bag tablets; and
- implementation of Real Time Descent Winds (automatic uplinking of up-to-date wind data to the aircraft, allowing crews to time the descent to minimize thrust inputs).

The Company has also participated in Required Navigation Performance ("RNP") operations as part of the FAA's Performance Based Navigation program, which is intended to modernize the U.S. air traffic control system by addressing limitations on air transportation capacity and making more efficient use of airspace. RNP combines the capabilities of advanced aircraft avionics, Global Positioning System ("GPS") satellite navigation (instead of less precise ground-based navigation), and new flight procedures to (i) enable aircraft to carry navigation capabilities, rather than relying on airports; (ii) improve operational capabilities by opening up many new and more direct airport approach paths to

produce safer and more efficient flight patterns; and (iii) conserve fuel and reduce carbon emissions. Since its first use of RNP in 2011, Southwest has conducted approximately 143,000 RNP approaches, including over 85,000 in 2018. Southwest must rely on RNP approaches published by the FAA, and the rate of introduction and utilization of RNP approaches continues to be slower than expected, with fuel efficient RNP approaches currently available at only 50 of Southwest's airports. In addition, even at airports with approved RNP approaches, the clearance required from air traffic controllers to perform RNP approaches is often not granted. Southwest continues to work with the FAA to develop and seek more use of RNP approaches and to evolve air traffic control rules to support greater utilization of RNP.

As part of its commitment to corporate sustainability, the Company has published the Southwest One Report™ describing the Company's sustainability strategies, which include the foregoing and other efforts to reduce greenhouse gas emissions and address other environmental matters such as energy and water conservation, waste minimization, and recycling. Information contained in the Southwest One Report is not incorporated by reference into, and does not constitute a part of, this Form 10-K.

#### Data Privacy and Security Regulation

The airline industry has experienced heightened legislative and regulatory focus on data privacy and security in the United States and elsewhere. As a result, the Company must comply with a growing and fast-evolving set of legal requirements in this area. For example, the California Consumer Privacy Act of 2018 requires significant compliance efforts from businesses across the United States to the extent they do business in California and collect personal information from California residents. The new law gives consumers much broader access and control over their personal information. This regulatory environment is increasingly challenging and may present material obligations and risks to the Company's business, including significantly expanded compliance burdens, costs, and enforcement risks.

The Company expects the federal government to closely examine cyber-security and data privacy in 2019. This could include the DOT looking at new requirements, guidance, or best practices for the industry, as well as the introduction of new legislation in Congress.

#### International Regulation

All international air service is subject to certain U.S. federal requirements and approvals, as well as the regulatory requirements of the appropriate authorities of the foreign countries involved. The Company has obtained the necessary economic authority from the DOT, as well as approvals required by the FAA and applicable foreign government entities, to conduct operations, under certain circumstances, to points outside of the continental United States currently served by the Company. Certain international authorities and approvals held by the Company are subject to periodic renewal requirements. The Company requests extensions of such authorities and approvals when and as appropriate. To the extent the Company seeks to serve additional foreign destinations in the future, or to renew its authority to serve certain routes, it may be required to obtain necessary authority from the DOT and/or approvals from the FAA, as well as any applicable foreign government entity.

Certain international route authorities are governed by bilateral air transportation agreements between the United States and foreign countries. Changes in U.S. or foreign government aviation policies could result in the alteration or termination of such agreements, diminish the value of the Company's existing international authorities, present barriers to renewing existing or securing new authorities, or otherwise affect the Company's international operations. In particular, there is still a degree of uncertainty about the future of scheduled commercial flight operations between the United States and Cuba as a result of changes in diplomatic relations between the two governments, as well as travel and trade restrictions implemented by the U.S. government in 2017. There are also capacity limitations at certain airports in Mexico and the Caribbean, which could impact future service levels. In general, bilateral agreements between the United States and foreign countries the Company currently serves, or may serve in the future, may be subject to renegotiation or reinterpretation from time to time. While the U.S. government has negotiated "open skies" agreements with many countries, which allow for unrestricted access between the United States and respective foreign destinations, agreements with other countries may restrict the Company's entry into those destinations and/or its related growth opportunities.

The CBP is the federal agency of the U.S. Department of Homeland Security charged with facilitating international trade, collecting import duties, and enforcing U.S. regulations with respect to trade, customs, and immigration. As the

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Company expands its international flight offerings, CBP and its requirements and resources will also become increasingly important considerations to the Company. For instance, with the exception of flights from a small number of foreign "preclearance" locations, arriving international flights may only land at CBP-designated airports, and CBP officers must be present and in sufficient quantities at those airports to effectively process and inspect arriving international passengers and cargo. Thus, CBP personnel and CBP-mandated procedures can affect the Company's operations, costs, and Customer experience. The Company has made, and expects to continue to make, significant investments in facilities, equipment, and technologies at certain airports in order to improve the Customer experience and to assist CBP with its inspection and processing duties; however, the Company is not able to predict the impact, if any, that various CBP measures or the lack of CBP resources will have on Company revenues and costs, either in the short-term or the long-term.

#### Insurance

The Company carries insurance of types customary in the airline industry and in amounts the Company deems adequate to protect the Company and its property and to comply both with federal regulations and certain of the Company's credit and lease agreements. The policies principally provide coverage for public and passenger liability, property damage, cargo and baggage liability, loss or damage to aircraft, engines, and spare parts, and workers' compensation. In addition, the Company carries a cyber-security insurance policy with regards to data protection and business interruption associated with both security breaches from malicious parties and from certain system failures. Although the Company has been able to purchase aviation, property, liability, and professional insurance via the commercial insurance marketplace, available commercial insurance could be more expensive in the future and/or have material differences in coverage than insurance that has historically been provided and may not be adequate to protect the Company's risk of loss from future events, including acts of terrorism. Further, available cyber-security insurance with regards to data protection and business interruption could be more expensive in the future and/or have material differences in coverage than insurance that has historically been provided and may not be adequate to protect the Company's risk of loss. With respect to any insurance claims, policy coverages and claims are subject to acceptance by the many insurers involved and may require arbitration and/or mediation to effectively settle the claims over prolonged periods of time.

#### Competition

Competition within the airline industry is intense and highly unpredictable, and Southwest currently competes with other airlines on virtually all of its scheduled routes. As a result of moderately improved economic conditions and an increased focus by airlines on costs, the airline industry has become increasingly competitive in recent years with a healthier financial condition and improved profitability.

Key competitive factors within the airline industry include (i) pricing and cost structure; (ii) routes, loyalty programs, and schedules; and (iii) customer service, operational reliability, and amenities. Southwest also competes for customers with other forms of transportation, as well as alternatives to travel. In recent years, the majority of domestic airline service has been provided by Southwest and the other largest major U.S. airlines, including American Airlines, Delta Air Lines, and United Airlines. The DOT defines major U.S. airlines as those airlines with annual revenues of at least \$1 billion; there are currently 13 passenger airlines offering scheduled service, including Southwest, that meet this standard.

#### Pricing and Cost Structure

Pricing is a significant competitive factor in the airline industry, and the availability of fare information on the Internet allows travelers to easily compare fares and identify competitor promotions and discounts. During 2018, the Company experienced competitive challenges associated with industry changes from both a fare level and product offering perspective. As discussed above under "Business - Industry," other carrier offerings ranged from a "Basic Economy" fare product, designed to compete with ULCC fares, to a "Premium Economy" product, targeted to appeal to customers willing to pay a premium for additional amenities. Also in response to ULCC pricing, some carriers have removed their fare floors for certain routes, leading to a lower fare offering across the industry. These changes have put increased pressure on the industry's fare environment and have created a challenging revenue environment. Pricing can be driven by a variety of factors. For example, airlines often discount fares to drive traffic in new markets or to stimulate traffic when necessary to improve load factors and/or cash flow. In addition, multiple airlines have

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able to reduce fares because they have been able to lower their operating costs as a result of reorganization within and outside of bankruptcy. Further, some of the Company's competitors have continued to grow and modernize their fleets and expand their networks, potentially enabling them to better control costs per available seat mile (the average cost to fly an aircraft seat (empty or full) one mile), which in turn may enable them to lower their fares.

The Company believes its low-cost operating structure continues to provide it with an advantage over many of its airline competitors by enabling it to continue to charge low fares. However, ULCCs, which have increased capacity in the Company's markets, have surpassed the Company's cost advantage with larger aircraft, increased seat density, and lower wages. The Company believes it continues to have a competitive advantage through its differentiation of Southwest from many of its competitors by not charging additional fees for items such as first and second checked bags for each ticketed Customer, flight changes, seat selection, snacks, curbside check-in, and telephone reservations; nevertheless, it has become increasingly difficult for the Company to improve upon its industry cost position absent using techniques favored by competitors.

#### Routes, Loyalty Programs, and Schedules

The Company also competes with other airlines based on markets served, loyalty opportunities, and flight schedules. Some major airlines have more extensive route structures than Southwest, including more extensive international networks. In addition, many competitors have entered into significant commercial relationships with other airlines, such as global alliances, code-sharing, and capacity purchase agreements, which increase the airlines' opportunities to expand their route offerings. An alliance or code-sharing agreement enables an airline to offer flights that are operated by another airline and also allows the airline's customers to book travel that includes segments on different airlines through a single reservation or ticket. As a result, depending on the nature of the specific alliance or code-sharing arrangement, a participating airline may be able to, among other things, (i) offer its customers access to more destinations than it would be able to serve on its own, (ii) gain exposure in markets it does not otherwise serve, and (iii) increase the perceived frequency of its flights on certain routes. Alliance and code-sharing arrangements not only provide additional route flexibility for participating airlines, they can also allow these airlines to offer their customers more opportunities to earn and redeem loyalty miles or points. A capacity purchase agreement enables an airline to expand its route structure by paying another airline (e.g., a regional airline with smaller aircraft) to operate flights on its behalf in markets that it does not, or cannot, serve itself. The Company continues to evaluate and implement initiatives to better enable itself to offer additional itineraries.

The Company's anticipated new routes to Hawaii in 2019 are expected to be subject to significant competition. West Coast to Hawaii capacity increased in 2018, and is expected to continue to increase in 2019 with Southwest flights from California to Hawaii. Certain other major airlines have more experience with Hawaiian operations and have more extensive Hawaiian route structures and schedules than Southwest. Further, the longer stage length of the Company's Hawaiian routes, as compared with the Company's average stage length of its other routes, could put pressure on the Company's revenues per available seat mile.

#### Customer Service, Operational Reliability, and Amenities

Southwest also competes with other airlines with respect to customer service, operational reliability (such as ontime performance), and passenger amenities. According to statistics published by the DOT, Southwest consistently ranks at or near the top among domestic carriers in Customer Satisfaction for having the lowest Customer complaint ratio. However, carriers are increasingly focusing on operational reliability as an opportunity to win and retain Customers. In addition, some airlines have more seating options and associated passenger amenities than does Southwest, including first-class, business class, and other premium seating and related amenities. New and different types of aircraft flown by competitors could have operational attributes and passenger amenities that could be considered more favorable than those associated with the Company's existing fleet.

#### Other Forms of Competition

The airline industry is subject to varying degrees of competition from other forms of transportation, including surface transportation by automobiles, buses, and trains. Inconveniences and delays associated with air travel security measures can increase surface competition. In addition, surface competition can be significant during economic downturns when consumers cut back on discretionary spending and fewer choose to fly, or when gasoline prices are lower, making surface transportation a less expensive option. Because of the relatively high percentage of short-haul



travel provided

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by Southwest, it is particularly exposed to competition from surface transportation in these instances. The airline industry is also subject to technology advancements that may limit the demand for air travel, including competition from alternatives to air travel such as videoconferencing and the Internet, which can increase in the event of travel inconveniences and economic downturns. The Company is subject to the risk that air travel inconveniences and economic downturns may, in some cases, result in permanent changes to consumer behavior in favor of surface transportation and electronic communications.

#### Seasonality

The Company's business is seasonal. Generally, in most markets the Company serves, demand for air travel is greater during the summer months, and, therefore, revenues in the airline industry tend to be stronger in the second (April 1 - June 30) and third (July 1 - September 30) quarters of the year than in the first (January 1 - March 31) and fourth (October 1 - December 31) quarters of the year. As a result, in many cases, the Company's results of operations reflect this seasonality. Factors that could alter this seasonality include, among others, the price of fuel, general economic conditions, extreme or severe weather and natural disasters, fears of terrorism or war, or changes in the competitive environment. Therefore, the Company's quarterly operating results are not necessarily indicative of operating results for the entire year, and historical operating results in a quarterly or annual period are not necessarily indicative of future operating results.

#### Employees

At December 31, 2018, the Company had approximately 58,800 active fulltime equivalent Employees, consisting of approximately 24,900 flight, 3,000 maintenance, 20,800 ground, Customer, and fleet service, and 10,100 management, technology, finance, marketing, and clerical personnel (associated with non-operational departments). Approximately 83 percent of these Employees were represented by labor unions. The Railway Labor Act establishes the right of airline employees to organize and bargain collectively. Under the Railway Labor Act, collective-bargaining agreements between an airline and a labor union generally do not expire, but instead become amendable as of an agreed date. By the amendable date, if either party wishes to modify the terms of the agreement, it must notify the other party in the manner required by the Railway Labor Act and/or described in the agreement. After receipt of the notice, the parties must meet for direct negotiations. If no agreement is reached, either party may request the National Mediation Board to appoint a federal mediator. If no agreement is reached in mediation, the National Mediation Board may determine an impasse exists and offer binding arbitration to the parties. If either party rejects binding arbitration, a 30-day "cooling off" period begins. At the end of this 30-day period, the parties may engage in "self-help," unless a Presidential Emergency Board is established to investigate and report on the dispute. The appointment of a Presidential Emergency Board maintains the "status quo" for an additional period of time. If the parties do not reach agreement during this period, the parties may then engage in "self-help." "Self-help" includes, among other things, a strike by the union or the airline's imposition of any or all of its proposed amendments and the hiring of new employees to replace any striking workers.

The following table sets forth the Company's Employee groups subject to collective bargaining and the status of their respective collective-bargaining agreements as of December 31, 2018:

Employee Group	Approximate Number of Employees	Representatives	Status of Agreement
Southwest Pilots	9,100	Southwest Airlines Pilots' Association ("SWAPA")	Amendable September 2020
Southwest Flight Attendants	15,200	Transportation Workers of America, AFL-CIO, Local 556 ("TWU 556")	In negotiations
Southwest Ramp, Operations, Provisioning, Freight Agents	13,400	Transportation Workers of America, AFL-CIO, Local 555 ("TWU 555")	Amendable February 2021
Southwest Customer Service Agents, Customer Representatives, and Source of Support Representatives	7,400	International Association of Machinists and Aerospace Workers, AFL-CIO ("IAM 142")	In negotiations
Southwest Material Specialists (formerly known as Stock Clerks)	300	International Brotherhood of Teamsters, Local 19 ("IBT 19")	In negotiations. The Company reached a tentative agreement with IBT 19 in January 2019. If ratified by the Company's Material Specialists, the contract will become amendable in 2024.
Southwest Mechanics	2,400	Aircraft Mechanics Fraternal Association ("AMFA")	In negotiations
Southwest Aircraft Appearance Technicians	200	AMFA	Amendable November 2020
Southwest Facilities Maintenance Technicians	40	AMFA	Amendable November 2022
Southwest Dispatchers	300	Transportation Workers of America, AFL-CIO, Local 550 ("TWU 550")	Amendable June 2019
Southwest Flight Simulator Technicians	50	International Brotherhood of Teamsters ("IBT")	Amendable May 2019. The Company reached a tentative agreement with IBT in February 2019. If ratified by the Company's Flight Simulator Technicians, the contract will become amendable in 2024.
Southwest Flight Crew Training Instructors	130	Transportation Workers of America, AFL-CIO, Local 557 ("TWU 557")	Amendable January 2020
Southwest Meteorologists	10	TWU 550	Amendable June 2019

Additional Information About the Company

The Company was incorporated in Texas in 1967. The following documents are available free of charge through the Company's website, [www.southwest.com](http://www.southwest.com): the Company's annual report on Form 10-K, quarterly reports on Form 10-Q, current reports on Form 8-K, and any amendments to those reports that are filed with or furnished to the Securities and Exchange Commission ("SEC") pursuant to Sections 13(a) or 15(d) of the Securities Exchange Act of 1934. These materials are made available through the Company's website as soon as reasonably practicable after they are electronically filed with, or furnished to, the SEC. In addition to its reports filed or furnished with the SEC, the

Company publicly discloses material information from time to time in its press releases, at annual meetings of Shareholders, in publicly accessible conferences and Investor presentations, and through its website (principally in its Press Room and Investor Relations pages). References to the Company's website in this Form 10-K are provided as a convenience and do not constitute, and should not be deemed, an incorporation by reference of the information contained on, or available through, the website, and such information should not be considered part of this Form 10-K.