

SOUTHWEST AIRLINES CO
Form 10-Q
July 30, 2014

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

FORM 10-Q

(Mark One)

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

For the quarterly period ended June 30, 2014

or

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

For the transition period from _____ to _____

Commission File No. 1-7259

Southwest Airlines Co.

(Exact name of registrant as specified in its charter)

TEXAS

74-1563240

(State or other jurisdiction of incorporation or organization)

(IRS Employer Identification No.)

P.O. Box 36611

Dallas, Texas

75235-1611

(Address of principal executive offices)

(Zip Code)

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

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

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

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

Large accelerated filer

Accelerated filer

Non-accelerated filer (Do not check if a smaller reporting company)

Smaller reporting company

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act). Yes

No

Number of shares of Common Stock outstanding as of the close of business on July 28, 2014: 685,140,186

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SOUTHWEST AIRLINES CO.
FORM 10-Q
PART I – FINANCIAL INFORMATION

Item 1. Financial Statements

Southwest Airlines Co.

Condensed Consolidated Balance Sheet

(in millions)

(unaudited)

	June 30, 2014	December 31, 2013
ASSETS		
Current assets:		
Cash and cash equivalents	\$1,882	\$1,355
Short-term investments	2,112	1,797
Accounts and other receivables	447	419
Inventories of parts and supplies, at cost	435	467
Deferred income taxes	165	168
Prepaid expenses and other current assets	276	250
Total current assets	5,317	4,456
Property and equipment, at cost:		
Flight equipment	17,592	16,937
Ground property and equipment	2,792	2,666
Deposits on flight equipment purchase contracts	688	764
Assets constructed for others	515	453
	21,587	20,820
Less allowance for depreciation and amortization	7,860	7,431
	13,727	13,389
Goodwill	970	970
Other assets	877	530
	\$20,891	\$19,345
LIABILITIES AND STOCKHOLDERS' EQUITY		
Current liabilities:		
Accounts payable	\$1,292	\$1,247
Accrued liabilities	1,645	1,229
Air traffic liability	3,485	2,571
Current maturities of long-term debt	605	629
Total current liabilities	7,027	5,676
Long-term debt less current maturities	2,153	2,191
Deferred income taxes	3,017	2,934
Construction obligation	468	437
Other noncurrent liabilities	710	771
Stockholders' equity:		
Common stock	808	808
Capital in excess of par value	1,263	1,231
Retained earnings	6,979	6,431
Accumulated other comprehensive income (loss)	111	(3)

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Treasury stock, at cost	(1,645) (1,131)
Total stockholders' equity	7,516	7,336	
	\$20,891	\$19,345	

See accompanying notes.

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

	Three months ended June 30,		Six months ended June 30,	
	2014	2013	2014	2013
OPERATING REVENUES:				
Passenger	\$4,752	\$4,380	\$8,685	\$8,218
Freight	44	43	84	82
Other	215	220	409	427
Total operating revenues	5,011	4,643	9,178	8,727
OPERATING EXPENSES:				
Salaries, wages, and benefits	1,406	1,298	2,680	2,481
Fuel and oil	1,425	1,489	2,739	2,946
Maintenance materials and repairs	236	281	486	571
Aircraft rentals	75	92	156	185
Landing fees and other rentals	295	292	560	558
Depreciation and amortization	228	213	449	422
Acquisition and integration	38	26	56	39
Other operating expenses	533	519	1,061	1,022
Total operating expenses	4,236	4,210	8,187	8,224
OPERATING INCOME	775	433	991	503
OTHER EXPENSES (INCOME):				
Interest expense	34	33	66	62
Capitalized interest	(6	) (8	) (12	) (13
Interest income	(2	) (2	) (3	) (3
Other gains (losses), net	3	47	(50)	) 1
Total other expenses	29	70	1	47
INCOME BEFORE INCOME TAXES	746	363	990	456
PROVISION FOR INCOME TAXES	281	139	373	173
NET INCOME	\$465	\$224	\$617	\$283
NET INCOME PER SHARE, BASIC	\$0.67	\$0.31	\$0.89	\$0.39
NET INCOME PER SHARE, DILUTED	\$0.67	\$0.31	\$0.88	\$0.39
COMPREHENSIVE INCOME	\$588	\$87	\$731	\$154
WEIGHTED AVERAGE SHARES OUTSTANDING				
Basic	690	714	694	719
Diluted	698	722	703	727

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Cash dividends declared per common share	\$.06	\$.04	\$.10	\$.05
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See accompanying notes.

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

	Three months ended June 30,		Six months ended June 30,	
	2014	2013	2014	2013
CASH FLOWS FROM OPERATING ACTIVITIES:				
Net income	\$465	\$224	\$617	\$283
Adjustments to reconcile net income to cash provided by (used in) operating activities:				
Depreciation and amortization	228	213	449	422
Unrealized (gain) loss on fuel derivative instruments	(7	) 55	(67	) 33
Deferred income taxes	(11	) 21	81	23
Changes in certain assets and liabilities:				
Accounts and other receivables	10	(51	) (61	) (147
Other assets	(21	) 6	(14	) (19
Accounts payable and accrued liabilities	424	162	448	282
Air traffic liability	153	199	914	907
Cash collateral received from (paid to) derivative counterparties	95	(53	) 106	(25
Other, net	2	2	(15	) 1
Net cash provided by operating activities	1,338	778	2,458	1,760
CASH FLOWS FROM INVESTING ACTIVITIES:				
Capital expenditures	(500	) (193	) (907	) (727
Purchases of short-term investments	(1,159	) (900	) (1,929	) (1,624
Proceeds from sales of short-term and other investments	803	793	1,622	1,580
Other, net	(1	) —	(1) —
Net cash used in investing activities	(857	) (300	) (1,215	) (771
CASH FLOWS FROM FINANCING ACTIVITIES:				
Proceeds from Employee stock plans	25	13	73	19
Payments of long-term debt and capital lease obligations	(73	) (52	) (119	) (216
Payments of cash dividends	(42	) (28	) (97	) (43
Repayment of construction obligation	(2	) —	(5) —
Repurchase of common stock	(240	) (251	) (555	) (351
Other, net	(8	) (9	) (13	) (22
Net cash used in financing activities	(340	) (327	) (716	) (613
NET CHANGE IN CASH AND CASH EQUIVALENTS	141	151	527	376
CASH AND CASH EQUIVALENTS AT BEGINNING OF PERIOD	1,741	1,338	1,355	1,113
CASH AND CASH EQUIVALENTS AT END OF PERIOD	\$1,882	\$1,489	\$1,882	\$1,489
CASH PAYMENTS FOR:				
Interest, net of amount capitalized	\$33	\$26	\$67	\$67

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Income taxes	\$12	\$21	\$12	\$23
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SUPPLEMENTAL DISCLOSURE OF NONCASH
TRANSACTIONS

Assets constructed for others	\$19	\$47	\$31	\$75
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See accompanying notes.

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

1. BASIS OF PRESENTATION

Southwest Airlines Co. (the “Company”) operates Southwest Airlines, a major domestic airline. The unaudited Condensed Consolidated Financial Statements include accounts of the Company and its wholly owned subsidiaries, which include AirTran Holdings, LLC, the parent company of AirTran Airways, Inc. (“AirTran Airways”). On May 2, 2011 (the “acquisition date”), the Company acquired all of the outstanding equity of AirTran Holdings, Inc. (“AirTran Holdings”), the former parent company of AirTran Airways. Throughout this Form 10-Q, the Company makes reference to AirTran, which is meant to be inclusive of the following: (i) for periods prior to the acquisition date, AirTran Holdings and its subsidiaries, including, among others, AirTran Airways; and (ii) for periods on and after the acquisition date, AirTran Holdings, LLC, the successor to AirTran Holdings, and its subsidiaries, including among others, AirTran Airways. The Company continues to incur costs associated with the integration of AirTran, and those costs are included in Acquisition and integration costs in the accompanying unaudited Condensed Consolidated Statement of Comprehensive Income.

The accompanying unaudited Condensed Consolidated Financial Statements of the Company and its subsidiaries have been prepared in accordance with accounting principles generally accepted in the United States for interim financial information and with the instructions to Form 10-Q and Article 10 of Regulation S-X. Accordingly, they do not include all of the information and footnotes required by generally accepted accounting principles in the United States (“GAAP”) for complete financial statements. The unaudited Condensed Consolidated Financial Statements for the interim periods ended June 30, 2014 and 2013 include all adjustments which are, in the opinion of management, necessary for a fair presentation of the results for the interim periods. This includes all normal and recurring adjustments and elimination of significant intercompany transactions. Financial results for the Company and airlines in general can be seasonal in nature. In many years, the Company's revenues, as well as its operating income and net income, have been better in its second and third fiscal quarters than in its first and fourth fiscal quarters. Air travel is also significantly impacted by general economic conditions, the amount of disposable income available to consumers, unemployment levels, and corporate travel budgets. These and other factors, such as the price of jet fuel in some periods, the nature of the Company's fuel hedging program, the periodic volatility of commodities used by the Company for hedging jet fuel, and the requirements related to hedge accounting, have created, and may continue to create, significant volatility in the Company's financial results. See Note 3 for further information on fuel and the Company's hedging program. Operating results for the three and six months ended June 30, 2014, are not necessarily indicative of the results that may be expected for the year ended December 31, 2014. For further information, refer to the Consolidated Financial Statements and footnotes thereto included in the Southwest Airlines Co. Annual Report on Form 10-K for the year ended December 31, 2013.

2. ACCOUNTING CHANGES AND NEW ACCOUNTING PRONOUNCEMENTS

The Company's policy is to record revenue for the estimated spoilage of tickets (including partial tickets) once the flight date has passed, under the redemption method. Initial spoilage estimates are routinely adjusted and ultimately finalized once the tickets expire, which is typically 12 months after the original purchase date. Spoilage estimates are based on the Customer's historical travel behavior as well as assumptions about the Customer's future travel behavior. Assumptions used to generate spoilage estimates can be impacted by several factors including, but not limited to: fare increases, fare sales, changes to the Company's ticketing policies, changes to the Company's refund, exchange and unused funds policies, or economic factors. A change to previously recorded estimates of tickets expected to spoil in the future resulted in additional passenger revenue of \$47 million in second quarter 2014. Revisions to the Company's assumptions regarding Customer behavior subsequent to the implementation of its No Show policy were a

contributing factor to the change in estimate. The impact of this change to net income, net of profitsharing and taxes, for the three and six months ended June 30, 2014, was \$25 million. This change in estimate also resulted in a \$.04 increase in both basic and diluted net income per share for the three months ended June 30, 2014, and a \$.04 increase in both basic and diluted net income per share for the six months ended June 30, 2014.

On May 28, 2014, the Financial Accounting Standards Board and the International Accounting Standards Board issued converged guidance on recognizing revenue in contracts with customers. The new guidance establishes a single core principle in the Accounting Standards Update ("ASU") No. 2014-09, which is the recognition of revenue to depict the transfer of promised goods or services to customers in an amount that reflects the consideration to which the entity expects to be entitled in exchange for those goods or services. This guidance will affect any reporting organization that either enters into contracts with customers to transfer goods or services or enters into contracts for the transfer of non-financial assets. This ASU is effective for fiscal years, and interim periods within those years, beginning on or after December 15, 2016, and early adoption is not permitted. The Company is evaluating the new guidance and plans to provide additional information about its expected impact at a future date.

3. FINANCIAL DERIVATIVE INSTRUMENTS

Fuel contracts

Airline operators are inherently dependent upon energy to operate and, therefore, are impacted by changes in jet fuel prices. Furthermore, jet fuel and oil typically represent one of the largest operating expenses for airlines. The Company endeavors to acquire jet fuel at the lowest possible cost and to reduce volatility in operating expenses through its fuel hedging program. Although the Company may periodically enter into jet fuel derivatives for short-term timeframes, because jet fuel is not widely traded on an organized futures exchange, there are limited opportunities to hedge directly in jet fuel for time horizons longer than approximately 24 months into the future. However, the Company has found that financial derivative instruments in other commodities, such as West Texas Intermediate ("WTI") crude oil, Brent crude oil, and refined products, such as heating oil and unleaded gasoline, can be useful in decreasing its exposure to jet fuel price volatility. The Company does not purchase or hold any financial derivative instruments for trading or speculative purposes.

The Company has used financial derivative instruments for both short-term and long-term time frames and primarily uses a mixture of purchased call options, collar structures (which include both a purchased call option and a sold put option), call spreads (which include a purchased call option and a sold call option), and fixed price swap agreements in its portfolio. Although the use of collar structures and swap agreements can reduce the overall cost of hedging, these instruments carry more risk than purchased call options in that the Company could end up in a liability position when the collar structure or swap agreement settles. With the use of purchased call options and call spreads, the Company cannot be in a liability position at settlement, but may be exposed to price changes beyond a certain market price.

The Company evaluates its derivative volumes strictly from an "economic" standpoint and thus does not consider whether the derivatives have qualified or will qualify for hedge accounting. The Company defines its "economic" hedge as the net volume of fuel derivative contracts held, including the impact of positions that have been offset through sold positions, regardless of whether those contracts qualify for hedge accounting. The level at which the Company is economically hedged for a particular period is also dependent on current market prices for that period, as well as the types of derivative instruments held and the strike prices of those instruments. For example, the Company may enter into "out-of-the-money" option contracts (including catastrophic protection), which may not generate intrinsic gains at settlement if market prices do not rise above the option strike price. Therefore, even though the Company may have an "economic" hedge in place for a particular period, that hedge may not produce any hedging gains and may even produce hedging losses depending on market prices, the types of instruments held, and the strike prices of those instruments.

For the three months ended June 30, 2014, the Company had fuel derivative instruments in place for 33 percent of its fuel consumption. As of June 30, 2014, the Company had fuel derivative instruments in place to provide coverage for up to 41 percent of its remaining 2014 estimated fuel consumption, depending on where market prices settle. The following table provides information about the Company's volume of fuel hedging for the years 2014 through 2018 on an "economic" basis considering current market prices:

Period (by year)	Fuel hedged as of June 30, 2014 (gallons in millions) (a)	Derivative underlying commodity type as of June 30, 2014
Remainder of 2014	365	WTI crude, Brent crude oil, and Gulf Coast jet fuel
2015	1,165	Brent crude oil, Heating oil, and Gulf Coast jet fuel
2016	1,089	Brent crude oil and Heating oil
2017	820	WTI crude and Brent crude oil
2018	98	Brent crude oil

(a) The Company determined gallons hedged based on market prices and forward curves as of June 30, 2014. Due to the types of derivatives utilized by the Company, these volumes represent the maximum economic hedge in place and may vary significantly as market prices fluctuate.

Upon proper qualification, the Company accounts for its fuel derivative instruments as cash flow hedges. Generally, utilizing hedge accounting, all periodic changes in fair value of the derivatives designated as hedges that are considered to be effective are recorded in Accumulated other comprehensive income (loss) ("AOCI") until the underlying jet fuel is consumed. See Note 4. The Company's results are subject to the possibility that periodic changes will not be effective, as defined, or that the derivatives will no longer qualify for hedge accounting. Ineffectiveness results when the change in the fair value of the derivative instrument exceeds the change in the value of the Company's expected future cash outlay to purchase and consume jet fuel. To the extent that the periodic changes in the fair value of the derivatives are ineffective, the ineffective portion is recorded to Other (gains) losses, net, in the unaudited Condensed Consolidated Statement of Comprehensive Income. Likewise, if a hedge ceases to qualify for hedge accounting, any change in the fair value of derivative instruments since the last reporting period is recorded to Other (gains) losses, net, in the unaudited Condensed Consolidated Statement of Comprehensive Income in the period of the change; however, any amounts previously recorded to AOCI would remain there until such time as the original forecasted transaction occurs, at which time these amounts would be reclassified to Fuel and oil expense. When the Company has sold derivative positions in order to effectively "close" or offset a derivative already held as part of its fuel derivative instrument portfolio, any subsequent changes in fair value of those positions are marked to market through earnings. Likewise, any changes in fair value of those positions that were offset by entering into the sold positions are concurrently marked to market through earnings. However, any changes in value related to hedges that were deferred as part of AOCI while designated as a hedge would remain until the originally forecasted transaction occurs. In a situation where it becomes probable that a fuel hedged forecasted transaction will not occur, any gains and/or losses that have been recorded to AOCI would be required to be immediately reclassified into earnings. The Company did not have any such situations occur during 2013, or during the six months ended June 30, 2014.

In some situations, an entire commodity type used in hedging may cease to qualify for special hedge accounting treatment. During 2013, the Company's routine statistical analysis performed to determine which commodities qualify for special hedge accounting treatment on a prospective basis dictated that WTI crude oil based derivatives no longer qualify for hedge accounting. This is primarily due to the fact that the correlation between WTI crude oil prices and jet fuel prices during recent periods has not been as strong as in the past, and therefore the Company can no longer demonstrate that derivatives based on WTI crude oil prices will result in effective hedges on a prospective basis. As such, the change in fair value of all of the Company's derivatives based in WTI have been recorded to Other (gains) losses subsequent to July 1, 2013, and all future changes in the fair value of such instruments will continue to be recorded directly to earnings in future periods. The change in fair value of the Company's WTI derivative contracts for the three and six months ended June 30, 2014, were increases of \$15 million and \$20 million, respectively, which resulted in gains in the unaudited Condensed Consolidated Statement of Comprehensive Income. Any amounts previously recorded to AOCI will remain there until such time as the original forecasted transaction occurs in accordance with hedge accounting requirements. The Company will continue to evaluate whether it can qualify for hedge accounting for WTI derivative contracts in future periods.

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

(in millions)	Balance Sheet location	Asset derivatives		Liability derivatives	
		Fair value at 6/30/2014	Fair value at 12/31/2013	Fair value at 6/30/2014	Fair value at 12/31/2013
Derivatives designated as hedges*					
Fuel derivative contracts (gross)	Prepaid expenses and other current assets	\$125	\$74	\$1	\$—
Fuel derivative contracts (gross)	Other assets	385	209	3	1
Interest rate derivative contracts	Other assets	17	20	—	—
Interest rate derivative contracts	Other noncurrent liabilities	—	—	72	77
Total derivatives designated as hedges		\$527	\$303	\$76	\$78
Derivatives not designated as hedges*					
Fuel derivative contracts (gross)	Prepaid expenses and other current assets	\$181	\$175	\$216	\$182
Fuel derivative contracts (gross)	Other assets	61	16	107	99
Fuel derivative contracts (gross)	Accrued liabilities	—	9	—	21
Total derivatives not designated as hedges		\$242	\$200	\$323	\$302
Total derivatives		\$769	\$503	\$399	\$380

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

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

(in millions)	Balance Sheet location	June 30, 2014	December 31, 2013
Cash collateral deposits held from counterparties for fuel contracts - current	Offset against Prepaid expenses and other current assets	\$23	\$—
Cash collateral deposits held from counterparties for fuel contracts - noncurrent	Offset against Other assets	82	—
Cash collateral deposits provided to counterparties for interest rate contracts - noncurrent	Offset against Other noncurrent liabilities	32	32
Due to third parties for fuel contracts	Accounts payable	2	—
Receivable from third parties for fuel contracts - current	Accounts and other receivables	34	57
Deferred premium gain for fuel contracts - noncurrent	Other noncurrent liabilities	12	2

All of the Company's fuel derivative instruments and interest rate swaps are subject to agreements that follow the netting guidance in the applicable accounting for derivatives and hedging. The types of derivative instruments the Company has determined are subject to netting requirements in the accompanying unaudited Condensed Consolidated

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Balance Sheet are those in which the Company pays or receives cash for transactions with the same counterparty that settle on the same day and in the same currency via one net payment or receipt. For cash collateral held by the Company or provided to counterparties, the Company nets such amounts against the fair value of the Company's derivative portfolio by each counterparty. The Company has elected to utilize netting for both its fuel derivative instruments and interest rate swap agreements and also classifies such amounts as either current or noncurrent, based on the net fair value position with each of the Company's counterparties in the unaudited Condensed Consolidated Balance Sheet.

The Company's application of its netting policy associated with cash collateral differs depending on whether its derivative instruments are in a net asset position or a net liability position. If its fuel derivative instruments are in a net asset position with a counterparty, cash collateral amounts held are first netted against current outstanding derivative amounts associated with that counterparty until that balance is zero, and then any remainder is applied against the fair value of noncurrent outstanding derivative instruments. If the Company's fuel derivative instruments are in a net liability position with the counterparty, cash collateral amounts provided are first netted against noncurrent outstanding derivative amounts associated with that counterparty until that balance is zero, and then any remainder is applied against the fair value of current outstanding derivative instruments.

The Company has the following recognized financial assets and financial liabilities resulting from those transactions that meet the scope of the disclosure requirements as necessitated by applicable accounting guidance for balance sheet offsetting:

Offsetting of derivative assets
(in millions)

Description	Balance Sheet location	(i)	(ii)	(iii) = (i) + (ii)	(i)	(ii)	(iii) = (i) + (ii)
		June 30, 2014	December 31, 2013				
		Gross amounts of recognized assets	Gross amounts offset in the Balance Sheet	Net amounts of assets presented in the Balance Sheet	Gross amounts of recognized assets	Gross amounts offset in the Balance Sheet	Net amounts of assets presented in the Balance Sheet
Fuel derivative contracts	Prepaid expenses and other current assets	\$ 306	\$(240)	) \$ 66	\$ 249	\$(182)	) \$ 67
Fuel derivative contracts	Other assets	\$ 446	\$(192)	) \$ 254	(a) \$ 225	\$(100)	) \$ 125 (a)
Fuel derivative contracts	Accrued liabilities	\$—	\$—	\$—	(a) \$ 9	\$(9)	) \$— (a)
Interest rate derivative contracts	Other assets	\$ 17	\$—	\$ 17	(a) \$ 20	\$—	\$ 20 (a)

Offsetting of derivative liabilities
 (in millions)

Description	Balance Sheet location	(i)	(ii)	(iii) = (i) + (ii)	(i)	(ii)	(iii) = (i) + (ii)	
		June 30, 2014			December 31, 2013			
		Gross amounts of recognized liabilities	Gross amounts offset in the Balance Sheet	Net amounts of liabilities presented in the Balance Sheet	Gross amounts of recognized liabilities	Gross amounts offset in the Balance Sheet	Net amounts of liabilities presented in the Balance Sheet	
Fuel derivative contracts	Prepaid expenses and other current assets	\$240	\$(240)	) \$—	\$182	\$(182)) \$—	
Fuel derivative contracts	Other assets	\$192	\$(192)	) \$—	(a) \$100	\$(100)	) \$—	(a)
Fuel derivative contracts	Accrued liabilities	\$—	\$—	\$—	(a) \$21	\$(9)	) \$12	(a)
Interest rate derivative contracts	Other noncurrent liabilities	\$72	\$(32)	) \$40	(a) \$77	\$(32)	) \$45	(a)

(a) The net amounts of derivative assets and liabilities are reconciled to the individual line item amounts presented in the unaudited Condensed Consolidated Balance Sheet in Note 5.

The following tables present the impact of derivative instruments and their location within the unaudited Condensed Consolidated Statement of Comprehensive Income for the three and six months ended June 30, 2014 and 2013:

Derivatives in cash flow hedging relationships

(in millions)	(Gain) loss recognized in AOCI on derivatives (effective portion) Three months ended June 30,		(Gain) loss reclassified from AOCI into income (effective portion) (a) Three months ended June 30,		(Gain) loss recognized in income on derivatives (ineffective portion) (b) Three months ended June 30,	
	2014	2013	2014	2013	2014	2013
Fuel derivative contracts	\$(122)	)* \$189	* \$(1)	)* \$37	* \$(28)	) \$3
Interest rate derivatives	3	* (11)	)* 3	* 4	* —	(1)
Total	\$(119)	) \$178	\$2	\$41	\$(28)	) \$2

*Net of tax

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

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

Derivatives in cash flow hedging relationships

(Gain) loss recognized in AOCI on derivatives	(Gain) loss reclassified from AOCI into income	(Gain) loss recognized in income on derivatives
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(in millions)	(effective portion)		(effective portion)(a)		(ineffective portion)(b)	
	Six months ended		Six months ended		Six months ended	
	June 30,		June 30,		June 30,	
	2014	2013	2014	2013	2014	2013
Fuel derivative contracts	\$(110	)* \$218	* \$(1	)* \$63	* \$(41	) \$12
Interest rate derivatives	5	* (14	)* 7	* 9	* (1	) (1
Total	\$(105	) \$204	\$6	\$72	\$(42	) \$11

*Net of tax

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

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

Derivatives not in cash flow hedging relationships

(in millions)	(Gain) loss recognized in income on derivatives		Location of (gain) loss recognized in income on derivatives
	Three months ended June 30, 2014	2013	
Fuel derivative contracts	\$16	\$32	Other (gains) losses, net

Derivatives not in cash flow hedging relationships

(in millions)	(Gain) loss recognized in income on derivatives		Location of (gain) loss recognized in income on derivatives
	Six months ended June 30, 2014	2013	
Fuel derivative contracts	\$(40	) \$(28	) Other (gains) losses, net

The Company also recorded expense associated with premiums paid for fuel derivative contracts that settled/expired during the three months ended June 30, 2014 and 2013 of \$17 million and \$12 million, respectively, and the six months ended June 30, 2014 and 2013 of \$34 million and \$17 million, respectively. These amounts are excluded from the Company's measurement of effectiveness for related hedges and are included as a component of Other (gains) losses, net, in the unaudited Condensed Consolidated Statement of Comprehensive Income.

The fair values of the derivative instruments, depending on the type of instrument, were determined by the use of present value methods or option value models with assumptions about commodity prices based on those observed in underlying markets or provided by third parties. Included in the Company's cumulative net unrealized gains from fuel hedges as of June 30, 2014, were approximately \$12 million in unrealized gains, net of taxes, which are expected to be realized in earnings during the twelve months subsequent to June 30, 2014. In addition, as of June 30, 2014, the Company had already recognized cumulative net gains due to ineffectiveness and derivatives that did not qualify for hedge accounting treatment totaling \$99 million, net of taxes. These net gains were recognized during the three months ended June 30, 2014 and prior periods, and are reflected in Retained earnings as of June 30, 2014, but the underlying derivative instruments will not expire/settle until third quarter 2014 or future periods.

Interest rate swaps

The Company is party to certain interest rate swap agreements that are accounted for as either fair value hedges or cash flow hedges, as defined in the applicable accounting guidance for derivative instruments and hedging. The interest rate swap agreements accounted for as fair value hedges qualify for the "shortcut" method of accounting for hedges, which dictates that the hedges are assumed to be perfectly effective, and, thus, there is no ineffectiveness to be recorded in earnings. For the Company's interest rate swap agreements accounted for as cash flow hedges, ineffectiveness is required to be measured at each reporting period. The ineffectiveness associated with all of the Company's, including AirTran's, interest rate cash flow hedges for all periods presented was not material.

Credit risk and collateral

Credit exposure related to fuel derivative instruments is represented by the fair value of contracts that are an asset to the Company at the reporting date. At such times, these outstanding instruments expose the Company to credit loss in the event of nonperformance by the counterparties to the agreements. However, the Company has not experienced any significant credit loss as a result of counterparty nonperformance in the past. To manage credit risk, the Company selects and periodically reviews counterparties based on credit ratings, limits its exposure with respect to each counterparty, and monitors the market position of the fuel hedging program and its relative market position with each counterparty. At June 30, 2014, the Company had agreements with all of its active counterparties containing early termination rights and/or bilateral collateral provisions whereby security is required if market risk exposure exceeds a specified threshold amount based on the counterparty credit rating. The Company also had agreements with counterparties in which cash deposits, letters of credit, and/or pledged aircraft are required to be posted as collateral whenever the net fair value of derivatives associated with those counterparties exceeds specific thresholds. The following table provides the fair values of fuel derivatives, amounts posted as collateral, and applicable collateral posting threshold amounts as of June 30, 2014, at which such postings are triggered:

(in millions)	Counterparty (CP)						Total
	A	B	C	D	E	Other (a)	
Fair value of fuel derivatives	\$148	\$61	\$73	\$92	\$25	\$26	\$425
Cash collateral held from (by) CP	105	—	—	—	—	—	105
Aircraft collateral pledged to CP	—	—	—	—	—	—	—
Letters of credit (LC)	—	—	—	—	—	—	—
Option to substitute LC for aircraft	(250) to (650) (d)	(100) to (500) (d)	N/A	(250) to (650) (d)	N/A		
Option to substitute LC for cash	N/A	>(500)	(100) to (150) (e)	(50) to (250) or >(650) (d)	N/A		
If credit rating is investment grade, fair value of fuel derivative level at which:							
Cash is provided to CP	(50) to (250) or >(650)	(50) to (100) or >(500)	>(50)	(50) to (250) or >(650)	>(50)		
Cash is received from CP	>50	>150	>175 (c)	>200	>30		
Aircraft or cash can be pledged to CP as collateral	(250) to (650) (d)	(100) to (500) (d)	N/A	(250) to (650) (d)	N/A		
If credit rating is non-investment grade, fair value of fuel derivative level at which:							
Cash is provided to CP	(0) to (250) or >(650)	(0) to (100) or >(500)	(b)	(0) to (250) or >(650)	(b)		
Cash is received from CP	(b)	(b)	(b)	(b)	(b)		
Aircraft or cash can be pledged to CP as collateral	(250) to (650)	(100) to (500)	N/A	(250) to (650)	N/A		

(a) Individual counterparties with fair value of fuel derivatives <\$20 million.

(b) Cash collateral is provided at 100 percent of fair value of fuel derivative contracts.

(c) Thresholds may vary based on changes in credit ratings within investment grade.

(d) The Company has the option of providing cash, letters of credit, or pledging aircraft as collateral. No letters of credit or aircraft were pledged as collateral with such counterparties as of June 30, 2014.

(e) The Company has the option of providing cash or letters of credit as collateral. No cash or letters of credit were pledged as collateral with such counterparties as of June 30, 2014.

4. COMPREHENSIVE INCOME

Comprehensive income includes changes in the fair value of certain financial derivative instruments that qualify for hedge accounting, unrealized gains and losses on certain investments, and actuarial gains/losses arising from the Company's postretirement benefit obligation. The differences between Net income and Comprehensive income for the three and six months ended June 30, 2014 and 2013 were as follows:

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(in millions)	Three months ended June 30,	
	2014	2013
NET INCOME	\$465	\$224
Unrealized gain (loss) on fuel derivative instruments, net of deferred taxes of \$72 and (\$90)	121	(152)
Unrealized gain on interest rate derivative instruments, net of deferred taxes of \$- and \$9	—	15
Other, net of deferred taxes of \$1 and \$-	2	—
Total other comprehensive income (loss)	\$123	\$(137)
COMPREHENSIVE INCOME	\$588	\$87

(in millions)	Six months ended June 30,	
	2014	2013
NET INCOME	\$617	\$283
Unrealized gain (loss) on fuel derivative instruments, net of deferred taxes of \$64 and (\$91)	109	(155)
Unrealized gain on interest rate derivative instruments, net of deferred taxes of \$1 and \$15	2	23
Other, net of deferred taxes of \$3 and \$2	3	3
Total other comprehensive income (loss)	\$114	\$(129)
COMPREHENSIVE INCOME	\$731	\$154

A rollforward of the amounts included in AOCI, net of taxes, is shown below for the three and six months ended June 30, 2014:

(in millions)	Fuel derivatives	Interest rate derivatives	Defined benefit plan items	Other	Deferred tax	Accumulated other comprehensive income (loss)
Balance at March 31, 2014	\$(40)	\$(55)	\$65	\$11	\$7	\$(12)
Changes in fair value	195	(5)	—	3	(72)	121
Reclassification to earnings	(2)	5	—	—	(1)	2
Balance at June 30, 2014	\$153	\$(55)	\$65	\$14	\$(66)	\$111

(in millions)	Fuel derivatives	Interest rate derivatives	Defined benefit plan items	Other	Deferred tax	Accumulated other comprehensive income (loss)
Balance at December 31, 2013	\$(20)	\$(58)	\$65	\$8	\$2	\$(3)
Changes in fair value	175	(8)	—	6	(65)	108
Reclassification to earnings	(2)	11	—	—	(3)	6
Balance at June 30, 2014	\$153	\$(55)	\$65	\$14	\$(66)	\$111

The following tables illustrate the significant amounts reclassified out of each component of AOCI for the three and six months ended June 30, 2014:

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Three months ended June 30, 2014
(in millions)

AOCI components	Amounts reclassified from AOCI	Affected line item in the unaudited Condensed Consolidated Statement of Comprehensive Income
Unrealized gain on fuel derivative instruments	\$(2) (1) \$(1)	) Fuel and oil expense) Less: Tax Expense) Net of tax
Unrealized gain on interest rate derivative instruments	\$5 2 \$3	Interest expense Less: Tax Expense Net of tax
Total reclassifications for the period	\$2	Net of tax

Six months ended June 30, 2014
(in millions)

AOCI components	Amounts reclassified from AOCI	Affected line item in the unaudited Condensed Consolidated Statement of Comprehensive Income
Unrealized gain on fuel derivative instruments	\$(2) (1) \$(1)	) Fuel and oil expense) Less: Tax Expense) Net of tax
Unrealized gain on interest rate derivative instruments	\$11 4 \$7	Interest expense Less: Tax Expense Net of tax
Total reclassifications for the period	\$6	Net of tax

5. SUPPLEMENTAL FINANCIAL INFORMATION

Other assets (in millions)	June 30, 2014	December 31, 2013
Derivative contracts	\$271	\$145
Intangible assets (a)	369	166
Non-current investments	39	44
Other	198	175
Other assets	\$877	\$530

(a) Intangible assets primarily consist of acquired leasehold rights to certain airport owned gates at Chicago's Midway International Airport, take-off and landing slots (a "slot" is the right of an air carrier, pursuant to regulations of the Federal Aviation Administration ("FAA"), to operate a takeoff or landing at a specific time at certain airports) at certain domestic slot-controlled airports, and certain intangible assets recognized from the AirTran acquisition. The increase in Intangible assets during 2014 was primarily due to the acquisition of additional slots at Washington Reagan National Airport, which were divested by AMR Corporation, the parent company of American Airlines, Inc., in connection with the merger with US Airways Group, Inc. The slots acquired are not subject to amortization due to the ability to renew the slots on an unlimited basis, the expectation that the slots will contribute positive cash flows for an indefinite period of time, and the Company's recent significant growth in certain slot-controlled airports. The purchase price paid for these slots was included as a component of Capital expenditures in the accompanying unaudited Condensed Consolidated Statement of Cash Flows.

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Accounts payable (in millions)	June 30, 2014	December 31, 2013
Accounts payable trade	\$221	\$189
Salaries payable	157	156
Taxes payable	214	146
Aircraft maintenance payable	322	331
Fuel payable	106	102
Other payables	272	323
Accounts payable	\$1,292	\$1,247
Accrued liabilities (in millions)	June 30, 2014	December 31, 2013
Profitsharing and savings plans	\$391	\$244
Aircraft and other lease related obligations	122	173
Vacation pay	287	278
Health	72	73
Derivative contracts	—	12
Workers compensation	162	161
Income taxes	313	3
Property and other taxes	65	62
Other	233	223
Accrued liabilities	\$1,645	\$1,229
Other noncurrent liabilities (in millions)	June 30, 2014	December 31, 2013
Postretirement obligation	\$144	\$138
Non-current lease-related obligations	242	290
Other deferred compensation	160	163
Deferred gains from sale and leaseback of aircraft	59	65
Derivative contracts	40	45
Other	65	70
Other noncurrent liabilities	\$710	\$771

For further details on fuel derivative and interest rate derivative contracts, see Note 3.

Other Operating Expenses

Other operating expenses consist of distribution costs, advertising expenses, personnel expenses, professional fees, and other operating costs, none of which individually exceed 10 percent of Operating expenses.

6. LEASES

On July 9, 2012, the Company signed an agreement with Delta Air Lines, Inc. and Boeing Capital Corp. to lease or sublease all 88 of AirTran's Boeing 717-200 aircraft ("B717s") to Delta at agreed-upon lease rates. The first converted B717 was delivered to Delta during late September 2013, and as of June 30, 2014, the Company had delivered a total of 36 B717s to Delta. Over the expected term of the transition period for all B717s, the Company expects to average approximately three B717 conversions per month. Following the purchase of two formerly leased B717 aircraft during first quarter 2014, a total of 76 of the B717s are on operating lease, ten are owned, and two are currently classified as capital leases.

The B717s add complexity to the Company's operations, as Southwest Airlines has historically operated an all-Boeing 737 fleet. From a fleet management perspective, the transition of approximately three B717s per month to Delta allows the Company to minimize the impact of this transaction on operations, as the B717 capacity lost is expected to be replaced through the capacity gained as a result of (i) the Company's modification of the retirement dates for a portion of its 737-300 and 737-500 aircraft and (ii) its receipt of new 737 deliveries from Boeing or its acquisition of pre-owned 737s.

The Company will pay the majority of the costs to convert the aircraft to the Delta livery and perform certain maintenance checks prior to the delivery of each aircraft. The agreement to pay these conversion and maintenance costs is a "lease incentive" under applicable accounting guidance. The sublease terms for the 76 B717s currently on operating lease and the two B717s currently classified as capital leases coincide with the Company's remaining lease terms for these aircraft from the original lessor, which range from approximately two to nine years. The leasing of the ten B717s owned

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by the Company is subject to certain conditions, and the lease terms are for seven years, after which Delta has the option to purchase the aircraft at the then-prevailing market value. The Company will account for the lease and sublease transactions with Delta as operating leases, except for the two aircraft classified by the Company as capital leases. The subleases of these two aircraft will be accounted for as direct financing leases. There are no contingent payments and no significant residual value conditions associated with the transaction.

The accounting for this transaction is based on the guidance provided for lease transactions. For the components of this transaction finalized in third quarter 2012 and with respect to which the lease inception has been deemed to occur, the Company recorded a charge of approximately \$137 million during third quarter 2012. The charge represented the remaining estimated cost, at the scheduled date of delivery of each B717 to Delta (including the conversion, maintenance, and other contractual costs to be incurred), of the Company's lease of the B717s that were originally accounted for as operating leases, net of the future sublease income from Delta and the remaining unfavorable aircraft lease liability established as of the acquisition date. During second quarter 2014, the Company recorded an additional \$17 million in expense for its revised estimate of conversion costs for these B717s. The charges recorded by the Company for this transaction were included as a component of Acquisition and integration costs in the Company's unaudited Condensed Consolidated Statement of Comprehensive Income and were included as a component of Other, net in Cash flows from operating activities in the Company's unaudited Condensed Consolidated Statement of Cash Flows, and the corresponding liability for this transaction is included as a component of Current liabilities and Other noncurrent liabilities in the Company's unaudited Condensed Consolidated Balance Sheet. A rollforward of the Company's B717 lease/sublease liability for 2014 and 2013 is shown below:

(in millions)	B717 lease/sublease liability
Balance at December 31, 2012	\$ 128
Lease/sublease accretion	6
Lease/sublease payments, net (a)	(12
Balance at December 31, 2013	\$ 122
Lease/sublease accretion	3
Lease/sublease expense adjustment	17
Lease/sublease payments, net (a)	(63
Balance at June 30, 2014	\$ 79

(a) Includes lease conversion cost payments

The Company may also incur other costs associated with this transaction, such as potential changes associated with the extension of the time between when the Company removes an aircraft from revenue service and the time it is delivered to Delta. The Company has anticipated a reasonable period of transition time for the conversion process, but for some aircraft this period of time will be longer than anticipated due to the Company's plans to halt all B717 service on or around the end of 2014. The Company may incur additional charges at the time the aircraft are removed from service. Any additional charges are not expected to be material.

7. COMMITMENTS AND CONTINGENCIES

Commitments

In December 2013, the Company entered into an agreement with Broward County, Florida, which owns and operates Fort Lauderdale-Hollywood International Airport, to oversee and manage the design and construction of the airport's Terminal 1 Modernization Project at a cost not to exceed \$295 million. In addition to significant improvements to the existing Terminal 1, the project includes the design and construction of a new five-gate Concourse A with an

international processing facility. Funding for the project will come directly from Broward County sources, but will flow through the Company in its capacity as manager of the project. Construction on the project is not expected to begin until mid to late 2015. The Company believes that due to its agreed upon role in overseeing and managing the project, it will be considered the owner of the project for accounting purposes. As such, in the unaudited Condensed Consolidated Balance Sheet, the Company is expected to record an increase in Assets constructed for others as the project is built (with a

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corresponding cash outflow in Investing activities in the unaudited Condensed Consolidated Statement of Cash Flows), and an increase to Construction obligation (with a corresponding cash inflow in Financing activities in the unaudited Condensed Consolidated Statement of Cash Flows) as reimbursements are received from Broward County.

The Company entered into a Memorandum of Agreement (“MOA”) with the City of Houston (“City”), effective June 2012, to expand the existing Houston Hobby airport facility. As provided in the MOA, the Company and the City have entered into an Airport Use and Lease Agreement (“Lease”) to control the execution of this expansion and the financial terms thereof. Per the MOA and Lease, this project provides for a new five-gate international terminal with international passenger processing facilities, expansion of the existing security checkpoint, and upgrades to the Southwest ticket counter area. The project is estimated to cost \$156 million, and the Company has agreed to provide the funding for, as well as management over, the project. In return, the capital cost portion of the rent the Company pays for the international facility will be waived from the initial occupancy until the expiration of the Lease. However, after completion of the project, the City may purchase the facility under the Lease at the then-unamortized cost of the facility. This purchase would trigger payment of the previously waived capital cost component of rents owed the City. Additionally, some portion of the project is expected to qualify for rental credits that would be utilized upon completion of the facility against the Company’s current lease space at the airport. Construction began during third quarter 2013 and is estimated to be completed during the second half of 2015.

As a result of its significant involvement in the Houston Hobby project, the Company has evaluated its ongoing accounting requirements in consideration of accounting guidance provided for lessees involved in asset construction, and has determined that it qualifies as the accounting owner of the facility during the construction period. As such, during construction, the Company records expenditures as Assets constructed for others in the unaudited Condensed Consolidated Balance Sheet, along with a corresponding outflow within Capital expenditures, in the unaudited Condensed Consolidated Statement of Cash Flows. As of June 30, 2014, the Company had recorded construction costs related to Houston Hobby of \$26 million.

In March 2013, the Company executed a lease agreement with Los Angeles World Airports (“LAWA”), which owns and operates Los Angeles International Airport. Under the lease agreement, which was amended in June 2014, the Company will oversee and manage the design, development, financing, construction and commissioning of the airport’s Terminal 1 Modernization Project (the “Project”) at a cost of approximately \$500 million. The Company and LAWA are currently determining how the Project will be funded. Under one option being considered, a quasi-governmental special purpose entity would act as a conduit borrower under a syndicated credit facility provided by a group of lenders. Loans made under the credit facility would be used to fund the development of the Project. Outstanding loans would be repaid with the proceeds of LAWA’s payments to purchase completed Project phases. And, the Company would guaranty the obligations of the conduit borrower under the credit facility. Certain minor enabling projects have begun, and major construction on the project is expected to begin late 2014 or early 2015. The Company believes that due to its agreed upon role in overseeing and managing the project, it will be considered the owner of the project for accounting purposes.

During 2008, the City of Dallas approved the Love Field Modernization Program (“LFMP”), a project to reconstruct Dallas Love Field with modern, convenient air travel facilities. Pursuant to a Program Development Agreement with the City of Dallas and the Love Field Airport Modernization Corporation (or “LFAMC,” a Texas non-profit “local government corporation” established by the City of Dallas to act on the City of Dallas’ behalf to facilitate the development of the LFMP), the Company is managing this project. Major construction commenced during 2010. New ticketing and check-in areas opened during fourth quarter 2012, and 12 new gates and new concessions opened in 2013. Full completion of the project is scheduled for second half 2014. The project consists of the complete

replacement of gate facilities with a new 20-gate facility, including infrastructure, systems and equipment, aircraft parking apron, fueling system, roadways and terminal curbside, baggage handling systems, passenger loading bridges and support systems, and other supporting infrastructure.

It is currently expected that the total construction costs associated with the LFMP project will be approximately \$519 million. Although the City of Dallas has received commitments from various sources that are helping to fund portions

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of the LFMP project, including the FAA, the Transportation Security Administration, and the City of Dallas' Aviation Fund, the majority of the funds used are from the issuance of bonds. During fourth quarter 2010, \$310 million of such bonds were issued by the LFAMC, and the Company has guaranteed principal and interest payments on the bonds. An additional tranche of such bonds totaling \$146 million was issued during second quarter 2012, and the Company has guaranteed the principal and interest payments on these bonds as well. The Company currently expects that as a result of the funding commitments from the above mentioned sources and the bonds that have been issued thus far, no further bond issuances and related guarantees from the Company will be required to complete the LFMP project.

In conjunction with the Company's significant presence at Dallas Love Field, its rights to occupy 16 of the available gates upon completion of the facility, and other factors, the Company agreed to manage the majority of the LFMP project. Based on these facts, the Company has evaluated its ongoing accounting requirements in consideration of accounting guidance provided for lessees involved in asset construction. The Company has recorded and will continue to record an asset and corresponding obligation for the cost of the LFMP project as the construction of the facility occurs. As of June 30, 2014, the Company had recorded LFMP construction costs of \$470 million within Assets constructed for others and had recorded a liability of \$468 million within Construction obligation in its unaudited Condensed Consolidated Balance Sheet. Upon completion of different phases of the LFMP project, the Company has placed the associated assets in service and has begun depreciating the assets over their estimated useful lives. The corresponding LFMP liabilities will be reduced primarily through the Company's airport rental payments to the City of Dallas as the construction costs of the project are passed through to the Company via recurring airport rates and charges. These payments are reflected as Repayment of construction obligation in the unaudited Condensed Consolidated Statement of Cash Flows.

Contingencies

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

8. FAIR VALUE MEASUREMENTS

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

As of June 30, 2014, the Company held certain items that are required to be measured at fair value on a recurring basis. These included cash equivalents, short-term investments (primarily treasury bills, commercial paper, and certificates of deposit), certain noncurrent investments, interest rate derivative contracts, fuel derivative contracts, and available-for-sale securities. The majority of the Company's short-term investments consist of instruments classified as Level 1. However, the Company has certificates of deposit, commercial paper, and Eurodollar time deposits that are classified as Level 2, due to the fact that the fair value for these instruments is determined utilizing observable inputs in non-active markets. Noncurrent investments consist of certain auction rate securities, primarily those collateralized by student loan portfolios, which are guaranteed by the U.S. Government. Other available-for-sale securities primarily consist of investments associated with the Company's excess benefit plan.

The Company's fuel and interest rate derivative instruments consist of over-the-counter contracts, which are not traded on a public exchange. Fuel derivative instruments include swaps, as well as different types of option contracts, whereas interest rate derivatives consist solely of swap agreements. See Note 3 for further information on the Company's derivative instruments and hedging activities. The fair values of swap contracts are determined based on inputs that are readily available in public markets or can be derived from information available in publicly quoted markets. Therefore, the Company has categorized these swap contracts as Level 2. The Company's Treasury Department, which

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reports to the Chief Financial Officer, determines the value of option contracts utilizing an option pricing model based on inputs that are either readily available in public markets, can be derived from information available in publicly quoted markets, or are provided by financial institutions that trade these contracts. The option pricing model used by the Company is an industry standard model for valuing options and is the same model used by the broker/dealer community (i.e., the Company's counterparties). The inputs to this option pricing model are the option strike price, underlying price, risk free rate of interest, time to expiration, and volatility. Because certain inputs used to determine the fair value of option contracts are unobservable (principally implied volatility), the Company has categorized these option contracts as Level 3. Volatility information is obtained from external sources, but is analyzed by the Company for reasonableness and compared to similar information received from other external sources. The fair value of option contracts considers both the intrinsic value and any remaining time value associated with those derivatives that have not yet settled. The Company also considers counterparty credit risk and its own credit risk in its determination of all estimated fair values. To validate the reasonableness of the Company's option pricing model, on a monthly basis, the Company compares its option valuations to third party valuations. If any significant differences were to be noted, they would be researched in order to determine the reason. However, historically, no significant differences have been noted. The Company has consistently applied these valuation techniques in all periods presented and believes it has obtained the most accurate information available for the types of derivative contracts it holds.

The Company's investments associated with its excess benefit plan consist of mutual funds that are publicly traded and for which market prices are readily available. This plan is a non-qualified deferred compensation plan designed to hold Employee contributions in excess of limits established by Section 415 of the Internal Revenue Code of 1986, as amended. Payments under this plan are made based on the participant's distribution election and plan balance. Assets related to the funded portion of the deferred compensation plan are held in a rabbi trust, and the Company remains liable to these participants for the unfunded portion of the plan. The Company records changes in the fair value of the liability and the asset in the Company's earnings.

All of the Company's auction rate security instruments, totaling \$32 million (net) at June 30, 2014, are classified as available-for-sale securities and are reflected at their estimated fair value in the unaudited Condensed Consolidated Balance Sheet. The Company's Treasury Department determines the estimated fair values of these securities utilizing a discounted cash flow analysis. The Company has performed, and routinely updates, a valuation for each of its auction rate security instruments, considering, among other items, the collateralization underlying the security investments, the expected future cash flows, including the final maturity, associated with the securities, estimates of the next time the security is expected to have a successful auction or return to full par value, forecasted reset rates based on the LIBOR or the issuer's net loan rate, and a counterparty credit spread. To validate the reasonableness of the Company's discounted cash flow analyses, the Company compares its valuations to third party valuations on a quarterly basis.

The following tables present the Company's assets and liabilities that are measured at fair value on a recurring basis at June 30, 2014, and December 31, 2013:

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Description	June 30, 2014 (in millions)	Fair value measurements at reporting date using:		
		Quoted prices in active markets for identical assets (Level 1)	Significant other observable inputs (Level 2)	Significant unobservable inputs (Level 3)
Assets				
Cash equivalents				
Cash equivalents (a)	\$1,388	\$1,388	\$—	\$—
Commercial paper	340	—	340	—
Certificates of deposit	12	—	12	—
Eurodollar time deposits	142	—	142	—
Short-term investments:				
Treasury bills	1,880	1,880	—	—
Certificates of deposit	232	—	232	—
Noncurrent investments (b)				
Auction rate securities	32	—	—	32
Interest rate derivatives	17	—	17	—
Fuel derivatives:				
Swap contracts (c)	48	—	48	—
Option contracts (c)	704	—	—	704
Other available-for-sale securities	64	59	—	5
Total assets	\$4,859	\$3,327	\$791	\$741
Liabilities				
Fuel derivatives:				
Swap contracts (c)	\$(29)	) \$—	\$(29)) \$—
Option contracts (c)	(298)	) —	—	) (298)
Interest rate derivatives	(72)	) —	(72)) —
Deferred compensation	(155)	) (155)) —) —
Total liabilities	\$(554)	) \$(155)	) \$(101)	) \$(298)

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

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

(c) In the unaudited Condensed Consolidated Balance Sheet amounts are presented as a net asset.

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Description	December 31, 2013 (in millions)	Fair value measurements at reporting date using:			
		Quoted prices in active markets for identical assets (Level 1)	Significant other observable inputs (Level 2)	Significant unobservable inputs (Level 3)	
Assets					
Cash equivalents					
Cash equivalents (a)	\$992	\$992	\$—	\$—	
Commercial paper	280	—	280	—	
Certificates of deposit	23	—	23	—	
Eurodollar time deposits	60	—	60	—	
Short-term investments:					
Treasury bills	1,570	1,570	—	—	
Certificates of deposit	227	—	227	—	
Noncurrent investments (b)					
Auction rate securities	39	—	—	39	
Interest rate derivatives	20	—	20	—	
Fuel derivatives:					
Swap contracts (c)	16	—	16	—	
Option contracts (c)	458	—	—	458	
Option contracts (d)	9	—	—	9	
Other available-for-sale securities	63	58	—	5	
Total assets	\$3,757	\$2,620	\$626	\$511	
Liabilities					
Fuel derivatives:					
Swap contracts (c)	\$(8	) \$—	\$(8) \$—	
Option contracts (c)	(274) —	—	(274)
Option contracts (d)	(21) —	—	(21)
Interest rate derivatives	(77	) —	(77) —	
Deferred Compensation	(158	) (158) —	—	
Total liabilities	\$(538	) \$(158	) \$(85	) \$(295

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

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

(c) In the unaudited Condensed Consolidated Balance Sheet amounts are presented as a net asset.

(d) In the unaudited Condensed Consolidated Balance Sheet amounts are presented as a net liability.

The Company had no transfers of assets or liabilities between any of the above levels during the six months ended June 30, 2014, or the year ended December 31, 2013. The following tables present the Company's activity for items measured at fair value on a recurring basis using significant unobservable inputs (Level 3) for the three and six months ended June 30, 2014:

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(in millions)	Fair value measurements using significant unobservable inputs (Level 3)			Total
	Fuel derivatives	Auction rate securities	Other securities	
Balance at March 31, 2014	\$206	\$32	\$5	\$243
Total gains (realized or unrealized)				
Included in earnings	36	—	—	36
Included in other comprehensive income	166	—	—	166
Purchases	79	(a) —	—	79
Sales	(73	) (a) —	—	(73
Settlements	(8	) —	—	(8
Balance at June 30, 2014	\$406	\$32	(b) \$5	\$443
The amount of total gains for the period included in earnings attributable to the change in unrealized gains or losses relating to assets still held at June 30, 2014	\$36	\$—	\$—	\$36

(a) The purchase and sale of fuel derivatives are recorded gross based on the structure of the derivative instrument and whether a contract with multiple derivatives is purchased as a single instrument or separate instruments.

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

(in millions)	Fair value measurements using significant unobservable inputs (Level 3)			Total
	Fuel derivatives	Auction rate securities	Other securities	
Balance at December 31, 2013	\$172	\$39	\$5	\$216
Total gains (realized or unrealized)				
Included in earnings	105	—	—	105
Included in other comprehensive income	144	2	—	146
Purchases	100	(a) —	—	100
Sales	(100	) (a) (9	) —	(109
Settlements	(15	) —	—	(15
Balance at June 30, 2014	\$406	\$32	(b) \$5	\$443
The amount of total gains for the period included in earnings attributable to the change in unrealized gains or losses relating to assets still held at June 30, 2014	\$98	\$—	\$—	\$98

(a) The purchase and sale of fuel derivatives are recorded gross based on the structure of the derivative instrument and whether a contract with multiple derivatives is purchased as a single instrument or separate instruments.

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

The significant unobservable input used in the fair value measurement of the Company's derivative option contracts is implied volatility. Holding other inputs constant, a significant increase (decrease) in implied volatility would result in a significantly higher (lower) fair value measurement, respectively, for the Company's derivative option contracts. The significant unobservable inputs used in the fair value measurement of the Company's auction rate securities are time to principal recovery, an illiquidity premium, and counterparty credit spread. Holding other inputs constant, a significant increase (decrease) in such unobservable inputs would result in a significantly lower (higher) fair value measurement,

respectively.

The following table presents a range of the unobservable inputs utilized in the fair value measurements of the Company's assets and liabilities classified as Level 3 at June 30, 2014:

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Quantitative information about Level 3 fair value measurements

	Valuation technique	Unobservable input	Period (by year)	Range
Fuel derivatives	Option model	Implied volatility	Third quarter 2014	8-19%
			Fourth quarter 2014	12-19%
			2015	12-20%
			2016	11-19%
			2017	11-16%
			2018	11-14%
Auction rate securities	Discounted cash flow	Time to principal recovery		8 years
		Illiquidity premium		3%
		Counterparty credit spread		1-3%

All settlements from fuel derivative contracts that are deemed “effective” are included in Fuel and oil expense in the period the underlying fuel is consumed in operations. Any “ineffectiveness” associated with hedges, including amounts that settled in the current period (realized), and amounts that will settle in future periods (unrealized), is recorded in earnings immediately as a component of Other (gains) losses, net. See Note 3 for further information on hedging. Any gains and losses (realized and unrealized) related to other investments are reported in Other operating expenses and were immaterial for the three and six months ended June 30, 2014 and 2013.

The carrying amounts and estimated fair values of the Company’s long-term debt (including current maturities), as well as the applicable fair value hierarchy tier, at June 30, 2014, are presented in the table below. The fair values of the Company’s publicly held long-term debt are determined based on inputs that are readily available in public markets or can be derived from information available in publicly quoted markets; therefore, the Company has categorized these agreements as Level 2. Six of the Company’s debt agreements are not publicly held. The Company has determined the estimated fair value of this debt to be Level 3, as certain inputs used to determine the fair value of these agreements are unobservable. The Company utilizes indicative pricing from counterparties and a discounted cash flow method to estimate the fair value of the Level 3 items.

(in millions)	Carrying value	Estimated fair value	Fair value level hierarchy
5.25% Notes due 2014	\$352	\$355	Level 2
5.75% Notes due 2016	317	348	Level 2
5.25% Convertible Senior Notes due 2016	114	226	Level 2
5.125% Notes due 2017	319	348	Level 2
Fixed-rate 717 Aircraft Notes payable through 2017 - 10.38%	7	8	Level 2
French Credit Agreements due 2018 - 1.03%	41	41	Level 3
Fixed-rate 737 Aircraft Notes payable through 2018 - 7.02%	27	28	Level 3
Term Loan Agreement due 2019 - 6.315%	195	201	Level 3
Term Loan Agreement due 2019 - 6.84%	79	85	Level 3
Term Loan Agreement due 2020 - 5.223%	393	378	Level 3
Floating-rate 737 Aircraft Notes payable through 2020	320	322	Level 3
Pass Through Certificates due 2022 - 6.24%	363	420	Level 2
7.375% Debentures due 2027	135	164	Level 2

9. LONG-TERM DEBT

On April 1, 2014, the Company prepaid a portion of its Fixed-rate 717 Aircraft Notes payable in the amount of \$35 million prior to their 2017 maturity date. This repayment was associated with eight of the ten Boeing 717s pledged as

collateral for the notes. As a result of the early repayment, the Company incurred a \$5 million make-whole penalty, representing the present value of the future interest payments on the notes, which is reflected as a component of Interest expense in the unaudited Condensed Consolidated Statement of Comprehensive Income. In addition, the Company wrote off the remainder of its unamortized debt premium associated with these notes in second quarter 2014, in the amount of \$5 million, which is reflected as a reduction to Interest expense in the unaudited Condensed Consolidated Statement of Comprehensive Income.

10. NET INCOME PER SHARE

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

	Three months ended June 30,		Six months ended June 30,	
	2014	2013	2014	2013
NUMERATOR:				
Net income	\$465	\$224	\$617	\$283
Incremental income effect of interest on 5.25% convertible notes	1	1	2	1
Net income after assumed conversion	\$466	\$225	\$619	\$284
DENOMINATOR:				
Weighted-average shares outstanding, basic	690	714	694	719
Dilutive effect of Employee stock options and restricted stock units	2	2	3	2
Dilutive effect of 5.25% convertible notes	6	6	6	6
Adjusted weighted-average shares outstanding, diluted	698	722	703	727
NET INCOME PER SHARE:				
Basic	\$0.67	\$0.31	\$0.89	\$0.39
Diluted	\$0.67	\$0.31	\$0.88	\$0.39
Potentially dilutive amounts excluded from calculations:				
Stock options and restricted stock units	—	10	—	15

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

Relevant comparative operating statistics for the three and six months ended June 30, 2014 and 2013 are included below. The Company provides these operating statistics because they are commonly used in the airline industry and, as such, allow readers to compare the Company's performance against its results for the prior year period, as well as against the performance of the Company's peers.

	Three months ended June 30,		Change %
	2014	2013	
Revenue passengers carried	29,155,114	28,960,367	0.7
Enplaned passengers			