SOUTHWEST AIRLINES CO
Form 10-Q
November 01, 2017

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

FORM 10-Q

(Mark One)
þ QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934
For the quarterly period ended September 30, 2017
or
¨ TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934
For the transition period from ________ to ________
Commission File No. 1-7259

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

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

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

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

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

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

Large accelerated filer þ	Accelerated filer ¨
Non-accelerated filer ¨ (Do not check if a smaller reporting company)	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 Exchange Act).Yes ¨ No þ

Number of shares of Common Stock outstanding as of the close of business on October 30, 2017: 593,387,660

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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)

	September 30, 2017	December 31, 2016
ASSETS		
Current assets:		
Cash and cash equivalents	$ 1,460	$ 1,680
Short-term investments	1,580	1,625
Accounts and other receivables	579	546
Inventories of parts and supplies, at cost	438	337
Prepaid expenses and other current assets	223	310
Total current assets	4,280	4,498
Property and equipment, at cost:		
Flight equipment	21,004	20,275
Ground property and equipment	4,219	3,779
Deposits on flight equipment purchase contracts	1,118	1,190
Assets constructed for others	1,460	1,220
	27,801	26,464
Less allowance for depreciation and amortization	9,645	9,420
	18,156	17,044
Goodwill	970	970
Other assets	843	774
	$ 24,249	$ 23,286
LIABILITIES AND STOCKHOLDERS' EQUITY		
Current liabilities:		
Accounts payable	$ 1,124	$ 1,178
Accrued liabilities	1,593	1,985
Air traffic liability	3,932	3,115
Current maturities of long-term debt	316	566
Total current liabilities	6,965	6,844
Long-term debt less current maturities	2,763	2,821
Deferred income taxes	3,697	3,374
Construction obligation	1,311	1,078
Other noncurrent liabilities	713	728
Stockholders' equity:		
Common stock	808	808
Capital in excess of par value	1,436	1,410
Retained earnings	12,806	11,418
Accumulated other comprehensive loss	(136)	(323)

Treasury stock, at cost	(6,114)	(4,872)
Total stockholders' equity	8,800	8,441
	$ 24,249	$ 23,286

See accompanying notes.

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

	Three months ended September 30,		Nine months ended September 30,	
	2017	2016	2017	2016
OPERATING REVENUES:				
Passenger	$4,745	$4,669	$14,403	$13,971
Freight	42	42	128	129
Other	484	428	1,366	1,250
Total operating revenues	5,271	5,139	15,897	15,350
OPERATING EXPENSES:				
Salaries, wages, and benefits	1,795	1,909	5,395	5,089
Fuel and oil	1,003	941	2,915	2,696
Maintenance materials and repairs	263	258	758	801
Aircraft rentals	51	56	158	174
Landing fees and other rentals	324	307	969	918
Depreciation and amortization	302	315	939	903
Other operating expenses	699	658	2,021	1,854
Total operating expenses	4,437	4,444	13,155	12,435
OPERATING INCOME	834	695	2,742	2,915
OTHER EXPENSES (INCOME):				
Interest expense	28	31	84	93
Capitalized interest	(15)	(12)	(38)	(34)
Interest income	(9)	(6)	(24)	(17)
Other (gains) losses, net	39	64	207	135
Total other expenses (income)	43	77	229	177
INCOME BEFORE INCOME TAXES	791	618	2,513	2,738
PROVISION FOR INCOME TAXES	288	230	913	1,016
NET INCOME	$503	$388	$1,600	$1,722
NET INCOME PER SHARE, BASIC	$0.84	$0.63	$2.65	$2.73
NET INCOME PER SHARE, DILUTED	$0.84	$0.62	$2.64	$2.70
COMPREHENSIVE INCOME	$630	$517	$1,787	$2,274
WEIGHTED AVERAGE SHARES OUTSTANDING				
Basic	597	618	605	630
Diluted	598	625	606	638

Cash dividends declared per common share	$.125	$.100	$.350	$.275

See accompanying notes.

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

	Three months ended September 30,		Nine months ended September 30,	
	2017	2016	2017	2016
CASH FLOWS FROM OPERATING ACTIVITIES:				
Net income	$503	$388	$1,600	$1,722
Adjustments to reconcile net income to cash provided by (used in) operating activities:				
Depreciation and amortization	302	315	939	903
Loss on asset impairment	—	—	—	21
Aircraft grounding charge	63	—	63	—
Unrealized/realized (gain) loss on fuel derivative instruments	(42)	(67)	(20)	(101)
Deferred income taxes	82	315	213	395
Changes in certain assets and liabilities:				
Accounts and other receivables	—	(320)	(23)	(355)
Other assets	(64)	(16)	(264)	(61)
Accounts payable and accrued liabilities	89	247	(156)	272
Air traffic liability	(80)	(77)	817	686
Cash collateral received from derivative counterparties	151	114	286	230
Other, net	(8)	(43)	(89)	(128)
Net cash provided by operating activities	996	856	3,366	3,584
CASH FLOWS FROM INVESTING ACTIVITIES:				
Capital expenditures	(638)	(464)	(1,603)	(1,364)
Assets constructed for others	(17)	(33)	(113)	(70)
Purchases of short-term investments	(531)	(641)	(1,653)	(1,670)
Proceeds from sales of short-term and other investments	566	549	1,696	1,671
Other, net	—	5	—	—
Net cash used in investing activities	(620)	(584)	(1,673)	(1,433)
CASH FLOWS FROM FINANCING ACTIVITIES:				
Proceeds from Employee stock plans	7	6	22	23
Reimbursement for assets constructed for others	17	33	113	68
Payments of long-term debt and capital lease obligations	(106)	(68)	(534)	(171)
Payments of cash dividends	(75)	(62)	(274)	(222)
Repayment of construction obligation	(2)	(2)	(7)	(6)
Repurchase of common stock	(300)	(250)	(1,250)	(1,450)
Other, net	6	(3)	17	(10)
Net cash used in financing activities	(453)	(346)	(1,913)	(1,768)
NET CHANGE IN CASH AND CASH EQUIVALENTS	(77)	(74)	(220)	383
CASH AND CASH EQUIVALENTS AT BEGINNING OF PERIOD	1,537	2,040	1,680	1,583
CASH AND CASH EQUIVALENTS AT END OF PERIOD	$1,460	$1,966	$1,460	$1,966

CASH PAYMENTS FOR:				
Interest, net of amount capitalized	$16	$27	$61	$77
Income taxes	$229	$264	$611	$902
SUPPLEMENTAL DISCLOSURE OF NONCASH TRANSACTIONS				
Flight equipment acquired through the assumption of debt	$—	$20	$—	$20
Flight equipment under capital leases	$77	$—	$180	$251
Assets constructed for others	$39	$50	$127	$165

See accompanying notes.

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

1. BASIS OF PRESENTATION

Southwest Airlines Co. (the "Company") operates Southwest Airlines, a major passenger airline that provides scheduled air transportation in the United States and near-international markets. The unaudited Condensed Consolidated Financial Statements include accounts of the Company and its wholly owned subsidiaries.

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 September 30, 2017 and 2016 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, corporate travel budgets, natural disasters, and other factors beyond the Company's control. 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 nine months ended September 30, 2017, are not necessarily indicative of the results that may be expected for future quarters or for the year ended December 31, 2017. 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, 2016.

2. NEW ACCOUNTING PRONOUNCEMENTS

On August 28, 2017, the Financial Accounting Standards Board (the "FASB") issued Accounting Standards Update ("ASU") No. 2017-12, Targeted Improvements to Accounting for Hedging Activities. The standard amends the hedge accounting model to enable entities to better portray the economics of their risk management activities in the financial statements and enhance the transparency and understandability of hedge results. The amendments also simplify the application of hedge accounting in certain situations. This ASU is effective for fiscal years, and interim periods within those years, beginning after December 15, 2018, with early adoption permitted in any interim or annual period. The most significant impacts of this ASU on the Company's accounting will be the elimination of ineffectiveness for all cash flow hedges in a hedging relationship, as well as a change in classification of premium expense associated with option contracts. Currently, such premium expense for the Company's fuel hedges is reflected as a component of Other (gains) losses, net, in the Condensed Consolidated Statement of Income, but under the new ASU will be reflected as a component of the line item to which the hedge relates, which is Fuel and oil expense. The Company is currently considering early adoption of the ASU as of January 1, 2018.

On March 10, 2017, the FASB issued ASU No. 2017-07, Improving the Presentation of Net Periodic Pension Cost and Net Periodic Postretirement Benefit Cost. The standard requires employers to present the service cost component of the net periodic benefit cost in the same income statement line item as other employee compensation costs arising from services rendered during the period. The other components of net benefit cost, including amortization of prior service cost/credit, and settlement and curtailment effects, are to be included in nonoperating expenses. This ASU is effective for fiscal years, and interim periods within those years, beginning after December 15, 2017. The Company does not expect this to have a material impact on Operating income and expects this to have no impact on Net income. The Company will adopt this guidance as of January 1, 2018.

On January 26, 2017, the FASB issued ASU No. 2017-04, Simplifying the Test for Goodwill Impairment. The standard simplifies the accounting for goodwill impairment by removing Step 2 of the goodwill impairment test (as defined by the FASB), which requires a hypothetical purchase price allocation (implied fair value of goodwill) to measure impairment loss. This ASU is effective for fiscal years, and interim periods within those years, beginning after December 15, 2019, with early adoption permitted. The Company does not expect this ASU to have a significant impact on its financial statement presentation or results.

On February 25, 2016, the FASB issued ASU No. 2016-02, Leases. The standard is effective for fiscal years, and interim periods within those years, beginning after December 15, 2018, with early adoption permitted. The guidance requires lessees to recognize a right-of-use asset and a lease liability on the balance sheet for all leases (with the exception of short-term leases) at the lease commencement date and recognize expenses on the income statement in a similar manner to the current guidance in Accounting Standards Codification 840, Leases. The lease liability will be measured at the present value of the unpaid lease payments and the right-of-use asset will be derived from the calculation of the lease liability. Lease payments will include fixed and in-substance fixed payments, variable payments based on an index or rate, reasonably certain purchase options, termination penalties, fees paid by the lessee to the owners of a special-purpose entity for restructuring the transaction, and probable amounts the lessee will owe under a residual value guarantee. Lease payments will not include variable lease payments other than those that depend on an index or rate, any guarantee by the lessee of the lessor’s debt, or any amount allocated to non-lease components.

The Company has formed a project team to evaluate and implement the standard, and currently believes the most significant impact of this ASU on its accounting will be the balance sheet impact of its aircraft operating leases, which will significantly increase assets and liabilities. As of September 30, 2017, the Company had 53 leased aircraft under operating leases and also had another 76 aircraft under operating leases that are being subleased to another airline. As of September 30, 2017, the net present value of future rents for those aircraft was approximately $1.0 billion. This amount only includes contractual payments due to lessors, and does not consider certain items that the standard requires to be assessed in determining the final asset and liability to be reflected on the Company's balance sheet, such as lease renewal options and potential impairments, nor does it consider the sublease income that is due from third parties. The Company also has operating leases related to terminal operations space and other real estate leases. Although the real estate leases will also have a substantial impact to the balance sheet, the Company does not expect the leases related to terminal operations space to have a significant impact since variable lease payments, other than those based on an index or rate, are excluded from the measurement of the lease liability. The Company also does not expect the adoption of this ASU to impact any of its existing debt covenants.

In addition, the standard eliminates the current build-to-suit lease accounting guidance and could result in derecognition of build-to-suit assets and liabilities that remained on the balance sheet after the end of the construction period. The underlying leases for these facilities will be subject to evaluation under the new standard. See Note 7 for further information on the Company’s build-to-suit projects.

The Company anticipates utilizing the modified retrospective transition approach to adopt the standard, which requires application of the new guidance for all periods presented with an option to use certain practical expedients. The Company currently plans to adopt the standard as of January 1, 2018, pending successful implementation of a third-party lease accounting software and completion of remaining administrative tasks. The Company is continuing to evaluate the new guidance and plans to provide additional information in its 2017 10-K.

On May 28, 2014, the FASB issued ASU No. 2014-09, Revenue from Contracts with Customers. Following the FASB's finalization of a one year deferral of this standard, the ASU is now effective for fiscal years, and interim periods within those years, beginning after December 15, 2017. The Company has formed a project team to evaluate and work to implement the standard, and currently believes the most significant impact of this ASU on its accounting will be the elimination of the incremental cost method for frequent flyer accounting, which will require the Company to re-value its liabilities associated with Customer flight points with a relative fair value approach, resulting in a significant increase in the liabilities. The Company's liabilities associated with these flight points were $64 million at September 30, 2017, and the Company currently estimates that applying a relative fair value approach would increase the liabilities by approximately 20 to 25 times that value, depending on various assumptions made at the time of measurement. The adoption of the new standard is also expected to result in different income statement classification for certain types of revenues which are currently classified as Other revenues, but under the new ASU would be included in Passenger revenues. Based on the Company's full year 2016 results, the amount to be reclassified would have been approximately $600 million. However, the estimated impact of this ASU would not have had a material impact on Operating revenues and would not have impacted any of its existing debt covenants. The Company currently anticipates utilizing the full retrospective method of adoption allowed by the standard, in order to provide for comparative results in all periods presented, and will adopt the standard as of January 1, 2018. The Company is continuing to evaluate the new guidance both internally and through its participation in an industry working group, and plans to continue to provide relevant and material information prior to adoption. The Company is in the process of completing its analysis of information necessary to recast prior period results, however it does not believe there are any remaining significant implementation topics associated with the adoption of this ASU that have not yet been addressed.

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 represents 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 timeframes, 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), put spreads (which include a purchased put option and a sold put 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 does not have coverage once market prices fall below the strike price of the purchased call option.

For the purpose of evaluating its net cash spend for jet fuel and for forecasting its future estimated jet fuel expense, the Company evaluates its hedge volumes strictly from an "economic" standpoint and thus does not consider whether the hedges have qualified or will qualify for hedge accounting. The Company defines its "economic" hedge as the net volume of fuel derivative contracts held, including the impact of positions that have been offset through sold positions, regardless of whether those contracts qualify for hedge accounting. 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 at settlement and may even produce hedging losses depending on market prices, the types of instruments held, and the strike prices of those instruments.

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

For the three and nine months ended September 30, 2017, the Company had fuel derivative instruments in place for up to 61 percent and 62 percent, respectively, of its fuel consumption. As of September 30, 2017, the Company also had fuel derivative instruments in place to provide coverage at varying price levels, but up to a maximum of approximately 64 percent of its remaining 2017 estimated fuel consumption, depending on where market prices settle. The following table provides information about the Company's volume of fuel hedging on an economic basis considering current market prices:

Period (by year)	Maximum fuel hedged as of September 30, 2017 (gallons in millions) (a)	Derivative underlying commodity type as of September 30, 2017
Remainder of 2017	320	WTI crude and Brent crude oil
2018	1,647	WTI crude and Brent crude oil
2019	1,377	WTI crude and Brent crude oil
Beyond 2019	358	WTI crude oil

(a) Due to the types of derivatives utilized by the Company and different price levels of those contracts, 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 in the period of the change. 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 and were de-designated as hedges 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 2016, or during the nine months ended September 30, 2017.

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

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:

		Asset derivatives		Liability derivatives	
	Balance Sheet	Fair value at	Fair value at	Fair value at	Fair value at
(in millions)	location	9/30/2017	12/31/2016	9/30/2017	12/31/2016
Derivatives designated as hedges (a)					
Fuel derivative contracts (gross)	Prepaid expenses and other current assets	$ 23	$ 7	$ 36	$ 44
Fuel derivative contracts (gross)	Other assets	85	126	—	—
Fuel derivative contracts (gross)	Accrued liabilities	16	4	84	412
Interest rate derivative contracts	Other noncurrent liabilities				