SOUTHWEST AIRLINES CO
Form 10-Q
April 29, 2016

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 March 31, 2016
or
¨ TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934
For the transition period from ________ to ________
Commission File No. 1-7259

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

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

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

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

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

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

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

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

Number of shares of Common Stock outstanding as of the close of business on April 26, 2016: 638,686,803

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PART I – FINANCIAL INFORMATION

Item 1. Financial Statements
Southwest Airlines Co.
Condensed Consolidated Balance Sheet
(in millions)
(unaudited)

	March 31, 2016	December 31, 2015
ASSETS		
Current assets:		
Cash and cash equivalents	$2,388	$ 1,583
Short-term investments	1,194	1,468
Accounts and other receivables	511	474
Inventories of parts and supplies, at cost	289	311
Prepaid expenses and other current assets	192	188
Total current assets	4,574	4,024
Property and equipment, at cost:		
Flight equipment	19,735	19,462
Ground property and equipment	3,308	3,219
Deposits on flight equipment purchase contracts	1,202	1,089
Assets constructed for others	986	915
	25,231	24,685
Less allowance for depreciation and amortization	9,267	9,084
	15,964	15,601
Goodwill	970	970
Other assets	733	717
	$22,241	$ 21,312
LIABILITIES AND STOCKHOLDERS' EQUITY		
Current liabilities:		
Accounts payable	$1,153	$ 1,188
Accrued liabilities	2,472	2,591
Air traffic liability	3,675	2,990
Current maturities of long-term debt	953	637
Total current liabilities	8,253	7,406
Long-term debt less current maturities	2,355	2,541
Deferred income taxes	2,609	2,490
Construction obligation	825	757
Other noncurrent liabilities	703	760
Stockholders' equity:		
Common stock	808	808
Capital in excess of par value	1,387	1,374
Retained earnings	9,872	9,409
Accumulated other comprehensive loss	(894)	(1,051)

Treasury stock, at cost	(3,677)	(3,182)
Total stockholders' equity	7,496	7,358
	$ 22,241	$ 21,312

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 March 31,	
	2016	2015
OPERATING REVENUES:		
Passenger	$4,398	$4,178
Freight	42	44
Other	386	192
Total operating revenues	4,826	4,414
OPERATING EXPENSES:		
Salaries, wages, and benefits	1,539	1,419
Fuel and oil	852	877
Maintenance materials and repairs	262	229
Aircraft rentals	59	60
Landing fees and other rentals	302	285
Depreciation and amortization	290	244
Acquisition and integration	—	23
Other operating expenses	578	497
Total operating expenses	3,882	3,634
OPERATING INCOME	944	780
OTHER EXPENSES (INCOME):		
Interest expense	30	32
Capitalized interest	(11)	(6)
Interest income	(5)	(1)
Other (gains) losses, net	114	32
Total other expenses (income)	128	57
INCOME BEFORE INCOME TAXES	816	723
PROVISION FOR INCOME TAXES	305	270
NET INCOME	$511	$453
NET INCOME PER SHARE, BASIC	$0.80	$0.67
NET INCOME PER SHARE, DILUTED	$0.79	$0.66
COMPREHENSIVE INCOME	$668	$449
WEIGHTED AVERAGE SHARES OUTSTANDING		
Basic	641	674
Diluted	648	682

Cash dividends declared per common share	$.075	$.060

See accompanying notes.

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

	Three months ended March 31,	
	2016	2015
CASH FLOWS FROM OPERATING ACTIVITIES:		
Net income	$511	$453
Adjustments to reconcile net income to cash provided by (used in) operating activities:		
Depreciation and amortization	290	244
Unrealized/realized (gain) loss on fuel derivative instruments	88	11
Deferred income taxes	26	19
Changes in certain assets and liabilities:		
Accounts and other receivables	(21)	(130)
Other assets	4	13
Accounts payable and accrued liabilities	313	177
Air traffic liability	685	717
Cash collateral provided to derivative counterparties	(231)	(17)
Other, net	(49)	(35)
Net cash provided by operating activities	1,616	1,452
CASH FLOWS FROM INVESTING ACTIVITIES:		
Capital expenditures	(438)	(573)
Assets constructed for others	(11)	(22)
Purchases of short-term investments	(256)	(316)
Proceeds from sales of short-term and other investments	530	609
Net cash used in investing activities	(175)	(302)
CASH FLOWS FROM FINANCING ACTIVITIES:		
Proceeds from Employee stock plans	11	13
Proceeds from termination of interest rate derivative instruments	—	12
Reimbursement for assets constructed for others	10	2
Payments of long-term debt and capital lease obligations	(56)	(51)
Payments of cash dividends	(96)	(81)
Repayment of construction obligation	(2)	(2)
Repurchase of common stock	(500)	(300)
Other, net	(3)	—
Net cash used in financing activities	(636)	(407)
NET CHANGE IN CASH AND CASH EQUIVALENTS	805	743
CASH AND CASH EQUIVALENTS AT BEGINNING OF PERIOD	1,583	1,282
CASH AND CASH EQUIVALENTS AT END OF PERIOD	$2,388	$2,025
CASH PAYMENTS FOR:		
Interest, net of amount capitalized	$27	$32

Income taxes	$73	$111
SUPPLEMENTAL DISCLOSURE OF NONCASH TRANSACTIONS		
Flight equipment under capital leases	$169	$41
Assets constructed for others	$60	$43

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, 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. AirTran's final passenger service was on December 28, 2014.

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 March 31, 2016 and 2015 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, 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 months ended March 31, 2016, are not necessarily indicative of the results that may be expected for future quarters or for the year ended December 31, 2016. 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, 2015.

2. NEW ACCOUNTING PRONOUNCEMENTS AND CHANGES IN ACCOUNTING OR ESTIMATES

New accounting pronouncements
On March 30, 2016, the Financial Accounting Standards Board ("FASB") issued Accounting Standards Update ("ASU") No. 2016-09, Improvements to Employee Share-Based Payment Accounting. The standard is part of the FASB effort to simplify various aspects related to how share-based payments are accounted for and presented in the financial statements. This ASU is effective for fiscal years, and interim periods within those years, beginning after December 15, 2016. Early adoption is permitted in any interim or annual period, with any adjustments reflected as of the beginning of the fiscal year of adoption. The Company is evaluating the new guidance and plans to provide additional information at a future date.
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 Company

believes the most significant impact of this ASU will be the presentation of operating leases with durations greater than twelve months, with certain exceptions, on the balance sheet. The Company is evaluating the new guidance and plans to provide additional information about its expected financial impact at a future date.

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

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 on or after December 15, 2017, with early adoption permitted for fiscal years, and interim periods within those years, beginning on or after December 15, 2016. The Company 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 liability associated with flight points earned by Customers with a relative fair value approach, resulting in a significant increase in the liability. The Company is continuing to evaluate the new guidance and plans to provide additional information about its expected financial impact at a future date.

Changes in accounting or estimates
Southwest sells frequent flyer points and related services to companies participating in its frequent flyer program. Historically, funds received from the sale of points associated with these agreements were accounted for under the residual method. Under this method, the Company estimated the portion of the amounts received from the sale of frequent flyer points that related to free travel and these amounts were deferred and recognized as Passenger revenue when the ultimate free travel awards were flown. On July 1, 2015, the Company executed an amended co-branded credit card agreement ("Agreement") with Chase Bank USA, N.A. (“Chase”), through which the Company sells loyalty points and other items to Chase. This material modification triggered an accounting change under ASU No. 2009-13, which is recorded on a prospective basis. The impact of the accounting change is that the Company estimated the selling prices and volumes over the term of the Agreement in order to determine the allocation of proceeds to each of the deliverables (travel points to be awarded; use of the Southwest Airlines’ brand and access to Rapid Reward Member lists; advertising elements; and the Company’s resource team). The Company records passenger revenue related to air transportation and certificates for discounted companion travel when the transportation is delivered. The other elements are recognized as Other - net revenue when earned.

The Company followed the transition approach of ASU No. 2009-13, which required that the Company adjust the existing deferred revenue balance to reflect the value, on a relative selling price basis, of any undelivered element remaining at the date of contract modification. The relative selling price of the undelivered element (air transportation) was lower than the rate at which it had been deferred under the residual method. The estimated impacts on revenue and earnings from this change in accounting principle for the three months ended March 31, 2016 are as follows:

(in millions, except per share amounts)	Three months ended March 31, 2016
Passenger revenue	$ (54)
Other revenue	169
Operating revenues	$ 115
Net income	$ 62
Net income per basic share	$ 0.10
Net income per diluted share	$ 0.09

At the end of December 2015, the Company revised its future firm delivery schedule by adding 33 Boeing 737-800 aircraft and converting all of its remaining Boeing 737-700 firm orders to 737-800s. Furthermore, in first quarter

2016, the Company made the decision to further simplify its operations and resolve uncertainty surrounding Federal Aviation Administration ("FAA") pilot training requirements for flying both its Classic Boeing 737-300 and Boeing 737-8 aircraft, which is scheduled to be added to the Company’s fleet in mid-2017. These decisions have resulted in the Company accelerating the retirement of its less-efficient Boeing 737-300 fleet to no later than third quarter 2017, versus the original scheduled retirement of this fleet that had extended out to 2021. This change in retirement dates is considered a change in estimate and has been accounted for on a prospective basis as of the dates the decisions were finalized. Therefore, the Company has recorded and will record accelerated depreciation expense over the remainder of the useful lives for each aircraft and related parts.

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The estimated impacts on expense and earnings from this change in assumption for the three months ended March 31, 2016 are as follows:

(in millions, except per share amounts)	Three months ended March 31, 2016
Depreciation expense	$ 28
Net income	$ (15)
Net income per basic share	$ (0.02)
Net income per diluted share	$ (0.02)

The estimated impact of the acceleration of retirement dates for these aircraft for the remainder of 2016 is an approximate $88 million increase to Depreciation and amortization expense.

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), 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.

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.

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For the three months ended March 31, 2016, the Company had fuel derivative instruments in place for up to 15 percent of its fuel consumption. As of March 31, 2016, the Company also has fuel derivative instruments in place to provide coverage at varying price levels, but up to a maximum of approximately 60 percent of its remaining 2016 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 2016 through 2018 on an “economic” basis:

Period (by year)	Fuel hedged as of March 31, 2016 (gallons in millions) (a)	Derivative underlying commodity type as of March 31, 2016
Remainder of 2016	884	Brent crude oil and Gulf Coast jet fuel
2017	1,269	WTI crude and Brent crude oil
2018	731	Brent 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. 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 2015, or during the three months ended March 31, 2016.

In some situations, an entire commodity type used in hedging may cease to qualify for special hedge accounting treatment. As an example, in certain prior periods, the Company's routine statistical analysis performed to determine which commodities qualified for special hedge accounting treatment on a prospective basis dictated that WTI crude oil based derivatives no longer qualified for hedge accounting. This was primarily due to the fact that the correlation between WTI crude oil prices and jet fuel prices fell below established thresholds, and therefore the Company could no longer demonstrate that derivatives based on WTI crude oil prices would result in effective hedges on a prospective basis. As such, the changes in fair value of all of the Company's derivatives based in WTI were recorded directly to Other (gains) losses on a prospective basis. The Company's routine statistical analysis performed for the three months ended March 31, 2016, dictated that all commodities currently being utilized by the Company do qualify for hedge accounting.

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

Southwest Airlines Co.
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(unaudited)

and liabilities associated with the Company's derivative instruments within the unaudited Condensed Consolidated Balance Sheet:

		Asset derivatives		Liability derivatives	
(in millions)	Balance Sheet location	Fair value at 3/31/2016	Fair value at 12/31/2015	Fair value at 3/31/2016	Fair value at 12/31/2015
Derivatives designated as hedges*					
Fuel derivative contracts (gross)	Prepaid expenses and other current assets	$1	$ 2	$—	$ —
Fuel derivative contracts (gross)	Other assets	6	2	26	—
Fuel derivative contracts (gross)	Accrued liabilities	74	107	548	526
Fuel derivative contracts (gross)	Other noncurrent liabilities	54	55	498	658
Interest rate derivative contracts	Other assets	16	2	—	—
Interest rate derivative contracts	Other noncurrent liabilities	—	—	46	49
Total derivatives designated as hedges		$151	$ 168	$1,118	$ 1,233
Derivatives not designated as hedges*					
Fuel derivative contracts (gross)	Prepaid expenses and other current assets	$29	$ 39	$19	$ 26
Fuel derivative contracts (gross)	Other assets	39	5	—	—
Fuel derivative contracts (gross)	Accrued liabilities	920	1,395	1,390	1,854
Fuel derivative contracts (gross)	Other noncurrent liabilities	298	330	348	352
Total derivatives not designated as hedges		$1,286	$ 1,769	$1,757	$ 2,232
Total derivatives		$1,437	$ 1,937	$2,875	$ 3,465

* 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	March 31, 2016	December 31, 2015
Cash collateral deposits held from counterparties for fuel contracts - current	Offset against Prepaid expenses and other current assets	$ 9	$ —
Cash collateral deposits held from counterparties for fuel contracts - noncurrent	Offset against Other assets	4	—
Cash collateral deposits provided to counterparties for fuel contracts - current	Offset against Accrued liabilities	586	235

Cash collateral deposits provided to counterparties for fuel contracts - noncurrent	Offset against Other noncurrent liabilities	494	600
Due to third parties for fuel contracts	Accounts payable	53	46

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 standards for derivatives and hedging. The types of derivative instruments the Company has determined are subject to netting requirements in the accompanying unaudited Condensed

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

Consolidated Balance Sheet are those in which the Company pays or receives cash for transactions with the same counterparty 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)

		(i)	(ii)	(iii) = (i) + (ii)	(i)	(ii)	(iii) = (i) + (ii)
		March 31, 2016			December 31, 2015		
Description	Balance Sheet location	Gross amounts of recognized assets	Gross amounts offset in the Balance Sheet	Net amounts of assets presented in the Balance Sheet (a)	Gross amounts of recognized assets	Gross amounts offset in the Balance Sheet	Net amounts of assets presented in the Balance Sheet (a)
Fuel derivative contracts	Prepaid expenses and other current assets	$30	$(28)	$ 2	$41	$(26)	$ 15
Fuel derivative contracts	Other assets	$45	$(30)	$ 15	$7	$—	$ 7
Fuel derivative contracts	Accrued liabilities	$1,580	$(1,580)	$ —	$1,737	$(1,737)	$ —
Fuel derivative contracts	Other noncurrent liabilities	$846	$(846)	$ —	$985	$(985)	$ —
Interest rate derivative contracts	Other assets	$16	$—	$ 16	$2	$—	$ 2

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

Offsetting of derivative liabilities
(in millions)

		(i)	(ii)	(iii) = (i) + (ii)	(i)	(ii)	(iii) = (i) + (ii)
		March 31, 2016			December 31, 2015		
Description	Balance Sheet location	Gross amounts of recognized liabilities	Gross amounts offset in the Balance Sheet	Net amounts of liabilities presented in the Balance Sheet (a)	Gross amounts of recognized liabilities	Gross amounts offset in the Balance Sheet	Net amounts of liabilities presented in the Balance Sheet (a)
Fuel derivative contracts	Prepaid expenses and other current assets	$28	$(28)	$ —	$26	$(26)	$ —
Fuel derivative contracts	Other assets	$30	$(30)	$ —	$—	$—	$ —
Fuel derivative contracts	Accrued liabilities	$1,938	$(1,580)	$ 358	$2,380	$(1,737)	$ 643
Fuel derivative contracts	Other noncurrent liabilities	$846	$(846)	$ —	$1,010	$(985)	$ 25
Interest rate derivative contracts	Other noncurrent liabilities	$46	$—	$ 46	$49	$—	$ 49

(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 months ended March 31, 2016 and 2015:

Derivatives in cash flow hedging relationships

	(Gain) loss recognized in AOCI on derivatives (effective portion)		(Gain) loss reclassified from AOCI into income (effective portion) (a)		(Gain) loss recognized in income on derivatives (ineffective portion) (b)	
	Three months ended March 31,		Three months ended March 31,		Three months ended March 31,	
(in millions)	2016	2015	2016	2015	2016	2015
Fuel derivative contracts	$ 36 *	$ 48 *	$ 195 *	$ 45 *	$ 4	$ (13)
Interest rate derivatives	5 *	4 *	2 *	3 *	—	(1)
Total	$ 41	$ 52	$ 197	$ 48	$ 4	$ (14)

*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 Three months ended March 31, 2016	2015	Location of (gain) loss recognized in income on derivatives
Fuel derivative contracts	$ 76	$ 19	Other (gains) losses, net

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The Company also recorded expense associated with premiums paid for fuel derivative contracts that settled/expired during the three months ended March 31, 2016 and 2015 of $35 million and $26 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 losses from fuel hedges as of March 31, 2016, recorded in AOCI, were approximately $547 million in unrealized losses, net of taxes, which are expected to be realized in earnings during the twelve months subsequent to March 31, 2016.

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. Several of the Company's interest rate swap agreements 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 that do not qualify for the "shortcut" method of accounting, ineffectiveness is required to be measured at each reporting period. The ineffectiveness associated with all of the Company’s interest rate 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 March 31, 2016, 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. In certain cases, the Company has the ability to substitute among these different forms of collateral at its discretion. For example, at March 31, 2016, the Company had chosen to provide all of its collateral in the form of cash postings, although it could have chosen to provide aircraft and/or letters of credit for a significant portion of its collateral posted.

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The following table provides the fair values of fuel derivatives, amounts posted as collateral, and applicable collateral posting threshold amounts as of March 31, 2016, at which such postings are triggered:

	Counterparty (CP)							
(in millions)	A	B	C	D	E	F	Other (a)	Total
Fair value of fuel derivatives	$(565)	$ (183)	$ (118)	$ (415)	$ (145)	$ 15	$ 3	$(1,408)
Cash collateral held from (by) CP	(544)	(140)	(12)	(355)	(31)	15	—	(1,067)
Aircraft collateral pledged to CP	—	—	—	—	—	—	—	—
Letters of credit (LC)	—	—	—	—	—	—	—	—
Option to substitute LC for aircraft	(200) to (600)(h)	(100) to (500)(d)	N/A	(150) to (550)(d)	(150) to (550)(d)	N/A		
Option to substitute LC for cash	N/A	>(500)(e)	(225) to (275)(e)	(75) to (150) or >(550)(e)	(75) to (150) or >(550)(e)	(g)		
If credit rating is investment grade, fair value of fuel derivative level at which:								
Cash is provided to CP	(50) to (200) or >(600)	(50) to (100) or >(500)	>(125)	(75) to (150) or >(550)	(125) to (150) or >(550)	>(100)		
Cash is received from CP	>50	>150	>175(c)	>250	>75	>0		
Aircraft or cash can be pledged to CP as collateral	(200) to (600)(f)	(100) to (500)(d)	N/A	(150) to (550)(d)	(150) to (550)(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 (200) or >(600)	(0) to (100) or >(500)	(b)	(0) to (150) or >(550)	(0) to (150) or >(550)	(b)		
Cash is received from CP	(b)	(b)	(b)	(b)	(b)	(b)		
Aircraft or cash can be pledged to CP as collateral	(200) to (600)	(100) to (500)	N/A	(150) to (550)	(150) to (550)	N/A		

(a) Individual counterparties with fair value of fuel derivatives <$5 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.
(e) The Company has the option of providing cash or letters of credit as collateral.
(f) The Company has the option of providing cash or pledging aircraft as collateral.
(g) The Company has the option to substitute letters of credit for 100 percent of cash collateral requirement.

(h) The Company has the option of providing letters of credit in addition to aircraft collateral if the appraised value of the aircraft does not meet the collateral requirements.

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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 months ended March 31, 2016 and 2015, were as follows:

	Three months ended March 31,	
(in millions)	2016	2015
NET INCOME	$511	$453
Unrealized gain (loss) on fuel derivative instruments, net of deferred taxes of $93 and ($1)	160	(3)
Unrealized loss on interest rate derivative instruments, net of deferred taxes of ($1) and $-	(3)	(1)
Total other comprehensive income (loss)	$157	$(4)
COMPREHENSIVE INCOME	$668	$449

A rollforward of the amounts included in AOCI, net of taxes, is shown below for the three months ended March 31, 2016:

(in millions)	Fuel derivatives	Interest rate derivatives	Defined benefit plan items	Other	Deferred tax	Accumulated other comprehensive income (loss)
Balance at December 31, 2015	$ (1,666)	$ (30)	$ 22	$ 6	$ 617	$ (1,051)
Changes in fair value	(57)	(8)	—	—	25	(40)
Reclassification to earnings	310	4	—	—	(117)	197
Balance at March 31, 2016	$ (1,413)	$ (34)	$ 22	$ 6	$ 525	$ (894)

The following table illustrates the significant amounts reclassified out of each component of AOCI for the three months ended March 31, 2016:

Three months ended March 31, 2016 (in millions) AOCI components	Amounts reclassified from AOCI	Affected line item in the unaudited Condensed Consolidated Statement of Comprehensive Income
Unrealized loss on fuel derivative instruments	$ 310	Fuel and oil expense
	115	Less: Tax Expense
	$ 195	Net of tax
Unrealized loss on interest rate derivative instruments	$ 4	Interest expense
	2	Less: Tax Expense
	$ 2	Net of tax

Total reclassifications for the period	$	197	Net of tax

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5. SUPPLEMENTAL FINANCIAL INFORMATION

(in millions)	March 31, 2016	December 31, 2015
Intangible assets	$ 460	$ 464
Non-current investments	41	40
Other	232	213
Other assets	$ 733	$ 717

(in millions)	March 31, 2016	December 31, 2015
Accounts payable trade	$ 191	$ 178
Salaries payable	171	173
Taxes payable	246	179
Aircraft maintenance payable	75	168
Fuel payable	49	48
Other payables	421	442
Accounts payable	$ 1,153	$ 1,188

(in millions)	March 31, 2016	December 31, 2015
ProfitSharing and savings plans	$ 798	$ 655
Aircraft and other lease related obligations	50	74
Vacation pay	314	309
Accrued union bonuses	244	329
Health	80	86
Derivative contracts	358	643
Workers compensation	191	187
Property and income taxes	232	62
Other	205	246
Accrued liabilities	$ 2,472	$ 2,591

(in millions)	March 31, 2016	December 31, 2015
Postretirement obligation	$ 206	$ 201
Non-current lease-related obligations	155	165
Other deferred compensation	168	179
Deferred gains from sale and leaseback of aircraft	40	43
Derivative contracts	46	74
Other	88	98
Other noncurrent liabilities	$ 703	$ 760

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 exceeded 10 percent of Operating expenses.

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6. 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 March 31,	
	2016	2015
NUMERATOR:		
Net income	$511	$453
Incremental income effect of interest on 5.25% convertible notes	1	1
Net income after assumed conversion	$512	$454
DENOMINATOR:		
Weighted-average shares outstanding, basic	641	674
Dilutive effect of Employee stock options and restricted stock units	1	2
Dilutive effect of 5.25% convertible notes	6	6
Adjusted weighted-average shares outstanding, diluted	648	