Invesco Mortgage Capital Inc.
Form 424B5
June 20, 2011

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The information in this preliminary prospectus supplement is not complete and may be changed. This preliminary prospectus supplement and the accompanying prospectus are not an offer to sell these securities and are not soliciting an offer to buy these securities in any state where the offer or sale thereof is not permitted.

SUBJECT TO COMPLETION, DATED JUNE 20, 2011

PRELIMINARY PROSPECTUS SUPPLEMENT TO PROSPECTUS DATED MAY 27, 2011

15,000,000 Shares

Invesco Mortgage Capital Inc.

Common Stock

We are offering 15,000,000 shares of our common stock as described in this prospectus supplement and the accompanying prospectus.

Our common stock is traded on the New York Stock Exchange, or NYSE, under the symbol IVR. The closing price of our common stock on the NYSE on June 17, 2011 was $20.89 per share.

The underwriters may also purchase up to an additional 2,250,000 shares of our common stock from us at the public offering price, less the underwriting discount, within 30 days after the date of this prospectus supplement to cover over-allotments, if any.

To assist us in maintaining our qualification as a real estate investment trust, or REIT, for federal income tax purposes, no person may own more than 9.8% by value or number of shares, whichever is more restrictive, of our outstanding shares of common stock, unless our board of directors waives this limitation.

Investing in our common stock involves risk. See the risks set forth under the heading Item 1A. Risk Factors beginning on page 14 of our Annual Report on Form 10-K for the year ended December 31, 2010 and the risks set forth under the heading Item 1A. Risk Factors beginning on page 41 of our Quarterly Report on Form 10-Q for the quarter ended March 31, 2011.

	Per Share	Total
Public offering price	$	$
Underwriting discounts and commissions	$	$
Proceeds, before expenses, to us	$	$

Neither the Securities and Exchange Commission nor any state securities commission has approved or disapproved of these securities or determined if this prospectus supplement or the accompanying prospectus is truthful or complete. Any representation to the contrary is a criminal offense.

The shares will be ready for delivery on or about , 2011.

Credit Suisse **Morgan Stanley**

The date of this prospectus supplement is , 2011.

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PROSPECTUS SUPPLEMENT

PROSPECTUS

You should rely only on the information contained in this document or to which we have referred you. We have not authorized anyone to provide you with information that is different. This document may only be used where it is legal to sell these securities. The information in this document may only be accurate on the date of this document.

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ABOUT THIS PROSPECTUS SUPPLEMENT

This prospectus supplement is a supplement to the accompanying prospectus that is also a part of this document. This prospectus supplement and the accompanying prospectus are part of a registration statement on Form S-3ASR that we filed with the Securities and Exchange Commission, or SEC or Commission, using a shelf registration process. This prospectus supplement contains specific information about us and the terms on which we are offering and selling shares of our common stock. To the extent that any statement made in this prospectus supplement is inconsistent with statements made in the prospectus, the statements made in the prospectus will be deemed modified or superseded by those made in this prospectus supplement. To the extent any information or data in any documents filed by the Company and incorporated by reference herein is inconsistent with prior information or data previously provided by the Company, the information or data in the previously filed document shall be deemed modified or superseded by the subsequent information or data. Before you purchase shares of our common stock, you should carefully read this prospectus supplement, the accompanying prospectus and the registration statement, together with the documents incorporated by reference in this prospectus supplement and the accompanying prospectus.

When used in this prospectus, the terms company, issuer, we, our, and us refer to Invesco Mortgage Capit and its consolidated subsidiaries, unless otherwise specified. Our Manager refers to Invesco Advisers, Inc., a Delaware corporation, our external manager. Invesco refers to Invesco Ltd., together with its consolidated subsidiaries (other than us), which is the indirect parent company of our Manager.

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SPECIAL NOTE REGARDING FORWARD-LOOKING STATEMENTS

We make forward-looking statements in this prospectus supplement, the accompanying prospectus and other filings we make with the SEC within the meaning of Section 27A of the Securities Act of 1933, as amended, or the Securities Act, and Section 21E of the Securities Exchange Act of 1934, as amended, or the Exchange Act, and such statements are intended to be covered by the safe harbor provided by the same. Forward-looking statements are subject to substantial risks and uncertainties, many of which are difficult to predict and are generally beyond our control. These forward-looking statements include information about possible or assumed future results of our business, financial condition, liquidity, results of operations, plans and objectives. When we use the words believe, expect, anticipate, estimate, plan, continue, intend, should, may or similar expressions, we intend to ide forward-looking statements. Statements regarding the following subjects, among others, may be forward-looking:

- use of proceeds of this offering;
- our business and investment strategy;
- our investment portfolio;
- our projected operating results;
- the impact of any deficiencies in foreclosure practices of third parties and related delays in the foreclosure process;
- actions and initiatives of the U.S. government and changes to U.S. government policies, including the Dodd-Frank Wall Street Reform and Consumer Protection Act and our ability to respond to and comply with such actions, initiatives and changes;
- our ability to obtain additional financing arrangements and the terms of such arrangements;
- financing and advance rates for our target assets;
- our expected leverage;
- general volatility of the securities markets in which we invest;
- our expected investments;
- interest rate mismatches between our target assets and our borrowings used to fund such investments;
- changes in interest rates and the market value of our target assets;
- changes in prepayment rates on our target assets;
- effects of hedging instruments on our target assets;
- rates of default or decreased recovery rates on our target assets;
- modifications to whole loans or loans underlying securities;
- the degree to which our hedging strategies may or may not protect us from interest rate volatility;

changes in governmental regulations, tax law and rates, and similar matters and our ability to respond to such changes;

our ability to maintain our qualification as a REIT for U.S. federal income tax purposes;

our ability to maintain our exemption from registration under the Investment Company Act of 1940, as amended;

- availability of investment opportunities in mortgage-related, real estate-related and other securities;
- availability of qualified personnel;
- estimates relating to our ability to continue to make distributions to our shareholders in the future;
- changes to accounting principles generally accepted in the U.S.;
- our understanding of our competition; and
- market trends in our industry, interest rates, real estate values, the debt securities markets or the general economy.

The forward-looking statements are based on our beliefs, assumptions and expectations of our future performance, taking into account all information currently available to us. You should not place undue reliance on these forward-looking statements. These beliefs, assumptions and expectations can change as a result of many possible events or factors, not all of which are known to us. Some of these factors are described in our Annual Report on Form 10-K for the year ended December 31, 2010 and our Quarterly Report on Form 10-Q for the quarter ended March 31, 2011, both of which are incorporated by reference in this prospectus supplement and the accompanying prospectus, under the headings Risk Factors, Management s Discussion and Analysis of Financial Condition and Results of Operations and Business. If a change occurs, our business, financial condition, liquidity and results of operations may vary materially from those expressed in our forward-looking statements. Any forward-looking statement speaks only as of the date on which it is made. New risks and uncertainties arise over time, and it is not possible for us to predict those events or how they may affect us. Except as required by law, we are not obligated to, and do not intend to, update or revise any forward-looking statements, whether as a result of new information, future events or otherwise.

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PROSPECTUS SUPPLEMENT SUMMARY

This summary highlights selected information about us. It may not contain all the information that may be important to you in deciding whether to invest in our common stock. You should read this entire prospectus supplement and the accompanying prospectus, together with the information incorporated by reference, including the risk factors, financial data and related notes, before making an investment decision.

Our Company

Invesco Mortgage Capital Inc. is a Maryland corporation primarily focused on investing in, financing and managing residential and commercial mortgage-backed securities and mortgage loans. We invest in residential mortgage-backed securities for which a U.S. government agency or a federally chartered corporation guarantees payments of principal and interest on the securities, or Agency RMBS. In addition, we invest in residential mortgage-backed securities that are not issued or guaranteed by a U.S. government agency, or non-Agency RMBS, commercial mortgage-backed securities, or CMBS, and residential and commercial mortgage loans. We generally finance our Agency RMBS, non-Agency RMBS and CMBS through repurchase agreement financing. In addition, we have historically financed our CMBS portfolio with financings under the U.S. government s Term Asset-Backed Securities Loan Facility, which was repaid and replaced by repurchase agreements during 2010. We have also financed our investments in certain non-Agency RMBS, CMBS and residential and commercial mortgage loans by contributing capital to one of the legacy securities public-private investment funds established and managed by our Manager or one of its affiliates, that receive financing under the U.S. government s Public-Private Investment Program, or the Invesco PPIP Fund, which, in turn, invests in our target assets. We are externally managed and advised by Invesco Advisers, Inc., a Delaware corporation and an indirect, wholly-owned subsidiary of Invesco Ltd., an independent global investment company listed on the New York Stock Exchange (NYSE: IVZ).

We have elected to be taxed as a REIT for federal income tax purposes beginning with our taxable year ended December 31, 2009 and we intend to continue to be taxed as a REIT. To assist us in maintaining our qualification as a REIT, shareholders are generally restricted from owning more than 9.8% by value or number of shares, whichever is more restrictive, of our outstanding shares of common stock. In addition, our charter contains various other restrictions on the ownership and transfer of our common stock. See Restrictions on Ownership and Transfer in the accompanying prospectus.

Our principal offices are located at 1555 Peachtree Street, NE, Atlanta, Georgia 30309, and our telephone number at that address is (404) 892-0896. Our website is located at *http://www.invescomortgagecapital.com*. The information contained on our website is not part of this prospectus supplement or the accompanying prospectus.

Recent Developments

Our book value per share of common stock at May 31, 2011 was $20.63, compared to $21.24 at March 31, 2011, in each case on a fully diluted basis. The May 31, 2011 book value includes our retained earnings of April and May 2011. This decline in our book value was primarily due to the change in the valuation of our interest rate hedges. Since May 31, 2011, swap rates have experienced further declines and the markets in which we participate have experienced increased volatility, which could negatively impact our book value.

On June 9, 2011, our board of directors declared a dividend of $0.97 per share for the second quarter of 2011. The dividend represents our estimate of undistributed taxable earnings. The dividend will be paid on July 28, 2011 to shareholders of record on June 17, 2011 and therefore, investors in this offering will not be entitled to receive this dividend.

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The Offering

Common stock offered by us [1]	15,000,000 shares.
Common stock outstanding after this offering [1]	88,394,369 shares.
Use of Proceeds	Our net proceeds from the sale of the common stock will be approximately $ million, after deducting underwriting discounts and estimated offering expenses. If the underwriters over-allotment option is exercised in full, our net proceeds from the offering will be approximately $ million, after deducting underwriting discounts and estimated offering expenses. We plan to use all of the net proceeds from this offering to purchase Agency RMBS, non-Agency RMBS, CMBS and certain residential and commercial mortgage loans and to invest in the Invesco PPIP Fund, in each case subject to our investment guidelines and to the extent consistent with maintaining our REIT qualification and other general corporate purposes. Our Manager will make the final determinations as to the percentage of our equity that will be invested in, as well as the appropriate amounts of leverage that we maintain in respect of, each of our target assets and asset classes. Our Manager s determinations will depend upon then prevailing market conditions and may change over time in response to opportunities available in different interest rate, economic and credit environments. Until appropriate assets can be identified, our Manager may decide to use the net proceeds to pay off our short-term debt or invest the net proceeds in interest-bearing short-term investments, including funds which are consistent with our REIT election. These investments are expected to provide a lower net return than we seek to achieve from our target assets. Prior to the time we have fully used the net proceeds of this offering to acquire our target assets, we may fund our quarterly distributions out of such net proceeds.
Distribution Policy	We intend to continue to make regular quarterly distributions to holders of our common stock in an amount equal to at least 90% of our taxable income. U.S. federal income tax law generally requires that a REIT distribute annually at least 90% of its REIT taxable income, determined without regard to the deduction for dividends paid and excluding net capital gains, and that it pay tax at regular corporate rates on its undistributed taxable income.

Any distributions we make are at the discretion of our board of directors and depend upon, among other things, our actual results of operations. These results and our ability to continue to pay distributions will be affected by various factors, including the net interest and other income from our

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	portfolio, our operating expenses and any other expenditures.
New York Stock Exchange symbol	IVR
Risk Factors	Investing in our common stock involves a high degree of risk. You should carefully read and consider the information set forth under the headings Item 1A. Risk Factors beginning on page 14 of our Annual Report on Form 10-K for the year ended December 31, 2010 and Item 1A. Risk Factors beginning on page 41 of our Quarterly Report on Form 10-Q for the quarter ended March 31, 2011 and all other information in this prospectus supplement and the accompanying prospectus before investing in our common stock.

(1) We have granted the underwriters a 30-day option to purchase up to 2,250,000 additional shares of our common stock. Unless otherwise indicated, all amounts in this prospectus supplement assume no exercise of the underwriters option.

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USE OF PROCEEDS

Our net proceeds from the sale of the common stock will be approximately $ million, after deducting underwriting discounts and estimated offering expenses. If the underwriters over-allotment option is exercised in full, our net proceeds from the offering will be approximately $ million, after deducting underwriting discounts and estimated offering expenses.

We plan to use all of the net proceeds from this offering to purchase Agency RMBS, non-Agency RMBS, CMBS and certain residential and commercial mortgage loans and to invest in the Invesco PPIP Fund, in each case subject to our investment guidelines and to the extent consistent with maintaining our REIT qualification and other general corporate purposes. Our Manager will make the final determinations as to the percentage of our equity that will be invested in, as well as the appropriate amounts of leverage that we maintain in respect of, each of our target assets and asset classes. Our Manager s determinations will depend upon then prevailing market conditions and may change over time in response to opportunities available in different interest rate, economic and credit environments. Until appropriate assets can be identified, our Manager may decide to use the net proceeds to pay off our short-term debt or invest the net proceeds in interest-bearing short-term investments, including funds which are consistent with our REIT election. These investments are expected to provide a lower net return than we seek to achieve from our target assets. Prior to the time we have fully used the net proceeds of this offering to acquire our target assets, we may fund our quarterly distributions out of such net proceeds.

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CAPITALIZATION

The following table sets forth (1) our actual capitalization at March 31, 2011, and (2) our capitalization as adjusted to reflect the effect of the sale of our common stock in this offering at the offering price of $ per share, after deducting the underwriting discount and estimated offering expenses. You should read this table together with our consolidated financial statements and the related notes incorporated by reference in this prospectus supplement and the accompanying prospectus.

	Actual (As of March 31, 2011)	As Adjusted for this Offering[1]
Shareholders equity:		
Common stock, par value $0.01 per share; 450,000,000 shares authorized, and 72,154,375, shares issued and outstanding, actual and 88,394,369 shares outstanding, as adjusted[2]	$ 722	$
Preferred Stock, par value $0.01 per share; 50,000,000 shares authorized and 0 shares issued and outstanding, actual and 0 shares outstanding, as adjusted		
Additional paid in capital	1,472,642	
Accumulated other comprehensive income	63,263	
Retained earnings	(6,228)	
Total shareholders equity	1,530,399	
Noncontrolling interests	32,592	
Total capitalization	$ 1,562,991	$

(1) Does not include the underwriters option to purchase up to 2,250,000 additional shares.

(2) Includes 1,238,527 shares issued under our Dividend Reinvestment and Share Purchase Plan in April, May and June 2011 and 1,467 shares issued to our non-executive directors in May 2011.

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UNDERWRITING

Subject to the terms and conditions of the underwriting agreement, the underwriters named below, through their representatives Credit Suisse Securities (USA) LLC and Morgan Stanley & Co. LLC, have severally agreed to purchase from us the following respective number of shares of common stock at a public offering price less the underwriting discounts and commissions set forth on the cover page of this prospectus supplement:

Underwriter	Number of Shares
Credit Suisse Securities (USA) LLC	
Morgan Stanley & Co. LLC	
Total	15,000,000

The underwriting agreement provides that the obligations of the several underwriters to purchase the shares of common stock offered hereby are subject to certain conditions precedent and that the underwriters will purchase all of the shares of common stock offered by this prospectus supplement, other than those covered by the over-allotment option described below, if any of these shares are purchased.

We have been advised by the representatives of the underwriters that the underwriters propose to offer the shares of common stock to the public at the public offering price set forth on the cover of this prospectus supplement and to dealers at a price that represents a concession not in excess of $ per share under the public offering price. After the initial public offering, the representatives of the underwriters may change the offering price and other selling terms.

We have granted to the underwriters an option, exercisable not later than 30 days after the date of this prospectus supplement, to purchase up to 2,250,000 additional shares of common stock at the public offering price less the underwriting discounts and commissions set forth on the cover page of this prospectus supplement. The underwriters may exercise this option only to cover over-allotments made in connection with the sale of the common stock offered by this prospectus supplement. To the extent that the underwriters exercise this option, each of the underwriters will become obligated, subject to conditions, to purchase approximately the same percentage of these additional shares of common stock as the number of shares of common stock to be purchased by it in the above table bears to the total number of shares of common stock offered by this prospectus supplement. We will be obligated to sell these additional shares of common stock to the underwriters to the extent the option is exercised. If any additional shares of common stock are purchased, the underwriters will offer the additional shares on the same terms as those on which the shares are being offered.

The underwriting discounts and commissions per share are equal to the public offering price per share of common stock less the amount paid by the underwriters to us per share of common stock. We have agreed to pay the underwriters the following discounts and commissions, assuming either no exercise or full exercise by the underwriters of the underwriters over-allotment option:

		Total Fees	
	Fee per Share	Without Exercise of the Over-Allotment Option	With Full Exercise of the Over-Allotment Option
Discounts and commissions	$	$	$

In addition, we estimate that our share of the total expenses of this offering, excluding underwriting discounts and commissions, will be approximately $275,500.

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We and our operating partnership, IAS Operating Partnership LP, have agreed to indemnify the underwriters against some specified types of liabilities, including liabilities under the Securities Act, and to contribute to payments the underwriters may be required to make in respect of any of these liabilities.

We, each of our directors and executive officers, our Manager and certain officers of our Manager and Invesco Investments (Bermuda) Ltd. have agreed not to offer, sell, contract to sell or otherwise dispose of or hedge, or enter into any transaction that is designed to, or could be expected to, result in the disposition of any shares of our common stock or other securities convertible into or exchangeable or exercisable for shares of our common stock or derivatives of our common stock owned by us or any of these persons prior to this offering for a period of 60 days after the date of this prospectus supplement without the prior written consent of Credit Suisse Securities (USA) LLC and Morgan Stanley & Co. LLC. However, each of our directors and executive officers and certain officers of our Manager may transfer or dispose of our shares during this 60-day lock-up period in the case of gifts or for estate planning purposes where the donee agrees to a similar lock-up agreement for the remainder of the 60-day lock-up period. In addition, we may issue shares pursuant to our Dividend Reinvestment and Share Purchase Plan during this 60-day lock-up period.

There are no agreements between Credit Suisse Securities (USA) LLC or Morgan Stanley & Co. LLC and any of our shareholders or affiliates releasing them from these lock-up agreements prior to the expiration of the 60-day lock-up period.

In connection with the offering, the underwriters may purchase and sell shares of our common stock in the open market. These transactions may include short sales, purchases to cover positions created by short sales and stabilizing transactions.

Short sales involve the sale by the underwriters of a greater number of shares than they are required to purchase in the offering. Covered short sales are sales made in an amount not greater than the underwriters option to purchase additional shares of common stock from us in the offering. The underwriters may close out any covered short position by either exercising their option to purchase additional shares or purchasing shares in the open market. In determining the source of shares to close out the covered short position, the underwriters will consider, among other things, the price of shares available for purchase in the open market as compared to the price at which they may purchase shares through the over-allotment option.

Naked short sales are any sales in excess of the over-allotment option. The underwriters must close out any naked short position by purchasing shares in the open market. A naked short position is more likely to be created if underwriters are concerned that there may be downward pressure on the price of the shares in the open market prior to the completion of the offering.

Stabilizing transactions consist of various bids for or purchases of our common stock made by the underwriters in the open market prior to the completion of the offering.

The underwriters may impose a penalty bid. This occurs when a particular underwriter repays to the other underwriters a portion of the underwriting discount received by it because the representatives of the underwriters have repurchased shares sold by or for the account of that underwriter in stabilizing or short covering transactions.

Purchases to cover a short position and stabilizing transactions may have the effect of preventing or slowing a decline in the market price of our common stock. Additionally, these purchases, along with the imposition of the penalty bid, may stabilize, maintain or otherwise affect the market price of our common stock. As a result, the price of our common stock may be higher than the price that might otherwise exist in the open market. These transactions may be effected on the NYSE or otherwise.

A prospectus in electronic format may be made available on web sites maintained by one or more underwriters. Other than the prospectus in electronic format, the information on any underwriter s web site and any information contained in any other web site maintained by an underwriter is not part of this prospectus supplement or the accompanying prospectus.

In the ordinary course of their businesses, the underwriters and/or their respective affiliates may engage in financial transactions with, and perform investment banking, lending, asset management and/or financial advisory services for us and/or our affiliates (including, but not limited to Invesco and our Manager). They receive customary fees and reimbursements of expenses for these transactions and services.

In addition, in the ordinary course of their various business activities, the underwriters and their respective affiliates may make or hold a broad array of investments and actively trade debt and equity securities (or related derivative securities) and financial instruments (including bank loans) for their own account and for the accounts of their customers and such investment and securities activities may involve our securities and/or instruments.

We have entered into master repurchase agreements and/or interest rate swap agreements with Credit Suisse Securities (USA) LLC and/or its affiliates and Morgan Stanley & Co. LLC and/or its affiliates, in each case for the financing of our acquisitions of Agency, non-Agency RMBS and CMBS and hedging of interest rate volatility.

Selling Restrictions European Economic Area

In relation to each Member State of the European Economic Area which has implemented the Prospectus Directive (each, a Relevant Member State), each underwriter has represented and agreed that it has not made and will not make an offer to the public of shares which are the subject of the offering (the Shares) in that Relevant Member State prior to the publication of a prospectus in relation to the Shares which has been approved by the competent authority in that Relevant Member State or, where appropriate, approved by the competent authority in another Relevant Member State and published and passported in accordance with the Prospectus Directive as implemented in that Relevant Member State, except that it may, make an offer to the public in that Relevant Member State of any Shares at any time following exemptions under the Prospectus Directive if they have been implemented in that Relevant Member State:

1. to legal entities which are authorized or regulated to operate in the financial markets or, if not so authorized or regulated, whose corporate purpose is solely to invest in securities;

2. to any legal entity which has two or more of (1) an average of at least 250 employees during the last financial year; (2) a total balance sheet of more than 43,000,000 and (3) an annual net turnover of more than 50,000,000, as shown in its last annual or consolidated accounts;

3. to fewer than 100 natural or legal persons (other than qualified investors as defined in the Prospectus Directive) subject to obtaining the prior consent of Credit Suisse Securities (USA) LLC for any such offer; or

4. in any other circumstances falling within Article 3(2) of the Prospectus Directive,

provided that no such offer of shares shall result in a requirement for the publication by us or any underwriter of a prospectus pursuant to Article 3 of the Prospectus Directive.

For the purposes of this provision, the expression an offer of shares to the public in relation to any shares in any Relevant Member State means the communication in any form and by any means of sufficient information on the terms of the offer and the shares to be offered so as to enable an investor to decide to purchase or subscribe the shares, as the same may be varied in that Relevant Member State by any measure implementing the Prospectus Directive in that Relevant Member State and the expression Prospectus Directive means Directive 2003/71/EC and includes any relevant implementing measure in each Relevant Member State.

In the case of any shares being offered to a financial intermediary as that term is used in Article 3(2) of the Prospectus Directive, such financial intermediary will also be deemed to have represented, acknowledged and agreed that the shares acquired by it in the offering have not been acquired on a non-discretionary basis on behalf of, nor have they been acquired with a view to their offer or resale to persons in circumstances which may give rise to an offer of any shares to the public other than their offer of resale in a Relevant Member State to qualified investors as so defined or in circumstances in which the prior consent of the underwriters has been obtained to each such proposed offer or resale. We, and the underwriters and their affiliates, and others will rely upon the truth and accuracy of the foregoing representation, acknowledgement and agreement. Notwithstanding the above, a person who is not a qualified investor and who has notified the underwriters of such fact in writing may, with the consent of the underwriters, be permitted to purchase shares in the offering.

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LEGAL MATTERS

Certain legal matters relating to this offering will be passed upon for us by Alston & Bird LLP, Atlanta, Georgia. Certain legal matters relating to this offering will be passed upon for the underwriters by Skadden, Arps, Slate, Meagher & Flom LLP, New York, New York. As to certain matters of Maryland law, Alston & Bird LLP may rely on the opinion of Venable LLP, Baltimore, Maryland.

EXPERTS

The audited financial statements and management s assessment of the effectiveness of internal control over financial reporting incorporated by reference in this prospectus and elsewhere in the registration statement have been so incorporated by reference in reliance upon the reports of Grant Thornton LLP, independent registered public accountants, upon the authority of said firm as experts in accounting and auditing, in giving said reports.

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PROSPECTUS

Invesco Mortgage Capital Inc.
Common Stock, Preferred Stock, Depositary Shares, Warrants,
Shareholder Rights, Debt Securities and Units

By this prospectus, we may offer, from time to time:

- shares of our common stock,
- shares of our preferred stock,
- depositary shares representing shares of our preferred stock,
- warrants to purchase shares of our common stock, preferred stock or depositary shares,
- rights issuable to our shareholders to purchase shares of our common stock or preferred stock, to purchase warrants exercisable for shares of our common stock or preferred stock, or to purchase units consisting of two or more of the foregoing,
- debt securities, which may consist of debentures, notes, or other types of debt, and
- units consisting of two or more of the foregoing.

We will provide specific terms of each issuance of these securities in supplements to this prospectus. We may offer and sell these securities to or through one or more underwriters, dealers and agents, or directly to purchasers, on a continuous or delayed basis. In addition, selling securityholders may sell these securities, from time to time, on terms described in the applicable prospectus supplement. You should read this prospectus and any supplement carefully before you decide to invest. This prospectus may not be used to consummate sales of these securities unless it is accompanied by a prospectus supplement.

The New York Stock Exchange, or NYSE, lists our common stock under the symbol IVR.

To assist us in continuing to qualify as a real estate investment trust, or REIT, for federal income tax purposes, no person may own more than 9.8% by value or number of shares, whichever is more restrictive, of our outstanding shares of common stock, unless our board of directors waives this limitation.

Our principal office is located at Two Peachtree Pointe, 1555 Peachtree Street N.E., Atlanta, Georgia 30309. Our telephone number is (404) 892-0896.

Investing in our securities involves risk. You should carefully consider the information referred to under the heading Risk Factors beginning on page 5 before you invest.

Neither the Securities and Exchange Commission nor any state securities commission has approved or disapproved of these securities or passed upon the adequacy or accuracy of this prospectus. Any representation to the contrary is a criminal offense.

The date of this prospectus is May 27, 2011.

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ABOUT THIS PROSPECTUS

This prospectus is part of a registration statement that we filed with the Securities and Exchange Commission, or SEC or Commission, using a shelf registration process. Under this shelf registration process, we may sell the securities described in this prospectus in one or more offerings. This prospectus provides you with a general description of the securities we may offer. Each time we offer to sell securities, we will provide a supplement to this prospectus that will contain specific information about the terms of that offering. The prospectus supplement may also add, update or change information contained in this prospectus. It is important for you to consider the information contained in this prospectus and any prospectus supplement together with additional information described under the heading Where You Can Find More Information.

You should rely only on the information incorporated by reference or set forth in this prospectus or the applicable prospectus supplement. We have not authorized anyone else to provide you with additional or different information. You should not assume that the information in this prospectus, the applicable prospectus supplement or any other offering material is accurate as of any date other than the dates on the front of those documents.

When used in this prospectus, the terms company, issuer, we, our, and us refer to Invesco Mortgage Capital I and its consolidated subsidiaries, unless otherwise specified. Invesco refers to Invesco Ltd., together with its consolidated subsidiaries (other than us), which is the indirect parent company of Invesco Advisers, Inc., our external manager.

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SPECIAL NOTE REGARDING FORWARD-LOOKING STATEMENTS

We make forward-looking statements in this prospectus and other filings we make with the SEC within the meaning of Section 27A of the Securities Act of 1933, as amended, or the Securities Act, and Section 21E of the Securities Exchange Act of 1934, as amended, or the Exchange Act, and such statements are intended to be covered by the safe harbor provided by the same. Forward-looking statements are subject to substantial risks and uncertainties, many of which are difficult to predict and are generally beyond our control. These forward-looking statements include information about possible or assumed future results of our business, financial condition, liquidity, results of operations, plans and objectives. When we use the words believe, expect, anticipate, estimate, plan, continue, should, may or similar expressions, we intend to identify forward-looking statements. Statements regarding the following subjects, among others, may be forward-looking:

- use of proceeds of this offering;
- our business and investment strategy;
- our investment portfolio;
- our projected operating results;
- the impact of any deficiencies in foreclosure practices of third parties and related delays in the foreclosure process;
- actions and initiatives of the U.S. government and changes to U.S. government policies, including the recently enacted Dodd-Frank Wall Street Reform and Consumer Protection Act and our ability to respond to and comply with such actions, initiatives and changes;
- our ability to obtain additional financing arrangements and the terms of such arrangements;
- financing and advance rates for our target assets;
- our expected leverage;
- general volatility of the securities markets in which we invest;
- our expected investments;
- interest rate mismatches between our target assets and our borrowings used to fund such investments;
- changes in interest rates and the market value of our target assets;
- changes in prepayment rates on our target assets;
- effects of hedging instruments on our target assets;
- rates of default or decreased recovery rates on our target assets;
- modifications to whole loans or loans underlying securities;
- the degree to which our hedging strategies may or may not protect us from interest rate volatility;

changes in governmental regulations, tax law and rates, and similar matters and our ability to respond to such changes;

our ability to maintain our qualification as a REIT for U.S. federal income tax purposes;

our ability to maintain our exemption from registration under the Investment Company Act of 1940, as amended;

availability of investment opportunities in mortgage-related, real estate-related and other securities;

availability of a U.S. government agency or a federally chartered corporation to guarantee payments of principal and interest on securities;

availability of qualified personnel;

estimates relating to our ability to continue to make distributions to our shareholders in the future;

changes to accounting principles generally accepted in the U.S.;

our understanding of our competition; and

market trends in our industry, interest rates, real estate values, the debt securities markets or the general economy.

The forward-looking statements are based on our beliefs, assumptions and expectations of our future performance, taking into account all information currently available to us. You should not place undue reliance on these forward-looking statements. These beliefs, assumptions and expectations can change as a result of many possible events or factors, not all of which are known to us. Some of these factors are described in this prospectus in the information referred to under the heading Risk Factors. If a change occurs, our business, financial condition, liquidity and results of operations may vary materially from those expressed in our forward-looking statements. Any forward-looking statement speaks only as of the date on which it is made. New risks and uncertainties arise over time, and it is not possible for us to predict those events or how they may affect us. Except as required by law, we are not obligated to, and do not intend to, update or revise any forward-looking statements, whether as a result of new information, future events or otherwise.

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WHERE YOU CAN FIND MORE INFORMATION

We file annual, quarterly and current reports, proxy statements and other information with the SEC. The public may read and copy any materials we file with the SEC at the SEC s Public Reference Room at 100 F Street, N.E, Washington, D.C. 20549. The public may obtain information on the operation of the Public Reference Room by calling the SEC at 1-800-SEC-0330. The SEC maintains an Internet site that contains reports, proxy statements, information statements and other information regarding issuers that file electronically with the SEC. The address of that site is http://www.sec.gov. Our common stock is listed on the NYSE under the symbol IVR, and all such reports, proxy statements and other information filed by us with the NYSE may be inspected at the NYSE s offices at 20 Broad Street, New York, New York 10005. Finally, we maintain an Internet site where you can find additional information. The address of our Internet site is http://www.invescomortgagecapital.com. All internet addresses provided in this prospectus or in any accompanying prospectus supplement are for informational purposes only and are not intended to be hyperlinks. In addition, the information on our Internet site, or any other Internet site described herein, is not a part of, and is not incorporated or deemed to be incorporated by reference in, this prospectus or any accompanying prospectus supplement or other offering materials.

We have filed a registration statement, of which this prospectus is a part, covering the securities offered hereby. As allowed by SEC rules, this prospectus does not contain all of the information set forth in the registration statement and the exhibits thereto. We refer you to the registration statement and the exhibits thereto for further information. This prospectus is qualified in its entirety by such other information.

INCORPORATION OF CERTAIN DOCUMENTS BY REFERENCE

The SEC s rules allow us to incorporate by reference information into this prospectus, which means that we can disclose important information to you by referring you to another document filed separately with the SEC. The information incorporated by reference is deemed to be part of this prospectus from the date of filing those documents. Any reports filed by us with the SEC on or after the date of this prospectus will automatically update and, where applicable, supersede any information contained in this prospectus or incorporated by reference in this prospectus. We have filed the documents listed below with the SEC under the Exchange Act, and these documents are incorporated herein by reference (other than information in such documents that is furnished and not deemed to be filed):

Our Annual Report on Form 10-K for the year ended December 31, 2010, filed on March 14, 2011;

Our Quarterly Report on Form 10-Q for the quarter ended March 31, 2011, filed on May 10, 2011;

Our Current Reports on Form 8-K filed on March 17, 2011, March 25, 2011 and May 11, 2011;

Our Proxy Statement on Schedule 14A filed with the SEC on March 30, 2011; and

The description of our common stock included in our Registration Statement on Form 8-A dated June 18, 2009.

All documents we file pursuant to Sections 13(a), 13(c), 14 or 15(d) of the Exchange Act on or after the date of this prospectus and prior to the termination of the offering of the securities to which this prospectus relates (other than information in such documents that is furnished and not deemed to be filed) shall be deemed to be incorporated by reference into this prospectus and to be part hereof from the date of filing of those documents. All documents we file pursuant to Sections 13(a), 13(c), 14 or 15(d) of the Exchange Act after the date of the initial registration statement that contains this prospectus and prior to the effectiveness of the registration statement shall be deemed to be incorporated by reference into this prospectus and to be part hereof from the date of filing those documents.

We will provide to each person, including any beneficial owner, to whom a copy of this prospectus is delivered, a copy of any or all of the information that has been incorporated by reference in this prospectus but not delivered with this prospectus (other than the exhibits to such documents which are not specifically incorporated by reference therein); we will provide this information at no cost to the requester upon written or oral request to Office of the Secretary, Invesco Mortgage Capital Inc., Two Peachtree Pointe, 1555 Peachtree Street N.E., Atlanta, Georgia 30309; Tel.: (404) 892-0896; E-mail: company.secretary@invescomortgagecapital.com.

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INVESCO MORTGAGE CAPITAL INC.

Invesco Mortgage Capital Inc. is a Maryland corporation primarily focused on investing in, financing and managing residential and commercial mortgage-backed securities and mortgage loans. We invest in residential mortgage-backed securities for which a U.S. government agency or a federally chartered corporation guarantees payments of principal and interest on the securities. In addition, we invest in residential mortgage-backed securities that are not issued or guaranteed by a U.S. government agency, commercial mortgage-backed securities and mortgage loans. We generally finance our agency and non-agency residential mortgage-backed securities and commercial mortgage-backed securities through repurchase agreement financing. We have also financed our investments in certain non-agency residential mortgage-backed securities, commercial mortgage-backed securities and residential and commercial mortgage loans by contributing capital to a legacy securities public-private investment fund established and managed by our manager or one of its affiliates, which, in turn, invests in our target assets, that received financing under the U.S. government s Public-Private Investment Program. We are externally managed and advised by Invesco Advisers, Inc., a Delaware corporation and an indirect, wholly-owned subsidiary of Invesco Ltd., an independent global investment company listed on the New York Stock Exchange (NYSE: IVZ).

We have elected to be taxed as a real estate investment trust for U.S. federal income tax purposes commencing with our taxable year ended December 31, 2009 and we intend to continue to be taxed as a REIT. To assist us in maintaining our qualification as a real estate investment trust, shareholders are generally restricted from owning more than 9.8% by value or number of shares, whichever is more restrictive, of our outstanding shares of common stock. In addition, our charter contains various other restrictions on the ownership and transfer of our common stock. See Restrictions on Ownership and Transfer.

RISK FACTORS

Investing in our securities involves risks. You should carefully consider the risks described under Risk Factors in our most recent Annual Report on Form 10-K and any subsequent Quarterly Reports on Form 10-Q (which descriptions are incorporated by reference herein), as well as the other information contained or incorporated by reference in this prospectus or in any prospectus supplement hereto before making a decision to invest in our securities. See Where You Can Find More Information, above.

USE OF PROCEEDS

Unless otherwise indicated in an accompanying prospectus supplement, we intend to use the net proceeds from the sale of the securities offered by this prospectus and the related accompanying prospectus supplement for the purchase of mortgage-backed securities, mortgage loans and for general corporate purposes. Unless otherwise indicated in an accompanying prospectus supplement, we will not receive any proceeds from the sale of securities by selling securityholders.

RATIO OF EARNINGS TO FIXED CHARGES

Our ratio of earnings to fixed charges for each of the periods indicated is as follows:

	Three Months Ended March 31,	Year Ended December 31,				
	2011	2010	2009	2008	2007	2006
Ratio of earnings to fixed charges	4.4x	4.3x	4.3x	N/A	N/A	N/A

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DESCRIPTION OF CAPITAL STOCK

The following is a summary of the rights and preferences of our capital stock. While we believe that the following description covers the material terms of our capital stock, the description may not contain all of the information that is important to you. We encourage you to read carefully this entire prospectus, our charter and bylaws and the other documents we refer to for a more complete understanding of our capital stock. Copies of our charter and bylaws are listed as exhibits to the registration statement of which this prospectus is a part. See Where You Can Find More Information.

General

Our charter provides that we may issue up to 450,000,000 shares of common stock, $0.01 par value per share, and 50,000,000 shares of preferred stock, $0.01 par value per share. Our charter authorizes our board of directors to amend our charter to increase or decrease the aggregate number of authorized shares of stock or the number of shares of stock of any class or series without shareholder approval. Under Maryland law, shareholders are not generally liable for our debts or obligations.

Shares of Common Stock

All shares of common stock offered by this prospectus will be duly authorized, validly issued, fully paid and nonassessable. Subject to the preferential rights of any other class or series of shares of stock and to the provisions of our charter regarding the restrictions on ownership and transfer of shares of stock, holders of shares of common stock are entitled to receive dividends on such shares of common stock out of assets legally available therefor if, as and when authorized by our board of directors and declared by us, and the holders of our shares of common stock are entitled to share ratably in our assets legally available for distribution to our shareholders in the event of our liquidation, dissolution or winding up after payment of or adequate provision for all our known debts and liabilities.

The shares of common stock that we are offering will be issued by us and do not represent any interest in or obligation of Invesco or any of its affiliates. Further, the shares are not a deposit or other obligation of any bank, are not an insurance policy of any insurance company and are not insured or guaranteed by the Federal Deposit Insurance Corporation, or FDIC, any other governmental agency or any insurance company. The shares of common stock will not benefit from any insurance guarantee association coverage or any similar protection.

Subject to the provisions of our charter regarding the restrictions on ownership and transfer of shares of stock and except as may otherwise be specified in the terms of any class or series of shares of common stock, each outstanding share of common stock entitles the holder to one vote on all matters submitted to a vote of shareholders, including the election of directors, and, except as provided with respect to any other class or series of shares of stock, the holders of such shares of common stock will possess the exclusive votim" width="1%"> 214

Landing fees and other rentals	278	257	791	705
Depreciation and amortization	217	191	620	523
Acquisition and integration	145	22	168	97
Other operating expenses	509	522	1,505	1,372
Total operating expenses	4,258	4,086	12,383	11,004
OPERATING INCOME	51	225	532	546
OTHER EXPENSES (INCOME):				
Interest expense	35	50	112	143
Capitalized interest	(5)	(3)	(16)	(8)

Interest income	(2)	(1)	(5)	(8)
Other (gains) losses, net	(10)	405	(119)	351
Total other expenses (income)	18	451	(28)	478
INCOME (LOSS) BEFORE INCOME TAXES	33	(226)	560	68
PROVISION (BENEFIT) FOR INCOME TAXES	17	(86)	217	42
NET INCOME (LOSS)	$16	$(140)	$343	$26
NET INCOME (LOSS) PER SHARE, BASIC	$.02	$(.18)	$.45	$.03
NET INCOME (LOSS) PER SHARE, DILUTED	$.02	$(.18)	$.45	$.03
COMPREHENSIVE INCOME (LOSS)	$211	$(546)	$442	$(225)
WEIGHTED AVERAGE SHARES OUTSTANDING				
Basic	739	792	756	773
Diluted	740	792	762	774
Cash dividends declared per common share	$.0100	$.0045	$.0245	$.0135

See accompanying notes.

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

	Three months ended September 30, 2012	Three months ended September 30, 2011	Nine months ended September 30, 2012	Nine months ended September 30, 2011
CASH FLOWS FROM OPERATING ACTIVITIES:				
Net income (loss)	$ 16	$ (140)	$ 343	$ 26
Adjustments to reconcile net income (loss) to cash provided by (used in) operating activities:				
Depreciation and amortization	217	191	620	523
Unrealized (gain) loss on fuel derivative instruments	(16)	393	(154)	274
Deferred income taxes	82	(90)	120	33
Amortization of deferred gains on sale and leaseback of aircraft	(3)	(3)	(9)	(10)
Changes in certain assets and liabilities:				
Accounts and other receivables	(2)	11	(107)	(96)
Other assets	(74)	(42)	(164)	(180)
Accounts payable and accrued liabilities	(187)	(39)	114	266
Air traffic liability	(5)	(92)	688	485
Cash collateral received from (provided to) derivative counterparties	252	(409)	218	(429)
Other, net	184	2	164	93
Net cash provided by (used in) operating activities	464	(218)	1,833	985
CASH FLOWS FROM INVESTING ACTIVITIES:				
Payment to acquire AirTran, net of AirTran cash on hand	-	-	-	(35)
Payments for purchase of property and equipment, net	(406)	(276)	(949)	(548)
Purchases of short-term investments	(663)	(1,525)	(1,918)	(4,788)
Proceeds from sales of short-term investments	775	1,664	2,192	4,414
Other, net	17	-	31	-

Net cash used in investing activities	(277)	(137)	(644)	(957)
CASH FLOWS FROM FINANCING ACTIVITIES:				
Proceeds from Employee stock plans	5	4	22	35
Proceeds from termination of interest rate derivative instrument	-	-	-	76
Payments of long-term debt and capital lease obligations	(48)	(48)	(517)	(110)
Payments of convertible debt obligations	-	-	-	(81)
Payments of cash dividends	(7)	(3)	(22)	(14)
Repurchase of common stock	(50)	(175)	(325)	(175)
Other, net	(2)	(2)	(8)	(4)
Net cash used in financing activities	(102)	(224)	(850)	(273)
NET CHANGE IN CASH AND CASH EQUIVALENTS	85	(579)	339	(245)
CASH AND CASH EQUIVALENTS AT BEGINNING OF PERIOD	1,083	1,595	829	1,261
CASH AND CASH EQUIVALENTS AT END OF PERIOD	$ 1,168	$ 1,016	$ 1,168	$ 1,016
CASH PAYMENTS FOR:				
Interest, net of amount capitalized	$ 39	$ 48	$ 119	$ 130
Income taxes	$ 2	$ -	$ 97	$ 5

See accompanying notes.

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

1. BASIS OF PRESENTATION

The accompanying unaudited Condensed Consolidated Financial Statements of Southwest Airlines Co. and its subsidiaries (the "Company") 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 accounting principles generally accepted in the United States for complete financial statements. The unaudited Condensed Consolidated Financial Statements for the interim periods ended September 30, 2012 and 2011 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, but does not include all of the information and footnotes required by generally accepted accounting principles ("GAAP") for complete financial statements. 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 5 for further information on fuel and the Company's hedging program. Operating results for the three and nine months ended September 30, 2012 are not necessarily indicative of the results that may be expected for the year ended December 31, 2012. 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, 2011.

Certain prior period amounts have been reclassified to conform to the current presentation. In the unaudited Condensed Consolidated Statement of Comprehensive Income (Loss) for the three and nine months ended September 30, 2011, the Company has reclassified $20 million and $46 million, respectively, from Other revenues to Passenger revenues associated with its sale of frequent flyer benefits from its co-branded Chase® Visa credit card.

2. AIRTRAN ACQUISITION AND RELATED MATTERS

AirTran Holdings, Inc.
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, Inc. ("AirTran Airways"), in exchange for Southwest Airlines Co. common stock and cash. 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 Airways offers scheduled airline services, using Boeing 717-200 aircraft and Boeing 737-700 aircraft, throughout the United States and to select international locations. In July 2012, the Company announced that

the Boeing 717-200 aircraft will be transitioned out of the Company's fleet over a three-year period beginning in August 2013. See Note 8 for further information. Approximately half of AirTran Airways' flights originate or terminate at its largest base of operation in Atlanta, Georgia. AirTran Airways also serves a number of markets with non-stop service from smaller bases of operation in Baltimore, Maryland; Milwaukee, Wisconsin; and Orlando, Florida.

Expenses related to the AirTran acquisition

The Company is expected to continue to incur substantial integration and transition expenses in connection with the AirTran acquisition, including the necessary costs associated with integrating the operations of the two companies. While the Company has assumed that a certain level of expenses will be incurred, there are many factors that could affect the total amount or the timing of these expenses, and many of the expenses that will be incurred are, by their nature, difficult to estimate. These expenses could, particularly in the near term, exceed the financial benefits that the Company expects to achieve from the AirTran acquisition and could continue to result in the Company taking significant charges against earnings during the integration process. The Company incurred consolidated acquisition and integration-related costs for the three months ended September 30, 2012 and 2011 of $145 million and $22 million, respectively, and for the nine months ended September 30, 2012 and 2011 of $168 million and $97 million, respectively, primarily consisting of costs associated with the lease and sublease of AirTran's Boeing 717-200 fleet, consulting, flight crew training, seniority integration, technology, and facility integration expenses. In the Company's unaudited Condensed Consolidated Statement of Comprehensive Income (Loss), these costs are classified as Acquisition and integration expenses. Also, see Note 8 for further information regarding the Boeing 717-200 lease/sublease transaction.

3. ACCOUNTING CHANGES AND NEW ACCOUNTING PRONOUNCEMENTS

During first quarter 2012, the Company changed the estimated retirement dates of several 737-300 and 737-500 aircraft based on revisions in the Company's fleet plan. This change, which was accounted for on a prospective basis, resulted in an acceleration of depreciation expense, since the majority of these aircraft had previously been expected to retire in periods beyond 2012, but were now expected to be retired during 2012. For the nine months ended September 30, 2012, the impact of this change was an increase in depreciation expense of approximately $28 million, excluding the impact of profitsharing and income taxes ($15 million after the impact of profitsharing and taxes, with a $.02 decrease in both basic and diluted net income per share). The impact of this change for the three months ended September 30, 2012, was not significant.

During third quarter 2012, the Company changed the estimated residual values of its entire fleet of owned 737-300 and 737-500 aircraft. This change was based on an agreement entered into during July 2012, pursuant to which the Company will lease or sublease certain aircraft to a third party, and the resulting impact this transaction will have on how the Company manages the ultimate retirement of its owned 737-300 and 737-500 aircraft. See Note 8 for further information on the lease/sublease transaction. Based on the expected retirement dates and current and expected future market conditions related to its owned 737-300 and 737-500 aircraft, the Company reduced the residual values of these aircraft from approximately ten percent of original cost to approximately two percent of original cost. As this reduction in residual value is considered a change in estimate, it has been accounted for on a prospective basis, and thus the Company will record additional depreciation expense over the remainder of the useful lives for each aircraft. The impact of this change on third quarter 2012 was an increase in depreciation expense of approximately $20 million, excluding the impact of profitsharing and income taxes ($10 million after the impact of profitsharing and taxes, with a $.01 decrease in both basic and diluted net income per share).

On December 16, 2011, the Financial Accounting Standards Board ratified Accounting Standards Update ("ASU") No. 2011-11, "Disclosures about Offsetting Assets and Liabilities." The new disclosure requirements mandate that entities disclose both gross and net information about instruments and transactions eligible for offset in the statement of financial position, as well as instruments and transactions subject to an agreement similar to a master netting arrangement. In addition, the standard requires disclosure of collateral received and posted in connection with master netting agreements or similar arrangements. This ASU is effective for fiscal years, and interim periods within those years, beginning on or after January 1, 2013. This ASU will not have a material effect on the Company's financial position or results of operations, but will change the Company's disclosure policies for financial derivative instruments. The Company plans to adopt this ASU for the interim period ending March 31, 2013.

4. NET INCOME (LOSS) PER SHARE

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

	Three months ended September 30,		Nine months ended September 30,	
	2012	2011	2012	2011
NUMERATOR:				
Net income (loss)	$ 16	$ (140)	$ 343	$ 26
Incremental income effect of interest on 5.25% convertible notes	-	-	2	-
Net income (loss) after assumed conversion	$ 16	$ (140)	$ 345	$ 26
DENOMINATOR:				
Weighted-average shares outstanding, basic	739	792	756	773
Dilutive effect of Employee stock options and restricted stock units	1	-	-	1
Dilutive effect of 5.25% convertible notes	-	-	6	-
Adjusted weighted-average shares outstanding, diluted	740	792	762	774
NET INCOME (LOSS) PER SHARE:				
Basic	$ .02	$ (.18)	$ .45	$ .03
Diluted	$ .02	$ (.18)	$ .45	$ .03
Potentially dilutive amounts excluded from calculations:				
Stock options and restricted stock units	32	48	40	48
5.25% convertible notes	6	6	-	6

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5. 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. Because jet fuel is not widely traded on an organized futures exchange, there are limited opportunities to hedge directly in jet fuel. 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 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.

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 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 the three months ended September 30, 2012, the Company had fuel derivatives in place for approximately 59 million gallons, or 12 percent, of its fuel consumption. As of September 30, 2012, the Company had fuel derivative instruments in place to provide coverage on a portion of its remaining 2012 estimated fuel consumption. The following table provides information about the Company's volume of fuel hedging for the years 2012 through 2016 on an "economic" basis considering current market prices:

Period (by year)	Fuel hedged as of September 30, 2012 (gallons in millions)(a)	Hedged commodity type as of September 30, 2012
Remainder of 2012	130	WTI crude oil
2013	183	WTI crude and Brent crude oil
2014	1,171	WTI crude and Brent crude oil
2015	609	WTI crude and Brent crude oil
2016	454	Brent crude oil

(a) The Company determines gallons hedged based on market prices and forward curves as of September 30, 2012. Due to the types of derivatives utilized by the Company, these volumes 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 6. 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 (Loss). 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 (Loss) 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. In a situation where it becomes probable that a 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 2011 or during the nine months ended September 30, 2012.

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:

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

(in millions)	Balance Sheet location	Asset derivatives Fair value at 09/30/12	Asset derivatives Fair value at 12/31/11	Liability derivatives Fair value at 09/30/12	Liability derivatives Fair value at 12/31/11
Derivatives designated as hedges*					
Fuel derivative contracts (gross)	Other current assets	$ 27	$ 17	$ -	$ -
Fuel derivative contracts (gross)	Other assets	296	542	20	107
Fuel derivative contracts (gross)	Accrued liabilities	21	97	2	8
Fuel derivative contracts (gross)	Other noncurrent liabilities	-	93	-	24
Interest rate derivative contracts	Other assets	71	64	-	-
Interest rate derivative contracts	Accrued liabilities	-	2	-	-
Interest rate derivative contracts	Other noncurrent liabilities	-	-	132	132
Total derivatives designated as hedges		$ 415	$ 815	$ 154	$ 271
Derivatives not designated as hedges*					
Fuel derivative contracts (gross)	Other current assets	$ 255	$ 124	$ 215	$ 58
Fuel derivative contracts (gross)	Other assets	405	26	513	272
Fuel derivative contracts (gross)	Accrued liabilities	158	326	279	687
		-	9	-	122

Fuel derivative contracts (gross)	Other noncurrent liabilities				
Total derivatives not designated as hedges		$ 818	$ 485	$ 1,007	$ 1,139
Total derivatives		$ 1,233	$ 1,300	$ 1,161	$ 1,410

* 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 also had the following amounts associated with fuel derivative instruments and hedging activities in its unaudited Condensed Consolidated Balance Sheet:

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

(in millions)	Balance Sheet location	September 30, 2012	December 31, 2011
Cash collateral deposits provided to counterparties - noncurrent	Offset against Other noncurrent liabilities	$ -	$ 41
Cash collateral deposits provided to counterparties - current	Offset against Accrued liabilities	13	185
Due to third parties for fuel contracts	Accrued liabilities	8	21
Receivable from third parties for fuel contracts - current	Accounts and other receivables	-	3
Receivable from third parties for fuel contracts - noncurrent	Other assets	54	-

The following tables present the impact of derivative instruments and their location within the unaudited Condensed Consolidated Statement of Comprehensive Income (Loss) for the three and nine months ended September 30, 2012 and 2011:

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 September 30,		Three months ended September 30,		Three months ended September 30,	
(in millions)	2012	2011	2012	2011	2012	2011
Fuel derivative contracts	$ (167)*	$ 417 *	$ 25 *	$ 45 *	$ 4	$ 85
Interest rate						

derivatives	3 *	30 *	-	-	-	-
Total	$ (164)	$ 447	$ 25	$ 45	$ 4	$ 85

*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

(in millions)	(Gain) loss recognized in AOCI on derivatives (effective portion) Nine months ended September 30, 2012	2011	(Gain) loss reclassified from AOCI into income (effective portion)(a) Nine months ended September 30, 2012	2011	(Gain) loss recognized in income on derivatives (ineffective portion)(b) Nine months ended September 30, 2012	2011
Fuel derivative contracts	$ (24)*	$ 297 *	$ 76 *	$ 78 *	$ 44	$ 127
Interest rate derivatives	5 *	34 *	-	-	-	-
Total	$ (19)	$ 331	$ 76	$ 78	$ 44	$ 127

*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 September 30, 2012	2011	Location of (gain) loss recognized in income on derivatives
Fuel derivative contracts	$ (32)	$ 284	Other (gains) losses, net

Derivatives not in cash flow hedging relationships

(Gain) loss recognized in income on derivatives

Nine months ended

Location of (gain) loss

(in millions)	September 30, 2012	2011	recognized in income on derivatives
Fuel derivative contracts	$ (200)	$ 129	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 September 30, 2012 and 2011 of $15 million and $36 million, respectively, and the nine months ended September 30, 2012 and 2011 of $33 million and $93 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 (Loss).

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 September 30, 2012, were approximately $87 million in unrealized losses, net of taxes, which are expected to be realized in earnings during the twelve months subsequent to September 30, 2012. In addition, as of September 30, 2012, the Company had already recognized cumulative net gains due to ineffectiveness and derivatives that did not qualify for hedge accounting treatment totaling $30 million, net of taxes. These net gains were recognized during the three months ended September 30, 2012 and prior periods, and are reflected in Retained earnings as of September 30, 2012, but the underlying derivative instruments will not expire/settle until fourth quarter 2012 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 September 30, 2012, 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 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 September 30, 2012, at which such postings are triggered:

	Counterparty (CP)						
(in millions)	A	B	C	D	E	Other(a)	Total
Fair value of fuel derivatives	$ (9)	$ 1	$ (17)	$ 1	$ 121	$ 36	$ 133
Cash collateral held (by) CP	-	(13)	-	-	-	-	(13)
Aircraft collateral pledged to CP	-	-	-	-	-	-	-
Letters of credit (LC)	-	-	-	-	-	-	-
Option to substitute LC for aircraft	(340) to (740)(d)	>(125)(d)	N/A	N/A	N/A		
Option to substitute LC for cash	N/A	N/A	(100) to (150)(e)	N/A	>(50)(e)		
If credit rating is investment grade, fair value of fuel derivative level at which:							
Cash is provided to CP	(40) to (340) or >(740)	0 to (125) or >(625)	>(50)	>(75)	>(50)		
Cash is received from CP	>75	>150	>125(c)	>125(c)	>250		
Aircraft or cash can be pledged to CP as collateral	(340) to (740)(d)	(125) to (625)(d)	N/A	N/A	N/A		
If credit rating is non-investment grade, fair value of fuel derivative level at which:							
Cash is provided to CP	(40) to (340)	0 to (125)	(b)	(b)	(b)		

	or >(740)	or >(625)			
Cash is received from CP	(b)	(b)	(b)	(b)	(b)
Aircraft can be pledged to CP as collateral	(340) to (740)	(125) to (625)	N/A	N/A	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 September 30, 2012.
(e) The Company has the option of providing cash or letters of credit as collateral. No letters of credit were pledged as collateral with such counterparties as of September 30, 2012.

The Company also has agreements with each of its counterparties associated with its outstanding interest rate swap agreements in which cash collateral may be required based on the fair value of outstanding derivative instruments, as well as the Company's and its counterparty's credit ratings. As of September 30, 2012, $67 million had been provided to one counterparty associated with interest rate derivatives based on the Company's outstanding net liability derivative position with that counterparty. In addition, in connection with interest rate swaps entered into by AirTran, $24 million had been provided to one counterparty at September 30, 2012, as a result of a net liability derivative position with that counterparty. The outstanding interest rate net derivative positions with all other counterparties at September 30, 2012, were not material.

Applicable accounting provisions require an entity to select a policy for how it presents the offset rights to reclaim cash collateral associated with the fair value of the related derivative assets or liabilities. In the accompanying unaudited Condensed Consolidated Balance Sheet, the Company has elected to present its cash collateral utilizing a net presentation, in which cash collateral amounts held or provided have been netted against the fair value of outstanding derivative instruments.

6. COMPREHENSIVE INCOME (LOSS)

Comprehensive income (loss) 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 (loss) for the three and nine months ended September 30, 2012 and 2011 were as follows:

	Three months ended September 30,	
(in millions)	2012	2011
NET INCOME (LOSS)	$ 16	$ (140)
Unrealized gain (loss) on fuel derivative instruments, net of deferred taxes of $120 and ($233)	192	(372)
Unrealized loss on interest rate derivative instruments, net of deferred taxes of ($2) and ($19)	(3)	(30)
Other, net of deferred taxes of $3 and ($3)	6	(4)
Total other comprehensive income (loss)	$ 195	$ (406)
COMPREHENSIVE INCOME (LOSS)	$ 211	$ (546)

	Nine months ended September 30,	
(in millions)	2012	2011
NET INCOME	$ 343	$ 26
Unrealized gain (loss) on fuel derivative instruments, net of deferred taxes of $63 and ($137)	100	(219)
Unrealized loss on interest rate derivative instruments, net of deferred taxes of ($3) and ($22)	(5)	(34)
Other, net of deferred taxes of $2 and $1	4	2
Total other comprehensive income (loss)	$ 99	$ (251)
COMPREHENSIVE INCOME (LOSS)	$ 442	$ (225)

A rollforward of the amounts included in AOCI, net of taxes, is shown below for the three and nine months ended September 30, 2012:

(in millions)	Fuel derivatives	Interest rate derivatives	Other	Accumulated other comprehensive income (loss)
Balance at June 30, 2012	$ (275)	$ (68)	$ 23	$ (320)

Changes in fair value	167	(3)	6	170
Reclassification to earnings	25	-	-	25
Balance at September 30, 2012	$ (83)	$ (71)	$ 29	$ (125)

(in millions)	Fuel derivatives	Interest rate derivatives	Other	Accumulated other comprehensive income (loss)
Balance at December 31, 2011	$ (183)	$ (66)	$ 25	$ (224)
Changes in fair value	24	(5)	4	23
Reclassification to earnings	76	-	-	76
Balance at September 30, 2012	$ (83)	$ (71)	$ 29	$ (125)

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7. OTHER ASSETS AND LIABILITIES

(in millions)	September 30, 2012	December 31, 2011
Derivative contracts	$ 294	$ 253
Intangible assets	144	155
Non-current investments	42	97
Other	139	121
Other assets	$ 619	$ 626

(in millions)	September 30, 2012	December 31, 2011
Retirement plans	$ 114	$ 110
Aircraft rentals	105	57
Vacation pay	263	248
Health	60	56
Derivative contracts	90	85
Workers compensation	155	162
Accrued taxes	61	68
Other	192	210
Accrued liabilities	$ 1,040	$ 996

(in millions)	September 30, 2012	December 31, 2011
Postretirement obligation	$ 116	$ 107
Non-current lease-related obligations	419	311
Airport construction obligation	304	202
Other	275	290
Other non-current liabilities	$ 1,114	$ 910

8. LEASES

On July 9, 2012, the Company signed an agreement with Delta Air Lines, Inc. ("Delta") and Boeing Capital Corp. to lease or sublease all 88 of AirTran's Boeing 717-200 aircraft ("B717s") to Delta, with the first delivery expected to occur in August 2013, at a rate of approximately three B717s per month. A total of 78 of the B717s are on operating lease, eight 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 beginning in August 2013 allows the Company to minimize the impact of this transaction on operations, as the B717 capacity lost will be replaced through the capacity gained as a result of the Company's modification of the retirement dates for a portion of its 737-300 and 737-500 aircraft, and its receipt of new 737 deliveries from Boeing, or other used 737s that could be acquired.

The Company will lease and/or sublease all 88 of the B717s to Delta at agreed-upon lease rates. In addition, 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 78 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 six years to approximately twelve years. The lease terms for the eight B717s that are owned by the Company are for a period of seven years, after which Delta will have 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 sublease 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 represents 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 78 B717s that are currently 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. The charges recorded by the Company for this transaction are included as a component of Acquisition and integration costs in the Company's unaudited Condensed Consolidated Statement of Comprehensive Income (Loss) and are 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 Other noncurrent liabilities in the Company's unaudited Condensed Consolidated Balance Sheet. See Note 2 for further information on the Company's Acquisition and integration costs. The Company may also incur other costs associated with this transaction, such as contract termination costs with certain aircraft maintenance vendors. Two of these vendor maintenance contracts have stated termination penalties totaling approximately $106 million if the Company were to terminate such contracts; however, termination of these contracts has not occurred and any charges would only be recorded at the time of contract termination or at the time any associated charges become probable and estimable.

The effect of this transaction on the Company's future expected contractual obligations and commitments related to operating leases is to reduce such amounts by: $5 million in 2013, $48 million in 2014, $88 million in 2015, $106 million in 2016, $106 million in 2017, and $345 million thereafter.

9. COMMITMENTS AND CONTINGENCIES

Commitments

During 2008, the City of Dallas approved the Love Field Modernization Program ("LFMP"), a project to reconstruct Dallas Love Field ("Airport") with modern, convenient air travel facilities. Pursuant to a Program Development Agreement ("PDA") 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 to act on the City's behalf to facilitate the development of the LFMP), the Company is managing this project. Major construction commenced during 2010, with completion of the project scheduled for the second half of 2014. The project is expected to include the renovation of the Airport airline terminals and 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 amount spent on the LFMP project will be approximately $519 million. Although the City of Dallas has received commitments from various sources that are expected to fund portions of the LFMP project, including the Federal Aviation Administration ("FAA"), the Transportation Security Administration, and the City's Aviation Fund, the majority of the funds used are expected to be 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 will be required to complete the LFMP project.

The Company has agreed to manage the majority of the LFMP project and, as a result, 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 September 30, 2012, the Company had recorded LFMP construction costs of $304 million, classified as both an asset as a component of Ground property and equipment and a corresponding liability as a component of Other non-current liabilities in its unaudited Condensed Consolidated Balance Sheet. Upon completion of the LFMP project, the Company expects to begin depreciating the assets over their estimated useful lives, and reduce the corresponding liabilities primarily through the Company's airport rental payments to the City of Dallas.

The Company also has contractual purchase commitments associated with scheduled aircraft acquisitions from Boeing. During the second quarter 2012, the Company revised its future aircraft delivery schedule to defer 30 firm deliveries from Boeing, originally scheduled for delivery in 2013 and 2014, to 2017 and 2018, resulting in a reduction in the Company's expected capital expenditures totaling approximately $1 billion from 2012 through 2014. However, this deferral did not result in a net change in the total future purchase commitments with Boeing by the Company.

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.

10. 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 September 30, 2012, 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 and commercial paper 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 (OTC) 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 5 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 Group, which 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 $37 million at September 30, 2012, are classified as available-for-sale securities and are reflected at estimated fair value in the unaudited Condensed Consolidated Balance Sheet. In periods when an auction process successfully took place every 30-35 days, quoted market prices would be readily available, which would qualify the securities as Level 1. However, due to events in credit markets beginning during first quarter 2008, the auction events for these remaining instruments failed, and have continued to fail through the current period. Therefore, the Company's Treasury Group 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 London Interbank Offered Rate ("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.

In association with its estimate of fair value related to auction rate security instruments as of September 30, 2012, the Company has previously recorded a temporary unrealized decline in fair value of $13 million, with an offsetting entry to AOCI. The Company continues to believe that this decline in fair value is due entirely to market liquidity issues, because the underlying assets for the majority of these auction rate securities held by the Company are currently rated investment grade by Moody's, Standard and Poor's, and Fitch and are almost entirely backed by the U.S. Government. The range of maturities for the Company's auction rate securities are from 6 years to 35 years. Considering the relative insignificance of these securities in comparison to the Company's liquid assets and other sources of liquidity, the Company has no current intention of selling these securities nor does it expect to be required to sell these securities before a recovery in their cost basis. At the time of the first failed auctions during first quarter 2008, the Company held a total of $463 million in auction rate securities and, since that time, has been able to sell $413 million of these instruments at par value.

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

The following tables present the Company's assets and liabilities that are measured at fair value on a recurring basis at September 30, 2012 and December 31, 2011:

		Fair value measurements at reporting date using:		
Description	September 30, 2012	Quoted prices in active markets for identical assets (Level 1)	Significant other observable inputs (Level 2)	Significant unobservable inputs (Level 3)
Assets		(in millions)		
Cash equivalents				
Cash equivalents (a)	$ 986	$ 986	$ -	$ -
Commercial paper	160	-	160	-
Certificates of deposit	22	-	22	-
Short-term investments:				
Treasury bills	1,824	1,824	-	-
Certificates of deposit	243	-	243	-
Noncurrent investments (b)				
Auction rate securities	37	-	-	37
Interest rate derivatives (see Note 5)	71	-	71	-
Fuel derivatives:				
Swap contracts (c)	87	-	87	-
Option contracts (c)	896	-	-	896
	66	-	66	-

Swap contracts (d)				
Option contracts (d)	113	-	-	113
Other available-for-sale securities	50	45	-	5
Total assets	$ 4,555	$ 2,855	$ 649	$ 1,051
Liabilities				
Fuel derivatives:				
Swap contracts (c)	$ (32)	$ -	$ (32)	$ -
Option contracts (c)	(716)	-	-	(716)
Swap contracts (d)	(212)	-	(212)	-
Option contracts (d)	(69)	-	-	(69)
Interest rate derivatives (see Note 5)	(132)	-	(132)	-
Deferred compensation	(134)	(134)	-	-
Total liabilities	$ (1,295)	$ (134)	$ (376)	$ (785)

(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, and are also net of cash collateral received from counterparties. See Note 5.
(d) In the unaudited Condensed Consolidated Balance Sheet, amounts are presented as a net liability, and are also net of cash collateral provided to counterparties. See Note 5.

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		Fair value measurements at reporting date using:		
Description	December 31, 2011	Quoted prices in active markets for identical assets (Level 1)	Significant other observable inputs (Level 2)	Significant unobservable inputs (Level 3)
Assets		(in millions)		
Cash equivalents				
Cash equivalents (a)	$ 774	$ 774	$ -	$ -
Commercial paper	48	-	48	-
Certificates of deposit	7	-	7	-
Short-term investments:				
Treasury bills	2,014	2,014	-	-
Certificates of deposit	221	-	221	-
Commercial paper	80	-	80	-
Noncurrent investments (b)				
Auction rate securities	67	-	-	67
Certificates of deposit	25	-	25	-
Interest rate derivatives (see Note 5)	66	-	66	-
Fuel derivatives:				
Option contracts (c)	709	-	-	709
Swap contracts (d)	180	-	180	-
Option contracts (d)	345	-	-	345

Other available-for-sale securities	43	38	-	5
Total assets	$ 4,579	$ 2,826	$ 627	$ 1,126
Liabilities				
Fuel derivatives:				
Swap contracts (c)	$ (65)	$ -	$ (65)	$ -
Option contracts (c)	(371)	-	-	(371)
Swap contracts (d)	(576)	-	(576)	-
Option contracts (d)	(266)	-	-	(266)
Interest rate derivatives (see Note 5)	(132)	-	(132)	-
Deferred Compensation	(121)	(121)	-	-
Total liabilities	$ (1,531)	$ (121)	$ (773)	$ (637)

(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, and are also net of cash collateral received from counterparties. See Note 5.
(d) In the unaudited Condensed Consolidated Balance Sheet, amounts are presented as a net liability, and are also net of cash collateral provided to counterparties. See Note 5.

The Company had no transfers of assets or liabilities between any of the above levels during the nine months ended September 30, 2012 or the year ended December 31, 2011. The following table presents the Company's activity for items measured at fair value on a recurring basis using significant unobservable inputs (Level 3) for the three and nine months ended September 30, 2012:

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

	Fair value measurements using significant unobservable inputs (Level 3)			
(in millions)	Fuel derivatives	Auction rate securities	Other securities	Total
Balance at June 30, 2012	$ 64	$ 54	$ 5	$ 123
Total gains (realized or unrealized)				
Included in earnings	(11)	-	-	(11)
Included in other comprehensive income	259	6	-	265
Purchases	79	-	-	79
Sales	(121)	(23)	-	(144)
Settlements	(46)	-	-	(46)
Balance at September 30, 2012	$ 224	$ 37 (a)	$ 5	$ 266
The amount of total losses for the period included in earnings attributable to the change in unrealized gains or losses relating to assets still held at September 30, 2012	$ (17)	$ -	$ -	$ (17)

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

	Fair value measurements using significant unobservable inputs (Level 3)			
(in millions)	Fuel derivatives	Auction rate securities	Other securities	Total
Balance at December 31, 2011	$ 417	$ 67	$ 5	$ 489
Total gains or (losses) (realized or unrealized)				
Included in earnings	(15)	-	-	(15)
Included in other comprehensive income	31	1	-	32
Purchases	408	-	-	408

Sales		(517)		(31)		-		(548)
Settlements		(100)		-		-		(100)
Balance at September 30, 2012	$	224	$	37 (a)	$	5	$	266
The amount of total gains or (losses) for the period included in earnings attributable to the change in unrealized gains or losses relating to assets still held at September 30, 2012	$	(16)	$	-	$	-	$	(16)

(a) 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 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.

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 September 30, 2012:

Quantitative information about Level 3 fair value measurements

	Valuation technique	Unobservable input	Period (by year)	Range
Fuel derivatives	Option model	Implied volatility	Fourth quarter 2012	16%-37%
			2013	23%-38%
			2014	22%-32%
			2015	21%-26%
			2016	20%-24%
Auction rate securities	Discounted cash flow	Time to principal recovery		6yrs-8yrs
		Illiquidity premium		3%-5%
		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 5 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 nine months ended September 30, 2012 and 2011.

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 September 30, 2012, 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. Seven 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
French Credit Agreements due 2012 - 1.23%	$ 3	$ 3	Level 3
5.25% Notes due 2014	368	384	Level 2
5.75% Notes due 2016	333	369	Level 2
5.25% Convertible Senior Notes due 2016	117	119	Level 2
5.125% Notes due 2017	331	364	Level 2
Fixed-rate 717 Aircraft Notes payable through 2017 - 10.39%	64	62	Level 2
French Credit Agreements due 2018 - 1.43%	61	61	Level 3

Fixed-rate 737 Aircraft Notes payable through 2018 - 7.02%	37	39	Level 3
Term Loan Agreement due 2019 - 6.315%	248	248	Level 3
Term Loan Agreement due 2019 - 6.84%	95	101	Level 3
Term Loan Agreement due 2020 - 5.223%	460	411	Level 3
Floating-rate 737 Aircraft Notes payable through 2020 - 3.97%	562	537	Level 3
Pass Through Certificates due 2022 - 6.24%	394	444	Level 2
7.375% Debentures due 2027	138	151	Level 2

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

Relevant comparative operating statistics for the three and nine months ended September 30, 2012 and 2011 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. As discussed in Note 2 to the unaudited Condensed Consolidated Financial Statements, these statistics include the operations of AirTran since the May 2, 2011 acquisition date, but prior to that date only include the operations of Southwest Airlines (“Southwest”).

	Three months ended September 30, 2012	2011	Change
Revenue passengers carried	28,318,779	28,208,036	0.4 %
Enplaned passengers	34,913,698	35,010,060	(0.3)%
Revenue passenger miles (RPMs) (000s)(1)	27,162,606	27,322,289	(0.6)%
Available seat miles (ASMs) (000s)(2)	33,080,807	33,318,089	(0.7)%
Load factor(3)	82.1 %	82.0 %	0.1 pts
Average length of passenger haul (miles)	959	969	(1.0)%
Average aircraft stage length (miles)	697	690	1.0 %
Trips flown	347,346	359,630	(3.4)%
Average passenger fare	$ 142.86	$ 143.03	(0.1)%
Passenger revenue yield per RPM (cents)(4)	14.89	14.77	0.8 %
Operating revenue per ASM (cents)(5)	13.02	12.94	0.6 %
Passenger revenue per ASM (cents)(6)	12.23	12.11	1.0 %
Operating expenses per ASM (cents)(7)	12.87	12.26	5.0 %
Operating expenses per ASM, excluding fuel (cents)	8.25	7.50	10.0 %
Operating expenses per ASM, excluding fuel and profitsharing (cents)	8.16	7.39	10.4 %
Fuel costs per gallon, including fuel tax	$ 3.19	$ 3.23	(1.2)%
Fuel costs per gallon, including fuel tax, economic	$ 3.16	$ 3.18	(0.6)%
Fuel consumed, in gallons (millions)	478	490	(2.4)%
Active fulltime equivalent Employees	46,048	45,112	2.1 %
Aircraft in service at period-end(8)	692	699	(1.0)%

	Nine months ended September 30, 2012	2011	Change
Revenue passengers carried	82,738,949	76,437,631	8.2 %
Enplaned passengers	101,278,271	94,040,092	7.7 %
Revenue passenger miles (RPMs) (000s)(1)	78,053,971	72,402,024	7.8 %
Available seat miles (ASMs) (000s)(2)	96,944,289	89,281,174	8.6 %
Load factor(3)	80.5 %	81.1 %	(0.6) pts
Average length of passenger haul (miles)	943	947	(0.4)%
Average aircraft stage length (miles)	694	679	2.2 %
Trips flown	1,033,968	974,221	6.1 %
Average passenger fare	$ 146.56	$ 142.27	3.0 %
Passenger revenue yield per RPM (cents)(4)	15.54	15.02	3.5 %
Operating revenue per ASM (cents)(5)	13.32	12.94	2.9 %
Passenger revenue per ASM (cents)(6)	12.51	12.18	2.7 %
Operating expenses per ASM (cents)(7)	12.77	12.32	3.7 %
Operating expenses per ASM, excluding fuel (cents)	8.01	7.68	4.3 %
Operating expenses per ASM, excluding fuel and profitsharing (cents)	7.90	7.60	3.9 %
Fuel costs per gallon, including fuel tax	$ 3.27	$ 3.17	3.2 %
Fuel costs per gallon, including fuel tax, economic	$ 3.27	$ 3.16	3.5 %
Fuel consumed, in gallons (millions)	1,404	1,307	7.4 %
Active fulltime equivalent Employees	46,048	45,112	2.1 %
Aircraft in service at period-end(8)	692	699	(1.0)%

(1) A revenue passenger mile is one paying passenger flown one mile. Also referred to as "traffic," which is a measure of demand for a given period.
(2) An available seat mile is one seat (empty or full) flown one mile. Also referred to as "capacity," which is a measure of the space available to carry passengers in a given period.
(3) Revenue passenger miles divided by available seat miles.
(4) Calculated as passenger revenue divided by revenue passenger miles. Also referred to as "yield," this is the average cost paid by a paying passenger to fly one mile, which is a measure of revenue production and fares.

(5) Calculated as operating revenue divided by available seat miles. Also referred to as "operating unit revenues," this is a measure of operating revenue production based on the total available seat miles flown during a particular period.
(6) Calculated as passenger revenue divided by available seat miles. Also referred to as “passenger unit revenues,” this is a measure of passenger revenue production based on the total available seat miles flown during a particular period.
(7) Calculated as operating expenses divided by available seat miles. Also referred to as "unit costs" or "cost per available seat mile," this is the average cost to fly an aircraft seat (empty or full) one mile, which is a measure of cost efficiencies.
(8) Includes leased aircraft and excludes aircraft that are not available for service or are in storage, held for sale, or for return to the lessor.

Reconciliation of Reported Amounts to non-GAAP Financial Measures (unaudited) (in millions, except per share and per ASM amounts)

	Three months ended September 30, 2012	2011	Percent Change	Nine months ended September 30, 2012	2011	Percent Change
Fuel and oil expense, unhedged	$ 1,503	$ 1,549		$ 4,526	$ 4,125	
Add: Fuel hedge losses included in Fuel and oil expense	25	37		89	25	
Fuel and oil expense, as reported	$ 1,528	$ 1,586		$ 4,615	$ 4,150	
Deduct: Net impact from fuel contracts	(12)	(24)		(2)	(17)	
Fuel and oil expense, non-GAAP	$ 1,516	$ 1,562	(2.9) %	$ 4,613	$ 4,133	11.6 %
Total operating expenses, as reported	$ 4,258	$ 4,086		$ 12,383	$ 11,004	
Add (Deduct): Reclassification between Fuel and oil and Other (gains) losses, net, associated with current period settled contracts	4	3		(8)	(6)	
Add (Deduct): Contracts settling in the current period, but for which gains and/or (losses) have been recognized in a prior period*	(16)	(27)		6	(11)	
Deduct: Acquisition and integration costs, net (a)	(145)	(22)		(168)	(95)	
Deduct: Charge for asset impairments, net of profitsharing	-	(14)		-	(14)	
Total operating expenses, non-GAAP	$ 4,101	$ 4,026	1.9 %	$ 12,213	$ 10,878	12.3 %

Operating income, as reported	$ 51	$ 225		$ 532	$ 546	
Add (Deduct): Reclassification between Fuel and oil and Other (gains) losses, net, associated with current period settled contracts	(4)	(3)		8	6	
Add (Deduct): Contracts settling in the current period, but for which gains and/or (losses) have been recognized in a prior period*	16	27		(6)	11	
Add: Acquisition and integration costs, net (a)	145	22		168	95	
Add: Charge for asset impairments, net of profitsharing	-	14		-	14	
Operating income, non-GAAP	$ 208	$ 285	(27.0) %	$ 702	$ 672	4.5 %
Net income (loss), as reported	$ 16	$ (140)		$ 343	$ 26	
Add (Deduct): Mark-to-market impact from fuel contracts settling in future periods	(37)	288		(193)	148	
Add: Ineffectiveness from fuel hedges settling in future periods	5	78		45	115	
Add (Deduct): Other net impact of fuel contracts settling in the current or a prior period (excluding reclassifications)	16	27		(6)	11	
Income tax impact of fuel contracts	10	(154)		60	(105)	
	87	14		103	59	

Add: Acquisition and integration costs, net (b)						
Add: Charge for asset impairments, net (b)	-	9		-	9	
Net income, non-GAAP	$ 97	$ 122	(20.5) %	$ 352	$ 263	33.8 %
Net income (loss) per share, diluted, as reported	$ 0.02	$ (0.18)		$ 0.45	$ 0.03	
Add (Deduct): Net impact to net income above from fuel contracts divided by dilutive shares	(0.01)	0.30		(0.13)	0.22	
Add: Impact of special items, net (b)	0.12	0.03		0.14	0.09	
Net income per share, diluted, non-GAAP	$ 0.13	$ 0.15	(13.3) %	$ 0.46	$ 0.34	35.3 %
Operating expenses per ASM (cents)	12.87	12.26		12.77	12.32	
Deduct: Fuel expense divided by ASMs	(4.62)	(4.76)		(4.76)	(4.64)	
Deduct: Impact of special items, net (a)	(0.44)	(0.12)		(0.17)	(0.12)	
Operating expenses per ASM, non-GAAP, excluding fuel and special items (cents)	7.81	7.38	5.8 %	7.84	7.56	3.7 %

* As a result of prior hedge ineffectiveness and/or contracts marked to market through earnings.
(a) Amounts net of profitsharing impact on charges incurred through March 31, 2011. The Company amended its profitsharing plan during second quarter 2011 to defer the profitsharing impact of acquisition and integration costs incurred from April 1, 2011, through December 31, 2013. The profitsharing impact of these costs will be realized in 2014 and beyond.
(b) Amounts net of taxes and profitsharing. See footnote (a) above.

Note Regarding Use of Non-GAAP Financial Measures
The Company's unaudited Condensed Consolidated Financial Statements are prepared in accordance with GAAP. These GAAP financial statements include (i) unrealized non-cash adjustments and reclassifications, which can be significant, as a result of accounting requirements and elections made under accounting pronouncements relating to derivative instruments and hedging and (ii) other charges the Company believes are not indicative of its ongoing operational performance.

As a result, the Company also provides financial information in this filing that was not prepared in accordance with GAAP and should not be considered as an alternative to the information prepared in accordance with GAAP. The Company provides supplemental non-GAAP financial information, including results that it refers to as "economic," which the Company's management utilizes to evaluate its ongoing financial performance and the Company believes provides greater transparency to investors as supplemental information to its GAAP results. The Company's economic financial results differ from GAAP results in that they only include the actual cash settlements from fuel hedge contracts - all reflected within Fuel and oil expense in the period of settlement. Thus, Fuel and oil expense on an economic basis reflects the Company's actual net cash outlays for fuel during the applicable period, inclusive of settled fuel derivative contracts. Any net premium costs paid related to option contracts are reflected as a component of Other (gains) losses, net, for both GAAP and non-GAAP (including economic) purposes in the period of contract settlement. These economic results provide a better measure of the impact of the Company's fuel hedges on its operating performance and liquidity since they exclude the unrealized, non-cash adjustments and reclassifications that are recorded in GAAP results in accordance with accounting guidance relating to derivative instruments, and they reflect all cash settlements related to fuel derivative contracts within Fuel and oil expense. This enables the Company's management, as well as investors, to consistently assess the Company's operating performance on a year-over-year or quarter-over-quarter basis after considering all efforts in place to manage fuel expense. However, because these measures are not determined in accordance with GAAP, such measures are susceptible to varying calculations and not all companies calculate the measures in the same manner. As a result, the aforementioned measures, as presented, may not be directly comparable to similarly titled measures presented by other companies.

For further information on (i) the Company's fuel hedging program, (ii) the requirements of accounting for derivative instruments, and (iii) the causes of hedge ineffectiveness and/or mark-to-market gains or losses from derivative instruments, please refer to the Company's Annual Report on Form 10-K for the fiscal year ended December 31, 2011, and Note 5 to the unaudited Condensed Consolidated Financial Statements.

In addition to its "economic" financial measures, as defined above, the Company has also provided other non-GAAP financial measures as a result of items that the Company believes are not indicative of its ongoing operations. These include expenses associated with the Company's acquisition and integration of AirTran. The Company believes that evaluation of its financial performance can be enhanced by a presentation of results that exclude the impact of these items in order to evaluate the results on a comparative basis with results in prior periods that do not include such items and as a basis for evaluating operating results in future periods. As a result of the Company's acquisition of AirTran, which closed on May 2, 2011, the Company has incurred and expects to continue to incur substantial charges associated with integration of the two companies. While the Company cannot predict the exact timing or amounts of such charges, it does expect to treat the charges as special items in its future presentation of non-GAAP results. See Note 2 and Note 8 to the unaudited Condensed Consolidated Financial Statements for further information on the AirTran acquisition.

Material Changes in Results of Operations

Overview

As discussed in Note 2 to the unaudited Condensed Consolidated Financial Statements, on May 2, 2011, the Company consummated its acquisition of AirTran. For GAAP reporting, the accompanying results of operations and cash flows contain AirTran's results beginning as of the acquisition date, while results of operations and cash flows prior to the acquisition date are only those of Southwest Airlines Co. and its subsidiaries.

The Company recorded third quarter and year-to-date GAAP and non-GAAP results for 2012 and 2011 as follows:

(in millions, except per share amounts)	Three months ended September 30,			Nine months ended September 30,		
GAAP	2012	2011	Percent Change	2012	2011	Percent Change
Net income	$ 16	$ (140)	n.a	$ 343	$ 26	n.a.
Net income per share, diluted	0.02	(0.18)	n.a	0.45	0.03	n.a.
Operating income	51	225	(77.3)	532	546	(2.6)
Non-GAAP						
Net income	$ 97	$ 122	(20.5)	$ 352	$ 263	33.8
Net income per share, diluted	0.13	0.15	(13.3)	0.46	0.34	35.3
Operating income	208	285	(27.0)	702	672	4.5

See the previous Note Regarding Use of Non-GAAP Financial Measures.

The Company's GAAP results for both the three and nine months ended September 30, 2012 and 2011 were significantly impacted by the non-cash adjustments recorded as a result of the Company's portfolio of future derivative contracts utilized to hedge against jet fuel price volatility, as well as acquisition and integration costs associated with the Company's 2011 acquisition of AirTran. See Note 5 to the unaudited Condensed Consolidated Financial Statements for further information on fuel hedging and Note 2 for further information on the acquisition of AirTran. In addition, the Company's GAAP results for both the three and nine months ended September 30, 2012 included a $137 million third quarter 2012 charge associated with the Company's agreement with Delta and Boeing Capital Corp. to lease or sublease all 88 of AirTran's Boeing 717s to Delta. See Note 8 to the unaudited Condensed Consolidated Financial Statements for further information on this transaction. Excluding the impact of these items, the Company's net income on a non-GAAP basis declined 20.5 percent for third quarter 2012 compared to the same prior year period. This decline primarily was a result of a 1.9 percent increase in non-GAAP operating expenses, while operating revenues remained relatively flat. For the nine months ended September 30, 2012, the Company's net income on a non-GAAP basis significantly exceeded its net income on a non-GAAP basis for the nine months ended September 30, 2011, primarily due to better 2012 revenue production.

The Company has implemented, and/or is in the midst of, several strategic initiatives that are intended to increase its revenues and reduce its unit costs. The Company's major strategic initiatives include:

- The acquisition and integration of AirTran. The 2011 acquisition of AirTran increased the Company's fleet size by 140 aircraft and expanded the Company's network into key U.S. markets such as Atlanta and Washington Reagan, and near-international locations such as the Caribbean and Mexico. The Company has been able to produce significant synergies and continues to plan for net pre-tax annual synergies of $400 million in 2013 (excluding acquisition and integration expenses). Significant changes are underway to AirTran's route network, including the closure of several airports that proved unsustainable as a result of high fuel costs, and the re-deployment of aircraft in new markets. In addition, during the first quarter of 2012, the Company obtained a single operating certificate from the FAA. The Company has also continued the process of transferring AirTran aircraft to Southwest to be converted to the Southwest livery. As of October 17, 2012, nine AirTran 737-700 aircraft had completed the conversion process and re-entered service as Southwest aircraft. In addition, the Company transitioned AirTran's airport facilities in Seattle and Des Moines to Southwest in third quarter 2012 and plans to continue transitioning AirTran airport facilities to Southwest.
- The launch of Southwest's All-New Rapid Rewards® frequent flyer program in first quarter 2011. The results of the program have exceeded the Company's expectations with respect to the number of new frequent flyer members, the amount spent per member on airfare, the number of flights taken by members, the number of Southwest's co-branded Chase® Visa credit card holders added, the number of points sold to business partners, and the number of frequent flyer points purchased by program members.
- The addition of a larger aircraft, the Boeing 737-800, to Southwest's fleet. The Company is scheduled to receive a total of 34 Boeing 737-800s during 2012, of which 26 had been delivered as of October 17, 2012. The Boeing 737-800 (i) is better suited for potential new destinations, including near-international locations, (ii) has the opportunity to generate additional revenue by replacing current aircraft on specified routes and locations that are restricted due to space constraints or slot controls (a "slot" is the right of an air carrier, pursuant to regulations of the FAA, to operate a takeoff or landing at a specific time at certain airports), and (iii) operates at a lower unit cost than aircraft in the Company's existing fleet.
- Fleet modernization efforts. The Company announced in December 2011 that Southwest will be the first airline to accept delivery of Boeing's new, more fuel-efficient 737 MAX aircraft, which is expected to enter service in 2017. The Company placed orders for a total of 150 Boeing 737 MAX aircraft and added a total of 58 Boeing 737NG aircraft to its existing firm order book. The 737 MAX is expected to reduce CO2 emissions and improve fuel burn by an additional 10 to 11 percent over today's most fuel-efficient, single-aisle airplane. In January 2012, the Company also announced it would retrofit its 737-700 fleet with an updated cabin interior. Evolve: The New Southwest Experience is intended to enhance Customer comfort, personal space, and the overall travel experience, while improving fleet efficiency and being environmentally responsible. By maximizing the space inside the plane, Evolve allows for the added benefit of six additional seats on each 737-700 aircraft, along with more climate-friendly and cost-effective materials. These retrofits for Southwest 737-700 aircraft began in March 2012 and are expected to be completed in 2013. Over the next several years, AirTran aircraft that are transitioned to the Southwest fleet will also receive the new Evolve interior. As of October 17, 2012, 156 of the Company's 737-700 aircraft had been converted to the Evolve interior, including nine transitioned AirTran aircraft. The Company has also made the decision to retrofit a portion of its 737-300 fleet with Evolve.
- Reservation System Replacement. The Company has entered into a contract with Amadeus IT Group to implement Amadeus' Altea reservations solution to support the Company's international service. The Amadeus technology is expected to support Southwest's operation of international flights, which are expected to begin in 2014. The contract also provides the option for Southwest to migrate its domestic business to Amadeus in the future.

The Company has continued working towards creating a "codeshare" between the Southwest and AirTran reservations systems, which would allow Customers to book flights on either carrier through a single source and to book connecting itineraries between the two carriers. This project is expected to be completed in 2013. Progress also continues on the integration of Southwest's and AirTran's unionized workforce. During third quarter 2012, the International Association of Machinists and Aerospace Workers, AFL-CIO ("IAM 142"), which represents the Customer Service Agents and Customer Representatives at both Southwest and AirTran, announced it had reached a decision regarding the methodology for integrating the seniority lists of the two merging workgroups. The decision by IAM 142 is not subject to a vote by the respective workgroups. In addition, during October 2012, a settlement agreement was reached for integrating the seniority lists of the Company's Material Specialists at Southwest and AirTran. Based on these agreements, all Southwest and AirTran workgroup seniority integration methodologies have now been resolved. The Company's Pilots, Flight Attendants, Mechanics, Flight Instructors, Dispatchers, and Ramp, Operations, Provisioning, and Freight Agents have also successfully completed the seniority integration negotiation process.

During third quarter 2012, Southwest initiated service to both Akron-Canton and Dayton Airports in Ohio, which complements existing AirTran service to those cities. From Akron-Canton, Southwest offers two daily roundtrip flights to Chicago Midway Airport and one daily roundtrip flight to Denver. From Dayton, Southwest offers one daily roundtrip flight to Denver. Southwest also announced it would begin service to Branson, Missouri in March 2013, which would represent Southwest's 79th destination. Southwest will offer daily roundtrip service to Branson from Dallas Love Field, Houston Hobby, and Chicago Midway Airports, and will provide Saturday-only service to Orlando, Florida. These new flights will also complement existing AirTran service between Branson and Atlanta, Georgia.

The Company plans to continue its route network and schedule optimization efforts, but does not expect to grow its overall fleet size for 2012. Along with its expected receipt of 34 Boeing 737-800 aircraft deliveries during 2012, the Company also expects to retire approximately 38 of its older Boeing 737-300s and 737-500s and currently expects 2012 ASMs to approximate the combined 2011 ASMs of Southwest and AirTran, including during the pre-acquisition period from January 1, 2011 to May 1, 2011 for AirTran.

Comparison of three months ended September 30, 2012 to three months ended September 30, 2011

Operating Revenues

Operating revenues for third quarter 2012 decreased by $2 million, which was relatively flat compared to third quarter 2011. Based on traffic and revenue trends thus far in October, the Company currently expects a solid year-over-year increase in operating unit revenues in fourth quarter 2012.

Passenger revenues for third quarter 2012 increased 0.3 percent on a dollar basis. The majority of the increase in passenger revenues was attributable to higher passenger yields, as the Company implemented fare increases in an attempt to buffer a portion of the impact of high fuel costs and also benefitted from a higher portion of revenues from business partners being classified as Passenger revenues. The Company’s load factor in third quarter 2012 was relatively flat compared to third quarter 2011. As of October 17, 2012, October passenger unit revenues were running ahead of the comparable year ago period by approximately four percent.

Freight revenues for third quarter 2012 increased by $4 million, or 11.4 percent, compared to third quarter 2011, primarily due to an increase in shipments as a result of better demand than in third quarter 2011. The Company currently expects Freight revenues for fourth quarter 2012 to increase slightly as compared to fourth quarter 2011.

Other revenues for third quarter 2012 decreased by $18 million, or 7.4 percent, compared to third quarter 2011, the majority of which was due to a higher portion of revenues from business partners being classified as Passenger revenues. The classification of such amounts is influenced by average fares, among other factors. Based on current trends, the Company expects Other revenues for fourth quarter 2012 to increase slightly as compared to fourth quarter 2011.

Operating expenses

Operating expenses for third quarter 2012 increased by $172 million, or 4.2 percent, compared to third quarter 2011, while capacity decreased 0.7 percent over the same period. Historically, except for changes in the price of fuel, changes in Operating expenses for airlines are largely driven by changes in capacity, or ASMs. However, third quarter 2012 was affected by increases in certain other operating expenses which were not driven by capacity, such as a large increase in acquisition and integration expenses. The following table presents the Company’s Operating expenses per ASM for the third quarters of 2012 and 2011, followed by explanations of these changes on a per-ASM basis and/or on a dollar basis:

(in cents, except for percentages)	Three months ended September 30, 2012		Three months ended September 30, 2011		Per-ASM change		Percent change	
Salaries, wages, and benefits	3.59	¢	3.44	¢	.15	¢	4.4	%
Fuel and oil	4.62		4.76		(.14	)	(2.9	)
Maintenance materials and repairs	.91		.82		.09		11.0	
Aircraft rentals	.28		.27		.01		3.7	
Landing fees and other rentals	.84		.77		.07		9.1	
Depreciation and amortization	.65		.57		.08		14.0	
Acquisition and integration	.44		.07		.37		n.a.	
Other operating expenses	1.54		1.56		(.02	)	(1.3	)
Total	12.87	¢	12.26	¢	.61	¢	5.0	%

On a dollar basis, Operating expenses increased by 4.2 percent for third quarter 2012 compared to third quarter 2011, primarily due to increases in Salaries, wages, and benefits, Maintenance materials and repairs, and Acquisition and integration expenses. Operating expenses per ASM (unit costs) for third quarter 2012 increased 5.0 percent compared to third quarter 2011 primarily due to higher Acquisition and integration expense associated with AirTran, including the $137 million charge recorded as a result of the Boeing B717 transaction with Delta. See Notes 2 and 8 to the unaudited Condensed Consolidated Financial Statements. On a non-GAAP basis, the Company's third quarter 2012 Operating expenses per ASM, excluding fuel, increased 5.8 percent compared to third quarter 2011, primarily due to higher Salaries, wages, and benefits, maintenance, and depreciation and amortization expenses. Based on current cost trends, the Company expects fourth quarter 2012 unit costs, excluding fuel, profitsharing, and special items, to increase approximately 6.0 percent compared to fourth quarter 2011's unit costs, excluding fuel, profitsharing, and special items. See the previous Note Regarding Use of Non-GAAP Financial Measures.

Salaries, wages, and benefits expense for third quarter 2012 increased by $43 million, or 3.8 percent, compared to third quarter 2011. Salaries, wages and benefits expense per ASM for third quarter 2012 increased 4.4 percent compared to third quarter 2011. The majority of these increases was a result of higher wage rates for the majority of the Company's workforce compared to third quarter 2011. Based on current cost trends and anticipated capacity, the Company expects Salaries, wages, and benefits expense per ASM in fourth quarter 2012, excluding profitsharing, to increase from fourth quarter 2011's 3.60 cents, primarily due to higher wage rates.

Fuel and oil expense for third quarter 2012 decreased by $58 million, or 3.7 percent, compared to third quarter 2011. On a per-ASM basis, third quarter 2012 Fuel and oil expense decreased 2.9 percent versus third quarter 2011. Both the nominal dollar and unit cost decreases were primarily due to better efficiency, as gallons consumed decreased 2.4 percent compared to third quarter 2011; while year-over-year capacity was down only 0.7 percent. The improvement in fuel efficiency was primarily due to the Company continuing to replace older Classic Fleet (737-300s and 737-500s) aircraft with new next-generation 737s. As a result of the Company's fuel hedging program and inclusive of accounting for derivatives and hedging, the Company recognized net losses totaling $25 million in third quarter 2012 in Fuel and oil expense relating to fuel derivative instruments versus net losses totaling $37 million recognized in Fuel and oil expense in third quarter 2011. These totals are inclusive of cash settlements realized from the expiration/settlement of fuel derivatives, which were $13 million paid to counterparties in the third quarter of each year. These totals exclude gains and/or losses recognized from hedge ineffectiveness and from derivatives that do not qualify for hedge accounting, which impacts are recorded as a component of Other (gains) losses, net. See Note 5 to the unaudited Condensed Consolidated Financial Statements.

As of October 17, 2012, on an economic basis, the Company had derivative contracts in place related to expected future fuel consumption for the following periods:

Period	Average percent of estimated fuel consumption covered by fuel derivative contracts at varying WTI/Brent crude-equivalent price levels
2013	less than 15%
2014	approx. 50%
2015	approx. 30%
2016	approx. 15%

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As a result of applying hedge accounting in prior periods the Company has amounts "frozen" in Accumulated other comprehensive income (loss) ("AOCI"), and these amounts will be recognized in the Company's unaudited Condensed Consolidated Statement of Comprehensive Income (Loss) in future periods when the underlying fuel derivative contracts settle. The following table displays the Company's estimated fair value of remaining fuel derivative contracts (not considering the impact of the cash collateral provided to or received from counterparties— See Note 5 to the unaudited Condensed Consolidated Financial Statements for further information), as well as the amount of deferred gains/losses in AOCI at September 30, 2012, and the expected future periods in which these items are expected to settle and/or be recognized in earnings (in millions):

Year	Fair value (liability) of fuel derivative contracts at September 30, 2012	Amount of gains (losses) deferred in AOCI at September 30, 2012 (net of tax)
Fourth quarter 2012	$ (29)	$ (21)
2013	(9)	(87)
2014	87	51
2015	49	(31)
2016	35	5
Total	$ 133	$ (83)

Based on forward market prices and the amounts in the above table (and excluding any other subsequent changes to the fuel hedge portfolio), the Company's jet fuel costs per gallon could exceed market (i.e., unhedged) prices during some of these future periods. This is based primarily on expected future cash settlements associated with fuel derivatives, but excludes any impact associated with the ineffectiveness of fuel hedges or fuel derivatives that are marked to market because they do not qualify for hedge accounting. See Note 5 to the unaudited Condensed Consolidated Financial Statements for further information. Assuming no changes to the Company's current fuel derivative portfolio, but including all previous hedge activity for fuel derivatives that have not yet settled, and considering only the expected net cash payments related to hedges that will settle, the Company is providing a sensitivity table for fourth quarter 2012, first half of 2013, and second half of 2013 jet fuel prices at different crude oil assumptions as of October 17, 2012, and for expected premium costs associated with settling contracts each period.

	Estimated difference in economic jet fuel price per gallon, above/(below) unhedged market prices, including taxes		
Average WTI Crude Oil price per barrel	4Q 2012	1Q 2013	2013
$60		$0.25	$0.07
$70		$0.07	$0.02
$80		$0.03	$0.01
Current Market (1)	(2)	$0.03	$0.01
$100		$0.00	$0.00
$110		($0.08)	($0.02)
$125		($0.14)	($0.04)
Estimated Premium Costs (3)	$3 million	$13 million	$68 million

(1) WTI crude oil average market prices as of October 15, 2012 were approximately $92, $94 and $94 per barrel for fourth quarter 2012, first quarter 2013 and full year 2013, respectively.

(2) For fourth quarter 2012, the Company's estimated fuel consumption is not covered by fuel derivative contracts due to settling its fourth quarter 2012 contracts in advance of their original settlement dates. Therefore, the Company has effectively locked-in an above market amount of $0.09 per gallon, regardless of the price of jet fuel during fourth quarter 2012.

(3) Premium costs are recognized as a component of Other (gains) losses net.

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Maintenance materials and repairs expense for third quarter 2012 increased by $28 million, or 10.3 percent, compared to third quarter 2011. On a per-ASM basis, Maintenance materials and repairs expense for third quarter 2012 increased 11.0 percent compared to third quarter 2011. These increases were primarily attributable to higher engine repair costs on the 737-700 fleet, as well as costs associated with the Company's Evolve retrofit program, which began in March 2012. The Company currently expects Maintenance materials and repairs expense per ASM for fourth quarter 2012 to increase from fourth quarter 2011's results primarily due to continued Evolve retrofits; but to decrease slightly from third quarter 2012 due to timing of scheduled maintenance.

Aircraft rentals expense for third quarter 2012 increased by $2 million, or 2.2 percent, compared to third quarter 2011. On a per-ASM basis compared to third quarter 2011, Aircraft rentals expense in third quarter 2012 increased 3.7 percent. These increases were primarily due to expense associated with five Boeing 737-800 aircraft received during second quarter 2012 that are accounted for as operating leases. The Company currently expects Aircraft rentals expense per ASM for fourth quarter 2012 to be comparable to third quarter 2012's results.

Landing fees and other rentals expense for third quarter 2012 increased by $21 million, or 8.2 percent, compared to third quarter 2011. On a per-ASM basis compared to third quarter 2011, Landing fees and other rentals expense increased 9.1 percent. The majority of these increases were due to an increase in rates charged by two airports, Las Vegas and Sacramento, for space rentals versus the same prior year period. The Company currently expects Landing fees and other rentals expense per ASM for fourth quarter 2012 to increase from third quarter 2012's results due to increased space rentals and airport rate increases.

Depreciation and amortization expense for third quarter 2012 increased by $26 million, or 13.6 percent, compared to third quarter 2011. Approximately 90 percent of this increase was due to a reduction in salvage values for the Company's Classic Fleet, coupled with an acceleration of depreciation expense associated with aircraft in the Company's Classic Fleet that have been retired or are expected to be retired during 2012, based on the Company's current fleet plans. See Note 3 to the unaudited Condensed Consolidated Financial Statements for further information on the change in salvage values. In addition, approximately 10 percent of the increase was due to the net purchases of 23 owned aircraft (737-800s and 737-700s) during the twelve months ended September 30, 2012. On a per-ASM basis, Depreciation and amortization expense increased 14.0 percent compared to third quarter 2011, primarily due to the acceleration of depreciation expense associated with aircraft that are currently expected to be retired during 2012, based on the Company's current fleet plans, coupled with the reduction in salvage values for the Company's Classic Fleet. For fourth quarter 2012, the Company currently expects Depreciation and amortization expense per ASM to be comparable to third quarter 2012's results.

For third quarter 2012, the Company incurred $145 million of Acquisition and integration costs related to the acquisition of AirTran compared to $22 million in third quarter 2011. The third quarter 2012 costs primarily consisted of $137 million associated with the Company's lease/sublease transaction for AirTran's Boeing 717-200 fleet. Other integration-related costs included Employee training and facility integration expenses. See Notes 2 and 8 to the unaudited Condensed Consolidated Financial Statements.

Other operating expenses for third quarter 2012 decreased by $13 million, or 2.5 percent, compared to third quarter 2011, and decreased 1.3 percent on a per-ASM basis compared to third quarter 2011. The majority of these decreases was the result of a $17 million asset impairment in third quarter 2011 related to the Company's decision not to equip its Classic (737-300) aircraft with Required Navigation Performance (RNP) capabilities. For fourth quarter 2012, the Company currently expects Other operating expenses per ASM to increase from fourth quarter 2011's results, primarily due to higher advertising expenses.

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Other

Other expenses (income) include interest expense, capitalized interest, interest income, and other gains and losses. Interest expense for third quarter 2012 decreased by $15 million, or 30.0 percent, compared to third quarter 2011, primarily as a result of the Company's repayment of its $400 million 10.5% notes in December 2011 and $385 million 6.5% notes in March 2012. For fourth quarter 2012, the Company expects interest expense to be comparable to third quarter 2012's results.

Capitalized interest for third quarter 2012 increased by $2 million, or 66.7 percent, compared to third quarter 2011, primarily due to an increase in average progress payment balances for scheduled future aircraft deliveries.

Other (gains) losses, net, primarily includes amounts recorded as a result of the Company's hedging activities. See Note 5 to the unaudited Condensed Consolidated Financial Statements for further information on the Company's hedging activities. The following table displays the components of Other (gains) losses, net, for the three months ended September 30, 2012 and 2011:

	Three months ended September 30,	
(in millions)	2012	2011
Mark-to-market impact from fuel contracts settling in future periods	$ (37)	$ 288
Ineffectiveness from fuel hedges settling in future periods	5	78
Realized ineffectiveness and mark-to-market (gains) or losses	4	3
Premium cost of fuel contracts	15	36
Other	3	-
	$ (10)	$ 405

Income Taxes

The Company's effective tax rate was approximately 51.5 percent in third quarter 2012 compared to 38.1 percent in third quarter 2011. The higher rate in third quarter 2012 was due to the impact of a slight increase in the Company's full year 2012 expected tax rate had on the Company's relatively low net income for third quarter 2012. The Company currently projects a full year 2012 effective tax rate of approximately 38 to 40 percent based on currently forecasted financial results.

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Comparison of nine months ended September 30, 2012 to nine months ended September 30, 2011

Operating Revenues

Operating revenues for the nine months ended September 30, 2012, increased by $1.4 billion, or 11.8 percent, compared to the first nine months of 2011. The majority of the increase was due to the fact that the first nine months of 2012 results include nine full months of AirTran Operating revenues, while the first nine months of 2011 results only include AirTran Operating revenues following the May 2, 2011 acquisition date. Excluding the results of AirTran in both periods, Operating revenues for the nine months ended September 30, 2012 increased by 5.6 percent on a dollar basis compared to the first nine months of 2011, primarily due to a 5.5 percent increase in Southwest's passenger revenues. The majority of the increase in passenger revenues was attributable to higher passenger yields, as the Company implemented fare increases in an attempt to buffer a portion of the impact of high fuel costs. The remainder of the increase primarily was due to the 2.1 percent increase in Southwest's capacity, versus the first nine months of 2011. In the first nine months of 2012, Southwest's passenger revenue yields increased 3.4 percent, and average passenger fare increased 2.9 percent, compared to the first nine months of 2011. In addition to the fare increases the Company has been able to implement and other revenue management techniques, the year-over-year increase in passenger revenues benefitted from continued optimization of the Company's flight schedule to better match demand in certain markets and, at certain times, targeted marketing campaigns in which the Company differentiates its product and services from competitors. This increase in passenger revenues was partially offset by a slight decrease in the Company's load factor, partially due to the impact of higher airfares on Customer demand.

Freight revenues for the first nine months of 2012 increased by $15 million, or 14.6 percent, compared to the first nine months of 2011, primarily due to an increase in shipments as a result of better domestic economic conditions than the prior year.

Other revenues for the first nine months of 2012 increased by $98 million, or 17.1 percent, compared to the first nine months of 2011, of which approximately $78 million was due to the inclusion of the full nine months of AirTran results in 2012, while the first nine months of 2011 results only include AirTran Other revenues following the acquisition date. Excluding the results of AirTran in both periods, Other revenues for the first nine months of 2012 increased by 5.0 percent on a dollar basis compared to the first nine months of 2011. This increase was due to increased revenues from initiatives, such as the Company's EarlyBird product, for which Customers can pay $10 to automatically receive an assigned boarding position before general checkin begins, and service charges for unaccompanied minors and pets. Southwest's EarlyBird product and service charges for unaccompanied minors, pets, and excess bags contributed $165 million to Other revenues in the nine months ended September 30, 2012 versus $147 million generated from these products during the nine months ended September 30, 2011. The year-over-year increase in Other revenues from these initiatives and other ancillary revenue sources was partially offset by a year-over-year increase in the portion of the commissions earned from programs the Company sponsors with certain business partners that were classified as Passenger revenues as opposed to Other revenues. The classification of such amounts is influenced by average fares, among other factors. Other revenues for the first nine months of 2012 included approximately $113 million in baggage fees collected from AirTran Customers, versus approximately $74 million in baggage fees for the nine months ended September 30, 2011.

Operating expenses

Operating expenses for the first nine months of 2012 increased by $1.4 billion, or 12.5 percent, compared to the first nine months of 2011, while capacity increased 8.6 percent compared to the first nine months of 2011. The increase in consolidated operating expenses was primarily due to the inclusion of AirTran's operating expenses following the acquisition. Historically, except for changes in the price of fuel, changes in operating expenses for airlines are largely driven by changes in capacity, or ASMs. The following table presents the Company's operating expenses per ASM for the first nine months of 2012 and 2011, followed by explanations of these changes on a per-ASM basis and/or on a dollar basis:

	Nine months ended September 30,							
(in cents, except for percentages)	2012		2011		Per ASM change		Percent change	
Salaries, wages, and benefits	3.67	¢	3.61	¢	.06	¢	1.7	%
Fuel and oil	4.76		4.64		.12		2.6	
Maintenance materials and repairs	.89		.80		.09		11.3	
Aircraft rentals	.28		.24		.04		16.7	
Landing fees and other rentals	.82		.79		.03		3.8	
Depreciation and amortization	.64		.59		.05		8.5	
Acquisition and integration	.17		.11		.06		54.5	
Other operating expenses	1.54		1.54		-		-	
Total	12.77	¢	12.32	¢	.45	¢	3.7	%

On a dollar basis, excluding the results for AirTran in both periods, Operating expenses increased by 6.3 percent for the first nine months of 2012 compared to the first nine months of 2011, the majority was due to a higher average jet fuel cost per gallon, higher Depreciation and amortization, higher Salaries, wages, and benefits, and higher Acquisition and integration expenses. See Notes 2 and 8 to the unaudited Condensed Consolidated Financial Statements for further information on Acquisition and integration expenses. On a per-ASM basis, Operating expenses (unit costs) for the first nine months of 2012 increased 3.7 percent compared to the first nine months of 2011. Approximately 27 percent of this year-over-year cost per available seat mile increase was due to higher fuel costs, as the Company's average jet fuel cost per gallon increased 3.2 percent to $3.27, including the impact of hedging activity. The remainder of this increase was primarily due to higher Maintenance materials and repairs and Acquisition and integration expenses. On a non-GAAP basis, the Company's Operating expenses per ASM for the first nine months of 2012, excluding fuel, increased by 3.7 percent compared to the first nine months of 2011. See the previous Note Regarding Use of Non-GAAP Financial Measures.

Salaries, wages, and benefits expense for the nine months ended September 30, 2012, increased by $326 million, or 10.1 percent, compared to the nine months ended September 30, 2011. Approximately $172 million of this increase was due to the inclusion of the full nine months of AirTran results in 2012, while the first nine months of 2011 results only include AirTran Salaries, wages, and benefits expense following the acquisition date. Excluding the results of AirTran in both periods, Salaries, wages, and benefits expense increased by 5.2 percent on a dollar basis for the first nine months of 2012 compared to the first nine months of 2011. Approximately 64 percent of this year-over-year increase was a result of higher salaries expense, primarily due to an increase in average wage rates, coupled with a 7.8 percent increase in fulltime equivalent Employees. In addition, approximately eight percent of the increase was due to an increase in profitsharing expense resulting from higher income available for profitsharing. See Note 5 to the unaudited Condensed Consolidated Financial Statements for further information on fuel hedging. On a per-ASM basis, consolidated Salaries, wages, and benefits expense for the first nine months of 2012 increased 1.7 percent compared to the first nine months of 2011. On a per-ASM basis, the majority of this increase was due to the increase in profitsharing expense.

Fuel and oil expense for the nine months ended September 30, 2012, increased by $465 million, or 11.2 percent, compared to the nine months ended September 30, 2011. Approximately $327 million of this increase was due to the inclusion of the full nine months of AirTran results in 2012, while the first nine months of 2011 results only include AirTran Fuel and oil expense following the acquisition date. Excluding the results of AirTran in both periods, Fuel and oil expense for the first nine months of 2012 increased 3.8 percent on a dollar basis versus the first nine months of 2011. On a per-ASM basis, Fuel and oil expense for the first nine months of 2012 increased by 2.6 percent versus the first nine months of 2011. Both of these increases were primarily due to a 3.2 percent increase in the Company's average fuel cost per gallon. As a result of the Company's fuel hedging program and inclusive of accounting for derivatives and hedging, the Company recognized net losses totaling $89 million in the first nine months of 2012 in Fuel and oil expense relating to fuel derivative instruments versus net losses of $25 million recognized in Fuel and oil expense in the first nine months of 2011. These totals are inclusive of cash settlements realized from the expiration/settlement of fuel derivatives, which were $87 million paid to counterparties in the first nine months of 2012 versus $8 million paid to counterparties for the first nine months of 2011. These totals exclude gains and/or losses recognized from hedge ineffectiveness and from derivatives that do not qualify for hedge accounting, which impacts are recorded as a component of Other (gains) losses, net. See Note 5 to the unaudited Condensed Consolidated Financial Statements.

Maintenance materials and repairs expense for the nine months ended September 30, 2012, increased by $145 million, or 20.2 percent, compared to the nine months ended September 30, 2011. Approximately $103 million of this increase was due to the inclusion of the full nine months of AirTran results in 2012, while the first nine months of 2011 results only include AirTran Maintenance materials and repairs expense following the acquisition date. Excluding the results of AirTran in both periods, Maintenance materials and repairs expense for the first nine months of 2012 increased 6.9 percent on a dollar basis compared to the first nine months of 2011. The majority of the increase was attributable to higher airframe and component expense associated with the Company's ongoing Evolve modifications which began in first quarter 2012. On a per-ASM basis, Maintenance materials and repairs expense for the first nine months of 2012 increased 11.3 percent compared to the first nine months of 2011, as a result of higher airframe and component expense associated with the Evolve program.

Aircraft rentals expense for the nine months ended September 30, 2012, increased by $56 million, or 26.2 percent, compared to the nine months ended September 30, 2011. There was an increase of $61 million due to the inclusion of the full nine months of AirTran results in 2012, while the first nine months of 2011 results only include AirTran Aircraft rentals expense following the acquisition date. Excluding the results of AirTran in both periods, as well as the impact of amortization associated with the unfavorable aircraft lease liability created as part of purchase accounting adjustments based on the estimated fair value of AirTran Boeing 717 leases, Aircraft rentals expense for the first nine months of 2012 increased approximately 5.6 percent compared to the first nine months of 2011. See Note 2 to the unaudited Condensed Consolidated Financial Statements. On a per-ASM basis, Aircraft rentals expense for the first nine months of 2012 increased 16.7 percent compared to the first nine months of 2011. This increase on a per-ASM basis primarily was due to the fact that AirTran leases the majority of its aircraft fleet.

Landing fees and other rentals expense for the nine months ended September 30, 2012, increased by $86 million, or 12.2 percent, compared to the nine months ended September 30, 2011. Approximately $38 million of this increase was due to the inclusion of the full nine months of AirTran results in 2012, while the first nine months of 2011 results only include AirTran Landing fees and other rentals expense following the acquisition date. Excluding the results of AirTran in both periods, Landing fees and other rentals expense for the first nine months of 2012 increased by 7.4 percent on a dollar basis compared to the first nine months of 2011. The majority of the dollar increase was due to an increase in rates charged by airports for both landing fees and space rentals versus the same prior year period. On a per-ASM basis, Landing fees and other rentals expense for the first nine months of 2012 increased by 3.8 percent compared to the first nine months of 2011 primarily due to higher rates paid for airport space.

Depreciation and amortization expense for the nine months ended September 30, 2012, increased by $97 million, or 18.5 percent, compared to the nine months ended September 30, 2011. Approximately $18 million of this increase was due to the inclusion of the full nine months of AirTran results in 2012, while the first nine months of 2011 results only include AirTran Depreciation and amortization expense following the acquisition date. Excluding the results of AirTran in both periods, Depreciation and amortization expense for the first nine months of 2012 increased 15.9 percent on a dollar basis compared to the first nine months of 2011. Approximately 35 percent of this increase was due to an acceleration of depreciation expense associated with aircraft in the Company's Classic Fleet that have been retired or are currently expected to be retired during 2012, based on the Company's current fleet plans. Approximately 25 percent of this increase was due to a reduction in salvage values for the Company's Classic Fleet effective in July 2012. See Note 3 to the unaudited Condensed Consolidated Financial Statements for further information on these changes in estimates. In addition, approximately 19 percent of this increase was due to the net purchases of 23 owned aircraft (737-800s and 737-700s) during the twelve months ended September 30, 2011. On a per-ASM basis, Depreciation and amortization expense for the first nine months of 2012 increased by 8.5 percent compared to the first nine months of 2011, primarily due to the acceleration of depreciation expense associated with the Company's 737-300s and 737-500s that have been retired thus far in 2012 or are expected to be retired later in 2012, coupled with a reduction in salvage values for the Company's Classic Fleet.

For the first nine months of 2012, the Company incurred $168 million of Acquisition and integration costs related to the acquisition of AirTran compared to $97 million in the first nine months of 2011. These 2012 costs primarily consisted of costs associated with the Company's lease/sublease transaction for AirTran's Boeing 717-200 fleet, consulting, flight crew training, seniority integration, and facility integration expenses. See Note 2 and Note 8 to the unaudited Condensed Consolidated Financial Statements.

Other operating expenses for the nine months ended September 30, 2012, increased by $133 million, or 9.7 percent, compared to the nine months ended September 30, 2011. Approximately $81 million of this increase was due to the inclusion of the full nine months of AirTran results in 2012, while the first nine months of 2011 results only include AirTran Other operating expenses following the acquisition date. Excluding the results of AirTran in both periods, Other operating expenses for the first nine months of 2012 increased 4.9 percent on a dollar basis compared to the first nine months of 2011. Approximately 60 percent of this increase was due to consulting and other outside services costs associated with completed and ongoing projects related to the Company's strategic initiatives as previously discussed. On a per-ASM basis, Other operating expenses for the first nine months of 2012 were flat compared to the first nine months of 2011.

Other

Other expenses (income) include interest expense, capitalized interest, interest income, and other gains and losses. Interest expense for the first nine months of 2012 decreased by $31 million, or 21.7 percent, compared to the first nine months of 2011, primarily as a result of the Company's repayment of its $400 million 10.5% notes in December 2011 and $385 million 6.5% notes in March 2012.

Capitalized interest for the first nine months of 2012 increased by $8 million, or 100.0 percent, compared to the first nine months of 2011, primarily due to an increase in average progress payment balances for scheduled future aircraft deliveries.

Interest income for the first nine months of 2012 decreased by $3 million, or 37.5 percent, compared to the first nine months of 2011, primarily due to lower rates earned on invested cash and short-term investments.

Other (gains) losses, net, primarily includes amounts recorded as a result of the Company's hedging activities. See Note 5 to the unaudited Condensed Consolidated Financial Statements for further information on the Company's hedging activities. The following table displays the components of Other (gains) losses, net, for the nine months ended September 30, 2012 and 2011:

	Nine months ended September 30,	
(in millions)	2012	2011
Mark-to-market impact from fuel contracts settling in future periods	$ (193)	$ 148
Ineffectiveness from fuel hedges settling in future periods	45	115
Realized ineffectiveness and mark-to-market (gains) or losses	(8)	(6)
Premium cost of fuel contracts	33	93
Other	4	1
	$ (119)	$ 351

Income taxes

The Company's effective tax rate was approximately 39 percent for the first nine months of 2012, compared to approximately 62 percent for the first nine months of 2011. The higher rate for the first nine months of 2011 primarily was driven by a portion of acquisition-related costs being non-deductible, additional income tax expense of $5 million as a result of an IRS settlement agreed to in first quarter 2011 related to tax years 2007 through 2009, and a first quarter 2011 $2 million charge as a result of a State of Illinois tax law change.

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Liquidity and Capital Resources

Net cash provided by operating activities was $464 million for the three months ended September 30, 2012, compared to $218 million used in operating activities in the same prior year period. For the nine months ended September 30, 2012, net cash provided by operating activities was $1.8 billion compared to $985 million provided by operating activities in the first nine months of 2011. The operating cash flows for the nine months ended September 30, 2012 were largely impacted by the Company's results of operations (as adjusted for noncash depreciation and amortization expense), changes in Air traffic liability, Accounts payable and Accrued liabilities, and collateral received from fuel derivative counterparties. For the nine months ended September 30, 2012, in addition to net income (as adjusted for noncash depreciation and amortization expense), there was a $688 million increase in Air traffic liability as a result of bookings for future travel, and higher sales of points to business partners in the Company's frequent flyer program, and a net $114 million increase in cash flow associated with higher balances in Accounts payable and Accrued liabilities due to timing of payments. For the nine months ended September 30, 2011, there was a $485 million increase in Air traffic liability as a result of bookings for future travel and a net $266 million increase in cash flow associated with higher balances in Accounts payable and Accrued liabilities. Net cash provided by operating activities is primarily used to finance capital expenditures, repay debt, and provide working capital.

Net cash used in investing activities during the three months ended September 30, 2012 totaled $277 million, versus $137 million used in investing activities in the same prior year period. For the nine months ended September 30, 2012, net cash used in investing activities was $644 million, compared to $957 million used in the same prior year period. Investing activities in both years included payments for new aircraft delivered to the Company and progress payments for future aircraft deliveries, as well as changes in the balance of the Company's short-term investments and noncurrent investments. During the nine months ended September 30, 2012, the Company's short-term and noncurrent investments decreased by a net $274 million, versus a net increase of $374 million during the same prior year period.

Net cash used in financing activities during the three months ended September 30, 2012 was $102 million, compared to $224 million used in financing activities for the same period in 2011. For the nine months ended September 30, 2012, net cash used in financing activities was $850 million compared to $273 million used in financing activities in the same prior year period. During the nine months ended September 30, 2012, the Company repaid $517 million in debt and capital lease obligations that came due and repurchased approximately $325 million of its outstanding common stock through a share repurchase program. During the nine months ended September 30, 2011, the Company repaid $110 million in debt and capital lease obligations that came due, repurchased approximately $175 million of its outstanding common stock through a share repurchase program, and also used $81 million in cash to repay convertible noteholders. See Note 5 to the unaudited Condensed Consolidated Financial Statements for further information on the Company's interest rate derivative activities.

The Company is a "well-known seasoned issuer" and currently has an effective shelf registration statement registering an indeterminate amount of debt and equity securities for future sales. The Company intends to use the proceeds from any future securities sales off this shelf registration statement for general corporate purposes. The Company has not issued any securities under this shelf registration statement to date.

Contractual Obligations and Contingent Liabilities and Commitments

The Company has contractual obligations and commitments primarily with regard to future purchases of aircraft, payment of debt, and lease arrangements. During the nine months ended September 30, 2012, the Company purchased 20 new 737-800 aircraft from Boeing (one of which will not enter active service until fourth quarter 2012), leased five new 737-800 aircraft from a third party, and retired 30 of its older 737-300 and 737-500 aircraft from service. The Company currently plans to retire eight additional 737-300 and/or 737-500 aircraft from its current fleet during the remainder of 2012, which would result in the Company ending the year with 694 aircraft. As of October 17, 2012, the Company had the following scheduled aircraft deliveries:

	The Boeing Company 737NG				The Boeing Company 737MAX		
	-700 Firm Orders	-800 Firm Orders	Options	Additional -800s	Firm Orders	Options	Total
2012		29		5			34 (2)
2013		20					20
2014	5	24	15				44
2015	36		12				48
2016	31		12				43
2017	30		25		4		59
2018	25		28		15		68
2019					33		33
2020					34		34
2021					34	18	52
2022					30	19	49
2023						23	23
2024						23	23
Through 2027						67	67
Total	127 (1)	73	92	5 (3)	150 (4)	150	597

(1) The Company has flexibility to substitute 737-800s or 737-600s in lieu of 737-700 firm orders.
(2) Includes 26 aircraft delivered as of October 17, 2012.
(3) New delivery leased aircraft.
(4) The Company has the right, under certain conditions, including Boeing's decision to manufacture a MAX 7 aircraft, to substitute MAX 7 aircraft in place of future MAX 8 deliveries.

The Company’s financial commitments associated with the firm orders in the above aircraft table are as follows: $255 million remaining in 2012, $649 million in 2013, $967 million in 2014, $1.2 billion in 2015, $1.3 billion in 2016, and $7.9 billion thereafter.

For aircraft commitments with Boeing, the Company is required to make cash deposits towards the purchase of aircraft. These deposits are classified as Deposits on flight equipment purchase contracts in the unaudited Condensed Consolidated Balance Sheet until the aircraft is delivered, at which time deposits previously made are deducted from the final purchase price of the aircraft and are reclassified as Flight Equipment.

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The following table details information on the active aircraft in the Company's fleet that were in service as of September 30, 2012:

Type	Seats	Average Age (Yrs)	Number of Aircraft	Number Owned	Number Leased
717-200	117	11	88	8	80
737-300	137	20	136	84	52
737-500	122	21	20	11	9
737-700	137 or 143	8	424	379	45
737-800	175	-	24	19	5
TOTALS			692	501	191

The Company expects to incur approximately $550 million in integration and acquisition costs associated with the AirTran acquisition, approximately 55 percent of which has been recorded through September 30, 2012. These costs have been, and are expected to continue to be, funded with cash from operations. The Company believes that its current liquidity position, including unrestricted cash and short-term investments of $3.2 billion as of September 30, 2012, anticipated future internally generated funds from operations, and its fully available, unsecured revolving credit facility of $800 million that expires in April 2016, will enable it to meet these future integration expenditures. However, if a liquidity need were to arise, the Company believes it has access to financing arrangements because of its current investment grade credit ratings, large value of unencumbered assets, and modest leverage, which should enable it to meet its ongoing capital, operating, and other liquidity requirements. The Company will continue to consider various borrowing or leasing options to maximize liquidity and supplement cash requirements as necessary.

In January 2008, the Company's Board of Directors authorized the repurchase of up to $500 million of the Company's common stock. Through February 15, 2008, the Company had repurchased 4.4 million shares for a total of approximately $54 million, at which time repurchases under the program were suspended. On August 5, 2011, the Company's Board of Directors authorized the Company to resume a share repurchase program and approved the Company's repurchase, on a discretionary basis, of a total of up to $500 million of the Company's common stock following such authorization. In May 2012, the Company's Board of Directors increased the previous share repurchase authorization by an additional $500 million. During the three months ended September 30, 2012, the Company purchased approximately 6 million shares of its common stock for approximately $50 million, which brings its cumulative purchases under this program since the August 2011 authorization to approximately 65 million shares for approximately $550 million of the $1 billion in total authorized by the Board.

Cautionary Statement Regarding Forward-Looking Statements

This Form 10-Q contains “forward-looking statements” within the meaning of Section 27A of the Securities Act of 1933 and Section 21E of the Securities Exchange Act of 1934. Forward-looking statements are based on, and include statements about, the Company’s estimates, expectations, beliefs, intentions, and strategies for the future, and the assumptions underlying these forward-looking statements. Specific forward-looking statements can be identified by the fact that they do not relate strictly to historical or current facts and include, without limitation, statements related to the following:

- the Company’s strategic initiatives and related financial and operational goals and expectations;
- the Company’s plans with respect to its acquisition of AirTran and related financial and operational goals and expectations, including without limitation anticipated integration timeframes and expected benefits and costs associated with the acquisition;
- the Company’s fleet plans, including its fleet modernization plans, and related financial and operational goals expectations;
- the Company’s growth plans and expectations, including its network and capacity plans and expectations;
- the Company’s financial outlook and projected results of operations;
- the Company’s plans and expectations with respect to managing risk associated with changing jet fuel prices;
- the Company’s expectations with respect to liquidity, including anticipated needs for, and sources of, funds;
- the Company’s assessment of market risks; and
- the Company’s plans and expectations related to legal proceedings.

While management believes these forward-looking statements are reasonable as and when made, forward-looking statements are not guarantees of future performance and involve risks and uncertainties that are difficult to predict. Therefore, actual results may differ materially from what is expressed in or indicated by the Company’s forward-looking statements or from historical experience or the Company’s present expectations. Factors that could cause these differences include, among others:

- the impact of the economy on demand for the Company’s services and the impact of fuel prices, economic conditions, and actions of competitors on the Company’s business decisions, plans, and strategies;
- changes in the price of aircraft fuel, the impact of hedge accounting, and any changes to the Company’s fuel hedging strategies and positions;
- the Company’s ability to timely and effectively implement, transition, and maintain the necessary information technology systems and infrastructure to support its operations and initiatives;
- the Company’s ability to effectively integrate AirTran and realize the expected synergies and other benefits from the acquisition;
- the Company’s ability to timely and effectively prioritize its strategic initiatives and related expenditures;
- the Company’s dependence on third parties with respect to certain of its initiatives, in particular its fleet plans;
- the impact of governmental and other regulation on the Company’s operations; and
- other factors as set forth in the Company’s filings with the Securities and Exchange Commission, including the detailed factors discussed under the heading “Risk Factors” in the Company’s Annual Report on Form 10-K for the year ended December 31, 2011.

Caution should be taken not to place undue reliance on the Company’s forward-looking statements, which represent the Company’s views only as of the date this report is filed. The Company undertakes no obligation to update publicly or revise any forward-looking statement, whether as a result of new information, future events or otherwise.

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Item 3. Quantitative and Qualitative Disclosures About Market Risk

As discussed in Note 5 to the unaudited Condensed Consolidated Financial Statements, the Company endeavors to acquire jet fuel at the lowest possible cost and to reduce volatility in operating expenses through its fuel hedging program with the use of financial derivative instruments. At September 30, 2012, the estimated fair value of outstanding contracts, excluding the impact of cash collateral provided to or held from counterparties, was an asset of $133 million.

The Company's credit exposure related to fuel derivative instruments is represented by the fair value of contracts that are an asset to the Company. At such times, these outstanding instruments expose the Company to credit loss in the event of nonperformance by the counterparties to the agreements. As of September 30, 2012, the Company had seven counterparties with which the derivatives held were a net asset, totaling $159 million, and two counterparties with which the derivatives held were a net liability, totaling $26 million. 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. However, if one or more of these counterparties were in a liability position to the Company and were unable to meet their obligations, any open derivative contracts with the counterparty could be subject to early termination, which could result in substantial losses for the Company. At September 30, 2012, 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's 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 whenever the net fair value of derivatives associated with those counterparties exceeds specific thresholds.

At September 30, 2012, there were no cash collateral deposits held by the Company. At September 30, 2012, there were $13 million in cash collateral deposits posted with counterparties under the Company's bilateral collateral provisions and netted against current fuel derivative instruments within Accrued liabilities in the unaudited Condensed Consolidated Balance Sheet. No aircraft were pledged as collateral with such counterparties at September 30, 2012. Due to the terms of the Company's current fuel hedging agreements with counterparties and the types of derivatives held, in the Company's judgment, it does have some exposure to future cash collateral requirements. As an example, if market prices for the commodities used in the Company's fuel hedging activities were to decrease by 25 percent from market prices as of September 30, 2012, given the Company's current fuel derivative portfolio, its aircraft collateral facilities, and its investment grade credit rating, it would likely provide an additional $512 million in cash collateral, post $120 million in aircraft collateral, and post $31 million in letters of credit against these positions with its current counterparties. However, the Company would expect to also benefit from lower market prices paid for fuel used in its operations. See Note 5 to the unaudited Condensed Consolidated Financial Statements.

The Company is also subject to the risk that some of the fuel derivatives it uses to hedge against fuel price volatility do not provide adequate protection. A portion of fuel derivatives in the Company's hedge portfolio are based on the market price of West Texas intermediate crude oil ("WTI"). In some historical periods, however, the spread between WTI and jet fuel has widened, which has led to more of the Company's hedges being ineffective. Jet fuel prices have been more closely correlated with changes in the price of Brent crude oil ("Brent"). To the extent the spread between jet fuel and WTI stays at current levels or widens further, some of the Company's hedges could continue to be ineffective and not provide adequate protection against jet fuel price volatility.

See Item 7A "Quantitative and Qualitative Disclosures About Market Risk" in the Company's Annual Report on Form 10-K for the year ended December 31, 2011 for further information about market risk, and Note 5 to the unaudited Condensed Consolidated Financial Statements in this Form 10-Q for further information about the Company's fuel derivative instruments.

Item 4. Controls and Procedures

Disclosure Controls and Procedures

The Company maintains disclosure controls and procedures (as defined in Rule 13a-15(e) of the Securities Exchange Act) designed to provide reasonable assurance that the information required to be disclosed by the Company in the reports that it files or submits under the Exchange Act is recorded, processed, summarized, and reported within the time periods specified in the SEC's rules and forms. These include controls and procedures designed to ensure that this information is accumulated and communicated to the Company's management, including its Chief Executive Officer and Chief Financial Officer, as appropriate to allow timely decisions regarding required disclosure. Management, with the participation of the Chief Executive Officer and Chief Financial Officer, evaluated the effectiveness of the Company's disclosure controls and procedures as of September 30, 2012. Based on this evaluation, the Company's Chief Executive Officer and Chief Financial Officer have concluded that the Company's disclosure controls and procedures were effective as of September 30, 2012, at the reasonable assurance level.

Changes in Internal Control over Financial Reporting

There were no changes in the Company's internal control over financial reporting (as defined in Rule 13a-15(f) under the Exchange Act) during the fiscal quarter ended September 30, 2012, that have materially affected, or are reasonably likely to materially affect, the Company's internal control over financial reporting.

PART II. OTHER INFORMATION

Item 1. Legal Proceedings

A complaint alleging violations of federal antitrust laws and seeking certification as a class action was filed against Delta Air Lines, Inc. (“Delta”) and AirTran in the United States District Court for the Northern District of Georgia in Atlanta on May 22, 2009. The complaint alleged, among other things, that AirTran attempted to monopolize air travel in violation of Section 2 of the Sherman Act, and conspired with Delta in imposing $15-per-bag fees for the first item of checked luggage in violation of Section 1 of the Sherman Act. The initial complaint sought treble damages on behalf of a putative class of persons or entities in the United States who directly paid Delta and/or AirTran such fees on domestic flights beginning December 5, 2008. After the filing of the May 2009 complaint, several nearly identical complaints also seeking certification as class actions were filed in federal district courts in Atlanta, Georgia; Orlando, Florida; and Las Vegas, Nevada. All of the cases were consolidated before a single federal district court judge in Atlanta. A Consolidated Amended Complaint was filed in the consolidated action on February 1, 2010, which broadened the allegations to add claims that Delta and AirTran conspired to reduce capacity on competitive routes and to raise prices in violation of Section 1 of the Sherman Act. In addition to treble damages for the amount of first baggage fees paid to AirTran and to Delta, the Consolidated Amended Complaint seeks injunctive relief against a broad range of alleged anticompetitive activities, as well as attorneys’ fees. On August 2, 2010, the Court dismissed plaintiffs’ claims that AirTran and Delta had violated Section 2 of the Sherman Act; the Court let stand the claims of a conspiracy with respect to the imposition of a first bag fee and the airlines’ capacity and pricing decisions. On June 30, 2010, the plaintiffs filed a motion to certify a class, which AirTran and Delta have opposed. The Court has not yet ruled on the class certification motion. Although the original period for fact and expert discovery had ended, on February 3, 2012, the Court granted plaintiffs’ motion for supplemental discovery. The period for supplemental discovery against AirTran ended on May 3, 2012, but Delta was ordered to produce certain additional documents by July 16, 2012. AirTran and Delta moved for summary judgment on all of plaintiffs’ remaining claims on August 31, 2012. On September 12, 2012, plaintiffs moved to compel Delta to search for and produce additional documents, and the Court has suspended the briefing schedule for the motions for summary judgment while it considers the motion to compel. The motion to compel has been fully briefed and has been submitted to the Court for decision. AirTran denies all allegations of wrongdoing, including those in the Consolidated Amended Complaint, and intends to defend vigorously any and all such allegations.

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 Internal Revenue Service.

The Company’s management does not expect that the outcome in any of its currently ongoing legal proceedings or the outcome of any proposed adjustments presented to date by the Internal Revenue Service, individually or collectively, will have a material adverse effect on the Company’s financial condition, results of operations, or cash flow.

Item 1A. Risk Factors

There have been no material changes to the factors disclosed in Item 1A. Risk Factors in the Company's Annual Report on Form 10-K for the year ended December 31, 2011.

Item 2. Unregistered Sales of Equity Securities and Use of Proceeds

Issuer Purchases of Equity Securities (1)

	(a)	(b)	(c)	(d)
Period	Total number of shares purchased	Average price paid per share	Total number of shares purchased as part of publicly announced plans or programs	Maximum dollar value of shares that may yet be purchased under the plans or programs
July 1, 2012 through July 31, 2012	5,598,900	$ 8.81	5,598,900	$ 450,713,208
August 1, 2012 through August 31, 2012	76,100	$ 9.18	76,100	$ 450,014,922
September 1, 2012 through September 30, 2012	-	$ -	-	$ 450,014,922
Total	5,675,000		5,675,000	

(1) In January 2008, the Company's Board of Directors authorized the repurchase of up to $500 million of the Company's common stock. Through February 15, 2008, the Company had repurchased 4.4 million shares for a total of approximately $54 million, at which time repurchases under the program were suspended. On August 5, 2011, the Company's Board of Directors authorized the Company to resume a share repurchase program and approved the Company's repurchase, on a discretionary basis, of a total of up to $500 million of the Company's common stock following such authorization. On May 16, 2012, the Company's Board of Directors increased the previous share repurchase authorization by an additional $500 million. Repurchases are made in accordance with applicable securities laws in the open market or in private transactions from time to time, depending on market conditions, and may be discontinued at any time.

Item 3. Defaults Upon Senior Securities

None

Item 4. Mine Safety Disclosures

Not applicable

Item 5. Other Information

None

Item 6. Exhibits

3.1	Restated Certificate of Formation of the Company, effective May 18, 2012 (incorporated by reference to Exhibit 3.1 to the Company's Quarterly Report on Form 10-Q for the quarter ended June 30, 2012 (File No. 1-7259)).
3.2	Amended and Restated Bylaws of the Company, effective November 19, 2009 (incorporated by reference to Exhibit 3.1 to the Company's Current Report on Form 8-K dated November 19, 2009 (File No. 1-7259)).
10.1	Supplemental Agreement No. 78 to Purchase Agreement No. 1810, dated January 19, 1994, between The Boeing Company and the Company. (1)
10.2	Supplemental Agreement No. 79 to Purchase Agreement No. 1810, dated January 19, 1994, between The Boeing Company and the Company. (1)
31.1	Rule 13a-14(a) Certification of Chief Executive Officer.
31.2	Rule 13a-14(a) Certification of Chief Financial Officer.
32.1	Section 1350 Certifications of Chief Executive Officer and Chief Financial Officer. (2)
101.INS	XBRL Instance Document.
101.SCH	XBRL Taxonomy Extension Schema Document.
101.CAL	XBRL Taxonomy Extension Calculation Linkbase Document.
101.DEF	XBRL Taxonomy Extension Definition Linkbase Document.
101.LAB	XBRL Taxonomy Extension Labels Linkbase Document.
101.PRE	XBRL Taxonomy Extension Presentation Linkbase Document.

a) Exhibits

(1) Pursuant to 17 CFR 240.24b-2, confidential information has been omitted and has been filed separately with the Securities and Exchange Commission pursuant to a Confidential Treatment Application filed with the Commission.

(2) Furnished, not filed.

SIGNATURES

Pursuant to the requirements of the Securities Exchange Act of 1934, the Registrant has duly caused this report to be signed on its behalf by the undersigned thereunto duly authorized.

	SOUTHWEST AIRLINES CO.	
October 26, 2012	By	/s/ Tammy Romo
		Tammy Romo Chief Financial Officer (On behalf of the Registrant and in her capacity as Principal Financial and Accounting Officer)

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EXHIBIT INDEX

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