



Southwest Airlines 2011

Andrew C. Inkpen *Thunderbird School of Global Management*

"You are now free to move about the country."TM

In 2010, Southwest Airlines (Southwest), the once-scrappy underdog in the U.S. airline industry, carried more domestic passengers than any other U.S. airline. The company, unlike all its major competitors, had been consistently profitable for decades and had weathered energy crises, the September 11 terrorist attacks, and the 2008/09 recession. An insight into Southwest's operating philosophy can be found in the company's 2001 annual report:

Southwest was well poised, financially, to withstand the potentially devastating hammer blow of September 11. Why? Because for several decades our leadership philosophy has been: we manage in good times so that our Company and our People can be job secure and prosper through bad times. . . . Once again, after September 11, our philosophy of managing in good times so as to do well in bad times proved a marvelous prophylactic for our Employees and our Shareholders.

As Southwest neared its 40th year of service, the company was facing some major challenges. Legacy carriers in the United States had become more efficient, and the recent mega mergers involving Delta/Northwest and Continental/United were shaking up the industry. Smaller companies like JetBlue and Allegiant were pressuring Southwest's cost-advantage and low-fare focus. A major internal challenge for Southwest would be managing its acquisition of AirTran, a deal announced in late 2010. To make the acquisition a success, the company would have to integrate a workforce of more than 8,000 (about 25 percent the size of Southwest), a fleet of aircraft different from the Boeing 737s used by Southwest, and new markets that included non-U.S. destinations.

Copyright © 2011 Thunderbird School of Global Management. All rights reserved. This case was written by Professor Andrew Inkpen with research assistance from Chee Wee Tan, Valerie Degroot, Wes Edens, Jairaj Mashru, Sandip Patil, and Arturo Wagner for the purpose of classroom discussion only, and not to indicate either effective or ineffective management.

THE U.S. AIRLINE INDUSTRY

The U.S. commercial airline industry was permanently altered in October 1978 when President Carter signed the Airline Deregulation Act. Before deregulation, the Civil Aeronautics Board regulated airline route entry and exit, passenger fares, mergers and acquisitions, and airline rates of return. Typically, two or three carriers provided service in a given market, although there were routes covered by only one carrier. Cost increases were passed along to customers, and price competition was almost nonexistent. The airlines operated as if there were only two market segments: those who could afford to fly and those who couldn't.

Deregulation sent airline fares tumbling and allowed many new firms to enter the market. The financial impact on both established and new airlines was enormous. The fuel crisis of 1979 and the air-traffic controllers' strike in 1981 contributed to the industry's difficulties, as did the severe recession that hit the United States during the early 1980s. During the first decade of deregulation, more than 150 carriers, many of them start-up airlines, collapsed into bankruptcy. A total of 8 of the 11 major airlines dominating the industry in 1978 ended up filing for bankruptcy, merging with other carriers, or simply disappearing from the radar screen. Collectively, the industry made enough money during this period to buy two Boeing 747s.¹ The three major carriers that survived intact—Delta, United, and American—ended up with 80 percent of all domestic U.S. air traffic and 67 percent of trans-Atlantic business.² Appendices A and B provide a summary of the financial data for the major airlines. The rapid growth of Southwest is in stark contrast to the much slower growth of its major competitors.

Competition and lower fares led to greatly expanded demand for airline travel. Controlling for inflation, the average price to fly one domestic mile dropped by more than 50 percent since deregulation. By the mid-1990s, the airlines were having trouble meeting this demand. Travel increased from 200 million travelers in 1974 to 700 million in 2007 in the United States (due to the recession the number decreased in 2008 to 650 million in 2008 and to 620 million in 2009), with increases in runway and airport capacity lagging far behind.

Despite the financial problems experienced by many airlines started after deregulation, new firms continued to enter the market. For example, during the period 1994–2004, 66 new airlines were certified by the FAA. By 2004, 43 had shut down. Most of the new airlines competed with limited route structures and lower fares than the major airlines. The new airlines created a second tier of service providers that saved consumers billions of dollars annually and provided service in markets abandoned or ignored by major carriers.

Although deregulation fostered competition and the growth of new airlines, it also created a regional disparity in ticket prices and adversely affected service to small and remote communities. Airline workers generally suffered, with inflation-adjusted average employee wages falling from \$42,928 in 1978 to much lower levels over the subsequent decades. About 20,000 airline industry employees were laid off in the early 1980s, while productivity of the remaining employees rose 43 percent during the same period. In a variety of cases, bankruptcy filings were used to diminish the role of unions and reduce unionized wages. In the most recent round of bankruptcies, airline workers at United, Delta, and other major airlines were forced to accept pay cuts of up to 35 percent.

Industry Economics

About 80 percent of airline operating costs were fixed or semivariable. The only costs that were variable per passenger were travel agency commissions, food costs, and ticketing fees. The operating costs of an airline flight depended primarily on the distance traveled, not the number of passengers on board. For example, the crew and ground staff sizes were

¹ P. S. Dempsey, "Transportation Deregulation: On a Collision Course," *Transportation Law Journal*, 13, 1984, p. 329.

² W. Goralski, "Deregulation Deja Vu," *Telephony*, June 17, 1996, pp. 32–36.

determined by the type of aircraft, not the passenger load. Therefore, once an airline established its route structure, most of its operating costs were fixed.

Because of this high fixed-cost structure, the airlines developed sophisticated software tools to maximize capacity utilization, known as load factor. Load factor was calculated by dividing RPM (revenue passenger miles—the number of passengers carried multiplied by the distance flown) by ASM (available seat miles—the number of seats available for sale multiplied by the distance flown).

On each flight by one of the major airlines (excluding Southwest and a few other carriers), there were typically a dozen categories of fares. The airlines analyzed historical travel patterns on individual routes to determine how many seats to sell at each fare level. All the major airlines used this type of analysis and flexible pricing practice, known as the “yield management” system. These systems enabled the airlines to manage their seat inventories and the prices paid for those seats. The objective was to sell more seats on each flight at higher yields (total passenger yield was passenger revenue from scheduled operations divided by scheduled RPM). The higher the ticket price, the better the yield.

Although reducing operating costs was a high priority for the airlines, the nature of the cost structure limited cost reduction opportunities. Fuel costs (17 percent of the total operating costs at Southwest in 2004; 30 percent in 2009) were largely beyond the control of the airlines, and many of the larger airlines’ restrictive union agreements limited labor flexibility. The airline industry’s extremely high fixed costs made it one of the worst net profit margin performers when measured against other industries. Airlines were far outpaced in profitability by industries such as banks, health care, consumer products, and publishing.

In recent years, “a la carte” revenues such as baggage fees and change fees had become increasingly important for most of the airlines. For example, in 2010 US Airways expected to generate about \$500 million from a la carte fees, roughly the same as net profit. In contrast to most of its competitors, Southwest did not charge for checked bags.

To manage their route structures, the major airlines (except Southwest) maintained their operations around a “hub-and-spoke” network. The spokes fed passengers from outlying points into a central airport—the hub—where passengers could travel to additional hubs or their final destination. For example, to fly from Phoenix to Boston on Northwest Airlines, a typical route would involve a flight from Phoenix to Northwest’s Detroit hub. The passenger would then take a second flight from Detroit to Boston.

Establishing a major hub in a city like Chicago or Atlanta required a huge investment for gate acquisition and terminal construction. JetBlue’s new facility at JFK in New York was opened in 2009 and cost about \$800 million. Although hubs created inconveniences for travelers, hub systems were an efficient means of distributing services across a wide network. The major airlines were very protective of their so-called “fortress” hubs and used the hubs to control various local markets. For example, Northwest (now Delta) handled about 80 percent of Detroit’s passengers and occupied nearly the entire new Detroit terminal that opened in 2002, and Northwest’s deal with the local government assured that it would be the only airline that could have a hub in Detroit. When Southwest entered the Detroit market, the only available gates were already leased by Northwest. Northwest subleased gates to Southwest at rates 18 times higher than Northwest’s costs. Southwest eventually withdrew from Detroit, and then reentered, one of the only four markets Southwest had abandoned in its history (San Francisco, Denver, and Beaumont, Texas were the other three; Southwest reentered Denver in 2006).

Recent U.S. Airline Industry Performance

Despite the steadily growing customer demand, the airline industry always seemed to be one recession away from crisis. In 2010, the major airlines were on track to be profitable, a marked contrast to the heavy losses of 2009 (with the exception of Southwest). The continuing consolidation in the industry was expected to lead to lower operating costs and higher

ticket prices. Exhibits 1–9 provide data on the major U.S. competitors for the period 2002–2009:

- Exhibit 1—operating margins: Southwest has the highest margin in all years except 2007.
- Exhibit 2—average revenue passenger miles (RPM) per passenger: Southwest has the lowest in all years.
- Exhibit 3—passenger yield (passenger revenue per RPM): Southwest is the highest in most years.
- Exhibit 4—load factors: Southwest is the lowest in all years.
- Exhibit 5—unit costs per available seat mile: Southwest is the lowest in all years.
- Exhibit 6—unit costs per available seat mile excluding labor cost: Southwest is the lowest in all years.
- Exhibit 7—labor cost per available seat mile: Southwest moved from the lowest to the second highest.
- Exhibit 8—employees per aircraft: Southwest is the lowest in all years.
- Exhibit 9—net debt: Southwest is the lowest in all years.

After the September 11, 2001, terrorist attacks, domestic airlines lost about \$30 billion. The continuing specter of terrorism cast a long shadow on the global airline industry. In the United States, passengers were frustrated by increasingly more invasive security procedures. Fuel costs were a constant uncertainty, and new entrants continued to put pressure on the incumbents.

Other pressures on the industry included the following.

1. **Customer dissatisfaction with airline service.** Service problems were leading to calls for new regulation of airline competitive practices.
2. **Aircraft safety maintenance.** The aging of the general aircraft population meant higher maintenance costs and eventual aircraft replacement. The introduction of stricter government regulations for older planes placed new burdens on operators of older aircraft.
3. **Debt servicing.** The airline industry's debt load exceeded U.S. industry averages.
4. **Air-traffic delays.** Increased air-traffic control delays caused by higher travel demand and related airport congestion were expected to negatively influence customer satisfaction.
5. **Mergers.** Although most U.S. airline mergers had not delivered on their promises, financial pressures were pushing airlines into new merger discussions.
6. **Open Skies Agreement.** Legislation allowing greater access to U.S. markets by non-U.S. carriers was expected to increase competitive pressure.

EXHIBIT 1
Operating Margins for
Major U.S. Airlines

Source: Airline Data and Analysis Largest Airlines 2002–2009 by <http://AirlineFinancials.com>.

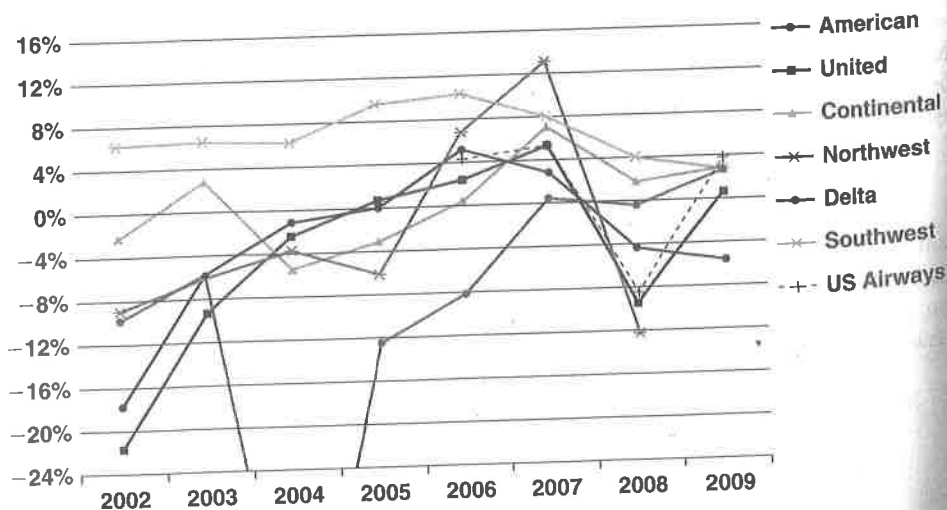


EXHIBIT 2 Average RPM per Passenger (average mileage per passenger flight) for Major U.S. Airlines

Source: Airline Data and Analysis Largest Airlines 2002–2009 by <http://AirlineFinancials.com>.

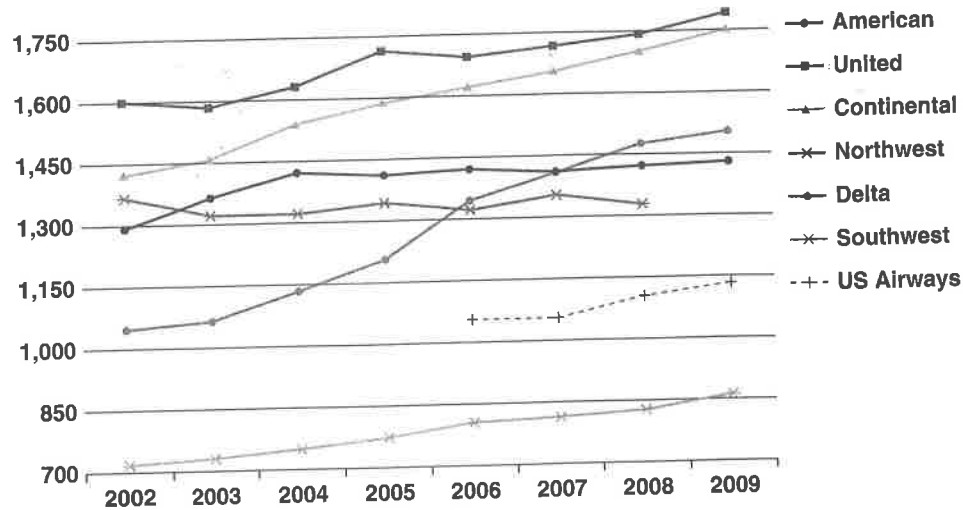


EXHIBIT 3 Passenger Revenue per RPM* 2002–2009 (in cents) for Major U.S. Airlines

*Passenger Revenue Per Revenue Passenger Mile, also known as Passenger Yield, is computed by dividing passenger revenues by revenue passenger miles. Yield—The passenger revenue per RPM in cents

Source: Airline Data and Analysis Largest Airlines 2002–2009 by <http://AirlineFinancials.com>.

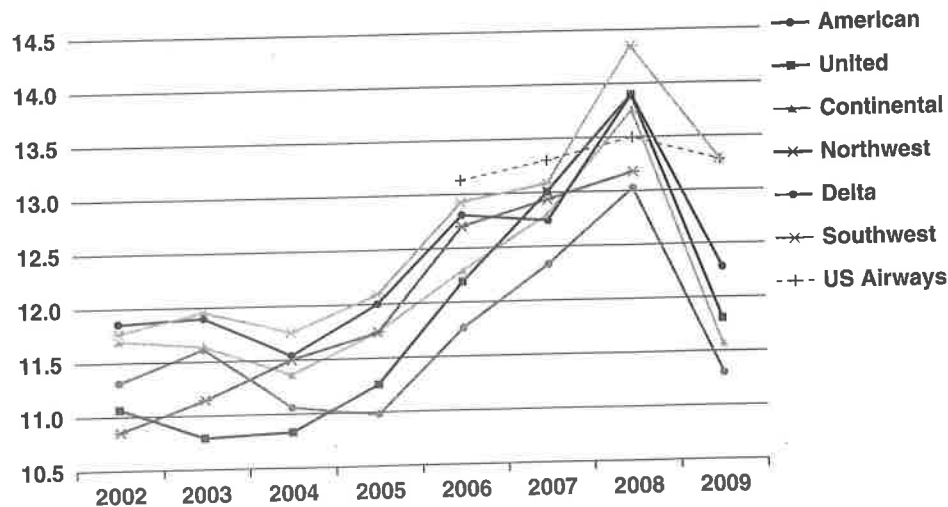


EXHIBIT 4 Load Factors 2002–2009 for Major U.S. Airlines

Source: Airline Data and Analysis Largest Airlines 2002–2009 by <http://AirlineFinancials.com>.

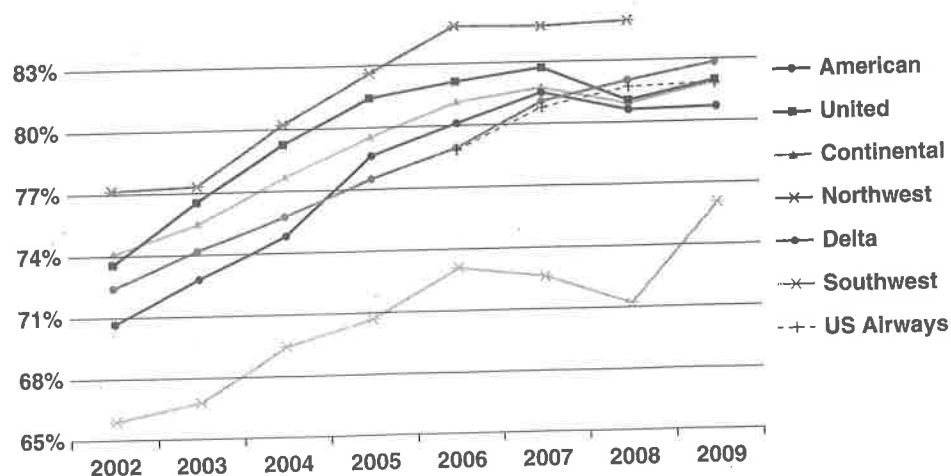


EXHIBIT 5 Unit Cost (CASM) (cents/ASM) for Major U.S. Airlines

Source: Airline Data and Analysis Largest Airlines 2002-2009 by <http://AirlineFinancials.com>.

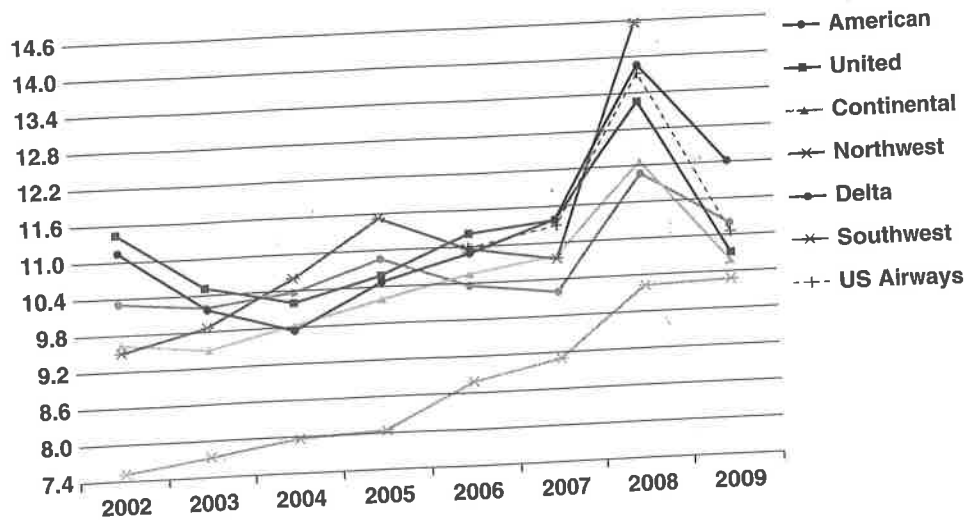


EXHIBIT 6 Unit Costs without Labor (cents/ASM) for Major U.S. Airlines

Source: Airline Data and Analysis Largest Airlines 2002-2009 by <http://AirlineFinancials.com>.

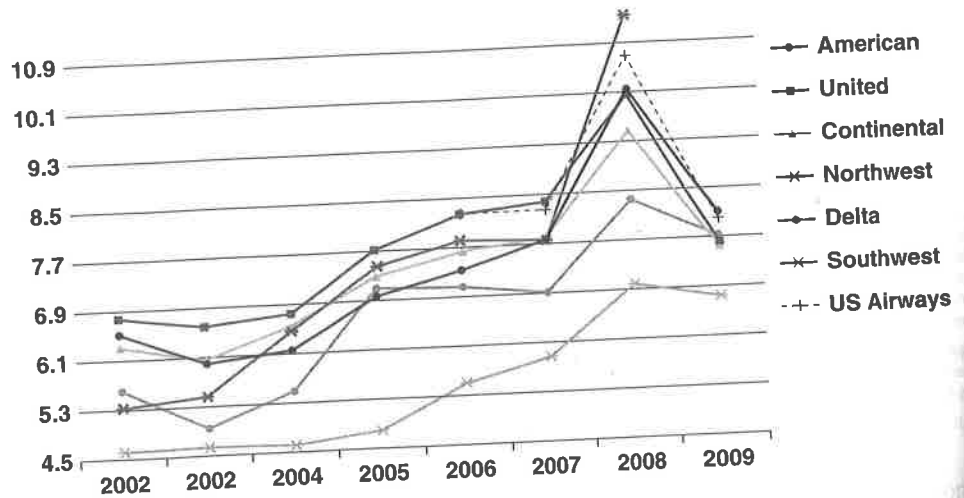


EXHIBIT 7 Total Labor Cost per ASM (cents/ASM) for Major U.S. Airlines

Source: Airline Data and Analysis Largest Airlines 2002-2009 by <http://AirlineFinancials.com>.

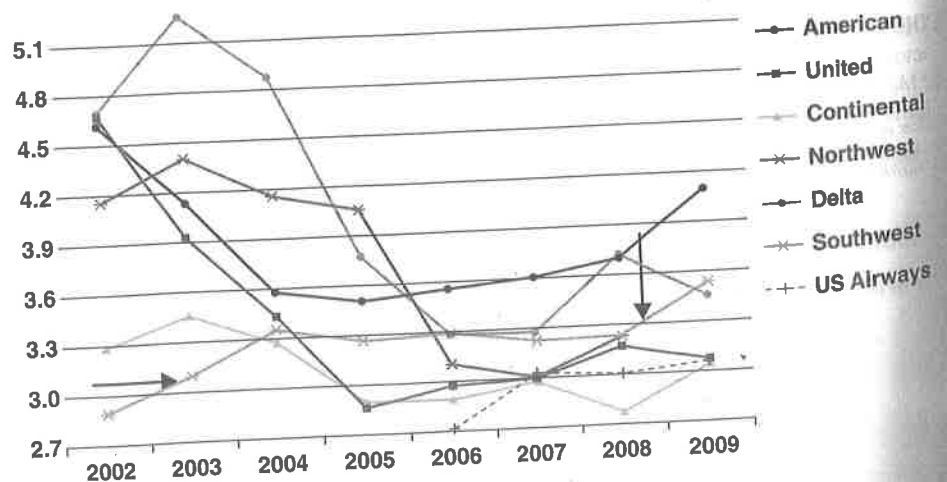


EXHIBIT 8 Average Employees per Aircraft (x 10) for Major U.S. Airlines

Source: Airline Data and Analysis Largest Airlines 2002-2009 by <http://AirlineFinancials.com>.

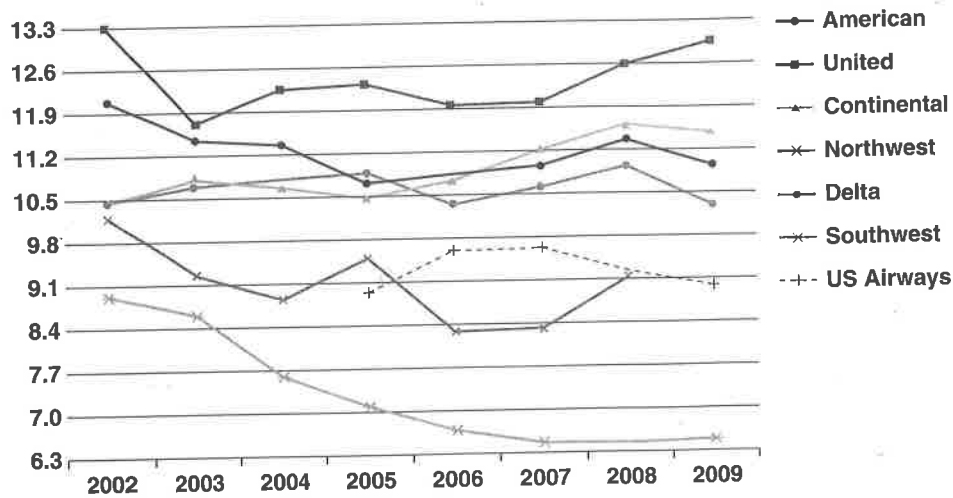
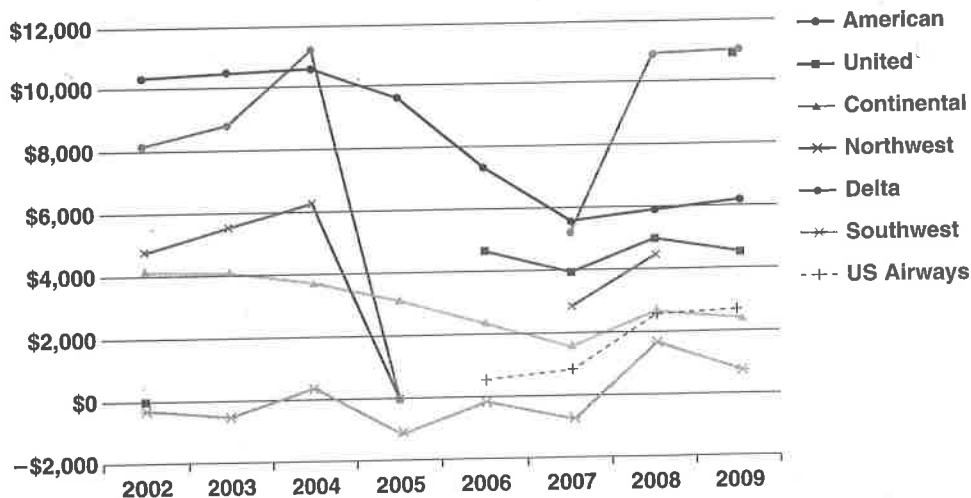


EXHIBIT 9 Net Debt for Major U.S. Airlines

Source: Airline Data and Analysis Largest Airlines 2002-2009 by <http://AirlineFinancials.com>.



SOUTHWEST AIRLINES BACKGROUND

In 1966, Herb Kelleher was practicing law in San Antonio when a client named Rollin King proposed starting a short-haul airline similar to the California-based Pacific Southwest Airlines. The airline would fly the Golden Triangle of Houston, Dallas, and San Antonio and, by staying within Texas, avoid federal regulations. Kelleher and King incorporated a company, raised initial capital, and filed for regulatory approval from the Texas Aeronautics Commission. Unfortunately, the other Texas-based airlines, namely, Braniff, Continental, and Trans Texas (later called Texas International), opposed the idea and waged a battle to prohibit Southwest from flying. Kelleher argued the company's case before the Texas Supreme Court, which ruled in Southwest's favor. The U.S. Supreme Court refused to hear an appeal filed by the other airlines. In late 1970, it looked as if the company could begin flying.

Southwest began building a management team and the purchase of three surplus Boeing 737s was negotiated. Meanwhile, Braniff and Texas International continued their efforts to

prevent Southwest from flying. The underwriters of Southwest's initial public stock offering withdrew and a restraining order against the company was obtained two days before its scheduled inaugural flight. Kelleher again argued his company's case before the Texas Supreme Court, which ruled in Southwest's favor a second time, lifting the restraining order. Southwest Airlines began flying the next day, June 18, 1971.³

When Southwest began flying to three Texas cities, the firm had 3 aircraft and 25 employees. Initial flights were out of Dallas' older Love Field airport and Houston's Hobby Airport, both of which were closer to downtown than the major international airports. Flamboyant from the beginning, original flights were staffed by flight attendants in hot pants. By 1996, the flight attendant uniform had evolved to khakis and polo shirts. The "Luv" theme was a staple of the airline from the outset and became the company's ticker symbol on Wall Street.

Southwest management quickly discovered that there were two types of travelers: convenience, time-oriented business travelers and price-sensitive leisure travelers. To cater to both groups, Southwest developed a two-tiered pricing structure. In 1972, Southwest was charging \$20 to fly between Houston, Dallas, and San Antonio, undercutting the \$28 fares of the other carriers. After an experiment with \$10 fares, Southwest decided to sell seats on weekdays until 7:00 P.M. for \$26 and after 7:00 P.M. and on weekends for \$13.⁴ In response, in January 1973, Braniff Airlines began charging \$13 for its Dallas-Houston Hobby flights. This resulted in one of Southwest's most famous ads, which had the caption, "Nobody's going to shoot Southwest out of the sky for a lousy \$13." Southwest offered travelers the opportunity to pay \$13 or \$26 and receive a free bottle of liquor. More than 75 percent of the passengers chose the \$26 fare and Southwest became the largest distributor of Chivas Regal scotch whiskey in Texas. In 1975, Braniff abandoned the Dallas-Houston Hobby route. When Southwest entered the Cleveland market, the unrestricted one-way fare between Cleveland and Chicago was \$310 on other carriers; Southwest's fare was \$59.⁵ One of Southwest's problems was convincing passengers that its low fares were not just introductory promotions but regular fares.

SOUTHWEST OPERATIONS

Although Southwest became one of the largest airlines in the United States, the firm did not deviate from its initial focus: primarily short-haul (less than 500 miles), point-to-point flights, a fleet consisting only of Boeing 737s, high-frequency flights, low fares, and no international flights. In 2009, the average Southwest one-way fare was \$131.82.

Southwest was the only large airline to operate without major hubs, although cities such as Phoenix, Houston, Chicago, Dallas, Denver, and Las Vegas were increasingly becoming important transit points for Southwest trips. For example, daily departures from Chicago, Southwest's second busiest airport, increased to 216 in 2010. With 212 daily flights, Las Vegas was Southwest's top city. Point-to-point service provided maximum convenience for passengers who wanted to fly between two cities, but insufficient demand could make such nonstop flights economically unfeasible. For that reason, the hub-and-spoke approach was generally assumed to generate cost savings for airlines through operational efficiencies. However, Southwest saw it another way: hub-and-spoke arrangements

³ K. Freiberg, and J. Freiberg, *Nuts: Southwest Airlines' Crazy Recipe for Business and Personal Success* (Austin, TX: Bard Press, 1996), p. 14–21.

⁴ *Ibid.*, p. 31.

⁵ *Ibid.*, p. 55.

resulted in planes spending more time on the ground waiting for customers to arrive from connecting points.

Turnaround time—the time it takes to unload a waiting plane and load it for the next flight—was about 15 minutes for Southwest, compared with the industry average of 45 minutes. This time savings was accomplished with a gate crew 50 percent smaller than other airlines. Pilots sometimes helped unload bags when schedules were tight. Flight attendants regularly assisted in the cleanup of airplanes between flights.

Relative to the other major airlines, Southwest had a “no frills” approach to services: No reserved seating or meals were offered. Seating was first come, first served. As to why the airline did not have assigned seating, Kelleher explained: “It used to be we only had about four people on the whole plane, so the idea of assigned seats just made people laugh. Now the reason is you can turn the airplanes quicker at the gate. And if you can turn an airplane quicker, you can have it fly more routes each day. That generates more revenue, so you can offer lower fares.”⁶

Unlike some of the major carriers, Southwest rarely offered delayed customers a hotel room or long-distance telephone calls. Southwest had only a limited participation in computerized reservation systems, preferring to have travel agents and customers book flights through its reservation center. Southwest was the first national carrier to sell seats from an Internet site and was the first airline to create a home page on the Internet. In the first half of 2010, online bookings were 81 percent via <http://southwest.com>. The company estimated that the online ticketing cost was \$1 per booking and \$6–8 with a travel agent. Southwest was also one of the first airlines to use ticketless travel, offering the service first in 1995. Southwest was the only major airline with a frequent flyer program based on the number of flights taken by a passenger, not miles flown.

Over the years, Southwest’s choice of markets resulted in significant growth in air travel at those locations. In Texas, traffic between the Rio Grande Valley (Harlingen) and the Golden Triangle grew from 123,000 to 325,000 within 11 months of Southwest entering the market.⁷ Within a year of Southwest’s arrival, the Oakland–Burbank route became the 25th largest passenger market, up from 179th. The Chicago–Louisville market tripled in size 30 days after Southwest began flying that route. Southwest was the dominant carrier in a number of cities, ranking first in market share in more than 50 percent of the largest U.S. city-pair markets. Exhibit 10 shows a comparison of Southwest across several years from 1971 to 2009.

Service Changes in 2007 and 2008/2009

In 2007, Southwest made several changes to its service offering:

- signed deals to participate in the Galileo and Worldspan reservations systems;
- added three new fare categories, including higher-tier fares for business travelers;
- began revamping gate areas that eventually will include television monitors, power ports, and new tables and seats;
- established new boarding processes; for example, travelers could pay extra to board first;
- modified the frequent flyer program to allow high-status customers to board first;
- increased emphasis on corporate sales;
- promoted the two-bags-fly-free campaign aggressively while no one else has such an offer in 2010.

⁶ Herb Kelleher, www.iflyswa.com/cgi-bin/imagemap/swagate 530.85.

⁷ Freiberg and Freiberg, p. 29.

EXHIBIT 10 Southwest Across the Years

	1971	1999	2007	2009
Size of fleet (end of year)	4	306	515	544
Number of employees	195	29,005	34,378	35,000
Number of passengers carried	108,554	52,600,000	101,947,800	8,600,000
Number of cities served	3	55	64	69
Number of trips flown	6,051	602,578	1,160,699	More than 3,200 per day
Total operating revenues (million \$)	2.33	4,736	7,369	10,400
Net income (million \$)	-3.8	433	645	99

Sources: Company press releases and Southwest Airlines Fact Sheet at www.southwest.com/about_swa/press/factsheet.html.

The rationale for the 2007 changes was explained by CEO Gary Kelly:

We've always been a business traveler's airline. At the same time, over 37 years we hadn't done much to try to customize the travel experience for the varieties of customer needs that we had. It was one-size-fits-all, and in today's competitive environment we felt that was not the best way to remain on top. We had the desire to improve our overall customer experience for the business traveler.⁸

SOUTHWEST'S PERFORMANCE

Southwest bucked the airline industry trend by earning profit for 38 consecutive years. Since 1987, Southwest ranked first in fewest overall customer complaints as published in the Department of Transportation's Air Travel Consumer Report. In Zagat's 2010 annual traveller's survey, Southwest won awards for top Web site; best consumer on-time estimates—domestic; best check-in experience; best value—domestic; and best luggage policy—domestic.⁹ Unfortunately for shareholders, the stock performance over the past few years lagged far behind the performance of the 1980s and 90s.

The average Southwest aircraft trip was 633 miles, with an average duration of about one hour and 52 minutes. This was up from 462 miles in 1999 and 394 in 1996. Southwest had 3,300 flights per day serving 64 cities. Each plane flew about seven flights daily, almost twice the industry average. Planes were used an average of 13 hours a day, about 40 percent more than major carriers like Delta and Northwest. Southwest's cost per available seat mile was the lowest in the industry for the major carriers (Exhibit 1), and the average age of its fleet was nine years, the lowest for the major carriers. Employee cost per available seat mile was much lower than major competitors (but not lower than some smaller carriers like Allegiant).

Southwest accomplished its enviable record by challenging accepted norms and setting competitive thresholds for other airlines to emulate. The company established numerous new industry standards. Southwest flew more passengers per employee than any other major airline while at the same time had the fewest number of employees per aircraft. Southwest maintained a debt-to-equity ratio much lower than the industry average and was one of the few airlines in the world with an investment grade credit rating. The company

⁸ "The 25 Most Influential Executives of 2007," *Business Travel News*, February 4, 2008.

⁹ Terry Maxon, "Zagat Names Top Airlines in Its Annual Airline Survey," *Airline Biz Blog*, Nov 29, 2010, <http://aviationblog.dallasnews.com/>.

had never curtailed service because of a union strike, and no passenger had ever died because of a safety incident.

Southwest had a fleet of 544 Boeing 737s, up from 417 in 2005, 106 in 1990, and 75 in 1987. Of the total fleet, 425 aircraft were owned and the remainder leased.

Herb Kelleher

Herb Kelleher was CEO of Southwest from 1981 to 2001. In 2001, at age 71, Kelleher stepped down as CEO but remained Chairman until 2008 when he resigned from the Board of Directors. Kelleher's leadership style combined flamboyance, fun, and a fresh, unique perspective. Kelleher played Big Daddy-O in one of the company videos, appeared as Elvis Presley in in-flight magazine advertisements, and earned the nickname "High Priest of Ha-Ha" from *Fortune*.¹⁰ Although Kelleher was unconventional and a maverick in his field, he led his company to consistently new standards for itself and for the industry. Sincerely committed to his employees, Kelleher generated intense loyalty to himself and the company. His ability to remember employees' names and to ask after their families was just one way he earned respect and trust. At one point, Kelleher froze his salary for five years in response to the pilots agreeing to do the same. Often when he flew, Kelleher would help the ground crew unload bags or help the flight crew serve drinks. His humor was legendary and served as an example for his employees to join in the fun of working for Southwest. He was called "a visionary who leads by example—you have to work harder than anybody else to show them you are devoted to the business."¹¹

Although Kelleher tried to downplay his personal significance to the company, especially when he gave up the CEO position in 2001, many analysts following Southwest credited the airline's success to Kelleher's unorthodox personality and engaging management style. As one analyst wrote, "The old-fashioned bond of loyalty between employees and company may have vanished elsewhere in corporate America, but it is stronger than ever at Southwest."¹² From October 1 to December 2001, Kelleher, CEO James Parker, and COO Colleen Barrett voluntarily relinquished their salaries. Gary Kelly, Southwest's former CFO, became CEO in 2004.

The Southwest Spirit

Customer service far beyond the norm in the airline industry was not unexpected at Southwest and had its own name—Positively Outrageous Service. Some examples of this service included a gate agent volunteering to watch a dog (a Chihuahua) for two weeks when an Acapulco-bound passenger showed up at the last minute without the required dog crate and an Austin passenger who missed a connection to Houston, where he was to have a kidney transplant operation, was flown there by a Southwest pilot in his private plane. Another passenger, an elderly woman flying to Phoenix for cancer treatment, began crying because she had no family or friends at her destination. The ticket agent invited her into her home and escorted her around Phoenix for two weeks.¹³

Southwest Airlines' customers were often surprised by the Southwest Spirit. On some flights, magazine pictures of gourmet meals were offered for dinner on an evening flight. Flight attendants were encouraged to have fun; songs, jokes, and humorous flight announcements were common. One flight attendant had a habit of popping out of overhead

¹⁰ K. Labich, "Is Herb Kelleher America's Best CEO?" *Fortune*, May 2, 1994, p. 45.

¹¹ "24th Annual CEO Survey: Herb Kelleher, Flying His Own Course," *IW*, November 20, 1995, p. 23.

¹² Labich, p. 46.

¹³ *IW*, p. 23.

luggage compartments as passengers attempted to stow their belongings, until the day she frightened an elderly passenger who called for oxygen.¹⁴ Herb Kelleher once served in-flight snacks dressed as the Easter Bunny.

Intense company communication and camaraderie was highly valued and essential to maintaining the esprit de corps found throughout the firm. The Southwest Spirit, as exhibited by enthusiasm and extroverted personalities, was an important element in employee screening conducted by Southwest's People Department. Employment at Southwest was highly desired. In 2006, a total of 3,363 employees were hired and 284,827 applications were received. Once landed, a job was fairly secure. The airline had not laid off an employee since 1971. Historically, employee turnover hovered around 7 percent, the lowest rate in the industry. In 2011, Southwest had more than 35,000 employees; in 1990, Southwest had 8,600 employees and less than 6,000 in 1987.

During initial training periods, efforts were made to share and instill Southwest's unique culture. New employee orientation, known as the new-hire celebration, have in the past included Southwest's version of the *Wheel of Fortune* game show, scavenger hunts, and company videos including the "Southwest Airlines Shuffle" in which each department introduced itself, rap style, and in which Kelleher appeared as Big Daddy-O. To join the People Department (i.e., Human Resources), employees required frontline customer experience.

Advanced employee training regularly occurred at the University of People at Love Field in Dallas. Various classes were offered, including team building, leadership, and cultural diversity. Newly promoted supervisors and managers attended a three-day class called "Leading with Integrity." Each department also had its own training division focusing on technical aspects of the work. "Walk-a-Mile Day" encouraged employees from different departments to experience firsthand the day-to-day activities of their coworkers. The goal of this program was to promote respect for fellow workers while increasing awareness of the company.¹⁵

Employee initiative was supported by management and encouraged at all levels. For example, pilots looked for ways to conserve fuel during flights, employees proposed designs for ice storage equipment that reduced time and costs, and baggage handlers learned to place luggage with the handles facing outward to reduce unloading time.

Red hearts and "Luv" were central parts of the internal corporate culture, appearing throughout the company literature. A mentoring program for new hires was called CoHearts. "Heroes of the Heart Awards" were given annually to one behind-the-scenes group of workers, whose department name was painted on a specially designed plane for a year. Other awards honored an employee's big mistake through the "Boner of the Year Award." When employees had a story about exceptional service to share, they were encouraged to fill out a "LUV Report."

Southwest placed great emphasis on maintaining cooperative labor relations: 87 percent of all employees were unionized. Southwest pilots belonged to an independent union and not the Airline Pilots Association, the union that represented more than 60,000 pilots. The company encouraged the unions and their negotiators to conduct employee surveys and to research their most important issues prior to each contract negotiation. At its 1994 contract discussion, the pilots proposed a 10-year contract with stock options in lieu of guaranteed pay increases over the first five years of the contract. In 1974, Southwest was the first airline to introduce employee profit sharing. Through the plan, employees owned about 10 percent of the company's stock.

¹⁴ B. O'Brian, "Flying on the Cheap," *Wall Street Journal*, October 26, 1992, p. A1.

¹⁵ A. Malloy, "Counting the Intangibles," *Computerworld*, June 1996, pp. 32-33.

Herb Kelleher summed up the Southwest culture and commitment to employees:

We don't use things like TQM. It's just a lot of people taking pride in what they're doing. . . . You have to recognize that people are still the most important. How you treat them determines how they treat people on the outside. . . . I give people the license to be themselves and motivate others in that way. We give people the opportunity to be a maverick. You don't have to fit in a constraining mold at work—you can have a good time. People respond to that.¹⁶

SOUTHWEST IMITATORS

Southwest's strategy spawned numerous imitators, most of which failed. Two of the more successful start-up firms, Midwest Express and America West, both went through Chapter 11 bankruptcy proceedings. ValuJet was grounded after its May 1996 crash in the Florida Everglades, reemerging a year later as AirTran and JetBlue.

The major airlines tried to compete directly with Southwest. The Shuttle by United, the so-called "airline within an airline," was started in October 1994. United's objective was to create a new airline owned by United with many of the same operational elements as Southwest: a fleet of 737s, low fares, short-haul flights, and less-restrictive union rules. United saturated the West Coast corridor with short-haul flights on routes such as Oakland–Seattle, San Francisco–San Diego, and Sacramento–San Diego. The Shuttle was unable to achieve the same level of productivity as Southwest, and in 2001, United discontinued Shuttle service and folded the remaining flights into its regular service. US Airways did the same with its Metrojet discount service. In 2003, United started a new discount carrier called TED.

Some of the attempts to imitate Southwest were almost comical. Continental Lite (CALite) was an effort by Continental Airlines to develop a low-cost service and revive the company's fortunes after coming out of bankruptcy in April 1993. In March 1994, Continental increased CALite service to 875 daily flights. Continental soon encountered major operational problems with its new strategy.¹⁷ With its fleet of 16 different planes, mechanical delays disrupted turnaround times. Various pricing strategies were unsuccessful. The company was ranked last among the major carriers for on-time service and complaints soared by 40 percent. In January 1995, Continental announced that it would reduce its capacity by 10 percent and eliminate 4,000 jobs. By mid-1995, Continental's CALite service had been largely discontinued. In October 1995, Continental's CEO was ousted.

A SUCCESSFUL START-UP: JETBLUE AIRWAYS

Morris Air, patterned after Southwest, was the only airline Southwest had acquired. Prior to the acquisition, Morris Air flew Boeing 737s on point-to-point routes, operated in a different part of the United States than Southwest, and was profitable. When Morris Air was acquired by Southwest in December 1993, seven new markets were added to Southwest's system. In 1999, Morris Air's former president, David Neeleman, announced plans for JetBlue Airways, a new airline based at New York's JFK Airport. JetBlue had a successful IPO in April 2002, with the stock rising 70 percent on the first day of trading. JetBlue had a geographically diversified flight schedule that included both short-haul and long-haul

¹⁶ H. Lancaster, "Herb Kelleher Has One Main Strategy: Treat Employees Well," *Wall Street Journal*, August 31, 1999, p. B1.

¹⁷ B. O'Brian, "Heavy Going: Continental's CALite Hits Some Turbulence in Battling Southwest," *Wall Street Journal*, January 10, 1995, A1, A16.

routes. Although JetBlue was viewed as a low-fare carrier, the airline emphasized various service attributes, such as leather seats, free LiveTV (a 24-channel satellite TV service with programming provided by DirecTV), and preassigned seating.

In 2011, JetBlue served 63 cities in the domestic United States, Mexico, and the Caribbean. JetBlue had a fleet of 116 Airbus A320 aircraft and 45 Embraer 190 regional jet aircraft. JetBlue's revenue in 2010 was \$3.8 billion, 31 percent that of Southwest (up from 26 percent in 2008). A major ice storm that hit New York in early 2007 severely tested the company. More than 1,200 flights were canceled over a six-day period. Not long after, David Neeleman was asked by the Board to step down as CEO. He remained as Chairman.

SOUTHWEST EXPANSION

Southwest grew steadily over the years prior to 2011 but the growth was highly controlled. New airports were carefully selected and only a few new cities were added each year. As Kelleher wrote to his employees in 1993, "Southwest has had more opportunities for growth than it has airplanes. Yet, unlike other airlines, it has avoided the trap of growing beyond its means. Whether you are talking with an officer or a ramp agent, employees just don't seem to be enamored of the idea that bigger is better."¹⁸

In October 1996, with the initiation of flights to Providence, Rhode Island, Southwest entered the northeast market. The entry into the northeast region of the United States was, in many respects, a logical move for Southwest. The northeast was the most densely populated area of the country and the only major region where Southwest did not compete. New England could provide a valuable source of passengers to Florida's warmer winter climates. Southwest's entry into Florida was exceeding initial estimates.

Despite the large potential market, the northeast offered a new set of challenges for Southwest. Airport congestion and air-traffic control delays could prevent efficient operations, lengthening turnaround time at airport gates and wreaking havoc on frequent flight scheduling. Inclement weather posed additional challenges for both air service and car travel to airports. Nevertheless, Southwest continued to add new northeast cities. A few years later, Southwest was flying to various northeast airports, including Long Island, New Hampshire, and Hartford. In 2004, Southwest began flying to Philadelphia, which was the first major northeast market entry. As of 2011 (excluding AirTran service), Southwest had not entered any markets outside the domestic United States.

THE AIRTRAN DEAL

In September 2010, Southwest announced that it would buy AirTran Airways for \$1.4 billion. The acquisition would give Southwest access to more than 30 new markets, including Atlanta and several tourist destinations in Mexico and the Caribbean. The deal strengthened Southwest's position in the Southeast and on the East Coast. AirTran had a lower cost structure than Southwest and integrating AirTran into Southwest's operations and culture could prove challenging. Most of AirTran's fleets were Boeing 717s, whereas Southwest only flew 737s. AirTran had international routes and offered first-class seats. Complicating the integration would be Southwest's limited experience with acquisitions.

Perhaps the most difficult challenge would be ensuring that the acquisition did not change or weaken the Southwest culture. According to Southwest's pilots' union president,

¹⁸ Freiberg and Freiberg, p. 61.

"The Achilles' heel of this transaction is how our company will be able to maintain our culture, and keep it alive for the next 40 years."¹⁹

FUTURE CHALLENGES

Although Southwest was profitable and had a strong financial position, competition was stiff. The newly merged carriers (Delta/Northwest and Continental/United) were expected to become more efficient, and smaller players like JetBlue and Allegiant had lower costs than Southwest. While Southwest's employee productivity remained high, its operating costs were rising. The company had the highest salaries for pilots of narrow-body jets, and salaries for mechanics and flight attendants were among the highest in the industry.

Clearly, the future promised dramatic changes to airline industry structure. Would Southwest be able to maintain its position as America's most prosperous airline? Could Southwest complete the AirTran acquisition and still ensure that customer service and company performance were satisfactory? In 2010, Southwest placed an order for 737-800s to replace older 737-700s, a smaller aircraft. With larger aircraft, would Southwest introduce longer flights to Hawaii and other more distant locations? Would the major airlines finally learn how to compete on cost with companies like Southwest and JetBlue?

According to CEO Gary Kelly, "We still have an underdog mentality. It's not a comfortable country-club environment for us. . . . We're still a maverick."²⁰

¹⁹ Jad Mouawad, "Pushing 40, Southwest Is Still Playing the Rebel," *New York Times*, November 20, 2010.

²⁰ Mouawad, *New York Times*.