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SOUTHWEST AIRLINES

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In 2013, Southwest Airlines (Southwest), the once scrappy underdog in the U.S. airline industry, was one of the largest U.S. airlines and, based on number of passengers, one of the largest in the world. The company, unlike all of 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 entered its 42nd 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, Continental/United, and American/US Airways were shaking up the industry. Smaller companies like JetBlue, Alaska, and Spirit 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 completed in 2011. To make the acquisition a success, the company would have to integrate a workforce of more than 8,000 (about 25% the size of Southwest) and manage a fleet of aircraft different from the Boeing 737s used by Southwest.

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. Eight 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% of all domestic U.S. air traffic and 67% of

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

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trans-Atlantic business.[2] Exhibits 1A and 1B provide summary financial data for the major airlines. The rapid growth of Southwest was 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% 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 U.S. Demand fell significantly during the recession and then started to grow again in 2010. Despite the overall growth in demand, from 2001 through 2011 total financial losses for the U.S. airline industry exceeded $50 billion.

The financial performance notwithstanding, new firms continued to enter the airline industry. For example, during the period 1994 to 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% during the same period. In a variety of cases, bankruptcy filings were used to diminish the role of unions and reduce unionized wages. Between 2000 and 2011, 51 U.S. passenger and cargo airlines filed for bankruptcy—13 of them in 2008.[3] In the most recent round of bankruptcies, airline workers at American, Delta, and other major airlines were forced to accept pay cuts of up to 35%.

Industry Economics

About 80% of airline operating costs are fixed or semi-variable. The few variable costs per passenger included 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 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 of the major airlines used this type of analysis and flexible pricing practice, known as a "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 RPMs). 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% of total operating costs at Southwest in 2004; 37% in 2012) 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 operating margin performers when measured against other industries. Airlines were far outpaced in profitability by industries such as banks, health care, consumer products, and oil and gas.

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[2] W. Goralski, "Deregulation Deja Vu," *Telephony*, June 17, 1996, pp. 32-36.
[3] Office of Inspector General, *Aviation Industry Performance: A Review of the Airline Industry, 2008-2011*, September 24, 2011.

In recent years, a la carte or ancillary revenues such as baggage fees and change fees had become increasingly important for most airlines. Some low-cost airlines, such as Spirit and Allegiant, generated more than 25% of total revenue from ancillary fees. 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 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% 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 re-entered, one of only three markets Southwest had abandoned in its history (Denver and Beaumont, Texas, were the other two; Southwest re-entered Denver in 2006).

Recent U.S. Airline Industry Performance

Despite steadily growing customer demand, the airline industry always seemed to be one recession away from crisis. In 2013, the major airlines were on track to be profitable, a marked contrast to the heavy losses of just a few years earlier (with the exception of Southwest). The continuing consolidation in the industry was expected to lead to lower operating costs and higher ticket prices.

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. Volatile fuel costs were a constant uncertainty, and new entrants continued to put pressure on the incumbents.

Other pressures on the industry included:

1. **Customer Dissatisfaction with Airline Service.** Service problems were leading to calls for new regulation of airline competitive practices.

2. **Aircraft Safety Maintenance.** The ageing 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. **Environmental Regulation.** Following actions in Europe, various U.S. groups were advocating new standards and taxes on airline emissions.

6. **Open Skies Agreement**. Legislation allowing greater access to U.S. markets by non-U.S. carriers was expected to increase competitive pressure.

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 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.[4]

When Southwest began flying to three Texas cities, the firm had three 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.[5] 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% 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.[6] 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 (excluding the AirTran route system, which included flights to various international locations). In 2012, the average Southwest one-way fare was $147.17.

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, there were 198 daily departures from Chicago, Southwest's busiest airport. 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

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[4] K. Freiberg and J. Freiberg, *Nuts: Southwest Airlines' Crazy Recipe for Business and Personal Success* (Austin, TX: Bard Press, 1996), pp. 14-21.
[5] Ibid., p. 31.
[6] Ibid., p. 55.

saw it another way: hub-and-spoke arrangements 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% 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."[7]

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 4th quarter 2012, 81% of passenger revenues were booked via **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 dollars spent 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.[8] 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. Table 1 shows a comparison of Southwest across several years from 1971 to 2012.

Table 1. Southwest Across the Years				
	1971	**1999**	**2007**	**2012**
Size of Fleet (End of Year)	4	306	515	694
Number of Employees	195	29,005	34,378	46,000
Number of Passengers Carried	108,554	52,600,000	101,947,800	109,000,00
Number of Cities Served	3	55	64	97
Number of Trips Flown	6,051	602,578	1,160,699	>1,284,800
Total Operating Revenues (Millions $)	2.33	4,736	7,369	17,100
Net Income (Millions $)	-3.8	433	645	421

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

Recent Service Changes

In 2007, Southwest made various changes to its service offering, including:

- Three new fare categories, including higher-tier fares for business travelers.
- New boarding processes; for example, travelers could pay extra to board first.
- Allowing customers with high status in the frequent flier program to board first.
- Increased emphasis on corporate sales.
- Promoted the "two-bags-fly-free campaign" aggressively.

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[7] Herb Kelleher, @ www.iflyswa.com/cgi-bin/imagemap/swagate 530.85.
[8] Freiberg and Freiberg, p. 29.

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.[9]*

In 2011, Southwest launched its new Rapid Rewards frequent flyer program. Under the new program, members earned points for every dollar spent, whereas under the prior program customers earned credits for flight segments flown. The new frequent flyer program was designed to increase revenue by (a) bringing in new customers, including new Rapid Rewards members, as well as new holders of Southwest's co-branded Chase Visa credit card; (b) increasing business from existing customers; and (c) strengthening Rapid Rewards hotel, rental car, credit card, and retail partnerships.

Southwest's Performance

Southwest bucked the airline industry trend by earning a profit for 40 consecutive years. Among the major airlines, Southwest consistently ranked first in fewest overall customer complaints as published in the Department of Transportation's Air Travel Consumer Report. For example, in December 2012, there were 18 complaints reported against Southwest and 140 against United. In Zagat's 2010 airline survey, Southwest won awards for top website; best consumer on-time estimates—domestic; best check-in experience; best value—domestic; and best luggage policy—domestic.[10]

The average Southwest flight had a duration of about one hour and 55 minutes and a length of 694 miles. This was up from 462 miles in 1999 and 394 in 1996. Each plane flew about seven flights daily, almost twice the industry average. Planes were used an average of 13 hours a day, about 40% more than major carriers like Delta and United. Table 2 shows that Southwest's cost per available seat mile was lower than the legacy carriers (American, Delta, US Airways, United) but not lower than some of the newer and smaller carriers such as JetBlue (one of the reasons for JetBlue's lower cost per ASM was its longer average flight length—1,085 miles at JetBlue). Southwest's on-time arrival and departure record, for many years near the top in the industry, had declined in recent years.

Table 2. Operating Data							
	Alaska	**Southwest**	**American**	**Delta**	**JetBlue**	**United**	**US Airways**
Load Factor	86.6%	80.4%	84.1%	85.7%	84.3%	85.1%	85.7%
Operating cost per ASM (cents)	14.52	14.18	16.79	16.71	11.34	17.07	17.79
Revenue per ASM (cents)[1]	16.49	14.82	16.30	18.22	12.45	17.26	18.89
On-time departure rank	#2	#11	#14	#5	#13	15	#3
On-time arrival rank	#2	#8	#15	#4	#12	14	#5

[1] Calculated by dividing operating revenue by available seat miles.

Source: U.S. Department of Transportation (US DOT).

The average age of the Southwest fleet was 11 years, the lowest for the major carriers. Employee cost per available seat mile was lower than major competitors (but not lower than some smaller carriers like Spirit and Allegiant).

Exhibits 2-10 provide data on the major U.S. competitors for the period:

- Exhibit 2—Operating margins: Southwest has the highest margin position until 2007.
- Exhibit 3—Average revenue passenger miles (RPM) per passenger: Southwest has the lowest in all years.
- Exhibit 4—Passenger yield (passenger revenue per RPM): Southwest is the highest
- Exhibit 5—Load factor: Southwest is the lowest in all years.
- Exhibit 6—Costs per available seat mile: Southwest is the lowest in all years.

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[9] "The 25 Most Influential Executives of 2007," *Business Travel News*, February 4, 2008.
[10] http://www.zagat.com/airlines.

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- Exhibit 7—Unit costs per available seat mile excluding labor cost: Southwest is the lowest in all years.
- Exhibit 8—Labor cost per available seat mile: Southwest cost moved from the lowest in 2003 to the second highest in 2007, where it has remained. Southwest also has the highest wage/salary per employee.
- Exhibit 9—Employees per aircraft: Southwest is the lowest in all years. This is a function of both labor productivity and aircraft size; Southwest has, on average, smaller aircraft than the legacy carriers.
- Exhibit 10—Net debt: Southwest is the lowest in all years.

Southwest accomplished its strong 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 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 606 Boeing 737s, up from 417 in 2005, 106 in 1990, and 75 in 1987. Southwest also had 88 Boeing 717s from the AirTran deal, which were to be sold. Of the total 737 fleet, 497 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.[11] 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."[12]

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."[13] 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; 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.[14]

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[11] K. Labich, "Is Herb Kelleher America's Best CEO?" *Fortune*, May 2, 1994, p. 45.
[12] "24th Annual CEO Survey: Herb Kelleher, Flying His Own Course," *IW*, November 20, 1995, p. 23.
[13] Labich, p. 46.
[14] *IW*, p. 23.

Southwest Airlines customers were often surprised by 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 luggage compartments as passengers attempted to stow their belongings, until the day she frightened an elderly passenger who called for oxygen.[15] 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 2012, Southwest received 114,845 job applications. Once landed, a job was secure. The airline had not laid off an employee since 1971 (the company had used some voluntary employee buyouts). Historically, employee turnover hovered around 7%, the lowest rate in the industry. In 2012, Southwest had about 46,000 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 co-workers. The goal of this program was to promote respect for fellow workers while increasing awareness of the company.[16]

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 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: 82% of all employees were unionized and represented by 11 different unions. 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% of the company's stock.

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.[17]

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[15] B. O'Brian, "Flying on the Cheap," *Wall Street Journal,* October 26, 1992, p. A1.
[16] A. Malloy, "Counting the Intangibles," *Computerworld,* June 1996, pp. 32-33.
17 H. Lancaster, "Herb Kelleher Has One Main Strategy: Treat Employees Well," *Wall Street Journal*, August 31, 1999, p. B1.

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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.

The major airlines tried to compete directly with Southwest. The Shuttle by United, a 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.[18] 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%. In January 1995, Continental announced that it would reduce its capacity by 10% and eliminate 4,000 jobs. By mid-1995, Continental's CALite service had been largely discontinued. In October 1995, Continental's CEO was ousted.

In East Asia in 2013, the airline-within-an-airline strategy was being used by many of the large carriers such as Singapore Airlines and Thai Airways as a means of competing against the many new start-ups in that region.

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 U.S. 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% on the first day of trading. JetBlue had a geographically diversified flight schedule that included both short-haul and long-haul 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 2013, JetBlue served more than 75 cities in the United States, Mexico, the Caribbean, and South America with more than 15,000 employees. Jet Blue had a fleet of 127 Airbus A320 aircraft and 54 Embraer 190 regional jet aircraft. JetBlue revenue in 2012 was $5.0 billion, about one third that of Southwest. The company was profitable in the three years 2010 through 2012.

Southwest Expansion

Southwest grew steadily over the years 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."[19]

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[18] B. O'Brian, "Heavy Going: Continental's CALite Hits Some Turbulence in Battling Southwest," *Wall Street Journal,* January 10, 1995, pp. A1, A16.
[19] Freiberg and Freiberg, p. 61.

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 U.S. 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.

In 2013, the company planned to add two new states (Maine and Kansas) and seven new U.S. cities to its network. Excluding AirTran service, Southwest had not entered any markets outside the domestic United States, but CEO Gary Kelly publicly stated that "opportunities for growth now lie beyond U.S. borders."[20]

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, "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."[21] In 2013, the integration was well under way and Southwest forecasted pre-tax annual synergies from the deal of $400 million in the current fiscal year.

Future Challenges

Although Southwest was profitable and had a strong financial position, competition was stiff. The newly merged legacy carriers were expected to become more efficient, and smaller players like JetBlue and Alegiant 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? Could Southwest grow profitably in international markets? 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."[22]

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[20] http://www.southwest.com/assets/pdfs/about-southwest/garys-greeting.pdf.
[21] Jad Mouawad, "Pushing 40, Southwest Is Still Playing the Rebel," *New York Times,* Nov. 20, 2010.
[22] Ibid.

Exhibit 1A. Revenue Passenger-Miles (RPM)* 1989-2011 (in 000s) for Major U.S. Airlines, All Airports

Year	American	America West	Continental	Delta	Northwest	Southwest	Trans World	United	US Airways
2011	126.4			164.2		83.9		97.8	60.7
2010	125.4			164.1		78.1		100.4	58.9
2009	122.4		77.8	100.7	62.9	74.6		100.5	57.9
2008	131.7		80.5	105.7	71.6	73.7		110.0	60.6
2007	138.4	17.7	81.4	103.3	72.9	72.3		117.4	43.5
2006	139.4	23.5	76.3	98.8	72.6	67.7		117.2	37.4
2005	138.4	24.3	68.4	103.7	75.9	60.3		114.3	40.2
2004	130.2	23.3	63.4	98.3	73.4	53.5		115.2	40.5
2003	120.3	21.3	57.6	89.4	68.8	48		104.4	37.8
2002	121.7	19.9	57.3	95.3	72.1	45.5		109.4	40
2001	106.2	19.1	58.8	97.7	73.3	44.7	20.8	116.6	46
2000	116.6	19.1	62.4	107.8	79.2	42.4	27.3	126.9	46.9
1999	110.2	17.7	58	104.8	74.2	36.8	26.1	125.5	41.5
1998	108.9	16.4	51	102	66.8	31.6	24.5	124.6	41.4
1997	107	16.2	44.3	99.7	72.1	26.4	25.2	121.4	41.7
1996	104.6	15.3	37.6	93.9	68.7	27.3	27.3	116.7	39.2
1995	102.7	13.3	35.8	85.2	62.6	23.5	25.1	111.8	38.1
1994	98.8	12.2	38.1	86.4	58.5	19.9	24.8	108.2	38.4
1993	97.1	11.2	40.1	82.9	58.7	16.9	22.8	101.3	35.5
1992	97.1	11.8	43.5	80.6	58.7	13.9	29.2	92.7	35.4

*Revenue Passenger-Miles, or RPM, is a measure of the volume of air passenger transportation. A revenue passenger-mile is equal to one paying passenger carried one mile.

Source: Bureau of Transportation Statistics Table T1: U.S. Air Carrier Traffic and Capacity Summary by Service Class.
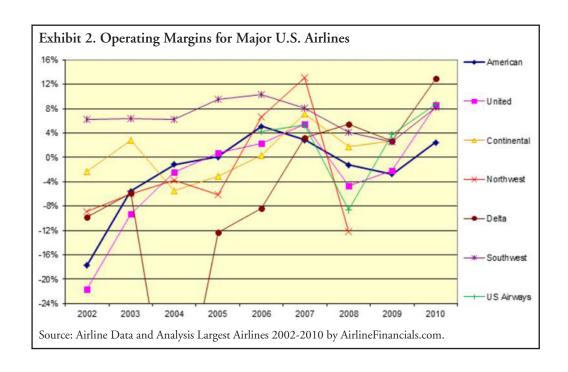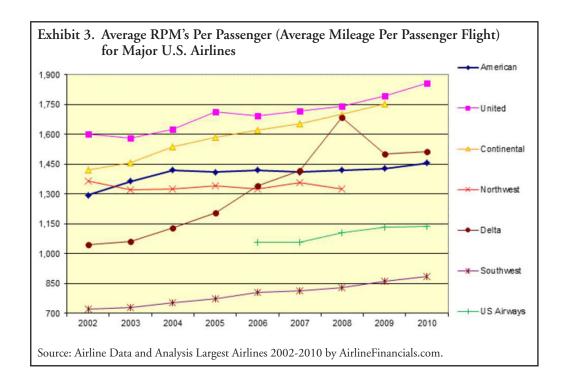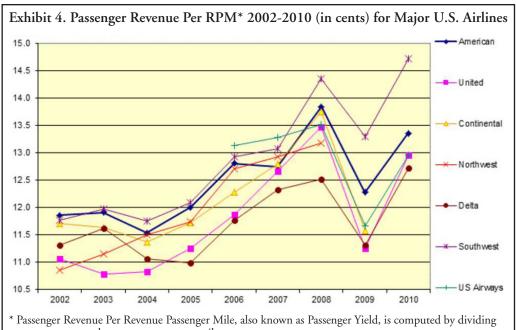
Exhibit 1B. Operating Revenues (in millions of dollars) 1992-2011 for Major U.S. Airlines, All Regions

Year	American	America West	Continental	Delta	Northwest	Southwest	Trans World	United	US Airways
2011	23,958			35,271		13,655		21,155	13,340
2010	22,150			31,894		12,103		19,682	12,195
2009	19,898		10,635	18,046		10,350		16,359	10,781
2008	21,210		11,382	20,973	10903	11,023		20,237	12,459
2007	22,833	2,737	10,615	19,238	9,545	7,369		20.049	9.317
2006	22,493	3,770	13,010	17,339	12,555	9,086		19,334	8.076
2005	20,657	3,397	11,108	16,112	12,316	7,584		17,304	7,212
2004	18,608	2,482	9,851	15,154	11,266	6,530		15,701	7,073
2003	17,403	2,223	7,333	14,203	9,184	5,937		13,398	6,762
2002	15,871	2,021	7,353	12,410	9,152	5,522		13,916	6,915
2001	15,639	2,035	7,972	13,211	9,592	5,555	2,633	16,087	8,253
2000	18,117	2,309	9,129	15,321	10,957	5,650	3,585	19,331	9,181
1999	16,090	2,164	8,027	14,901	9,868	4,736	3,309	17,967	8,460
1998	16,299	1,983	7,299	14,630	8,707	4,164	3,259	17,518	8,556
1997	15,856	1,887	6,361	14,204	9,984	3,817	3,330	17,335	8,501
1996	15,136	1,752	5,487	13,318	9,751	3,407	3,554	16,317	7,704
1995	15,610	1,562	4,919	12,557	8,909	2,873	3,281	14,895	6,985
1994	14,951	1,414	4,734	12,346	8,929	2,417	3,350	13,887	6,579
1993	14,737	1,332	5,086	12,376	8,448	2,067	3,094	14,354	6,623
1992	13,581	1,303	5,210	11,639	7,964	1,685	3,570	12,725	6,236

Source: Bureau of Transportation Statistics, Air Carrier Financial Reports Table P-12.

Exhibit 2. Operating Margins for Major U.S. Airlines

Source: Airline Data and Analysis Largest Airlines 2002-2010 by AirlineFinancials.com.

Exhibit 3. Average RPM's Per Passenger (Average Mileage Per Passenger Flight) for Major U.S. Airlines

Source: Airline Data and Analysis Largest Airlines 2002-2010 by AirlineFinancials.com.

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Exhibit 4. Passenger Revenue Per RPM* 2002-2010 (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.

Source: Airline Data and Analysis Largest Airlines 2002-2009 by AirlineFinancials.com.

Exhibit 5. Load Factors 2002-2010 for Major U.S. Airlines

Source: Airline Data and Analysis Largest Airlines 2002-2010 by AirlineFinancials.com.

Exhibit 6. Unit Cost (CASM) (cents/ASM) for Major U.S. Airlines

Source: Airline Data and Analysis Largest Airlines 2002-2010 by AirlineFinancials.com.

Exhibit 7. Unit Costs Without Labor (cents/ASM) for Major U.S. Airlines

Source: Airline Data and Analysis Largest Airlines 2002-2010 by AirlineFinancials.com.

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Exhibit 8. Total Labor Cost Per ASM (Cents/ASM) for Major U.S. Airlines

Source: Airline Data and Analysis Largest Airlines 2002-2010 by AirlineFinancials.com.

EXHIBIT 9. Average Employees Per Aircraft (x 10) for Major U.S. Airlines

Source: Airline Data and Analysis Largest Airlines 2002-2010 by AirlineFinancials.com.

Exhibit 10. Net Debt for Major U.S. Airlines

Source: Airline Data and Analysis Largest Airlines 2002-2010 by AirlineFinancials.com.

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