Southwest Airlines

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SOUTHWEST AIRLINES[1]

The tale of two men, one airline, and one cocktail napkin . . . . "Let's start our own airline," Rollin W. King said to his friend, Herb Kelleher, in a bar, decades ago. "Convince me," Herb replied. On a cocktail napkin, Rollin drew a triangle connecting Texas's major cities. He said, "We could offer fares so low people would fly instead of drive." Herb paused, placed his drink on the napkin, and then spoke: "Rollin, you're crazy. Let's do it."[1]

INTRODUCTION

Southwest Airlines continues to face a multitude of changing challenges to its historically successful business strategy. These challenges are both external and internal. External challenges include leaner competitors, increased safety concerns, and limited growth opportunities in current markets. Internally, the company faces challenges such as adapting to a new business strategy, keeping costs the lowest in the industry, keeping their unique culture, and maximizing the effectiveness of its talent. Southwest's talent is selected very carefully and compensated very competitively, resulting in high levels of customer service. Southwest's strategy of having the highest customer service while being cheap and efficient depends on highly motivated employees

[1]Source: Ari Ginsberg and Richard Freedman prepared the original version of this case with the research assistance of Bill Smith. It is used here with their permission. They thank Myron Uretsky, Eric Greenleaf, and Bethany Gertzog for their valuable comments and suggestions. They also appreciate the careful review, corrections, and helpful recommendations made by Susan Yancey of Southwest Airlines on an earlier version. The case is intended to serve as the basis for class discussion rather than to illustrate either effective or ineffective handling of an administrative situation.

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who deliver outstanding customer service. While keeping this strategy, Southwest is now trying to tap into two markets it previously did not focus on—business travelers and international travelers. How their employees will adapt to this new focus is critical to Southwest's continued success.

Southwest's cofounder and former CEO and chairman, Herb Kelleher, created a unique culture that has been sustained for almost 50 years. He is still the figurehead that embodies the company's greatest strengths. The unique culture that Kelleher championed and helped create has been able, thus far, to sustain the company's recruitment and retention goals for the types of employees it targets. Employee ownership has been used extensively to tie the fortunes of the company with those responsible for it and to retain employees who might otherwise turn to Southwest's competitors. Employee satisfaction (85% of employees say they are proud to work for Southwest), along with the recognition that Southwest is one of the best companies for attracting, developing, and retaining talented people, makes it a well-oiled industry leader.

The question is whether Southwest can continue its profitability, outstanding level of customer service, and reputation for being low cost, on time, and safe in the context of a strategy that it has never tried before. Can the firm continue to spend so much time and money on staffing and training while focusing on new customer segments and still remain competitive and profitable while external conditions apply pressure on its business?

In addition to these questions, all of the external environmental issues, such as increased direct competition, increased cost pressures, increased safety concerns, and the unpredictable economy will have an impact on the future growth and success of the company. The strategies that have been so successful in the past are being modified to allow the company to grow by tapping into new markets and new market segments, and these modifications will come with numerous accompanying challenges. The key to these challenges may be the company's understanding and appreciation of its people.

BACKGROUND

Few industries have experienced the turmoil faced by the U.S. domestic airline business during the past four decades. Once characterized by high wages, stable prices, and choreographed competition, the industry changed swiftly and dramatically when deregulation took effect in 1978. Several of the strongest and greatest airlines (e.g., Pan Am, Eastern) disappeared through mergers or bankruptcies. Strikes and disruptions interfered with companies' attempts to reduce costs. New competitors aggressively swooped into the marketplace, but the majority failed. September 11, 2001, and the last recession were hard on the American airline industry. But now, the industry is again in a period of high demand and expanding profitability. Despite the volatile conditions and many organizational failures, one carrier grew and prospered throughout this entire period: Southwest Airlines.

Southwest was controversial from its inception. Although the Texas Aeronautics Commission approved Southwest's petition to fly on February 20, 1968, the nascent airline was locked in legal battles for three years because competing airlines—Braniff, Trans-Texas, and Continental—fought through political and legal means to keep it out of the market. Through the efforts of Herb Kelleher, a New York University law school graduate, Southwest finally secured the support of both the Texas Supreme Court and the U.S. Supreme Court and began service June 18, 1971, to Houston, Dallas, and San Antonio.

Southwest emerged from these early legal battles with its now famous underdog fighting spirit. The company built its initial advertising campaigns around a prominent issue of the time as well as its airport location. Thus "Make Love, Not War" became the airline's theme, and the company became the Love airline. Fittingly, *LUV* was chosen as the company's stock ticker symbol. Southwest went on to see successful growth through four distinct periods. The Proud Texan period (1971–1978) saw the establishment of a large-city service network within its home state of Texas. Because it did not engage in interstate commerce, the fledgling carrier was not subject to many federal regulations, particularly those imposed by the Civil Aeronautics Board (CAB). The second phase, Interstate Expansion (1978–1986), was characterized by the opening of service to 14 other states. Interstate expansion was made possible by, and thus coincided with, the deregulation of the domestic airline industry. The third phase, National Achievement (1987–2011) was a time of considerable growth, distinguished recognition, and success. The most recent phase, International Expansion (2011–present), has continued the prosperity with substantial growth, continued recognition for service, and exceptional financial success. The cornerstone of international expansion was the acquisition of AirTran in 2011, which by all accounts was successfully concluded in 2014. Southwest Airlines now flies to at least 10 countries, including Mexico, Aruba, Puerto Rico, Jamaica, Bahamas, the Dominican Republic, Cuba, Costa Rica, Grand Cayman, and Turks and Caicos.

THE EXTERNAL ENVIRONMENT OF THE AIRLINE INDUSTRY

The competitive environment in which Southwest operates can be subdivided into customer segments, competitor groups, and passenger service segments.

The two major categories of passengers are (1) leisure travelers, who tend to be quite price-sensitive, and (2) business travelers, who are more concerned with convenience. To satisfy the different needs of these groups, airlines present a wide variety of services, depending on their strategy. For example, airlines differ by geographical coverage; some specialize in short-haul service while others provide a vast network of interconnected long- and short-haul flights on a global basis through a network of strategic alliances.

The U.S. airlines can be generally categorized into three major competitor groups based on geographical coverage. First are the national airlines such as America Airlines, Delta, and United. Together with Southwest, these four major players account for a large majority of the U.S. flight capacity. These four are the result of major mergers and acquisitions (United and Continental, Southwest and AirTran, Delta and Northwest, as well as American, US Airways, and America West), which have increased the competitiveness in the industry. Second are the regionals, which include Spirit Airlines, Alaska Airlines, and Hawaiian Airlines. Third are the commuter or feeder carriers, most of which operate as extensions of the major carriers. These include United Express, American Eagle, Delta Connection, Horizon Air, Mesa Airlines, and numerous others, some of which change quickly. These airlines can be further categorized into (1) traditional carriers with business and coach classes and (2) low-fare/low-frills, single-class carriers.

They also differ in how their routes are structured within the territories they serve. The two extremes are point-to-point and hub-and-spoke. The former is characterized by direct service between two points. The latter is characterized by complex and coordinated routes and by schedule structures that channel passengers from numerous far-flung airports (the spokes) through a central airport (the hub). The hub itself has many costly infrastructure requirements (baggage handling systems, large terminals, maintenance facilities, and parts inventories). For companies that rely on a network, like a hub-based airline or a telephone company, competitive advantage accrues from economies of scope (i.e., the geographic reach of the network). Economies of scope do not necessarily complement economies of scale, and in fact they are often achieved at the expense of scale economies and vice versa. Thus, although the hub-and-spoke system is driven by economies of scope, either strategy—hub-and-spoke or point-to-point—has its own inherent costs and organizational implications.[2]

Passenger service can also be characterized in terms of breadth. An airline may choose to provide a broad gamut of services including meals, advance seat assignments, lounges, and frequent flier programs (full service), or it can offer only Spartan services (no frills). A further differentiation is the number of service classes offered. Most airlines have two classes of service, first class and coach. Some offer three classes: first-class, business, and coach. Others offer only coach and a few offer only first class. In addition to the direct cost of providing differentiated service, amenities such as first-class seating and in-flight meals indirectly affect the cost structure of an airline by limiting the number of seats its aircraft can hold. A glossary of key terms related to the airline industry appears in Exhibit SA.1.

Exhibit SA.1: Glossary of Terms

ARC	Airline Reporting Corporation, an organization owned by the airlines that serves as a clearinghouse for processing airline tickets.
ASM	Available seat mile. One ASM is one sellable seat, flown for one mile. For example, a 138-seat Boeing 737 traveling 749 miles from LGA to ORD (LaGuardia to O'Hare) represents 103,362 ASMs.
Class of service	The fare level at which a ticket is sold. This does not refer to the cabin in which the passenger flies. For example, a United Airlines' availability display shows the following classes of service for coach: Y B M H Q V. By subdividing coach into classes, airlines can control inventory and manage yield.
Code share	An interline agreement by which two carriers are able to apply their flight numbers to the same plane. This often includes an interline connection. For example, American Airlines and South African Airlines code-share on SAA's

flight to JHB (Johannesburg). The flight has an AA flight number and an SAA flight number. AA can sell it as an American Airlines flight.

CRS Computer reservation system (CRS). Allows airlines and travel agents to reserve and sell seats on airline flights. CRS companies include Apollo, Sabre, System One, and Worldspan.

Direct flight Any flight designated by a single flight number. Direct flights can include multiple stops and even changes of aircraft. For example, Pan Am Flight 1 at one time made 11 stops as it flew "around the world" direct from LAX to JFK.

Full fare Designated as "full Y." The undiscounted first, business, or coach fare. For domestic fares, this is used to calculate the level of discounted fares. Full Y is rarely paid for domestic flights but is common on international flights when inventory is scarce.

Interline agreement Any of various agreements between carriers. Common interline agreements concern the transfer of baggage, the endorsement and acceptance of tickets, and joint airfares (e.g., a passenger flies USAir from Albany to JFK and then SAS to Copenhagen).

Inventory The number of seats available for each class of service for a given flight. For example, a USAir flight may have no K inventory available (seats to sell at K class fare levels), although higher-priced H seats may be available. Both seats are in coach.

Load factor The percentage of ASMs that are filled by paying passengers. Can be calculated by dividing RPMs by ASMs.

O&D Origin and destination. The originating and terminating airports of an itinerary segment. Connection points are not counted in O&Ds. This is different from city-pair, which refers to the origination and termination of a flight segment. For example, for a passenger traveling on NW from HPN (White Plains) to SMF (Sacramento), the O&D market is HPN-SMF. The city-pairs flown will be HPN-DTW and DTW-SMF (White Plains-Detroit, Detroit-Sacramento)

Restricted fare Any fare that has restrictive rules attached to it. Common restrictions include Saturday Night Stayover, Advance Purchase, Day/Time of Travel, Non-Refundability, and Class of Service. Generally, lower fares have greater restrictions.

RPM Revenue passenger mile. One passenger paying to fly one mile. For example, a passenger who pays to fly from LGA to ORD represents 749 RPMs. The class of service and fare paid are not considered in calculating RPMs.

Stage length The length of a flight segment. For example, the stage length between LGA and ORD is 749 miles.

Unrestricted fare A fare with no restrictions. Often, this is not the full fare. For example, American's Y26 fare is an unrestricted fare, but it is still lower than the full Y fare.

Yield Measured as revenue per RPM.

Competitive Environment

The Airline Deregulation Act of 1978 redefined the industry by eliminating the ability of the government to set fares, allocate routes, and control entry into and exit from markets. Unfortunately, most airlines were hamstrung by high cost structures, including exorbitant labor costs, and highly inefficient planes and infrastructure facilities. After the complete removal of entry and price controls by 1980, competition intensified considerably as new entrants cherry-picked the large carriers' most profitable routes. This led to an extended period of severe industry shakeout and consolidation.

Structural Characteristics

The industry's structural characteristics make it a tough place to be very profitable. In fact, if one were to total the profits and losses of all airlines since the industry was deregulated, the number would be close to zero, although this is changing. The overall industry is not highly concentrated, although it has become more so since the numerous recent mergers and acquisitions of the major players. Nevertheless, most discrete markets are served by a limited number of carriers. In the oligopolistic markets in which most airlines compete, the pricing actions of one company affect the profits of all competitors. Intense price wars have been a frequent event in the industry. Because competition varies from route to route, a carrier can dominate one market, be dominated in another, and face intense rivalry in a third. As a result of the hub-and-spoke system, airlines face head-to-head competition with more carriers in more markets.

Suppliers tend to have relatively high bargaining power. Certain unions are in a position to shut down airlines. Airplane manufacturers (Boeing, Airbus) have considerable power in altering the terms of purchase for planes because of the limited number of suppliers. Furthermore, the business is capital intensive and requires very large expenditures for airplanes and other infrastructure.

There is a relatively low threat of new entrants to the market place to compete against the major airlines. One of the newest major entrants, Virgin America, which entered in August 2007, was able to obtain only a 1% market share before it was acquired by American Airlines in 2016. Jet Blue, with a market share of a little more than 5%, is the newest airline (founded in 1998) that has been able to make substantial inroads into the industry.

There are, however, factors that could encourage new entrants. For example, there are few substitutes for long-haul air travel. In addition, most of the incumbents have high cost structures that are exceedingly difficult to improve significantly. Carrier failures and downsizing have also created a large supply of relatively new used aircraft, and the cost of acquiring aircraft is reduced further by the practice of aircraft leasing. Given high debt levels and low profitability in comparison to other industries, most airlines, including Southwest, have begun to lease their planes rather than purchase them. In light of high debt and low profits, the depreciation tax shield is not as valuable to the airlines. By leasing, carriers can sell that tax shield to the leasing company, actually creating value for the carrier. Also, new entrants are sometimes able to gain favorable terms by purchasing the excess capacity of other airlines, such as training and maintenance. As a result, entry barriers are not as high as one would expect compared to other capital-intensive industries.

Historically, new entrants could generally gain significant cost advantage by securing lower labor costs because they were not burdened by the unfavorable union contracts that affected many older airlines. Many of the union contracts agreed to by the major airlines called for higher pay and contained work rule provisions that reduced labor productivity. Today, however, many of these contracts have been renegotiated when airlines emerged from bankruptcy, which reduced these costs.

Profitability

To survive and profit in this tough environment, airlines attempt to manipulate three main variables:

- Cost, calculated as total operating expenses divided by available seat miles (ASM)
- Yield, calculated as total operating revenues divided by the number of revenue passenger miles (RPM)
- Load factor, calculated as the ratio between RPMs and ASMs, which measures capacity utilization

Thus, profitability, defined as income divided by ASM, is computed as:

$$\text{Profitability} = (\text{Yield} \times \text{Load factor}) \text{ [minus] cost}$$

The major airlines have faced intensive competition from low-priced airlines for the past 20–25 years. Though these low-priced airlines expanded the market for air travel, they also placed great downward pressure on the prices of the majors, thereby reducing their yields. To compete, the majors engaged in great cost-cutting efforts.

September 11, 2001, substantially affected the profitability of the industry. With the added costs of increased security, initial decreases in passengers, and dramatic increases in fuel costs, the industry did not achieve profitability again until 2006. Profitability of the industry was attained again in large part because the large carriers laid off 38% of the workforce, more than 170,000 workers over those five years. Further, pay was frequently reduced for those not laid off, often through bankruptcies.[3] The great recession of 2008 brought back the bad times of 2001. Demand for travel dropped substantially, causing losses for most airlines. Now, years after the great recession, the outlook for the industry looks much better.

Outlook

The outlook for the airline industry is currently positive. Most carriers have brought costs under control (although frequently through bankruptcies or mergers and acquisitions). The number of passengers are at an all-time high with steady expected growth in the future.

Despite these improvements, there are several threats to the industry as a whole. The first is a number of external factors that could raise costs industrywide. Rising costs lead to higher fares, which reduce the number of travelers. Increases in gas prices, labor unions wanting back the concessions that they gave up during the lean times, rising interest rates, or additional changes in government regulations could substantially increase costs. Second, there are a number of external factors unrelated to costs that could reduce customer demand. Changing economic conditions, technology failures, and perceived safety issues such as increases in actual or perceived terrorist activity could substantially reduce the number of airline passengers.

Numerous airlines shed their financial obligations through past bankruptcies. United Airlines, ATA, US Airways, Northwest Airlines, and Delta Airlines have emerged from bankruptcy proceedings. Because airlines emerging from bankruptcy are more competitive, the competitiveness of the industry itself is now more intense. This increased intensity has affected the plans of many in the industry. Smaller airlines, such as JetBlue, have reduced their growth plans. Further, many airlines, (e.g., United and Continental, Southwest and AirTran, Delta and Northwest, as well as American, US Airways, and America West), have consolidated through mergers. Nevertheless, the outlook is currently positive. As Southwest CEO Gary Kelly notes, "The airline industry is finally healthy, healthier than ever and as a consequence extraordinarily competitive."[4]

SOUTHWEST AIRLINES' MISSION AND OBJECTIVES

Southwest Airlines' mission focuses to an unusually great degree on customer service and employee commitment. According to its annual report, the mission of Southwest Airlines is "dedication to the highest quality of Customer Service delivered with a sense of warmth, friendliness, individual pride, and Company Spirit." Indeed, Southwest proudly proclaims, "We are a company of People, not planes. That is what distinguishes us from other airlines and other companies." In many respects, the vision that separates Southwest from many of its competitors is the degree to which it is defined by a unique partnership with, and pride in, its employees. As stated in one Annual Report:

> *At Southwest Airlines, People are our most important asset. Our People know that because that's the way we treat them. Our People, in turn, provide the best Customer Service in the airline industry. And that's what we are in business for—to provide Legendary Customer Service. We start by hiring only the best People, and we know how to find them. People want to work for a "winner," and because of our success and the genuine concern and respect we have for each of our Employees, we have earned an excellent reputation as a great place to work. As a result, we attract and hire the very best applicants. Once hired, we train, develop, nurture, and, most important of all, support our People! In other words, we empower our Employees to effectively make decisions and to perform their jobs in this very challenging industry.*

The airline's goal is to deliver a basic service very efficiently and safely. This translates into a number of fundamental objectives. A central pillar of its approach is to provide safe, low-price transportation in conjunction with maximum customer convenience. The airline provides a high frequency of flights with consistent on-time departures and arrivals. Southwest's employees also aspire to make this commodity service a fun experience. Playing games is encouraged—however, the fun spirit is tempered so that it is never in poor taste and does not alienate business travelers.

SOUTHWEST AIRLINES' STRATEGY

Southwest Airlines is categorized as a low-fare/no-frills airline. However, based on its current size and importance, it is now considered to be one of the major airlines despite its fit in the low-fare segment. In a fundamental sense, Southwest's business-level strategy has historically been to be the cheapest and most efficient operator in specific domestic regional markets, while continuing to provide its customers with a high level of convenience and service leveraged from its highly motivated employees. Essentially, Southwest's advantage is that although it is low-cost, it still has a good safety reputation and a high level of customer service.

Cost Leadership

Southwest operates as the lowest-cost major airline in the industry. Some estimate that Southwest has a 30–40% cost advantage over the other national airlines (American, Delta, and United) and a 10% advantage over low-cost carriers.[5] The airline devised a number of clever stratagems to achieve this low-cost structure. For example, by frequently serving smaller, less congested secondary airports in larger cities, which tend to have lower gate costs and landing fees, Southwest can maintain schedules cheaply and easily. Southwest's approach was also facilitated by its initial focus on the U.S. Southwest and other locations with generally excellent weather conditions, which leads to far fewer delays.

Southwest is the only major airline that uses the point-to-point strategy. By following a point-to-point strategy, Southwest need not coordinate flight schedules into connecting hubs and spokes, which dramatically reduces scheduling complexity and costs. Costs are reduced because a point-to-point strategy allows far easier reroutes under adverse weather conditions or when there are mechanical issues. It also allows for more flights per airplane because there can be a smooth flow of traffic throughout the day rather than the timing constraints of hub and spoke demands. This results in Southwest planes being in the air two hours more a day than its hub-using rivals.[6]

The fact that Southwest uses only one type of aircraft, the Boeing 737, also reduces costs. When Southwest acquired AirTran in 2011, this strategy was tested because AirTran had 86 Boeing 717 planes which allowed it to enter very small airports. After discovering the cost inefficiencies of these planes, over the next several years Southwest abandoned the smallest airports and leased all those planes to Delta. So, once again, Southwest currently only uses Boeing 737s, which substantially reduces training, maintenance, service, and part inventory costs.

Southwest's timely usage of fuel hedges have saved the company billions in fuel costs since 2000. Since then, Southwest has done an excellent job of locking in low prices for years before prices rise and reducing purchases in the futures market when they have peaked. Nevertheless, there were some quarters, such as the first quarter of 2017, where fuel hedging costs were over $100 million.[7]

During the great recession and after the AirTran acquisition, Southwest aggressively trimmed unpopular and unprofitable flights to reduce costs. Recent cost cutting initiatives included short-term initiatives such as a salary freeze for senior management and the introduction of a voluntary early retirement program, and long-term initiatives such as the installation of winglets (fuel-saving wing modifications) on all planes, the introduction of dual door deplaning, and upgrading technology.[8]

Fleet composition

Southwest has historically had the simplest fleet composition among the major airlines, flying only Boeing 737 planes. This composition was more complex following the AirTran acquisition, but after leasing all the AirTran Boeing 717 planes to Delta, it once again has the simplest composition among the major airlines. Southwest currently owns or leases approximately 735 planes and has firm orders for another 192 planes from Boeing through 2025. The company also has options or purchase rights on an additional 209 planes through 2027. In choosing the fuel-efficient 737, Southwest developed a close relationship with Boeing that enabled it to receive comparatively favorable purchase terms. Although Southwest flies a number of model variations of the 737, the cockpits of the entire fleet are standardized. Therefore, any pilot can fly any plane, and any plane can be deployed on any route. In addition to helping capture scale economies at a much smaller size than its larger competitors, the homogeneous fleet composition reduces the complexities of training, maintenance, and service. It is difficult to calculate the large savings associated with this approach, but they exist in almost all operating areas, including scheduling, training, aircraft deployment and use, wages and salaries, maintenance, and spare parts inventories.[9]

Route structure

Historically, Southwest has specialized in relatively short-haul flights and has experienced considerable threat from providers of ground transportation (cars, trains, and buses) because the buyers of these short-haul services tend to be quite price sensitive. Southwest has widened the market for air travel by attracting large numbers of patrons who previously relied on ground transportation. Emphasis on short-haul flights has also allowed them to pare costly services such as food, which passengers demand on longer flights. Passengers are provided with only an “extended snack”: pretzels, peanuts, and a beverage.

Historically, Southwest’s entry into new markets has reduced fares by an average of 65% and increased passenger traffic at least 30%. Some markets have seen traffic increase by as much as 500% after Southwest entered them. This increase in traffic and decrease in fares is now recognized as the Southwest Effect.[10]

To grow, Southwest is now considering expanding its route structure to include long-haul flights. This is necessary to tap into the business traveler and international traveler markets. The trick will be to keep the cost efficiencies while catering to travelers who expect more services.

Turnaround time

Its traditional route structure has helped Southwest to experience the most rapid aircraft turnaround time in the industry (15-20 minutes versus an industry average of 55 minutes). Interestingly, Southwest’s 20 Minute Turnaround can be traced directly to the carrier’s first days of operation in Texas when financial pressures forced the company to sell one of the four Boeing 737s it had purchased for its initial service. Having only three planes to fly three routes necessitated very rapid turnaround.

Rapid turnaround time is essential for short-haul flights because airplanes are airborne for a smaller percentage of time than on long-haul flights. Faster turnaround also allows Southwest to fly more daily segments with each plane, which in turn increases its assets' turnover. Their ability to maintain this practice is being challenged by heightened security requirements, but so far, they seem to be doing well. Short turnaround time is supported by Southwest's compensation practices. Pilots get paid only for the time they are actually flying, not for the time the pilots and their aircraft sit at a gate. Southwest continues to strive to reduce turnaround time. It is currently exploring the use of two-door deplaning as a way to cut several minutes off the turnaround.

Gates

Access to gates is often a constraining factor in the ability of airlines to expand because major airports have a limited number of gates and most are already taken by other airlines. An emphasis on less crowded secondary airports has alleviated this problem for Southwest in the past; the airline purchases or leases gates at airports, as opposed to renting the gates of other airlines, thus enabling it to use its own ground crews. Once this strategy was exhausted, Southwest began experimenting with entering primary airports and even the hubs of other airlines. From 2004 to 2010 Southwest entered Philadelphia, Pittsburgh, Washington, Denver, San Francisco, Boston, Minneapolis-St. Paul, and Milwaukee, among others. The acquisition of AirTran provided new or additional gate space and access to other cities including Atlanta, Charlotte, Des Moines, Newark, and Washington, D.C., as well as numerous cities in Mexico and the Caribbean.[11]

Fare structure

Southwest also controls costs through its simplified fare structure. While Southwest's major competitors have complex fare structures and use computers and artificial intelligence programs to maximize passenger revenues, Southwest historically offered no special business- or first-class seating. Recently, to generate revenue, Southwest introduced a business class which gave customers preferences in checking in and boarding. However, compared to the complicated fare structures of other airlines, Southwest offers a limited number of different fares. There are no requirements to stay over a Saturday night.

The simplified fare structure allows the majority of Southwest's customers (about 80%) to book their own ticket through Southwest's website (www.southwest.com). This reduces labor costs related to reservations and commissions.

Labor

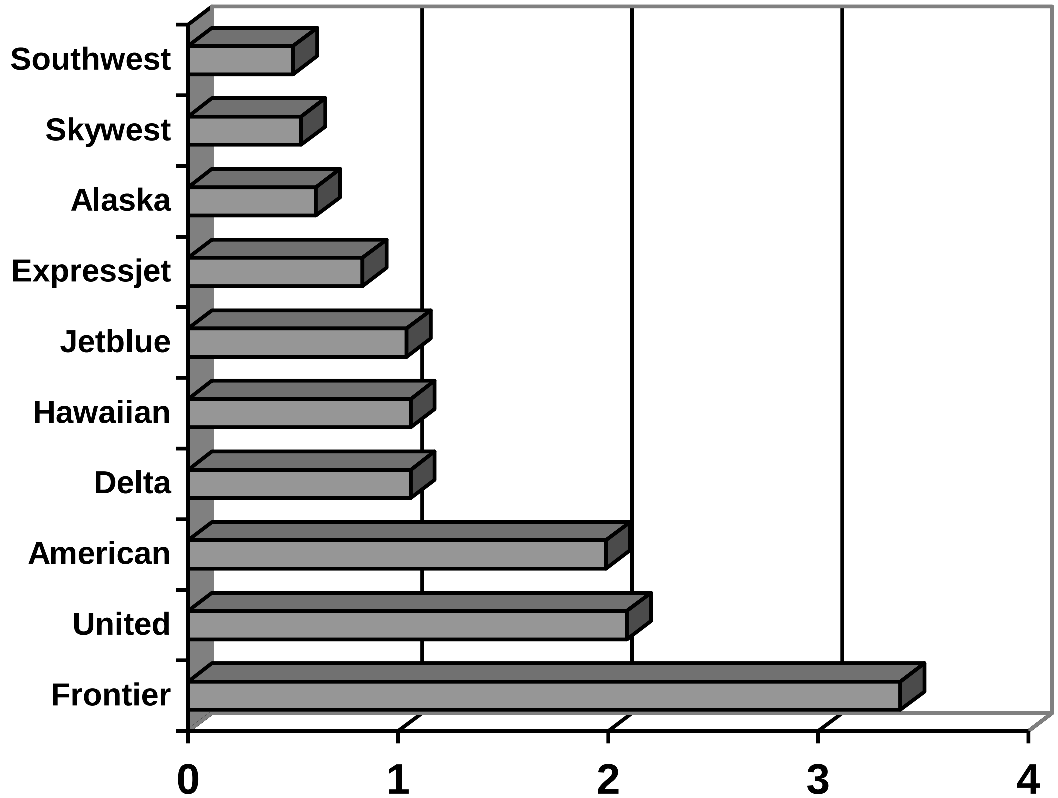
Labor is the largest cost component of airlines despite the heavy capital investment demanded in the industry. Southwest's labor costs are roughly 35% of all expenses. About 83% of Southwest's employees are represented by a union. Southwest currently has nine collective bargaining agreements in place. Given the ability of unions to bring carrier operations to a halt, it is not surprising that they wield considerable power. The International Association of Machinists and Aerospace Workers represents customer service and reservation employees; the Transportation Workers of America (TWU) represents flight attendants, dispatchers, flight crew training instructors, meteorologists, and ramp, operations, provisioning, and freight agents; the Southwest Airline Pilots' Association (SWAPA) represents pilots; and the International Brotherhood of Teamsters (IBT) represents stock clerks and flight simulator technicians. Mechanics and appearance technicians are represented by the Aircraft Mechanics Fraternal Association (AMFA).[12]

In an industry where unions and management have often been at war—and where unions have the power to resist essential changes—the quality of their relationship is a crucial issue. Southwest has never had a strike, lockout, layoffs, or pay cuts. Instead, when Southwest seeks to reduce labor costs, as it did in 2004, 2007, and 2009, it offers highly paid employees lucrative buyouts. Southwest's CEO, Gary C. Kelly, meets with union leaders quarterly to discuss finances and strategy. Southwest's base pay has historically been at or below market, with numerous opportunities to share in company success through variable pay programs including profit sharing and a stock purchase plan. However, currently Southwest's pay packages are generally at or above the market because of the drastic cuts in salaries by other airlines. Southwest has the highest level of benefits in the U.S. airline industry. Compensation and benefits will be described in greater detail later.

Customer Service

Southwest's approach to customer service is one of its core strategies. This strategy has paid off continuously for many years as shown in Exhibit SA.2, which reports the customer complaint rates of several airlines in 2017. Southwest has had the lowest complaint rate in most years since 1987, the year the Department of Transportation began collecting this data. Southwest also topped the J.D. Power rankings in the 2017 J.D. Power North America Airline Satisfaction Study. This study surveys over 10,000 travelers and measures their satisfaction with cost and fees, in-flight services, aircraft, boarding/deplaning/baggage, flight crew, check-in, and reservations.[13]

EXHIBIT SA.2: Complaints Per 100,000 Customers Boarded, January–June, 2017



Southwest's Positively Outrageous Service (POS) is different from the customer service associated with other major airlines. High levels of customer satisfaction are achieved with customer oriented employees, a customer friendly fee structure, and customer friendly policies. For example, Southwest is the only major airline that:

- Doesn't charge a fee for your first two bags.
- Doesn't charge a fee for changing flights.
- Doesn't overbook passengers.[14]

Service is provided with friendliness, caring, warmth, and company spirit; the staff goes out of their way to be helpful. If your flight has problems, you are likely to get a letter in a few days from Southwest's Senior Manager of Proactive Customer Communications apologizing and explaining what happened. This approach to service leverages Southwest's outstanding relationship with its employees. [15]

However, this stellar customer service does not include costly amenities like reserved seats, lounges, or food service, and it offers only very limited automatic baggage rechecking. By emphasizing flight frequency and on-time performance, Southwest has redefined the concept of quality air service. This unusual approach has allowed Southwest to differentiate its service while maintaining its cost leadership strategy. Recent customer service initiatives include a completely revamped Rapid Rewards Program (a frequent flier program), fleet-wide implementation of onboard wireless internet access, improved baggage tracking, "Fly By" security lanes (reserved for Business Select Customers and Rapid Rewards A-List Members), the Pets Are Welcome on Southwest (PAWS) initiative, and automated outbound messaging which alerts customers about flight changes.

Growth

Despite its remarkable growth in a very competitive industry, Southwest has historically not emphasized growth as an objective. Since its inception, Southwest has grown at a very constant rate, usually between 10 and 15% a year. Its controlled growth philosophy has been a key to its success.[16] The inability to manage rapid growth has been blamed for the failure of many carriers, including Braniff, People Express, and ValuJet. Thus, Southwest had not participated in the numerous acquisitions and mergers that occurred in the airline industry over the past decades, until 2011, when Southwest bought AirTran Airways for $1.4 billion. The acquisition substantially increased Southwest's revenue and capacity. The acquisition of AirTran allowed Southwest to:

- Expand its service to many more customers, adding hundreds of new itineraries to its portfolio.
- Enter markets it had little or no service to. These included Atlanta, New York, Boston, and Washington D.C
- Provide its customers with international options, using AirTran's Mexico and Caribbean routes.

The integration of AirTran employees into the Southwest culture was not easy, and took nearly four years to complete. However, the acquisition provided a means for quick growth without changing the way Southwest did business.[17]

These many years of sustained growth together with the recent acquisition of AirTran has resulted in Southwest now being the United States' largest airline when measured by number of passengers carried. It also has the most daily departures in the world. Sustaining growth in the future means that Southwest must now enter new markets and tap into a different customer base. Thus, Southwest is now focusing on increasing its share of the business traveler market and the international traveler market. Currently business customers comprise 35% of Southwest's fliers, compared to 50% in the other major airlines, and less than 5% of Southwest's flights are international. To increase both these figures, Southwest must increase its use of long-haul travel, a substantial change in strategy.

Social Responsibility

Part of Southwest's strategy is to be act in a socially responsible way in every aspect of their business. This includes helping communities and the environment. As part of their goals to be a good environmental steward, Southwest has undertaken a number of initiatives to make the company greener. Southwest unveiled their Green Plane to test the latest environmentally friendly cabin materials. They have also launched a more robust onboard recycling program. They have purchased green power in the form of wind energy, participated in emissions reduction research, and have been a leader in fuel conservation efforts. Southwest estimates that the fuel conservation efforts save over 8 million gallons of jet fuel a year. In 2016, Southwest started the Green Ambassadors network. The green ambassadors are 130 of Southwest's most environmentally passionate employees who coordinate green activities at each location. Some other indicators of the company's efforts to be green can be shown in the following data. In 2016, Southwest:

- Recycled 3,348 tons of waste
- Recycled more than 2/3rds of all hazardous waste
- Improved jet fuel efficiency by more than 30% since 2008

Southwest also strives to be socially responsible by helping communities. In 2016, Southwest donated more than $25 million in cash and flight tickets and more than 150,000 employee volunteer hours (worth more than $3.5 million) to charities. One of these charities is the Southwest Airlines Employee Catastrophic Assistance Charity (SWAECAC), started by an employee. This charity offers support to Southwest employees suffering financial hardships resulting from catastrophes.

THE INTERNAL ENVIRONMENT OF SOUTHWEST AIRLINES

Southwest, like most airlines, is a formal and centralized organization. Organizationally, Southwest is structured according to functions. The nature of operations in the airline business is quite mechanical. That is, airline operations naturally aim for efficiency and consistency. They are not spontaneous; they value clocklike behavior. Planes must be in certain places at certain times and must be operated safely and efficiently. Safety itself requires following very rigorous procedures to ensure proper maintenance and training. The reputation of an airline can be seriously damaged by only one or two serious accidents. Therefore, the organization of Southwest is characterized by a high degree of formalization and standardization.

How has Southwest Airlines maintained high levels of customer and employee satisfaction in the context of a functional organization? The company uses a number of mechanisms to allow employee participation. The fundamental concept is the notion of a “loose-tight” design. In the context of tight rules and procedures, employees are encouraged to take a wide degree of leeway. The company maintains rather informal job descriptions and decentralizes decision making regarding customer service. So, while there is very high standardization regarding operations, it is low with respect to customer service. Employees are empowered to do what is necessary to satisfy customers. Flight attendants are allowed to improvise cabin instructions and use their judgment in addressing passengers' needs. In fact, flight attendants were used to help design the galleys of the cabins. The company management operates with an informal open-door policy that allows employees to circumvent the formal hierarchy. Employees are encouraged to try things, knowing they will not be punished.

Size

Southwest operates about 730 Boeing 737s in more than 100 cities and employs about 53,000 people. Nevertheless, Southwest is still smaller than the largest major airlines when measured by number of employees. For example, American Airlines has over 120,000 employees, and United has 88,000. Yet Southwest carries more passengers in the United States than any other airline and has the most daily departures in the world. Further, its market value is greater than all the other major airlines, as are its profits.

Adaptability

Southwest has been a very nimble organization, quick to take advantage of market opportunities. For example, when American Airlines and USAir scaled back their California operations, Southwest quickly took over the abandoned gates, acquired more planes, and now has a substantial percentage of the California market. Southwest's expansions into big hubs like Philadelphia, Denver, Pittsburgh, Minneapolis–St. Paul, Boston, and Milwaukee were in response to opportunities created by competitors reducing service there. Southwest's adaptability is well described by Rita Bailey, formerly Southwest's HR director. She has said that "We used to think of Southwest as a speedboat circling around the slow cruise ships."[18]

Technology

Like all airlines, Southwest is a very heavy user of computer-related technology. This technology supports all activities from scheduling to reservations to general operations support. Their network supports a reservation system that has enabled Southwest to be the first carrier to offer ticketless travel on all of its flights. More than 90% of Southwest's customers choose the ticketless option, which eliminates the costs of printing and processing paper tickets. It is estimated that it costs an airline from $15 to $30 to produce and process a single paper ticket. The ticketless system offers significantly improved customer service by eliminating lines at ticket counters.

Marketing activities explicitly build on the Internet as a primary marketing channel. Southwest was the first carrier to host a website (www.southwest.com), which was deemed Best

Airline Website by *Air Transport World*. About 80% of flights are booked via the website. About 20 million customers subscribe to Southwest's weekly Click 'N Save emails. Southwest was the first airline to provide gate to gate Wi-Fi. The majority of Southwest planes now have it.

Southwest very recently revamped its technology to be state of the art. In 2017 it moved from its 30-year-old reservation system to a new state of the art technology platform. It was the single largest technology initiative in the company's history. The upgrade to the Amadeus Altea reservation system cost about $500 million, and will provide numerous new features including flight schedule optimization, automated rebookings during flight disruptions, and allow new fee-based services. The introduction of the new system required training 20,000 employees on its use.[19]

In 2017, Southwest also spent $300 million to revamp its operations technology with a web-based app package called OpSuite. OpSuite will allow employees to use smart phones and tablets instead of PCs and laptops to run all aspects of operations, including gate assignments, luggage tracking, and accessing a myriad of logistics data. OpSuite provides hundreds of different applications to help flight planners, pilots, maintenance teams, and customer service representatives do their jobs. It will transmit real-time data to employees and streamline communication between them, helping efficiency in numerous ways. For example, OpSuite helps with decision making when dealing with bad weather. Early results show that it has increased efficiency in recovering from weather events by 15%.[20]

Management

Southwest's chief executive officer (CEO), President and Chairman of the Board is Gary C. Kelly. However, the most important figure in Southwest's history stepped down from leadership position a few years ago. Cofounder, former CEO, and former Chairman of the Board, Herb

Kelleher, retired in 2013, but still comes to visit Southwest headquarters in Dallas on a regular basis.[21] Although he's now in his 80s and no longer a leader of the firm, Herb Kelleher still embodies Southwest's culture.

What set Herb Kelleher apart was his charismatic nature. His friendly, participative, deeply involved, and caring approach was and is revered throughout the organization. A very large number of employees know him, and he is reputed to know thousands of them by name. Kelleher's management style, which had been described as a combination of Sam Walton's thriftiness and Robin Williams' wackiness,[22] seems to have been consistent right from the beginning. Direct, visible, and, some would say, even bizarre—he has attended company parties dressed in drag and appeared in a company ad as Elvis. Kelleher is reputed to have engaged people in conversations for hours, at all hours, about company and industry issues, often with a drink in his hand. He almost always seemed ready for a party.

This fun-oriented atmosphere continues to pervade the organization under the leadership of Gary Kelly. Gary Kelly has attended Southwest's annual Halloween party as Edna Turnblad (from *Hairspray*), Dorothy (from the *Wizard of Oz*), and Gene Simmons (from the rock band Kiss) Although the Halloween party is the biggest one of the year, it is only one of eight company parties thrown yearly to help keep Southwest's culture thriving.[23]

Culture

The most distinguishing feature of Southwest Airlines is its culture. Forged over 45 years, Southwest's culture has been a source of sustainable competitive advantage. All of Southwest's employees receive a card from their employer on their birthday, the date of their anniversary, Thanksgiving, and Christmas. Halloween costume contests, poem contests, and chili cook-offs are common. When competitors and outside observers describe Southwest, they tend to focus on its cultural attributes. Herb Kelleher made the development and maintenance of culture one of his primary duties. The culture permeates the entire organization and sends clear signals about the behavior expected at Southwest**.**

In 1991, Southwest created a company culture committee, composed of people from all geographic areas and levels of the company. The committee, which meets four times a year, is charged with preserving and enhancing the company culture. The committee also raises funds to reward employee teams who just need a boost or who have worked especially hard. Flight crews might be surprised with snacks or with help cleaning their planes. One program created by the committee is called the Heroes of the Heart program. It is used to honor employees who are rarely seen by customers but who are unsung heroes. A subcommittee selects one group who shows outstanding effort in serving and supporting other employees. The group is honored with a party, gets a mention in the newsletter and in-flight magazine, and has their name painted on one of SWA's Heroes of the Heart–designated aircrafts. The culture creates a sense of family and mission.[24]

The culture also stresses the importance of having fun at work. Humor is a significant aspect of the work environment. Such attributes are believed by senior management to enhance a sense of community, trust, and spirit and to counterbalance the stress and pressures of the mechanistic demands of airline operations. One excerpt from Southwest's *The Book on Service: What Positively Outrageous Service Looks Like at Southwest Airlines* is rather instructive:

> *"Attitude breeds attitude . . ." If we want our customers to have fun, we must create a fun-loving environment. That means we have to be self-confident enough to reach out and share our sense of humor and fun—with both our internal and external customers. We*

must want to play and be willing to expend the extra energy it takes to create a fun experience with our customers."

This approach certainly contributes significantly to the lowest employee turnover rate in the industry (about 5%) and the highest level of consumer satisfaction.

Another characteristic is the cooperative relationship among employee groups. This can be an advantage in functional structures, which are notorious for generating coordination problems. In other airlines, work procedures clearly demarcate job duties. However, at Southwest everyone pitches in regardless of the task. Stories abound of pilots helping with baggage and of employees going out of their way to help customers. In one particularly bizarre story, an agent babysat a passenger's dog for two weeks so that the customer could take a flight on which pets were not allowed. Employee cooperation affects the bottom line. When pilots help flight attendants clean the aircraft and check in passengers at the gate, turnaround time, a cornerstone of the low-cost structure, is expedited.

The familial aspect of the culture is well demonstrated by senior management's decision to freeze their own pay as a cost-cutting measure during the last recession. Although headcount levels were also frozen, employee pay was not. Some interesting facts about Southwest Airlines are shown in Exhibit SA.3.

Exhibit SA.3: Southwest Airlines Fast Facts

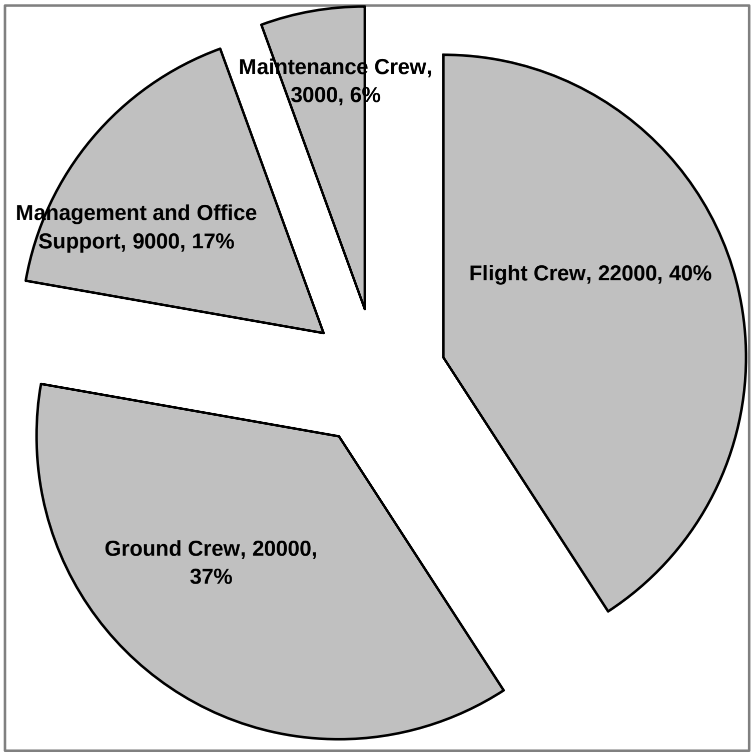
- Southwest has never had a layoff.
- Southwest has more than 3900 flights a day.
- Southwest serves over 60 million cans of soda, juices, and water annually.
- Each Southwest aircraft flies and average of five flights per day.
- Southwest's shortest daily flight is 148 miles, between Houston and Austin.
- Southwest's longest flight is 2,627 miles, between Los Angeles and Liberia, Costa Rica.
- If you had purchased $1,000 worth of stock in Southwest airlines in 1972 it would now be worth more than $1,000,000.
- In 1973, Southwest adopted the first profit-sharing plan in the U.S. airline industry.

- Southwest received over 340,000 resumes in 2016, and hired 7,207 new employees.
- Southwest has never had a strike or lockout.
- All of the employees who started with the company in 1971 are now millionaires.
- Southwest serves over 100 million bags of peanuts and pretzels annually.
- About 83% of Southwest's employees are unionized.
- Over 2300 of Southwest's employees have spouses who are also Southwest employees.
- Southwest has been profitable for more than 44 consecutive years.
- About three out of four Southwest passengers fly non-stop.
- Employees own about 8% of Southwest's stock.
- Average passenger airfare is under $150 one way.

HUMAN RESOURCE MANAGEMENT AT SOUTHWEST AIRLINES

At Southwest Airlines, the human resource function is called the People Department. According to the department's mission statement: "[R]ecognizing that our people are the competitive advantage, we deliver the resources and services to prepare our people to be winners, to support the growth and profitability of the company, while preserving the values and special culture of Southwest Airlines." The crucial importance of human resources to the strategy of Southwest has made the People Department more organizationally central to the company than its counterparts are at its competitors. Southwest has about 53,000 employees. As shown in Exhibit SA.4, of those, 22,000 are flight crew members. The importance of HR is reflected in every human resource function. Recruiting, selection, training, performance management, compensation, benefits, and labor relations all support Southwest's strategy and culture.

EXHIBIT SA.4: Number of Southwest Employees



Recruiting

Given Southwest's reputation as a great place to work, it generally receives many applications for each job opening. For example, in 2016, the company hired 7,207 people, but received over 340,000 applications. Historically, less than 1% of applicants are actually hired. In theory, the odds of getting into Harvard are lower![25] One could safely say that Southwest's reputation and unique employee-friendly culture make up its greatest recruiting tool. The time and money spent on the recruiting and selection process has resulted in a turnover rate of 5%, the lowest in the industry. Traditionally, an HR department in most companies does not do much to endear itself to finance. However, Southwest’s CEO, Gary Kelly, is convinced that investing in hiring is vital. “If you are not going to work hard to get people who are a good fit, it will hurt you. For example, we have never had a strike. What airline is even close to being able to say that?”

Selection

Southwest publicly explains almost every detail of the practices it uses to select employees. In theory, any company could attempt to copy the process and claim it as their own, but it would probably fail for a number of reasons. First, Southwest expends much more energy and time on the process than most companies do. To find the right people, they spend the money up front on the selection process in the belief that it becomes worthwhile over time. Not every company would be willing or able to make that type of investment. Second, Southwest’s selection process matches the unique culture of the company. This process was best described by Herb Kelleher:

> *We like mavericks—people who have a sense of humor. We look for attitude. We’ll train you on whatever you need to do, but the one thing we can’t do is change inherent attitudes. Other companies don’t value attitude. They don’t pay all that much attention to it. They don’t make it a priority. I’ve been with companies where they have an opening, and you know what they consider the function of the personnel department? To plug a hole as quickly as they possibly can. That’s quite different from what we do in many cases. Some years ago our VP of the People Department told me they had interviewed 34 people for a ramp agent position in Amarillo, Texas, and she was a little embarrassed about the amount of time it was taking and the implied cost of it, and my answer was: if you have to interview 134 people to get the right attitude on the ramp in Amarillo, Texas, do it.* [26]

What does Southwest look for in the selection process? The approach places great emphasis on hiring based on attitude. The search is for something that Southwest considers to be elusive and important: a blend of energy, humor, team spirit, and self-confidence. These key predictors are used by Southwest to indicate how well applicants will perform and fit in with its own unique culture. The process can take up to six weeks before anybody is hired. About 20% of recruits fail to make it through the training period at the University for People in Dallas.

The process

The People Department at Southwest enjoys an extremely important role in its selection and placement process. This kind of centralized process helps the organization, as the applicants have to go to one place and specialists trained in selection techniques can assist in the process of deciding which candidates should be hired and where they ought to be placed. Southwest keeps the line managers and other employees involved in the process, and doing so benefits the company for a number of reasons. Employees who get the opportunity to contribute in the selection of their team members become more committed to helping them succeed, and the process also gives them a sense of urgency. The involvement of all levels of management and employees along with the HR department in the selection and placement process helps Southwest build a strong network of employees, who can then successfully forward the organization's mission of providing the right service to its customers.

The People Department has sound procedures in place for any level of selection, be it in the form of personality tests, interviews, or other assessments. The selection and placement decisions, however, are ultimately made by a combined panel of line managers and specialized representatives from the People Department. These decisions seem to be made with the full participation of present employees in the spirit of true partnership. The People Department is responsible for designing the process and is largely responsible for attracting, helping in the selection and placement of, and retaining a strong set of employees.

All applications go through the People Department, and prospective candidates are then interviewed and tested for *aptitude and attitude* by a panel of interviewers in keeping with a consistent process developed by the HR function. Once selection decisions are made, the placement of the right individual in the right position is once again done with the involvement of all levels of employees from that department, along with specialists.

The selection process has enabled Southwest to maintain a strong, unified culture in the face of enormous growth and to groom management talent within the company. This is reflected at the senior management level, where promotions within the ranks have led to most positions being occupied by insiders, some of them having started their careers in entry-level positions.

Personality test as a selection technique

The predictors most stringently used for the selection of employees are personality and values. How does Southwest identify applicants with the desired personality and values? One way is its use of a personality test to rate candidates (on a scale from one to five) on seven separate traits. The seven areas evaluated include cheerfulness, optimism, decision-making skills, team spirit, communication, self-confidence, and self-starter skills. Anything less than a three is considered cause for rejection. With this methodology, the airline has chosen to use a multiple-hurdles approach, where an applicant must exceed fixed levels of proficiency on all of the predictors to be accepted. With this approach, a higher rating in one area will not compensate for a lower score on one of the other predictors. Southwest believes in these seven predictors and that failing to make the grade in even one will guarantee that the person will be unsuccessful on the job. The process of selection based on the seven predictors applies to everyone from pilots to mechanics.

In the words of Libby Sartain, "we would rather go short and work overtime than hire one bad apple."[27]

The interview as a selection technique

In addition to the evaluation of the seven predictors, Southwest uses other methods in the selection process. The process, as at most companies, includes a number of interviews, depending on the job. For example, a panel of representatives from the People Department and the In-flight Department first interviews the candidates for flight attendant jobs. Before the selection process is finished, the candidates also have one-on-one interviews with a recruiter or supervisor from the hiring department and a peer. The selection is highly systematic, and a multiple-hurdles approach combined with a good interview design help to ensure that only the best candidates get selected. The selection of candidates who fit the organizational culture of Southwest is undoubtedly critical to its success.

The interviewers look for team-oriented people with matching prior work experiences. A common theme in screening all candidates has to do with people skills. The easiest way to get into trouble at Southwest is to offend another employee. Even when pilots are interviewed, the airline goes out of its way to find candidates who lack an attitude of superiority and who seem likely to treat coworkers with respect. Southwest's system for selecting its people is time intensive but based on a history of bringing in people who fit into the culture of the company.[28]

Southwest developed its interview process in collaboration with Development Dimensions International, a consulting firm that specializes in designing sound selection procedures. The procedures at Southwest Airlines adhere to the basic principles of good interview design: structured questions, systematic scoring, multiple interviewers, and interviewer training. The questions are tailored to the specific needs and requirements of each job, as well as to attributes like judgment and decision-making skills. Questions frequently focus on past behaviors, such as “Describe a situation in which you handled a crisis at work” or “Give an example of when you were able to change a coworker’s attitude about something.”

Other selection techniques

In addition to personality tests and interviews, Southwest uses a number of unique and clever techniques to assess applicants. Applicants’ attitudes are assessed from the moment they call for an application. When someone calls for an application, managers jot down anything memorable about the conversation, whether good or bad. When applicants are flown out for an interview, they are given special tickets, so that all Southwest employees know this is a recruit. Again, anything memorable about the applicant, whether they were particularly friendly or complaining throughout the flight, is noted and passed to HR. At the interview site, Southwest asks applicants to speak in front of large groups of other applicants, but the speaker isn’t the only one being evaluated. Those in the audience are being watched to see if they are attentive and interested or bored and distracted. Southwest recruiter Michael Burkhardt sums up the technique, “We want to see how they interact with people when they think they’re not being evaluated.”[29]

Training

In an organization where attitudes, culture, and fit are so important, it is natural that the company places such a great emphasis on socialization and training. Just as McDonald’s has its Hamburger University, Southwest has its University for People. The University for People offers training for every stage of their careers. Courses at the University of People include:

- Freedom, LUV, and You (a comprehensive 1-day orientation for new hires)
- Leadership 101 (a course for employees to explore their interest in leadership)

- Leadership Southwest Style (a four-session course for front-line leaders)
- Next Level Leadership (a course for management-level leaders)
- Power Speak (a course on public speaking)
- Successful Performance Appraisals
- Every Customer Matters (a new initiative on customer service)

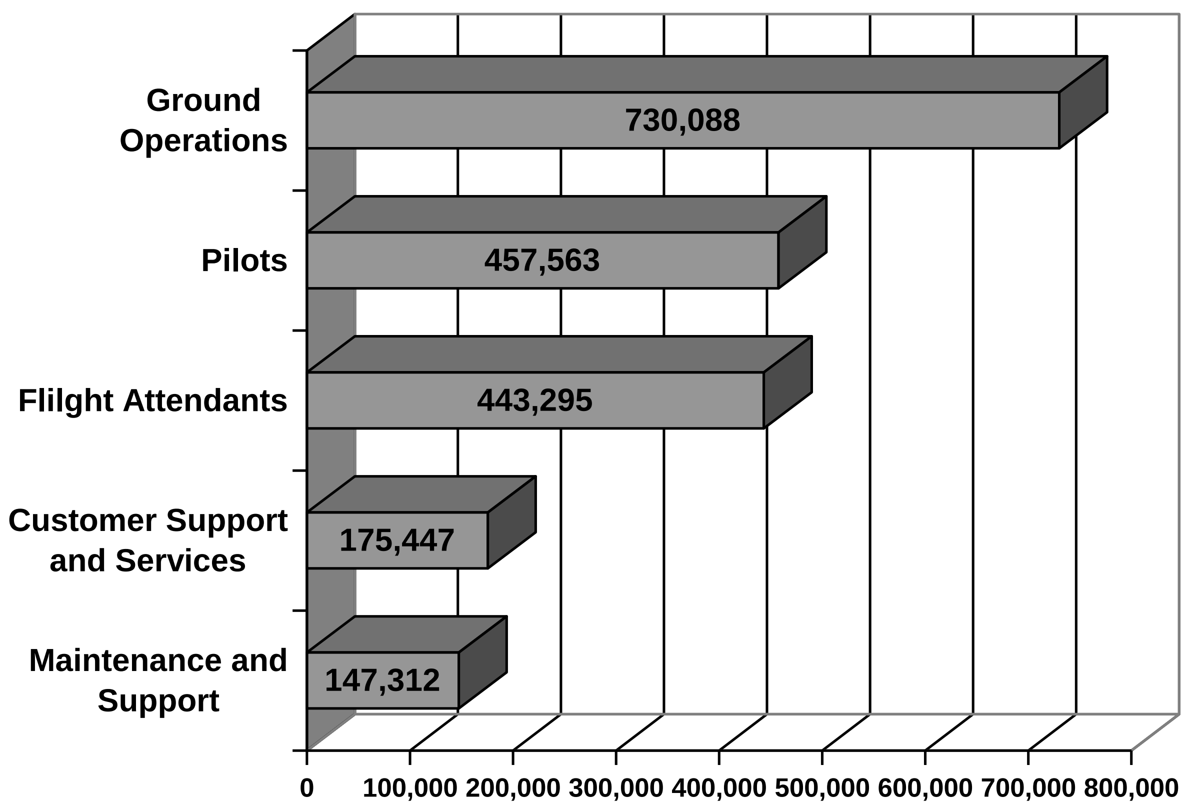
Southwest provides internal training but also encourages employees to attend external training and further specialize in their fields.

The training of new hires is focused on building relational competence as well as functional expertise. Each new hire receives one to two weeks of classroom training and two to three weeks of on-the-job training. Orientation includes ample exposure to Southwest's culture, including videos such as "Keeping the Spirit Alive," which offer Herb Kelleher dressed as Elvis and Southwest legends such as the company's origin on the cocktail napkin.

Training is very broadly focused so that new employees understand the jobs of the other Southwest staffers they may have to interact with. This helps employees understand how their job fits and how they can support others, consistent with the team aspect of the culture. To further this understanding, Southwest has a number of programs such as Day in the Field and Walk a Mile that allow employees to spend a day working in other departments or jobs.[30] Once a month, training directors meet to collaborate cross-departmentally to better improve the training programs at Southwest.

Everyone at Southwest has a responsibility for self-improvement and training. Exhibit SA.5 shows the total number of training hours employees spent in 2016. Once a year, all Southwest employees, including all senior management, are required to participate in training programs designed to reinforce shared values. Senior managers receive training in strategic leadership. Southwest has a Management-in-Training program to train employees with a high potential for leadership. This program has more than 20 training sessions over a three-month period. Except for flight training, which is regulated and certified, all training is done on the employee's own time. Nonetheless, the training department operates at full capacity, seven days a week. The fun spirit of Southwest emerges in graduates very early.[31]

EXHIBIT SA.5: Total Number of Employee Training Hours, 2016



Labor Relations

The importance of labor relations cannot be underestimated in a company that is about 83% unionized. Thus, the pay and benefits of most employees are specified through the collective bargaining process. Here again Kelleher's unusual abilities emerged. Somehow, he was able to convince union members and officials to identify with the company and closely tie employee fortunes with the company's. Largely due to Herb Kelleher, the relationship between Southwest and the unions has been generally collaborative, signaling trust and a willingness to compromise. The unions and the firm share the goal of wanting secure long-term commitments. This was evident by the unusually long 10-year contract signed with the pilots in 1995. When the flight attendants' contract negotiations became unusually combative in 2004, Kelleher, who was no longer CEO, stepped in and negotiated a generous contract. Larry Parker, then CEO, quit shortly afterward, and Gary Kelly took the reins of the company.[32]

With Gary Kelly at the helm, Southwest now finds itself in the unusual position of being a pay leader coming into contract negotiations. Southwest's pilots, mechanics, and flight attendants are among the best paid in the industry. This is a result of Southwest's long-term contracts, coupled with many other airlines' employees getting pay cuts through concessions and bankruptcies. Because paying employees more than competitors are paying is reducing Southwest's cost advantages, recent contract negotiations have been more difficult than in the past. For example, in 2016 the pilots union board voted 20-0 to ask Chairman and CEO Gary Kelly be removed, partly because of prolonged contract negotiations. However, eventually a contract was agreed upon that lasts through September 2020. Only time will tell if future contract negotiations will lead to concessions or continued high pay relative to other airlines.[33]

Compensation

Unlike the current situation, Southwest historically has paid its employees at or somewhat below the market in base pay, with plenty of opportunities for above-market pay through a number of different variable pay programs. These included profit sharing and stock purchase plans. Southwest introduced the first profit-sharing plan in the airline industry. Since profits are directly affected by costs, this pay program clearly supports Southwest's low-cost strategy. The program began with a cash component and a portion tied to a retirement account, but it is currently completely tied to a defined contribution plan. This is consistent with Southwest's view of long-term employee relationships. In 2016, Southwest contributed over $930 million to the employees' 401(k) and profit-sharing plans.

Southwest's stock purchase plan allows employees to purchase stock shares from payroll deductions at a discount. The profit-sharing payout can also be invested in Southwest stock. Southwest employees own around 8% of the company's stock. The airline's current stock price is prominently displayed at each Southwest facility to keep employees abreast of the value of their ownership.

Southwest also uses recognition to reward their employees. These awards occur at the local and corporate level. They are clearly supported by top management and are unquestionably tied to Southwest's strategy and culture. There are numerous programs in addition to the Heroes of the Heart, including the President's Award and the Winning Spirit Award. The awards in these programs and others are given to employees who perform at a high level consistent with Southwest's strategy and culture. The awards can come with plaques, monetary payments, photos taken during the awards ceremony, photos of the award winner with the CEO, and mention in the company newsletter. When customers send in letters raving about great service, managers attach a smiley face sticker, frame the letter, and hang it in the office. Each department has an agent of the month award, which can lead to an agent of the quarter award. Agents of the quarter receive plaques and an award luncheon. Employees who demonstrate exemplary service are celebrated in pictures and stories in the corporate newsletter, *Luv Lines*, as well as in the halls of headquarters. Meal vouchers are frequently given for exemplary behaviors as spot awards.[34]

Also noteworthy is that, in an era when chief executive pay has escalated to huge amounts, Southwest's company officers do not get the perks (e.g., cars or club memberships) often enjoyed by their counterparts in comparable organizations, and they even stay in the same hotels as flight crews. Southwest has refused to compete for executive talent based on salary. Like lower-level employees, company executives tend to get salaries below or at the market, but through stock ownership their monetary gains are closely tied to the company's financial future.

Benefits

Southwest provides one of the most attractive benefits packages in the industry to both full-time and part-time employees. Southwest spends more than $2 billion on employee benefits annually, so most are at no cost to the employee. Employees receive medical insurance, dental insurance, vision coverage, life insurance, long-term disability insurance, dependent care, adoption assistance, mental health assistance, and a 401(k) plan. Nine out of ten employees participate in the 401(k) plan. Employees and their families fly free on Southwest and at a discount on other carriers. Then, of course, there are the numerous parties. Another benefit is being part of the so-called Southwest Family. Southwest lets employees know how much they are valued by helping them in times of need, be it with financial assistance or something else. Finally, one of Southwest's most prized benefits is job security. Because Southwest has never had a layoff, employees realize that job security is an important benefit provided by Southwest and few other airlines.[35]

Southwest frequently surveys its employees so that it can offer benefits employees value. Recent improvements to Southwest's benefits package include improved mental health coverage, enhanced coverage for life and disability insurance, and reduced rates for dependent life insurance.[36]

Performance Management

As would be expected, Southwest employees' evaluations are based partly on demonstrating the Southwest Spirit of outrageous customer service. Managers who give an employee superior performance ratings must include documentation of actual examples of exemplary customer service that warranted the rating. However, most performance measures used at Southwest are broader and more cross-functional than a manager's judgment. This motivates cooperation rather than competition, consistent with Southwest's culture. At other airlines, delays are attributed to specific units such as fueling, cleaning, or baggage handling. At Southwest, delays are tied to the entire team or process, reducing blame shifting and encouraging employees to assist with other functions when needed. At most other airlines, the purpose of performance measurement is to provide accountability, frequently in connection with punitive implications. At Southwest, performance measurement is used as a performance management tool to foster cooperation, learning, and improvement.[37]

To promote employee awareness of the effects of their efforts on the company's bottom line, *LUV Lines* reports breakeven volumes per plane. Note that this measure is also a group rather than individual measure. The newsletter also informs employees not only of Southwest's issues, but of competitor news as well. Southwest shares detailed business information every quarter with its employees, under the label of *Knowing the Score*. The financials are explained in simple terms such as how costs have affected net income and the employees' profit sharing. The belief is that informed employees are better equipped to make decisions.

SOUTHWEST AIRLINES PERFORMANCE INDICATORS

Many different criteria can be used to evaluate Southwest's success in achieving its basic objectives. Certainly Southwest's different constituencies look at its performance in different ways. Southwest takes particular pride in the following accomplishments:

- Over 46 years of safe, reliable operations
- Since 1987, consistently at or near the top in fewest customer complaints in the Department of Transportation's Air Travel Consumer Report
- Forty-four years of profitability
- A route system that has grown to over 100 cities in 11 countries, carrying more than 150 million customers on around 730 Boeing 737 aircraft
- A passenger volume consisting of more domestic passengers and departures than any other U.S. airline in 2016
- Southwest Airlines was recognized as #8 on *Fortune's* list of the World's Most Admired Companies in 2016
- Named as one of the top 20 America's Best Employers by *Forbes* in 2016; recognized as one of Glassdoor's Best Places to Work in 2017
- Recognized by *Newsweek* as one of America's Greenest Companies in 2016
- Recognized by *Forbes* magazine as one of the Best Companies for Work-Life Balance

- Voted Most Trusted Brand for Airlines in *Reader's Digest's* 2016 Most Trusted Brands

No issue is more important than safety and security. One needs only to study the checkered history of ValuJet or Air Florida to see what one catastrophic crash can do to an airline when the airline is perceived to have been at fault. Southwest has maintained a strong 44-year safety record and is generally acknowledged to be one of the world's safest airlines.[38]

Customer Service

Of course, Southwest's customers remain one of the company's main constituencies. Despite its no-frills orientation, Southwest consistently receives the highest rankings for customer satisfaction. This is achieved through the successful management of customer expectations. By emphasizing low price and consistency, Southwest has successfully redefined the concept of quality airline service. For example, as previously discussed Southwest has consistently been one of the best airlines with respect to customer service as measured by the Department of Transportation (DOT) Air Travel Consumer Reports. It has frequently been rated as having the highest on-time record, best baggage handling, and fewest customer complaints.

Employee Satisfaction

Given its mission, employee satisfaction is another important indicator of company success. Personnel are a crucial determinant of organizational performance throughout the industry. Southwest's culture and how it treats its employees has consistently made it an employer of choice. Further, Southwest's corporate reputation for being both ethical and socially responsible makes its employees proud to be a member of the Southwest family.

There are many indicators of Southwest's success in satisfying and engaging employees. Consider for example:

- 85% are proud to work for Southwest.
- 83% think Southwest is a good corporate citizen.
- 79% recommend Southwest as a good place to work.
- 79% are satisfied with their jobs.

Further, employee surveys show that overall engagement at Southwest is 78%, more than three times that of the average company.

However, Southwest's employees are not only satisfied; they are productive. Southwest employees are the most productive in the industry. A single agent usually staffs gates, where competitors commonly use two or three. Ground crews are composed of six or fewer employees, about half the number used by other carriers. Despite the lean staffing, planes are turned around in half the time of many rivals. Southwest also has one of the lowest personnel turnover ratios in the industry.

Continued Profitability and Financial Stability

Southwest's high customer service, productive employees, and low-cost strategy have consistently led to profitability and financial stability in an industry that has frequently lost money. In fact, in 2016, Southwest had record profits ($2.2 billion), as well as record revenues ($20.4 billion) and the highest year-end stock price ever. Despite its low-cost structure, Southwest is not able to control all costs. One advantage that larger, broader-scope carriers can enjoy is a relatively limited exposure to fuel price volatility. Their broader scope can allow them to take advantage of geographic differences in fuel prices, but they do not always have the financial resources to hedge against future price increases. Southwest's aggressive fuel hedges has made the difference between being profitable or not for several years. Southwest (like

JetBlue) also has the advantage of a younger and more fuel-efficient fleet than its three major competitors.

Growth

Southwest's steady growth over numerous years is now evident by its current size. It operates nearly 4000 flights a day, and enplanes more than 150 million customers a year to over 100 destinations. It consistently ranks first in market share in the vast majority of its top 100 city-pair markets, and overall has more than two-thirds of the total market share in those markets. Southwest now has nearly 25% market share of the U.S. domestic market. Because of the Southwest Effect, the carrier gains this share by growing the size of each of its markets; this is achieved by means of a fare structure that is on average noticeably lower than that of the majors. Although growth is expected to slow in the next few years, Southwest is still targeting a 7% growth rate by expanding the international and business customer segments.

Successfully integrating AirTran lead to the single largest change in growth in the history of the company. Because of the differences in the culture, strategies, and business model between Southwest and AirTran, successfully integrating AirTran was clearly a great challenge that by all accounts Southwest overcame. However, achieving growth and other strategic goals in the future will also not be easy given the challenges ahead.

THE CHALLENGES AHEAD

Southwest Airlines is no Johnny-come-lately. Its basic strategy of consistent low-cost, no-frills, high-frequency, on-time air transportation with friendly service is a recipe that has been refined over more than 40 years. It has worked for the company in periods of catastrophic losses for the industry as well as in times of abundance. Southwest has been able to compete successfully with both the major airlines and those that have been formed to copy its formula. Nevertheless, there are numerous challenges ahead. As already noted, many of these challenges apply to the industry as a whole. But there are also challenges ahead that are more specific to Southwest, such as expanding the business market and entering the international market.

Expanding the Business Traveler Market

The ratio of business to leisure customers on Southwest is currently about 1 to 2, while it is 1 to 1 on the other U.S. majors. Southwest views business travelers as a growth opportunity, given its relatively small presence and large market share to go after. Also, because high fare paying business customers traveling long distances are very lucrative, increasing that market would substantially increase revenues. However, growing this market requires introducing more long-haul flights, which reduce Southwest's cost advantage and forces it to compete directly with the majors.

Southwest is slowly introducing more long haul flights, many out of Dallas. Southwest had been severely restricted in the locations it could fly to from Love Field, but those restrictions were lifted in 2014. Thus, it can now fly to big business markets like New York and Los Angeles. Business travelers also frequently fly internationally, so entering the international travel market seems to be consistent with growing the business traveler market. [39]

Entering the International Traveler Market

The acquisition of AirTran provided Southwest a means of entering the international traveler market for the first time. AirTran opened up routes to Latin America and the Caribbean, including Mexico, Aruba, Puerto Rico, Jamaica, Bahamas, and the Dominican Republic. Breaking into the international market through Latin America was particularly attractive because they are still relatively short haul flights (known as near-international) and Latin America is one of the world's fastest growing air travel destinations.

Since taking over the AirTran markets, Southwest has expanded its international presence. First by opening a $156 million dollar international terminal at Houston's Hobby airport, and then planning to do the same at Fort Lauderdale, Florida. Southwest's international destinations now also include Cuba, Costa Rica, Grand Cayman, and Turks & Caicos, with plans to serve over 50 cities in Central and South America within the next few years. Many of the benefits Southwest offers to customers such as free baggage and free ticket changes are appealing to the international traveler since currently no other airlines offer these benefits, and their costs on other airlines are substantial. Although international routes currently compose only 2% of Southwest's total capacity, it is expect to rise to over 15% over the next five years.[40]

Controlling Costs

Although controlling costs is an important challenge for all airlines, Southwest's situation is unique. It has been so good at controlling costs for so long that there is less room for cost savings than in other airlines. Southwest's cost advantage due to fuel hedges has been substantially reduced over the past few years. Also, Southwest's commitment to not having layoffs and pay cuts may lead to sustained increases in labor costs compared to other airlines when there is another economic downturn. Of course, one way to offset increased costs is to increase revenue.

Increasing Revenue

Although it does not charge luggage fees or ticket changing fees like almost all other airlines do, Southwest has introduced a number of new services to increase revenue. These include early bird check-in, the pets are welcome on Southwest program, "fly-by" check-in, and in-flight internet.[41]

Southwest is continuing to explore other options to increase revenue. These include, increasing the scope of its cargo services, increasing sales for ancillary services such as hotel rooms, rental cars, and vacation packages on its website, and introducing new charges for incidentals.[42] Many of these options mean further changing the way Southwest has been doing business since its inception. Thus, there is considerable risk in adopting them. Another way to increase revenue is to increase the size of the airline through continued growth, even after the acquisition of AirTran.

Future Growth

The acquisition of AirTran provided dramatic growth quickly, and it also helped position Southwest for future growth. By entering international markets through AirTran routes, Southwest has gained the experience needed to compete and expand these markets. However, future growth in the international markets will depend on maintaining its culture and high quality talent across nations. As companies expand, particularly in size and geographic location, they often find that it becomes increasingly more difficult to maintain the same culture. This will be even more difficult given the new challenge of expanding across different national cultures. No doubt, the leadership will have its hands full in maintaining the culture and the cost levels that have been so critical to Southwest's success.

Competition

During the last several years, the gap between Southwest and the rest of the majors has narrowed as other carriers have attempted to emulate Southwest's formula. Some of the larger traditional airlines have developed lowered-cost short-haul divisions. For example, both United and Delta have introduced an "airline within an airline" to lower costs for short-haul flights. These separate divisions may hire their own pilots and ground support at much lower costs under separate contractual relations with unions. Under these arrangements, pilots can often be employed for less than half the cost of the parent airline.[43] The industry has watched Southwest's tremendous success for over four decades; it's not surprising that a number of competitors have emerged, and will continue to emerge, that try to copy it.

At the same time, Southwest has adopted many of the features that the majors use to support their large networks. As Southwest has grown in scope, it has introduced national advertising, including NFL sponsorship; a frequent flyer program, including a branded credit card; business travel; long-haul flights, and international travel. The carrier's average stage length has increased over the last several years. Southwest has now expanded into geographic markets and climates that are not as compatible with its original fair-weather, low-congestion strategy. Its flights now frequently compete head to head with the other major carriers.

CONCLUSION

This is an exciting time for Southwest Airlines. In the last decade, it has overcome two major shocks to the U.S. Airline industry, the 9/11 terrorist attacks and the great recession. Even in the face of these tremendous obstacles, the company has been able to remain profitable every year. With the acquisition of AirTran, it entered into new territory and emerged as successful as ever. In one quick move it grew substantially and entered numerous new markets, including a segment it had not tapped before, the international market. The successful integration of AirTran has positioned Southwest for continued growth and success, but to do so it must now act more like the other major carriers and tap the business and international markets.[44] The key question is, "Can Southwest continue its success and culture while entering unfamiliar markets?"

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