Southwest Airlines

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Introduction

Although the airline industry is no longer experiencing the rapid growth it exhibited before 1990; commercial air travel in the U.S. remains the preferred method of transportation for a majority of Americans due to cost-effectiveness and timesaving characteristics. From 1980 to 1990 the number of passengers traveling by air increased by approximately 72%, in contrast, in the 1990-1998 period, the airline industry only experienced 36% growth. Furthermore, during 1965-1978, the government regulated the airline industry by forcing artificial wage increases and artificial price levels. In the post-deregulation era, labor negotiations were the cause of many labor strikes. The big carriers have tried to cut costs, but have been constrained by strong union opposition. For example, "Unions have fought against moves to shift unprofitable routes to lower cost regional jets with lower paid pilots." Confronted with cut-throat competition, particularly from low-cost rivals such as Southwest, now America's fourth largest carrier in terms of traffic flown, the big airlines have found themselves caught traditional fare wars that cut into their already slim profit margins. The domestic airline industry in the United States is characterized by intense rivalry and low profit margins. Through product differentiation and a strategy of low cost and no frills, Southwest has been successful in distinguishing itself from its competitors in order to sustain profitability in this aggressive industry.

Industry Analysis

Since the Airline Deregulation Act of 1978, the airline industry has endured a number of years of low profitability. "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."[1] In order to understand the consequences of deregulation, it is important to examine Porter's Five Forces as well as the influence of complements to the airline industry.

Rivalry

The extent to which rivalry exists will influence the overall profitability of the industry. Market concentration remains a significant factor affecting rivalry. In 1989, no

[1] http://www.t-bird.edu

single airline solely dominated the industry, but the eight largest carriers retained a total market share of 92%. Routes, airports, and hubs served by many carriers experienced intense rivalry. Profitable hubs are those set up in high traffic cities with high demand for air travel. In order to gain profits, airlines must beat out the competition by offering as much or more flights with time flexibility to a variety of destinations.

Other factors contributing to rivalry include high fixed costs, excess capacity, low differentiation, price wars, and readily available prices via the Internet. Due to the nature of the industry, high fixed costs are expected. "The airline industry's extremely high fixed costs made it one of the worst net profit margin."[2] Contributions to fixed costs in the airline industry include the costs of planes, fuel, pilots, flight attendants, and additional staff for baggage and customer service. The need to meet government regulations and hire experienced employees can cost an airline company millions of dollars. Another high cost includes high-tech computer systems that are capable of tracking frequent flier miles, differentiating between advance purchase and last-minute purchased tickets, accommodating customer flight changes, and offering an efficient operation schedule of departure and arrival times. To help recover these fixed costs, airlines must maximize their load factor by increasing revenue for passengers per miles. Currently there has been excess capacity on many routes; as a result, airlines have been participating in price wars in order to attract customers at all costs. Minimal differentiation among airlines and switching costs for passengers also magnify rivalry. An example of switching cost is the cost incurred if individuals or corporations change airlines and forgo the benefits of adding frequent flier miles onto previously accumulated miles on another airline. The decision to go with a new airline becomes burdensome since miles between airlines cannot be transferred. Even though the introduction of frequent flier programs was intended to increase customer loyalty, low cost airline strategies have diminished the effectiveness of these membership plans.

Rivalry has also increased greatly due to prices being readily available for comparison through the Internet. For instance, "Delta Air Lines, like most major carriers, distributes about 70% of its tickets through travel agents. Each one of those round-trips

[2] http://www.t-bird.edu

costs the airline $10 in fees," therefore increasing prices for consumers. One of Southwest's strong contributions to profit emerges from accepting online reservations and processing e-ticket for reduced prices by ticket-less travel. Many major carriers are challenging Southwest's online business through building alliances with e-Travel and using travel websites in order to create larger amounts of sales from smaller business or leisure travelers. By 2003, airlines expect a 20% increase in ticket sales by online purchases and sales from online agencies to add another 15% to 20% to the total number of tickets purchased.

Threat of Entry

During the first decade of deregulation, there were many entrants into the airline industry, "22 new airlines had been formed and another 43 entered through 1982"[3]. The wave of new airlines suggested that the airline industry had inefficient economies of scales and could support many new entrants. Even though economists predicted that barriers to entry were low and new firms "could easily deploy airlines and other assets to new routs in response"[4] to demand, later observations suggest however, that there was only room for 8 major carriers. Beginning in 1993, startups were eventually consolidated and incorporated into the major airline companies. "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,"[5] therefore proving that there was little threat of new entrants surviving in the airline industry.

Substitutes

Substitutes to air travel include cars, buses, and trains. The importance of buses and trains as substitutes has declined drastically over time. Switching costs between air travel and its substitutes are fairly low; however, the relevant importance of substitutes will change according to the route, reason for travel and the customer-type. For example, longer journeys, such as traveling across the U.S. or overseas, will depress the use of ground transportation. Traveling for a business trip can encourage flying whereas traveling for a family vacation can encourage driving. Since leisure travelers are more

[3] McAfee, Managerial Economics Course Packet, p. 140
[4] McAfee, Managerial Economics Course Packet, p. 140
[5] http://www.t-bird.edu

price-sensitive than business travelers, they are more likely to utilize substitutes, given that opportunity costs are taken into consideration.

Supplier Bargaining Power

Wage rates, having been the cause of many airline union strikes in the post-deregulation era, prove to contribute to the largest portion of the airline industry's operating expenses. Employee bargaining power will vary according to the type of employee and whether employees are unionized. Pilots have minimal bargaining power due to the fact other pilots are readily available. Airplane manufactures, such as Boeing or Airbus, have high bargaining power due to large switching costs associated with changing airplanes. However, this bargaining power will be smaller for airlines purchasing second-hand aircrafts.

Buyer bargaining Power

The inability of the majority of airline customers to coordinate and organize lessens the power of individual buyers. The extent to which airlines can engage in price discrimination will differ depending on the route and type of customer. Routes heavily flown by multiple airlines increase the availability of substitutes and therefore, are more likely to offer competitive prices. In contrast, flights with farther distances and a limited schedule and hubs, can often be dominated by one or two airlines, which tend to overcharge customers. Corporate discounting, which involves negotiations between corporations and airlines, has been a valuable strategy for larger corporations in lowering airfare and waiver fees. Nevertheless, corporation bargaining power still remains low due to the need for corporations to negotiate well in advance and the fact that discounts depend on airline offers, decisions and demand forecasts.

Complements

A few complements that support the airline industry include hotels and rental cars. Cooperation between airlines, hotels, and rental car companies enable airlines to bundle products in order to provide discounted travel packages. Oftentimes, airline packages are ineffective because customers find that purchasing the items separately provides cheaper rates. Southwest utilizes its computer reservation system in an effective manner by simultaneously displaying appealing schedules and deals/packages, thus allowing customers to secure a bargain while conveniently making reservations directly from their website.

Porter's Five Forces model helps paint a picture of the airline industry. The rivalrous nature of the industry has become obvious through intense price wars, strong supplier bargaining power, and high substitutability between products offered. These factors continually contribute to the industry's struggle to sustain profitability. Though there is little differentiation among major air carriers, we would like to take a look at how Southwest Airline's strategy has allowed it to sustain profitability, "financial success and tremendous growth since its starts as a small regional airline serving only intrastate flights within Texas"[6]. What specific aspect of Southwest's strategy has been successful in helping Southwest differentiate itself from other competitors?

Southwest Airlines

Southwest Airlines is the nation's fourth largest carrier in terms of customer boardings. Southwest began Customer Service on June 18, 1971 with three Boeing 737 aircraft serving three Texas cities - Dallas, Houston, and San Antonio. Southwest has grown immensely since then and now operates over 350 Boeing 737 aircraft all over the United States. With the lowest operating cost structure in the domestic airline industry, Southwest provides primarily short-haul, high frequency, point-to-point, and the lowest and simplest fares. The airline serves 59 airports in 58 cities in 30 states. Southwest also retains one of the best overall Customer Service records. "Southwest's core advantage is that they work more productively, more flexibly and more creatively."[7] 34,000 employees currently work for Southwest, which launches nearly 2,800 flights a day. Southwest Airlines' mission statement is "...dedication to the highest quality of customer service delivered with a sense of warmth, friendliness, individual pride, and company spirit".[8] The main objectives of Southwest's business strategy include focusing on transporting high numbers of passengers on short trips with high frequency, providing low fares, making a strong commitment to its employees and customers, and aggressive marketing

[6] McAfee, Managerial Economics Course Packet, p. 145
[7] Time Magazine, October 20,2002 Issue
[8] www.southwest.com

Southwest's motto to "keep it cheap, and keep it simple," has been a major factor in its success. In contrast to its major competitors, Southwest does not rely on a hub and spoke system, but rather concentrates on frequent point-to-point flights. Southwest offers about 2,700 daily flights to more than 55 cities in 29 states. Short flights, typically lasting an hour or less, and use of each plane for an average of 11 hours per day, three hours above the industry average, enables Southwest to spread its fixed costs over more seats. The airline usually lands at small airports to steer clear of the congestion at competitors' larger hubs. Their focus on point-to-point systems results in more direct routes, reducing connections, delays and overall trip time. As a result, the airline only requires a 55% load factor to break even.

Southwest Airlines' second strategy is to offer their customers low fares. Southwest continues to be the least expensive airline in its market. Even when they tried to match Southwest's cut-rate fares, the large carriers could not do so without incurring substantial losses. There are no frills such as full meals, seating assignments, or baggage transfers. Southwest only offers snacks such as peanuts and drinks on its flights. The elimination of such frills reduces cost as well as airplanes non-productive turnaround time at gates. Its fleet of about 345 aircraft consists only of one type, the Boeing 737, which is more fuel-efficient than the larger airplanes. Keeping just one type of plane also helps reduce training costs of pilots and mechanics, and also requires lower inventory levels of spare parts. In addition, Southwest offers a ticket-less travel system to trim travel agents' commissions and run its own reservation system. Significant portions of customers make reservations through its Web site. "The Online Sales Index, based on self-reported ticket sales data, represents the percentage of tickets sold from a specific airline's Web site for 2001. According to the Jupiter Airline CORE, Southwest is one of top airlines that scored the highest on online sales performance. These airlines are best at moving their customers to the online channel."[9]

[9] http://www.m-travel.com/20531.shtml

Rank	Carrier	Overall Index
1	Southwest sites	100
2	AA.com	78
3	JetBlue sites	76
4	Delta.com	73
5	United sites	70
6	USAirwsays.com	57
7	AirTran.com	48
8	NWA.com	48
9	Alaska Air sites	46
10	Continental	28

Southwest Airline's third strategy is their devotion to their employees and customers. CEO Herb Kelleher has created a culture at Southwest where employees feel like part of an extended family. His charisma and sense of creativity has helped to generate intense employee loyalty. The work force owns 11% of the company, which helps to align their interests with those of the airline.

Dividend Information

Year	Declaration Date	Record Date	Distribution Date	Amount Per Share
2002	7/18	9/4	9/25	.0045
2001	11/15	12/5	1/4	.0045
2000	11/16	12/6	1/3	.0037
1999	11/18	12/8	1/4	.0037
1998	11/19	12/9	1/5	.0033
1997	11/20	12/10	1/6	.0030

Southwest has achieved a team spirit that others can only envy. Southwest is known for providing their employees with tremendous amounts of information that will enable them to better understand the company, its mission, its customers, and its competitors. All employees understand that they must comply with Southwest's concept of never inconveniencing the valued customer. By sticking to its formula of excellent customer service and a positive work environment for employees, Southwest has enjoyed 28 consecutive years of profits.

The airline, nearly 85% unionized, has had only one strike in its history, confirming the notion that Southwest makes it a priority to gain employee satisfaction. In addition, Southwest only laid off three people in 25 years and it immediately rehired them. Thus, labor relations have not been a problem at Southwest. This job security strengthens employees' loyalty to the company. Efficient working practices and low employee turnover help to reduce Southwest's costs, thereby making it much more successful competitively.

Southwest's fourth strategy encompasses their aggressive marketing approach. Through marketing strategies, Southwest Airlines tries to distinguish itself from the rest of the airline industry. The marketing focuses on communicating to the customer that they offer real value while making flying fun. They promote themselves as offering safe, reliable, low-cost fare with outstanding service. Rather than competing with other carriers for existing travelers, Southwest targets a different set of passengers. "Southwest management quickly discovered that there were two types of travelers: convenience, time-oriented travelers, and price-sensitive leisure travelers."[10] Their goal was to cater to both groups.

They were the first airline with a frequent flyer program to give credit for the number of trips taken and not the number of miles flown. They also pioneered senior discounts, Fun Fares, Fun Packs, a same-day airfreight delivery service, ticket-less travel, and many other unique programs. Their commitment to this promise has brought them credibility and the airline industry's best cumulative consumer satisfaction record. Since Southwest offers short flights at low fares, customers normally using cars to travel might see air travel as a more feasible alternative. Southwest, through its distinguished business strategy, has successfully managed to generate customer loyalty, unlike the rest of the airlines where both product differentiation and customer loyalty are low.

[10] http://www.t-bird.edu

Obstacles to Southwest's continuing success

Southwest faces both internal threats to its continuing success, including the loss of Kelleher and losing its strategic direction, as well as external threats, which may include new entrants to the industry. CEO Herb Kelleher, who has announced plans to step down in 2001, has made large contributions to Southwest's highly collaborative corporate culture. Kelleher has played such a key role in building up Southwest, both through his business insight and his excellent interpersonal skills, that his departure would severely damage the company. The airline may also threaten its own success if it decides to change its strategic direction, an example of this being expansion into long-haul routes (elaboration below).

An external threat results when new entrants choose to operate on the same principles as Southwest. Although Southwest has a strong customer base and is geographically diverse, it could still be challenged on some of its routes by smaller upstarts. "34 start-up airlines formed between 1978 and 1992 were successful, with success defined as surviving ten years or longer without bankruptcy."[11] At times Southwest has been able to respond to such competition with nationwide fare promotions, but it must realize that this may not always be effective. Despite its prolonged success, Southwest should always be prepared to face new challenges that may arise among Southwest imitators.

Should Southwest begin flying longer routes?

In 1994, as a response to "Shuttle by United", Southwest threatened to invade United's long haul routes. This retaliatory measure does not make much sense for Southwest. Since Southwest enjoyed great success in short-haul routes, it might be tempted to venture into long-haul ones. In making business decisions, though, Southwest should remember its core strategy of excluding frills and maintaining a low cost structure.

Long haul services would threaten Southwest's current low-cost strategy in a number of ways. Passengers on long-haul flights would probably demand a full meal, consequently raising Southwest's costs and turnaround times. Long-haul flights would increase Southwest's fuel consumption, thereby increasing refueling times. Average

[11] http://www.t-bird.edu/pdf/about_us/a07020009.pdf

flight lengths would rise, so the number of daily flights would fall, thus reducing the number of seats over which to spread fixed costs. Southwest might also find it more economical to use larger planes for its long-haul routes, but this would conflict with its “keep it simple” strategy of using only 737s.

In terms of product differentiation, Southwest would suffer a loss of individuality, for example by serving full meals and having slower turnaround times. Southwest currently sees many of its potential customers as automobile drivers, however this customer base would diminish as journey lengths increased. As a result, rivalry between Southwest and the existing long-haul players would become more intense. A significant danger that might emerge as a result of pursuing long-haul routes is the retaliation of established carriers against Southwest’s penetration into their customer market, resulting in damaging price wars.

Conclusion

Southwest offers a low cost, friendly and simple service that distinguishes itself from its competitors and will allow it to sustain profitability in the airline industry. Southwest has been able to a build a loyal customer base with its genuine customer service and its employee's love of their job. Southwest always remembers that in order to succeed in an industry, it is often not the case of having a strategy of "doing it better", but rather one of "doing it differently." "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." Since its initiation, Southwest has managed to grow in a controlled fashion by adding only a few new cities each year. Southwest has proven itself to be successful and we believe it will continue to be profitable as long as it never ceases to offer customers efficient and low cost air transportation. With continuous aggressive promotion and strong commitment, Southwest will remain the preferred airline for providing low fares.