Case

Southwest Airlines

In late January 1995, Dave Ridley, vice president—marketing and sales at Southwest Airlines, was preparing to join Joyce Rogge, vice president—advertising and promotion, Keith Taylor, vice president—revenue management, and Pete McGlade, vice president—schedule planning, for their weekly "Tuesday meeting." The purpose of this regularly scheduled meeting was to exchange ideas, keep one another informed about external and internal developments pertaining to their areas of responsibility, and coordinate pricing and marketing activities. This informal gathering promoted communication among functional areas and fostered the team spirit that is an integral part of the Southwest corporate culture.

A recurrent "Tuesday meeting" topic during the past six months had been the changing competitive landscape for Southwest evident in the "Continental Lite" and "Shuttle By United" initiatives undertaken by Continental Airlines and United Airlines, respectively. Both initiatives represented targeted efforts by major carriers to match Southwest's price *and* service offering—a strategy that no major carrier had successfully implemented in the past. In early January 1995, Continental's effort was being scaled back due to operational difficulties and resulting financial losses.[1] However, United's initiative remained in effect. Launched on October 1, 1994, "Shuttle By United" was serving 14 routes in California and adjacent states by mid-January 1995, nine of which were in direct competition with Southwest. When "Shuttle By United" was announced, United's CEO predicted: "We're going to match them (Southwest) on price and exceed them on service."[2] In response to United's initiative, Southwest's chair Herb Kelleher said, the "United Shuttle is like an intercontinental ballistic missile targeted directly at Southwest."

Just as the meeting began, a staff member rushed in to tell the group that United had just made two changes in its "Shuttle By United" service and pricing. First, its service for the Oakland–Ontario, California, market would be discontinued effective April 2, 1995. This market had been among the most hotly contested routes among the nine where United and Southwest competed head-to-head and

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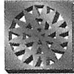
[1] Bridget O'Brian, "Continental's CALite Hits Some Turbulence in Battling Southwest," *Wall Street Journal* (January 10, 1995): A1, A5.

[2] Quoted in Jon Proctor, "Everyone Versus Southwest," *AIRWAYS Magazine* (November/December 1994): 6–13.

The cooperation of Southwest Airlines in the preparation of this case is gratefully acknowledged. This case was prepared by Professor Roger A. Kerin, of the Edwin L. Cox School of Business, Southern Methodist University, as a basis for class discussion and is not designed to illustrate effective or ineffective handling of an administrative situation. Certain information is disguised and not useful for research purposes. Copyright © 1996 by Roger A. Kerin. No part of this case may be reproduced without written permission of the copyright holder.

Southwest had lost market share on this route since October 1994. one-way walk-up first class and coach fare on all 14 "Shuttle By United" had just been increased by $10. "Shuttle By United" had Southwest's fare on the nine competitive routes and, as of mid-January been increasing the number of flights on these routes and the they did not compete.

Changes in United's pricing and service for its shuttle Southwest executives by surprise. The original agenda for the was immediately set aside. Attention focused on (1) what to make of pected developments and (2) how Southwest might respond "Shuttle By United" initiatives.



THE U.S. PASSENGER AIRLINE INDUSTRY

The U.S. Department of Transportation classified U.S. passenger three categories on the basis of annual revenue.[3] A "major carrier" with more than $1 billion in annual revenue. A "national carrier" revenues between $100 million and $1 billion, and a "regional airline" had annual revenues less than $100 million. Major carriers for more than 95 percent of domestic passengers carried in 1994. American Airlines, Continental Airlines, Delta Airlines, Northwest United Airlines—accounted for over 80 percent of all major carrier senger traffic. Exhibit 1 shows major air carrier estimated in the United States.

Industry Background

The status of the U.S. passenger airline industry in early 199 to 1978. Prior to 1978, and for 40 years, the U.S. airline industry by the federal government through the Civil Aeronautics Board regulated airline fares, routes, and company mergers, and required before any changes in fares or route systems

EXHIBIT 1 Estimated Market Shares for Major U.S. Carriers in 1994 Based on Revenue Passenger Miles Flown

Carrier	*Market Share (%)*	*Carrier*
1. United Airlines	22.1	6. USAir
2. American Airlines	20.2	7. Trans World Airlines
3. Delta Airlines	17.6	8. Southwest Airlines
4. Northwest Airlines	11.8	9. America West Airlines
5. Continental Airlines	8.5	

Source: Southwest Airlines company records. Figures rounded.

[3] This section is based on information provided in *FAA Aviation Forecasts* U.S. Department of Transportation, March 1995): *Standard & Poor's Industry* Standard & Poor's, January 1995); *U.S. Industrial Outlook* 1995 (Washington of Commerce, January 1995); Timothy K. Smith, "Why Air Travel Doesn't Work," 1995):42–56; and Jon Proctor, "Everyone Versus Southwest," *AIRWAYS* December 1994):6–13.

capacity, the CAB assured that individual airlines were awarded highly profitable and semi-exclusive routes necessary to subsidize less profitable routes, which they were also assigned in the public interest. Price competition was suppressed, airline cost increases were routinely passed along to passengers, and the CAB allowed airlines to earn a reasonable rate of return on their investments. In 1978, the Airline Deregulation Act was passed. This act allowed airlines to set their own fares and enter or exit routes without CAB approvals. Jurisdiction for mergers was first transferred to the U.S. Department of Transportation and subsequently assigned to the U.S. Justice Department in 1988. The CAB was dissolved in 1985.

Deregulation and a Decade of Transition Public policy makers and industry analysts expected that deregulation would proceed in an orderly manner with multiple existing major carriers serving previously semi-exclusive routes, bringing about healthy price competition. However, the carriers responded to deregulation with unexpected changes in their operations that would have long-term effects on the industry.

Two changes in particular were noteworthy. First, major carriers turned their attention to serving nonstop "long-haul" routes anchored by densely populated metropolitan areas or city-pairs which had been highly profitable in a regulated environment. This meant that longer routes such as New York to Los Angeles and Chicago to Dallas were favored over "short-haul" routes between smaller city pairs such as Baltimore and Newark, New Jersey. As major carriers pruned or reduced service on these short-haul routes, existing regional carriers and new airlines filled the void. In 1978, the United States had 36 domestic carriers; by 1985 the number had grown to 100. Second, major carriers almost uniformly abandoned point-to-point route systems and adopted the hub-and-spoke route system. Point-to-point systems involved nonstop flights between city-pairs and often "shuttle" flights back and forth between city-pairs. The hub-and-spoke system featured "feeder flights" from outlying cities to a central hub city, where passengers would either continue their trip on the same plane or transfer to another plane operated by the same carrier to continue to their final destination. The key to this route system was to schedule numerous feeder flights into the hub airport to coincide with the more profitable long hauls, with each spoke adding passengers to the larger aircraft flying these longer distances. Potential increased revenue and some cost economies from flying more passengers longer distances, however, were offset by increased costs resulting from reduced utilization of aircraft as they waited to collect passengers, the capital investment in hub facilities, and the need for a larger ground staff.

Competition to survive and succeed intensified in the airline industry immediately following deregulation. Newly formed airlines and regional carriers, which had been permitted to serve only regional markets in a regulated environment, expanded both the number and length of their routes. These carriers typically retained the point-to-point route system, which was more economical to operate than hubs. Absent the higher costs associated with the hub-and-spoke system, and with lower debt than older major carriers had assumed during the regulation era, these carriers had an immediate cost advantage. This advantage resulted in lower fares on both short- and long-haul routes. Price competition quickly erupted as all airlines scrambled to fill their seats. Price competition lowered the average fares paid on the formerly profitable long-haul routes serviced by major carriers while their operating costs remained high. The profit squeeze caused major carriers to cut their schedules and further reduce the number of short-haul routes.

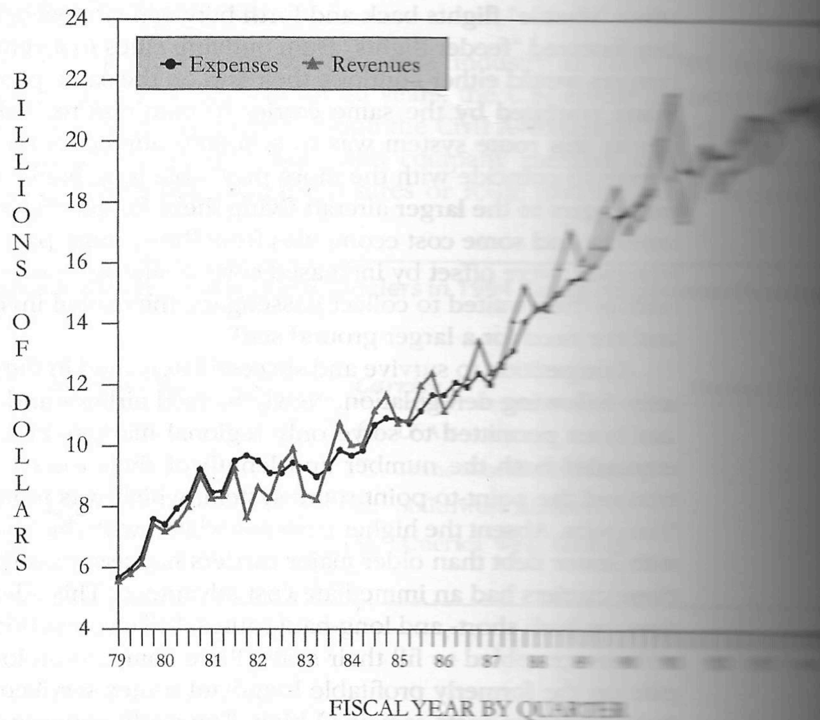
Within five years after deregulation, the major carriers found themselves in a price-cost predicament best described by a senior airline executive: "Either we don't match (fares) and we lose customers, or we match and then because our

costs are so high, we lose buckets of money."[4] This situation
the remainder of the 1980s as a price war of attrition was waged
ing in a flurry of acquisitions by major carriers. Noteworthy
Ozark Airlines by Trans World Airlines (TWA), Western
Republic Airlines by Northwest in 1986. In 1987, AMR
company), acquired Air California and USAir acquired Pacific

Financial Calamity in the Early 1990s Acquisition
led industry analysts to believe the U.S. airline industry
an oligopoly with a few carriers capturing a disproportionate
traffic. By the late 1980s, eight airlines controlled 91 percent
their financial condition was fragile due to a decade of

Carrier bankruptcy and collapse marked the early 1990s
a doubling of fuel prices during the Gulf War in 1991,
industry. The U.S. airline industry recorded a cumulative
from 1990 through 1993. (See Exhibit 2, which plots U.S.
revenues and expenses for fiscal years 1979 to 1994.) Between
Pan American Airlines (Pan Am), Continental Airlines,
Midway Airlines (a national carrier), Eastern Airlines, and TWA
tection under Chapter 11 of the U.S. Bankruptcy Code.
Midway ceased operations in 1991. Continental and TWA
ruptcy in 1993 as did America West in late 1994, and the
recorded a modest operating profit in the 1994 fiscal year.
financial and operating statistics for major U.S. carriers.

EXHIBIT 2 **U.S. Air Carrier Operating Revenues and**



Source: U.S. Department of Transportation.

[4] William M. Carley, "Rough Flying: Some Major Airlines Are
ers," *Wall Street Journal* (October 12, 1983):23.

EXHIBIT [illegible] [illegible] Financial and Operating Statistics for Major Carriers in the United States

	American Airlines (AMR)	America West Airlines	Continental Airlines	Delta Airlines	Northwest Airlines	Southwest Airlines	Trans World Airlines	United Airlines (UAL)	USAir
Financial Data ($ millions)									
Operating revenue	$14,895	$1,409	$5,670	$12,062	$8,343	$2,592	$3,408	$13,950	$6,997
Passenger	13,616	1,320	5,036	11,197	7,028	2,498	2,876	12,295	6,358
Freight/other	1,279	89	634	865	1,315	94	532	1,655	639
Operating expenses[a]	$14,309	$1,319	$5,921	$12,151	$7,879	$2,275	$3,883	$13,801	$7,773
Operating income	$586	$90	$(251)	$(89)	$464	$317	$(475)	$149	$(776)
Other income (expense)	$(593)	$2	$(399)	$(325)	$52	$(17)	$39	$22	$91
Net income before tax	$(7)	$92	$(650)	$(414)	$516	$300	$(436)	$171	$(685)
Operating Statistics									
Available seat miles (millions)	157,047[e]	18,060	65,861[f]	130,198	85,016	32,124	39,191	152,193	61,540
Revenue passenger miles (millions)	101,382	12,233	31,588	86,296	57,872	21,611	24,906	108,299	37,941
Load factor (%)	64.6	67.7	63.1	66.3	68.1	67.3	63.5	71.2	61.3
Yield (¢)[b]	13.40	10.79	11.44	12.97	12.14	11.56	11.31	11.35	16.76
Cost per available seat mile (¢)[c]	9.11	7.30	7.86	9.33	9.26	7.08	9.91	9.06	12.63
Labor productivity[d]	1,739	1,695	1,668	1,915	1,968	2,019	1,502	2,125	1,451

Operating expenses include interest expense.
Passenger revenue per revenue passenger mile.
Operating expenses including interest expense per available seat mile.
Thousands of available seat miles per employee.
Includes the American Eagle commuter airline and transportation business only.
Continental Airlines operating statistics are for jet operations only.
urce: Company annual reports. Data and calculations (all rounded) are useful for case analysis but not for research purposes. Revenue, expense, and operating statistics also clude international operations.

	Airlines (AMR)	West Airlines	Continental Airlines	Delta Airlines	Northwest Airlines	Airlines	Airlines	(UAL)	USAir
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Labor productivity[d]	1,739	1,695	1,668	1,915	1,968	2,019	1,502	2,125	1,451

[a] Operating expenses include interest expense.

[b] Passenger revenue per revenue passenger mile.

[c] Operating expenses including interest expense per available seat mile.

[d] Thousands of available seat miles per employee.

[e] Includes the American Eagle commuter airline and transportation business only.

[f] Continental Airlines operating statistics are for jet operations only.

Source: Company annual reports. Data and calculations (all rounded) are useful for case analysis but not for research purposes. Revenue, expense, and operating statistics also include international operations.

As existing airlines collapsed, new airlines were formed. The maj new carriers, such as ValuJet, Reno Air, and Kiwi International Airlines, tioned themselves as "low-fare, low-frill" airlines. Benefiting from a cheap ply of aircraft grounded by major carriers from 1989 to 1993, the availabili furloughed airline personnel, and cost economies of point-to-point route tems, these new entrants had cost structures that were again significantly be most major carriers. For example, Kiwi was started by former Eastern and Am personnel and was largely funded by its employees (pilots paid $5 each to get jobs; other employees paid $5,000). These new "low-fare, low- carriers reported combined revenues of about $1.4 billion in 1994 comp with $450 million in 1992. Although accounting for a small percentage of dustry revenue, their pricing practices depressed fares on a growing numbe routes also served by major carriers. In 1994, 92 percent of airline passen bought their tickets at a discount, paying on average just 35 percent of posted full fare.

Industry Economics and Carrier Performance

The financial performance of individual carriers and the U.S. airline industr a whole could be attributed, in part, to the underlying economics of air tr The majority of a carrier's costs (e.g., labor, fuel, facilities, planes) were fi regardless of the numbers of passengers served. The largest single cost to a rier was people (salaries, wages, and benefits) followed by fuel. These two sources represented almost one-half of an airline's costs and were relatively f at a particular level of operating capacity. Fuel costs were uncontrollable the industry had been periodically buffeted with skyrocketing fuel prices, recently during the Gulf War in 1991. Fuel cost was expected to increas 4.3 cents per gallon in late 1995 based on a tax imposed by the Revenue Re ciliation Act of 1993. Industry observers estimated that this tax would cos U.S. airline industry an additional $500 million annually in fuel expense.

Labor cost, by comparison, was a controllable expense within limits. more than 100,000 airline workers lost their jobs between 1989 and 1994. Re efforts by major carriers to reduce labor cost included United Airlines, w completed an employee buyout of 55 percent of the company in exchange $4.9 billion in labor concessions in the summer of 1994. In the spring of 1 Delta Airlines announced a three-year plan to reduce operating expense $2 billion, which would involve 12,000 to 15,000 jobs being eliminated.

Carrier Operating Performance Whereas the majority of a carrier's were fixed at a particular capacity level regardless of the number of passen carried, a carrier's passenger revenues were linked to the number of passen carried and the fare paid for a seat at a particular passenger capacity level. A rier's passenger capacity is measured by the available seat miles (ASMs) i transport given its airplane fleet, flight scheduling, and route length. An AS defined as one seat flown one mile whether the seat is occupied by a passe or is empty. Carrier productivity is typically tracked by dividing a carrier's operating cost by available seat miles. Carrier utilization is measured by is termed a load factor. Load factor is computed by dividing a carrier's rev passenger miles (RPMs) by its available seat miles. An RPM is defined as seat flown one mile with a passenger in it and is a measure of a carrier's tr Yield is the measure of a carrier's passenger revenue-producing ability and pressed as an average dollar amount received for flying one passenger one Yield is calculated by dividing passenger revenue by revenue passenger mil

The following expression shows how yield, load factor, and cost combine to determine the profitability of passenger operations for individual carriers, routes, and the industry:

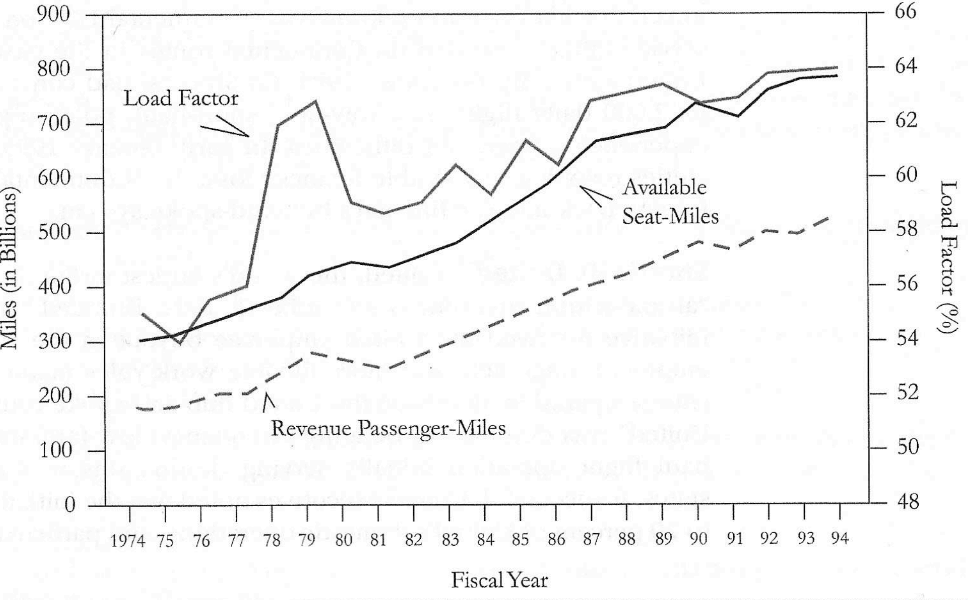
$$\text{Operating income} = (\text{yield} \times \text{load factor}) - \text{cost, or}$$

$$\frac{\text{Operating income}}{\text{ASM}} = \left(\frac{\text{passenger revenue}}{\text{RPM}} \times \frac{\text{RPM}}{\text{ASM}}\right) - \frac{\text{operating cost}}{\text{ASM}}$$

By setting operating income to zero and monitoring yield and cost, individual carriers frequently computed a break-even load factor for passenger operations which was continually compared with actual load factors. Actual load factors higher than the break-even load factor produced an operating income for passenger operations; actual load factors below a break-even load factor resulted in an operating loss.

Industry Trends Exhibit 4 charts available seat miles, revenue passenger miles, and load factors for all FAA certified airlines for the 1974 fiscal year through the 1994 fiscal year. While revenue passenger miles and available seat miles for the industry have shown an upward trend, load factor fluctuated due to periodic imbalances between industry capacity and passenger demand. For example, domestic airline capacity (ASMs) increased by only 1.6 percent in fiscal year 1994 while revenue passenger miles increased 6.5 percent, producing a load factor of 64.3 percent. This figure represented the highest industry load factor ever achieved on domestic routes. Domestic passenger yields evidenced a long-term downward trend for 25 years in real (adjusted for inflation) dollars. In terms of real yield (discounting fares for inflation), fares in the years 1969 to 1971 produced an average yield of 21.4 cents in 1994 dollars. By 1994, the average industry yield was 12.73 cents.

EXHIBIT 4 Available Seat Miles, Revenue Passenger Miles, and Load Factors for All Certified U.S. Airlines, 1974–1994 Fiscal Years



Source: U.S. Department of Transportation.

485

e to
es,

st per available seat mile also exhibited a downward trend since
te periodic fluctuations in fuel prices. Nevertheless, labor cost reductions
productivity improvements coupled with the gradual addition of more fuel-
icient and lower cost maintenance planes by major carriers had not kept pace
vith the declining yields in the industry. Efforts by major carriers to reduce labor
cost, described earlier, reflected the continuing attention to reducing the cost per
available seat mile.

The Airline-Within-an-Airline Concept

Only Southwest Airlines, among the major carriers, appeared able to effectively navigate the economics of air travel and avoid the financial calamity that had befallen the airline industry in the early 1990s. Operating primarily short-haul, point-to-point routes, with minimal amenities, and able to make a fast turnaround of its aircraft between flights, Southwest had much lower operating costs than other major carriers. Lower operating costs were passed on to customers in the form of consistently low fares. From 1990 through 1994, Southwest more than doubled its operating revenues and almost quadrupled its operating income. Its operating practices and financial performance prompted a 1993 U.S. Department of Transportation study to conclude: "The dramatic growth of Southwest has become the principal driving force in changes occurring in the airline industry . . . . As Southwest continues to expand, other airlines will be forced to develop low-cost service in short-haul markets."[5]

With Southwest's operating practices as a blueprint, several major carriers had already explored ways to implement a low-cost airline service in short-haul markets and produce a "clone" of Southwest. An outcome of this effort was the "airline-within-an-airline" concept. This concept involved operating a point-to-point, low-fare, short-haul, route system alongside a major carrier's hub-and-spoke route system.

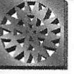
Continental Lite Continental was the first major carrier to implement the concept. Having just emerged from bankruptcy with lower operating costs and armed with a preponderance of consumer research showing that 75 percent of customers choose an airline on the basis of flight schedule and price, Continental unveiled what came to be known as "Continental Lite" on October 1, 1993. The service initially focused on Continental routes in the eastern and southeastern United States. By December 1994, Continental had converted about one-half of its 2,000 daily flights into low-fare, short-haul, point-to-point service, but was experiencing operating difficulties. In early January 1995, with operating difficulties resulting in a sizable financial loss, the "Continental Lite" initiative began folding back into Continental's hub-and-spoke system.

Shuttle By United United, the world's largest airline in 1994, inaugurated its "airline-within-an-airline" on October 1, 1994. Branded "Shuttle By United," the initiative followed the United employee buyout in the summer of 1994 when employee wage cuts and more flexible work rules made possible a lower-cost shuttle operation alongside the United hub-and-spoke route system. "Shuttle By United" was designed to be a high-frequency, low-fare, minimal amenity, short-haul flight operation initially serving destinations in California and adjacent states. If successful, United executives noted that the initiative could be expanded to 20 percent of United's domestic operations, and particularly to areas where the

[5] U.S. Department of Transportation press release, May 11, 1993.

airline had a significant presence. One such area was the Midwest, where United operated a large hub-and-spoke system out of Chicago's O'Hare Airport.

Beginning with 8 routes, 6 of which involved United's San Francisco hub, "Shuttle By United" expanded to 14 routes by January 1995. Eight of the 14 routes involved point-to-point routes separate and apart from United's San Francisco hub. Nine of the routes competed directly with Southwest. In early December 1994, United executives reported that the initiative was exceeding expectations and some routes were profitable. "The Shuttle is working well," said its president, A. B. "Sky" Magary.[6]



SOUTHWEST AIRLINES

Southwest Airlines was the eighth largest airline in the United States in 1994 based on the number of revenue passenger miles flown. Southwest recorded net income of $179.3 million on total operating revenue of $2.6 billion in 1994, thus marking 22 consecutive years of profitable operations—a feat unmatched in the U.S. airline industry over the past two decades. According to Southwest's chair, president, CEO, and cofounder, Herb Kelleher, Southwest's success formula could be succinctly described as, "Better quality plus lesser price equals value, plus spiritual attitude of our employees equals unbeatable."

The Southwest Model

Southwest began scheduled service on June 18, 1971, as a short-haul, point-to-point, low-fare, high-frequency airline committed to exceptional customer service. Beginning with three Boeing 737 aircraft serving three Texas cities—Dallas, Houston, and San Antonio—Southwest presently operates 199 Boeing 737 aircraft and provides service to 44 cities primarily in the midwestern, southwestern, and western regions of the United States. Fifty-nine percent of Southwest's capacity, measured in available seat miles flown, was deployed in the western United States, 22 percent in the Southwest (Texas, Oklahoma, Arkansas, and Louisiana), and 19 percent in the Midwest. Exhibit 5 on page 488 shows the Southwest route map in early 1995.

Except for the acquisitions of Muse Air in 1985 and Morris Air in 1993, Southwest's management has steadfastly insisted on growing internally and refining and replicating what came to be known as the "Southwest Model" in the airline industry. This model was a mixture of a relentless attention to customer service and operations, creative marketing, and Southwest's commitment to its people. A healthy dose of fun was added for good measure.

Customer Service Southwest's attention to customer service was embodied in the attitudes of its people. According to Kelleher:

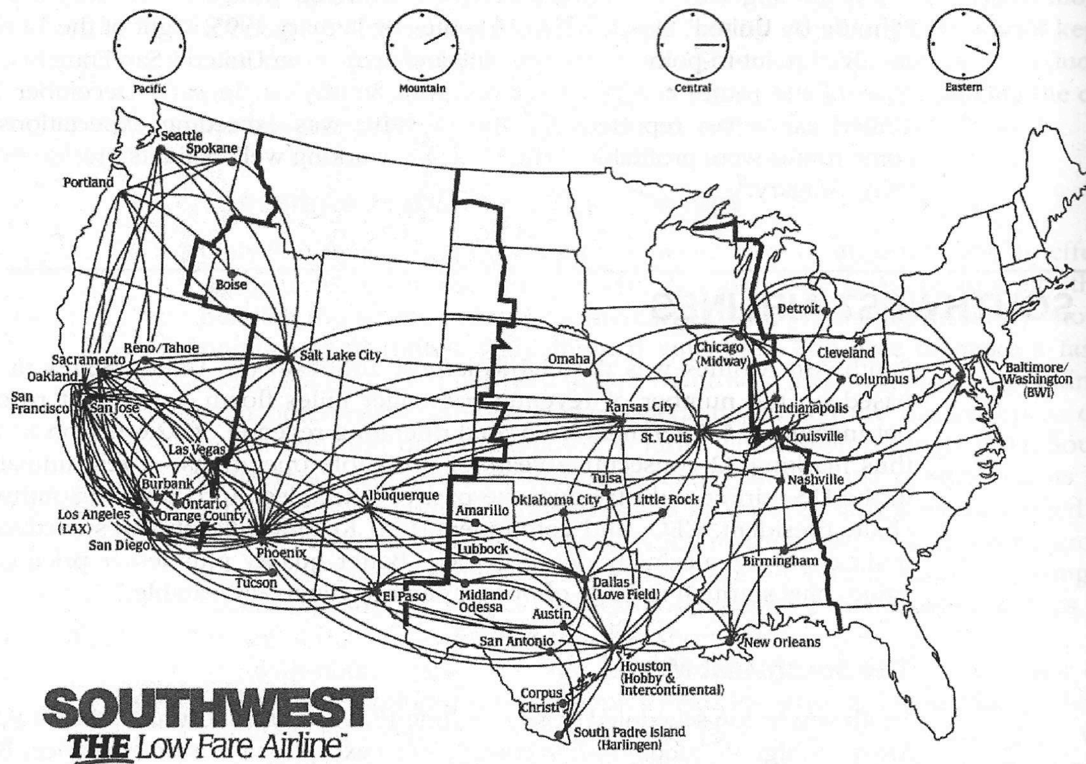
> What we are looking for, first and foremost, is a sense of humor. Then we are looking for people who have to excel to satisfy themselves and who work well in a collegial environment. We don't care that much about education and expertise, because we can train people to do whatever they have to do. We hire attitudes.[7]

A sense of humor, compassion for passengers and fellow workers, a desire to work, and a positive outlook manifested themselves in customer service at

[6] Quoted in Michael J. McCarty, "New Shuttle Incites a War Between Old Rivals," *Wall Street Journal* (December 1, 1994):B1, B5.

[7] Quoted in Kenneth Labich, "Is Herb Kelleher America's Best CEO?" *Fortune* (May 2, 1994):28–35.

EXHIBIT 5 Southwest Airlines Route Map in Early 1995



Source: Courtesy of Southwest Airlines.

Southwest. Pilots could be found assisting at a boarding gate; ticket agents could be seen handling baggage. So important was the attention to customer service that Southwest chronicled legendary achievements in an internal publication titled *The BOOK on Service: What Positively Outrageous Service Looks Like at Southwest Airlines*.

The Southwest focus on customer service also produced tangible results. In 1994, Southwest won the annual unofficial "triple crown" of the airline industry for the third consecutive year by ranking first among major carriers in the areas of on-time performance, baggage handling, and overall customer satisfaction (see Exhibit 6). No other airline had ever won the "triple crown" for even a single month.

Operations Southwest dedicated its efforts to delivering a short-haul, low-fare, point-to-point, high-frequency service to airline passengers. As a short-haul carrier with a point-to-point route system, it focused on local, not through or connecting, traffic that was common among carriers using a hub-and-spoke system. As a result, approximately 80 percent of its passengers flew nonstop. In 1994, the average passenger trip length was 506 miles and the average flight time was slightly over one hour. From its inception, Southwest executives recognized that flight schedules and frequency were important considerations for the short-haul traveler. This meant that Southwest aircraft had to "turn" quickly to maximize time in the air and minimize time on the ground. Turn referred to the elapsed time from the moment a plane arrived at the gate to the moment

EXHIBIT 6 U.S. Department of Transportation Rankings of Major Air Carriers for 1994 by On-Time Performance, Baggage Handling, and Customer Satisfaction

On-Time Performance		*Baggage Handling*		*Customer Satisfaction*	
Southwest	1	Southwest	1	Southwest	1
Northwest	2	America West	2	Delta	2
Alaska	3	American	3	Alaska	3
United	4	Delta	4	Northwest	4
American	5	Alaska	5	American	5
America West	6	United	6	United	6
Delta	7	TWA	7	USAir	7
TWA	8	USAir	8	America West	8
USAir	9	Northwest	9	TWA	9
Continental	10	Continental	10	Continental	10

Source: U.S. Department of Transportation.

when it was "pushed back," indicating the beginning of another flight.[8] More than half of Southwest's planes were turned in 15 minutes or less while the remainder were scheduled to turn in 20 minutes. The U.S. airline industry turn time averaged around 55 minutes. A result of this difference was that Southwest planes made about 10 flights per day, which was more than twice the industry average.

Southwest's operations differed from major carriers in other important ways. First, Southwest generally avoided major airline hubs in large cities. Instead, airports in smaller cities or less congested airports in larger cities were served. Midway Airport in Chicago, Illinois, and Love Field in Dallas, Texas, were examples of less congested airports in larger cities from which Southwest operated. Less congestion meant Southwest flights experienced less aircraft taxi time and less airport circling while awaiting landing permission. The practice of using secondary rather than hub airports also meant that Southwest did not transfer passenger baggage to other major airlines. In fact, Southwest did not coordinate baggage transfers with other airlines even in the few hub airports it served, such as Los Angeles International Airport (LAX).

Second, Southwest stood apart from other major carriers in terms of booking reservations and providing seat assignments. Rather than making reservations through computerized reservations systems, passengers and travel agents alike had to call Southwest. As a result, fewer than one-half of Southwest's seats were booked by travel agents. (Most airlines rely on travel agents to write up to 90 percent of their tickets.) Savings on travel agent commissions to Southwest amounted to about $30 million per year. Also, contrary to other major airlines, Southwest did not offer seat assignments. As Kelleher said, "We still reserve your seat. We just don't tell you whether it's 2C or 38B!" Instead, reusable, numbered boarding passes identified passengers and determined boarding priority. The

[8] Numerous activities occurred during a turn's elapsed time. Passengers got on and off the plane and baggage was loaded and unloaded. The cabin and lavatories were tidied and the plane was refueled, inspected, and provisioned with snacks and beverages.

first 30 passengers checked in at the gate board first, then a second group of 30 (31–60) boarded, and so forth.

Third, only beverages and snacks were served on Southwest flights. The principal snack was peanuts, and 64 million bags of peanuts were served in 1994. Cookies were offered on longer flights.

Finally, Southwest flew only Boeing 737 jets in an all-coach configuration since no fare classes (first class, economy, business, etc.) existed. This practice differed from other major carriers, which flew a variety of jet aircraft made by Airbus Industries, Boeing, and McDonnell Douglas, and reduced aircraft maintenance costs. Southwest's fleet was among the youngest of the major airlines at 7.6 years and had 25 new Boeing 737 aircraft scheduled for delivery in 1995. In 1994, less than 1 percent of Southwest flights were canceled or delayed due to mechanical incidents and Southwest was consistently ranked among the world's safest air carriers.

The combined effect of Southwest's operations was apparent in its cost structure. In 1994, Southwest's 7.08-cent cost per available seat mile was the lowest among major U.S. carriers.

Marketing Creative marketing was used to differentiate Southwest from other airlines since its beginning. As Kelleher put it, "We defined a personality as well as a market niche. [We seek to] amuse, surprise and entertain."

Southwest's marketing orientation was intertwined with its customer and operations orientation. In this regard, service, convenience, and price represented three pillars of Southwest's marketing effort. As with customer service and operations, Southwest's unique twist on marketing set it apart from other airlines. In the domain of pricing, for example, Southwest had always viewed the automobile as its primary competitor, not other airlines. According to Colleen Barrett, Southwest's executive vice president with responsibility for customers: "We've always seen our competition as the car. We've got to offer better, more convenient service at a price that makes it worthwhile to leave your car at home and fly with us instead." In 1994, Southwest's average passenger fare was $58.44. Marketing communications continually conveyed the benefits to customers of flying Southwest. Advertising campaigns over the past 24 years featured Southwest service in "The Love Airline" campaign, convenience in "The Company Plane" campaign, and most recently, low price in "*The* Low Fare Airline" campaign (see Exhibit 7).

Southwest offered a frequent flyer program called "The Company Club," but again with a difference. Consistent with its focus on flight frequency and short-hauls, passengers received a free ticket to any city Southwest served with 8 round-trips completed within 12 months. For 50 round-trips in a 12-month period, Southwest provided a companion pass valid for one year. Having no mileage or other qualifying airlines to track, the costs of "The Company Club" were minimal compared with other frequent flyer programs and rewarded the truly frequent traveler.

Southwest also flew uniquely painted planes that signified places on its route structure. Planes were painted to look like Shamu the Killer Whale to highlight Southwest's relationship with both Sea World of California and Texas. Other planes were painted to look like the Texas state flag and called "The Lone Star Over Texas," while others, such as "Arizona One," featured the Arizona state flag (see Exhibit 8 on page 492).

People Commitment The bond between Southwest and its workers was generally regarded by the company as the most important element in the Southwest

EXHIBIT 7 Representative Southwest Airlines Print Advertising Campaign

WHEN YOU WANT A LOW FARE, LOOK TO THE AIRLINE THAT OTHER AIRLINES LOOK TO.

Call your travel agent or 1-800-I-FLY-SWA

Source: Courtesy of Southwest Airlines.

model. Herb Kelleher referred to this bond as "a patina of spirituality." He added:

> I feel that you have to be with your employees through all their difficulties, that you have to be interested in them personally. They may be disappointed in their country. Even their family might not be working out the way they wish it would. But I want them to know that Southwest will always be there for them.[9]

[9] Quoted in Kenneth Labich, "Is Herb Kelleher America's Best CEO?" *Fortune* (May 2, 1994):28–35.

EXHIBIT 8 Southwest Airlines Aircraft

Source: Courtesy of Southwest Airlines.

The close relationship among all Southwest employees contributed to South-west's recent listing as one of the top 10 best companies to work for in a recent study of U.S. firms. The study noted that the biggest plus at Southwest was that "it's a blast to work here"; the biggest minus was that "you may work your tail off."[10]

Southwest's commitment to its people was evident in a variety of forms. The company had little employee turnover compared with other major airlines and was the first U.S. airline to offer an employee profit-sharing plan. Through this

[10] Robert Levering and Milton Mosckowitz, *The 100 Best Companies to Work for in America* (New York: Doubleday/Currency, 1993).

plan, employees owned about 10 percent of Southwest stock. Eighty percent of promotions were internal and cross-training in different areas as well as team building were emphasized at Southwest's "People University."

Competitive and Financial Performance

Southwest's attention to customer service and efficient operations, creative marketing, and people commitment produced extraordinary competitive and financial results.

Competitive Performance According to the U.S. Department of Transportation, Southwest carried more passengers than any other airline in the top 100 city-pair markets with the most passengers in the 48 contiguous United States.[11] These 100 markets represented about one-third of all domestic passengers. In its own top 100 city-pair markets, Southwest had an average 65 percent market share compared with about a 40 percent market share for other airlines in their own top 100 city-pair markets. Southwest consistently ranked first or second in market share in more than 90 percent of its top 50 city-pair markets. In Texas, where Southwest began operations in 1971, it ranked first in passenger boardings at 10 of the 11 Texas airports served and had an intra-Texas market share of 70.8 percent in mid-1994. Southwest recorded a market share of 56.4 percent in the intra-California market in mid-1994, compared with a market share of less than 3 percent in 1989.

Financial Performance Southwest's average revenue and income growth rate and return on total assets and stockholders' equity were the highest of any U.S. air carrier during the 1990s. Exhibit 9 on page 494 provides a five-year consolidated financial and operating summary for Southwest Airlines.

Even though Southwest achieved record revenue and income levels in 1994, net income in the fourth quarter 1994 (October 1–December 31, 1994) fell 47 percent compared to the fourth quarter 1993. The last time Southwest reported quarterly earnings that were less than the same quarter a year earlier was in the third quarter of 1991. Fourth quarter 1994 operating revenues were up only three percent compared to the same period in 1993. This result was considerably less than the double-digit gains in operating revenues recorded in each of the preceding three quarters compared to 1993. Southwest's fourth quarter financial report sent the company's stock price reeling to close at a 52-week low of $15.75 in December 1994 in New York Stock Exchange composite trading, down from a record $39.00 in February 1994.

Southwest's fourth quarter 1994 earnings performance reflected the cumulative effect of numerous factors. These included the conversion of recently acquired Morris Air Corporation to Southwest's operations, competitors' persistent use of fare sales, which Southwest often matched, and the airline-within-an-airline initiatives launched by Continental and United. Commenting on the fourth quarter financial and operating performance, Kelleher said:

> While these short-term results will be disappointing to our shareholders, the recent investments made to strengthen Southwest Airlines are vitally important to our long-term success. We are prepared emotionally, spiritually and financially to meet our increased competition head-on with even lower costs and even better customer service.[12]

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[11] U.S. Department of Transportation press release, May 11, 1993.

[12] Quoted in Terry Maxon, "Southwest Forecasts Dip in Earnings," *The Dallas Morning News*

EXHIBIT 9 **Southwest Airlines Five-Year Financial and Operating Summary (Abridged)**

		Selected Consolidated Financial Data[a]			
(In Thousands Except Per-Share Amounts)	*1994*	*1993*	*1992*	*1991*	*1990*
Operating revenues:					
Passenger	$2,497,765	$2,216,342	$1,623,828	$1,267,897	[illegible]
Freight	54,419	42,897	33,088	26,428	[illegible]
Charter and other	39,749	37,434	146,063	84,961	[illegible]
Total operating revenues	2,591,933	2,296,673	1,802,979	1,379,286	[illegible]
Operating expenses	2,275,224	2,004,700	1,609,175	1,306,675	[illegible]
Operating income	316,709	291,973	193,804	72,611	[illegible]
Other expenses (income), net	17,186	32,336	36,361	18,725	[illegible]
Income before income taxes	299,523	259,637	157,443	53,886	[illegible]
Provision for income taxes[c]	120,192	105,353	60,058	20,738	[illegible]
Net income[c]	$179,331	$154,284[d]	$97,385[e]	$33,148	[illegible]
Total assets	$2,823,071	$2,576,037	$2,368,856	$1,854,331	[illegible]
Long-term debt	$583,071	$639,136	$735,754	$617,434	[illegible]
Stockholders' equity	$1,238,706	$1,054,019	$879,536	$635,793	[illegible]
		Consolidated Financial Ratios[a]			
Return on average total assets	6.6%	6.2%[b]	4.6%[e]	2.0%	[illegible]
Return on average stockholders' equity	15.6%	16.0%[b]	12.9%[e]	5.3%	[illegible]
Debt as a percentage of invested capital	32.0%	37.7%	45.5%	49.3%	[illegible]
		Consolidated Operating Statistics[b]			
Revenue passengers carried	42,742,602[g]	36,955,221[g]	27,839,284	22,669,942	[illegible]
RPMs (thousands)	21,611,266	18,827,288	13,787,005	11,296,183	[illegible]
ASMs (thousands)	32,123,974	27,511,000	21,366,642	18,491,003	[illegible]
Load factor	67.3%	68.4%	64.5%	61.1%	[illegible]
Average length of passenger haul	506	509	495	498	[illegible]
Trips flown	624,476	546,297	438,184	382,752	[illegible]
Average passenger fare	$58.44	$59.97	$58.33	$55.93	[illegible]
Passenger revenue per RPM	11.56¢	11.77¢	11.78¢	11.22¢	[illegible]
Operating revenue per ASM	8.07¢	8.35¢	7.89¢	7.10¢	[illegible]
Operating expenses per ASM	7.08¢	7.25¢[h]	7.03¢	6.76¢	[illegible]
Number of employees at year-end	16,818	15,175	11,397	9,778	[illegible]
Size of fleet at year-end[i]	199	178	141	124	[illegible]

[a] The Selected Consolidated Financial Data and Consolidated Financial Ratios for 1992 through 1989 have been restated [illegible] include the financial results of Morris.

[b] Prior to 1993, Morris operated as a charter carrier; therefore, no Morris statistics are included for these years.

[c] Pro forma assuming Morris, an S Corporation prior to 1993, was taxed at statutory rates.

[d] Excludes cumulative effect of accounting changes of $15.3 million ($.10 per share).

[e] Excludes cumulative effect of accounting change of $12.5 million ($.09 per share).

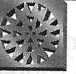
[f] Includes $2.6 million gains on sales of aircraft and $3.1 million from the sale of certain financial assets.

[g] Includes certain estimates for Morris.

[h] Excludes merger expenses of $10.8 million.

[i] Includes leased aircraft.

Source: Southwest Airlines *1994 Annual Report.*



SOUTHWEST VERSUS SHUTTLE BY UNITED

The maiden flight for "Shuttle By United" departed Oakland International Airport for Los Angeles International Airport at 6:25 A.M. on Saturday, October 1, 1994. Later that morning, United's executive vice president of operations, who flew in from United's world headquarters near Chicago to mark the occasion, spoke to the media. He said:

> What we're doing is getting back into the market and getting our passengers back. We used to own Oakland and LA, and then Herb (Kelleher) came in. What we have to do is protect what's ours.[13]

At the time, Dave Ridley believed that the Oakland flight had "symbolic significance" for two reasons. First, until the late 1980s, United was the dominant carrier at the Oakland airport, but left in the early 1990s following head-to-head competition with Southwest. Second, Oakland had become the main base of Southwest's Northern California operation and was the fastest growing of California's 10 major airports in terms of air traffic.

Shuttle by United[14]

Created by a team of United Airlines managers and workers over the course of a year and code-named "U2" internally, "Shuttle By United" was designed to replicate many operational features of Southwest: point-to-point service, low fares, frequent flights, and minimal amenities. Lowering operating cost was a high priority since United's cost for shorter domestic routes (under 750 miles) was 10.5 cents per available seat mile. United's targeted cost per seat mile was 7.5 cents for its shuttle operation.

Like Southwest, "Shuttle By United" featured Boeing 737 jets with a seating capacity of 137 passengers, focused on achieving 20-minute aircraft turns, and offered only beverage and snack (peanuts and pretzels) service. Management and ground crews alike had attended "enculturalization" and motivational classes that emphasized team-work and customer service. Unlike Southwest, "Shuttle By United" provided first-class (12 seats) and coach seating. Rather than boarding passengers in groups of 30 like Southwest, a boarding process—known as WILMA for windows, middle, and aisle seat—was used for seat assignments. Passengers assigned window seats boarded first, followed by middle seat travelers, and then aisle customers. United's "Mileage Plus" frequent flyer program was available to passengers, with an option that matched Southwest's offer of one free ticket for each eight shuttle round trips.

"Shuttle By United" was inaugurated with eight routes. Six of these were converted United routes involving the airline's San Francisco hub. Only three of the original eight routes competed directly with Southwest: San Francisco–San Diego, Oakland–Los Angeles, and Los Angeles–Sacramento. On these three routes, the "Shuttle By United" one-way, walk-up coach fare was identical to Southwest's $69 "California State Fare," which was Southwest's highest fare on

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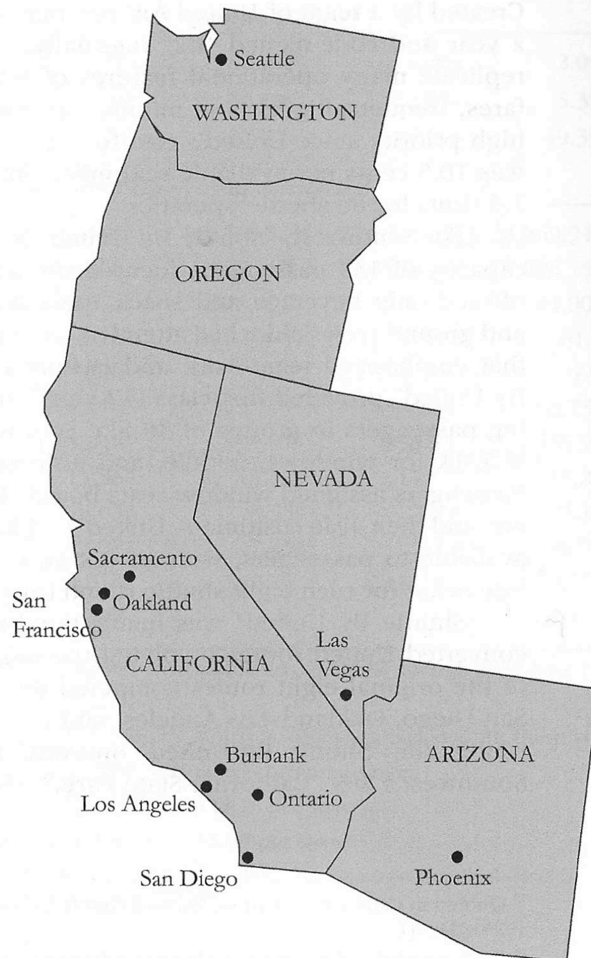
[13] Quoted in Catherine A. Chriss, "United Shuttle Takes Wing," *The Dallas Morning News* (October 3, 1994):1D, 4D.

[14] Portions of this discussion are based on Jesus Sanchez, "Shuttle Launch," *Los Angeles Times* (September 29, 1994):D1, D3; Randy Drummer, "The Not-So-Friendly Skies," *Daily Bulletin* (September 30, 1994):C1, C10; "United Brings Guns to Bear," *Airline Business* (November 1994): 10; Michael J. McCarthy, "New Shuttle Incites a War Between Old Rivals," *Wall Street Journal* (December 1, 1994):B1, B5.

all seats and flights within California.[15] One-way walk-up coach fares wa on the five noncompeting routes. Service from San Francisco to Burbank a to Ontario was priced at $104. Fares for the remaining San Francisco rou were $89 to Los Angeles, $99 to Las Vegas, and $139 to Seattle. The "Shuttle B United" first-class fare was typically $20 higher than its coach fare. "Shuttle B United" was advertised heavily using print and electronic media.

"Shuttle By United" soon expanded its route system to include six additio routes. All six routes competed directly with Southwest. Service out of Oaklan included Oakland–Burbank, Oakland–Ontario, and Oakland–Seattle. Los Angele to Phoenix and to Las Vegas and San Diego–Sacramento rounded out the ne service. Except for the Oakland–Seattle route, all one-way walk-up coach fare were $69 for Southwest and "Shuttle By United." A one-way walk-up coach fa of $99 was charged on the Oakland–Seattle route by the two airlines. "Shuttle B United" also increased its flight frequency in 12 of 14 city-pair markets, primari out of its San Francisco hub. Cities served by "Shuttle By United" appear in th map shown in Exhibit 10.

EXHIBIT 10 **Cities Served by "Shuttle By United"**



[15] Walk-up fares refer to the fare available at any time, with no restrictions, no penalties, and no advance purchase requirements.

In early December 1994, United reported that the cost per available seat mile of its shuttle operation had not yet achieved its targeted 7.5 cents. In an interview, "Sky" Magary said, "We're vaguely better than halfway there."[16]

Southwest Airlines

Southwest's planning for United's initiative began months before the "Shuttle By United" scheduled October 1 launch. In June 1994, a Southwest spokesperson said the airline would "vigorously fight to maintain our stronghold in California."

Prior to the launch of "Shuttle By United," Southwest committed additional aircraft to the California market to boost flight frequencies on competitive routes. By mid-January 1995, Southwest had deployed 16 percent of its total capacity (in terms of available seat miles flown) to the intra-California market. Thirteen percent of Southwest's total available seat mile capacity overlapped with "Shuttle By United" by late January 1995.

Southwest also boosted its advertising and promotion budget for the intra-California market, with particular emphasis in city-pairs where "Shuttle By United" competed directly with Southwest. Southwest's "*The* Low Fare Airline" advertising campaign spearheaded this effort. Southwest's walk-up fare remained at $69 during the fourth quarter of 1994, unchanged from the fourth quarter of 1993. However, Southwest's 21-day advance fares and other discount fares were being heavily promoted. The effect of this pricing was that Southwest's average passenger fare in the markets also served by "Shuttle By United" (excluding Oakland–Seattle) was $44 during the fourth quarter of 1994 and into early January 1995, compared with $45 in the third quarter of 1994. The average 1994 fourth-quarter fare for the Oakland–Seattle route was $51, down from $60 in the third quarter of 1994. Dave Ridley estimated that the average passenger fare for "Shuttle By United" was 5 to 10 percent higher than the average Southwest fare in the nine markets where it competed directly with Southwest, and about $20 higher than the average Southwest fare in the five markets served out of San Francisco where it did not compete directly with Southwest. The difference in average passenger fares between the airlines was due to first-class seating offered by "Shuttle By United" in competitive markets and generally higher fares in noncompetitive markets.

THE TUESDAY MEETING

The original agenda for the "Tuesday meeting" in late January 1995 focused mostly on operational issues. For example, Southwest would begin scheduled service to Omaha, Nebraska, in March 1995, and advertising, sales, promotion, and scheduling matters still required attention. Southwest's "ticketless" travel system, or "electronic ticketing" was also on the agenda. This system, whereby travelers make reservations by telephone, give their credit card number and receive a confirmation number, but receive no ticket in the mail, was scheduled to go nationwide on January 31, 1995, after a successful regional test. Final details were to be discussed.

Dave Ridley also intended to apprise his colleagues of the competitive situation in California. A staff member had prepared a report showing fourth quarter load factors by route for Southwest and estimated load factors for "Shuttle By

[16] Michael J. McCarthy, "New Shuttle Incites a War Between Old Rivals," *Wall Street Journal* (December 1, 1994):B1, B5.

EXHIBIT 11 Daily Scheduled City-Pair Round Trips by Southwest Airlines and "Shuttle By United" and Quarterly Load Factor Estimates

		Southwest Airlines Daily Round-Trip Flights		*Shuttle By United Daily Round-Trip Flights*		*1994 4th-Quarter Load Factor*		*1994 3rd-Quarter Load Factor*		*1993 4th-Quarter Load Factor*	
Market (City-Pair)	***Air Miles***	*October–December 1994*	*Mid–January 1995*	*October–December 1994*	*Mid–January 1995*	*United*	*Southwest*	*United*	*Southwest*	*United*	*Southwest*
San Francisco–Los Angeles	338	← No Service	→	31	40	66%	–	77%	–	68%	–
San Francisco–Burbank	359	← No Service	→	11	12	60%	–	70%	–	64%	–
San Francisco–Ontario	364	← No Service	→	11	12	47%	–	63%	–	64%	–
San Francisco–Las Vegas	417	← No Service	→	9	10	73%	–	85%	–	74%	–
San Francisco–Seattle	678	← No Service	→	13	16	74%	–	89%	–	77%	–
San Francisco–San Diego	417	12	12	10	12	77%	61%	87%	68%	84%	70%
Oakland–Los Angeles	338	19	25	10	15	62%	59%	–	74%	–	63%
Oakland–Burbank	326	13	16	7	11	40%	63%	–	80%	–	70%
Oakland–Ontario	362	12	14	7	7	32%	57%	–	68%	–	65%
Oakland–Seattle	671	4	7	4	5	52%	66%	–	77%	–	–
Los Angeles–Sacramento	374	5	6	5	6	81%	65%	73%	53%	67%	–
Los Angeles–Phoenix	366	25	23	9	10	48%	61%	–	60%	–	56%
Los Angeles–Las Vegas	241	13	19	10	12	61%	65%	–	73%	–	61%
San Diego–Sacramento	481	9	9	5	5	50%	68%	–	78%	–	67%

Source: Southwest Airlines company records. For analysis purpose, load factors can be applied to daily round-trip flights for both airlines on both legs of a round trip.

United." He wanted to share this information with the group (see Exhibit 11), along with other recent developments. For example, a few days earlier, "Shuttle By United" had reduced its one-way walk-up coach fare on the San Francisco–Burbank route to $69. This fare was identical to the one charged on the Oakland–Burbank route by both airlines. In addition, Southwest's consolidated yield and load factor for January 1995 were tracking lower than the consolidated yield and load factor for January 1994. If present traffic patterns continued, Southwest's consolidated load factor would be about five points lower in January 1995 as compared to January 1994.

Unexpected news that "Shuttle By United" intended to discontinue some service and raise fares altered the original meeting agenda and posed a number of questions for Southwest executives. For instance, did the fare increase signify a major modification in United's "We're going to match Southwest" strategy? If so, what were the implications for Southwest? How might Southwest react to these changes, if at all? Should Southwest follow with a $10 fare increase of its own or continue with its present price and service strategy? What might be the profit impact of United's action and Southwest's reaction, if any, for each airline? And how, if at all, was United's pricing action linked to the announced withdrawal from the Oakland–Ontario market?