# INTEGRATIVE CASE
# SOUTHWEST AIRLINES

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 years ago. "Convince me," Herb replied. Rollin drew a triangle connecting Texas' major cities on a cocktail napkin. 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 is currently facing a multitude of challenges to its historically successful business strategy. These challenges are both external and internal. External challenges include leaner competitors, higher gas prices, and limited growth opportunities. Internally, the company faces challenges such as managing the acquisition of AirTran Airways, reducing costs, keeping their unique culture intact with the addition of 8,000 new AirTran employees, and continuing to maximize the effectiveness of its talent. Southwest's talent is selected very carefully and highly productive, resulting in relatively low labor costs for the company. Southwest's strategy of being the cheapest and most efficient airline depends on highly motivated employees who deliver outstanding customer service. How AirTran employees will adapt to this situation 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 more than 37 years. He is 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 who are responsible for it and to retain employees who might otherwise turn to Southwest's competitors. Employee satisfaction, 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 an acquisition strategy that it has never tried before. Can the firm continue to spend so much time and money on staffing and training while managing the AirTran acquisition 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 gas prices, increased cost pressures, and the unpredictable economy will have an impact on the future growth and success of Southwest. The strategies that have been so successful in the past are being modified to allow the company to grow quickly through an acquisition, and these modifications will come with their own accompanying challenges. The key to overcoming 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 three 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, and the majority of these failed. The recent recession was particularly hard on the American airlines. But now, the industry is again entering a period of high demand and expanding profitability. And despite the volatile conditions and many organizational failures of the last 30 or so years, 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

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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 competitors—Braniff, TransTexas, 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 the airline began service on 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, Dallas' Love Field. 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 three 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. The second period, Interstate Expansion (1978–1986) was characterized by the opening of service to 14 other states. This expansion was made possible by, and thus coincided with, the deregulation of the domestic airline industry. The most recent period, National Achievement (1987–present), has been a time of considerable growth, distinguished recognition, and success.

## The External Environment of the Airline Industry

The competitive environment in which Southwest operates can be subdivided into customer segments, competitor groups, route structures, and passenger service segments. Each plays an important part in the strategy of most airlines.

The two major categories of passengers are leisure travelers, who tend to be quite price-sensitive, and 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 generally be categorized into three major competitor groups based on geographical coverage. First are the national airlines, such as American Airlines, Delta, America West, Southwest, JetBlue, and Continental. Second are the regionals, which include Spirit Airlines and Alaska Airlines. Third are the commuter or feeder carriers, most of which operate as extensions of the major carriers. Some of these include Atlantic Coast Airlines (operating as United Express), Atlantic Southeast Airlines (operating as Delta's Business Express), Ted, Song, Allegiant, and numerous others, some of which change quickly. These airlines can be further categorized into traditional carriers, with business and coach classes, and low-fare/low-frills, single-class carriers.

The airlines 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), which has many costly infrastructure requirements (e.g., baggage handling systems, large terminals, maintenance facilities, 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 economies of scale, 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, 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 (e.g., United and American on select flights). Still 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.

### 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 by 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 airline 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, that number would be negative. The overall industry is not highly

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**EXHIBIT SA.1** Glossary of Terms

| | |
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| **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, and 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 (AA) and South African Airlines (SAA) code share on SAA's flight to JHB (Johannesburg). The flight has an AA flight number and an SAA flight number, so it can also be sold as an AA flight. |
| **CRS** | Computer reservation system. This system 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 US Airways 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 US Airways 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. The load factor can be calculated by dividing RPMs by ASMs. |
| **O&D** | Origin and destination. This refers to the originating and terminating airports of an itinerary segment; connection points are not counted. O&D is different from city-pair, which refers to the origination and termination of a flight segment. For example, for a passenger traveling on Northwest Airlines 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. This refers to 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. |

concentrated, although it has become more so since deregulation. Nevertheless, most discrete markets are served by a limited number of carriers. And in the oligopolistic markets where most airlines compete, the pricing actions of one company affect the profits of all competitors. Therefore, intense price wars have been a frequent event in the industry. In addition, because competition varies from route to route, a carrier can dominate one market, be dominated in another, and face intense rivalry in a third. The hub-and-spoke system also means that airlines face head-to-head competition with more carriers in more markets.

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

If the industry is so difficult, why are there new airlines, such as Virgin America, which entered in August 2007? Because despite difficult economics, the industry is still attractive to new entrants. 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 leasing. Given high debt levels and low profitability in comparison to other industries, the depreciation tax shield is not as valuable to the airlines, and most, including Southwest, have begun to lease their planes rather than purchase them. By leasing, carriers can sell that tax shield to the leasing company, actually creating value for the carrier. As a result, entry barriers are not as high as one would expect compared to those of other capital-intensive industries.

Furthermore, new entrants generally gain significant cost advantage by securing lower labor costs because they are not burdened by the unfavorable union contracts that affect many older airlines. Many of the union contracts agreed to by the major airlines call for higher pay and contain work rule provisions that reduce labor productivity. In addition, new entrants are sometimes able to gain favorable terms by purchasing the excess capacity, such as training and maintenance, of other airlines.

## Profitability

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

1. Cost, calculated as total operating expenses divided by available seat miles (ASM).
2. Yield, calculated as total operating revenues divided by the number of revenue passenger miles (RPM).
3. 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

$$\text{Profitability} = (\text{Yield} \times \text{Load factor}) - \text{Cost}$$

The major airlines have faced intense competition from low-priced airlines for the past 15 to 20 years. These low-priced airlines expanded the market for air travel, but they also placed great downward pressure on the prices of the majors, thereby reducing their yields. To compete in this environment, the majors engaged in great cost-cutting efforts.

The events of September 11, 2001, also 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. And that profitability was attained again in large part because the major carriers laid off 38 percent of the workforce—more than 170,000 workers over those five years. Furthermore, pay was frequently reduced, often through bankruptcies, for those who were not laid off.[3] The recent recession brought back the bad times of 2001. Demand for travel dropped substantially, causing losses for most airlines.

## Outlook

The outlook for the airline industry is currently positive compared to the five years following September 11, 2001, and the last few recessionary years. Most carriers have brought costs under control (although frequently through bankruptcies or consolidation), and the number of passengers has returned to prerecession levels.

Despite these improvements, the industry as a whole faces several threats. First, a number of external factors could raise costs industrywide. Further increases in gas prices, labor unions wanting back the concessions they gave during the lean times, rising interest rates, or additional changes in government regulations could substantially increase costs. And rising costs lead to higher fares, which reduce the number of travelers. Second, a number of external factors unrelated to costs 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 as well.

Numerous airlines have shed their financial obligations through past bankruptcies. United Airlines, ATA, US Airways, Northwest Airlines, and Delta Airlines have all emerged from bankruptcy proceedings. And because the 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 and Frontier, have reduced their growth plans. Furthermore, a number of airlines (e.g., Continental and United, Delta and Northwest) have consolidated through mergers.[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 its 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.

Southwest'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, such as "Guess the weight of the gate agent." The fun spirit is tempered, however, 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, its current size and importance have led most analysts to consider it as one of the major airlines, despite its fit in the low-fare segment. In a fundamental sense, Southwest's business-level strategy is 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, and it has devised a number of clever stratagems to achieve this low-cost structure. For example, by 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 is also facilitated by its focus on the U.S. Southwest and other locations with generally excellent weather conditions, which leads to far fewer delays. Moreover, by following a point-to-point strategy, Southwest need not coordinate flight schedules into connecting hubs with those of other spokes, which dramatically reduces scheduling complexity and costs. That Southwest uses only one type of aircraft, the Boeing 737, also reduces costs. In addition, Southwest's timely usage of fuel hedges have saved the company billions in fuel costs since 2000; fuel hedges are currently in place through 2013. During the recent recession, Southwest also aggressively trimmed unpopular and unprofitable flights to reduce costs. Other recent cost-cutting initiatives include a salary freeze for senior management, the introduction of a voluntary early retirement program, and the installation of winglets (fuel-saving wing modifications) on all planes.

**Fleet Composition.** Historically, Southwest has had the simplest fleet composition among the major airlines, flying only Boeing 737 planes. The airline currently owns or leases approximately 540 planes and has firm orders for another 91 planes from Boeing through 2016. The company also has options or purchase rights on an additional 113 planes through 2018. 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 every operating area, including scheduling, training, aircraft deployment and use, wages and salaries, maintenance, and spare parts inventories.

As will be discussed later, Southwest is buying AirTran Airways. AirTran's fleet includes 86 Boeing 717s, a smaller aircraft. These planes provide an opportunity for Southwest to enter smaller markets, but they also add complexities to almost all operating areas. Southwest hopes that the benefits of its simple fleet configuration will remain with the introduction of this additional plane type.

**Route Structure.** Southwest has specialized in relatively short-haul flights, and because the buyers of these short-haul services tend to be quite price sensitive, the airline has experienced considerable threat from providers of ground transportation (e.g., cars, trains, buses). Even so, 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, that passengers demand on longer flights. On Southwest 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 percent and increased passenger traffic by at least 30 percent. Some markets, however, have seen traffic increase by as much as 500 percent after Southwest entered them. This increase in traffic and decrease in fares is now recognized as the Southwest Effect.[5]

**Turnaround Time.** The route structure of Southwest Airlines has helped it to achieve 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 these planes are airborne for a smaller percentage of time than those 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 also 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.

**Gates.** Because major airports have a limited numbers of gates and most are already taken, access to gates is often a constraining factor in the ability of airlines to expand. An emphasis on less crowded secondary airports has alleviated this problem for Southwest. In addition, 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. Recently, Southwest has been experimenting with entering primary airports—and even the hubs of other airlines. Since 2004, Southwest has entered Philadelphia, Pittsburgh, Denver, San Francisco, Boston, Minneapolis–St. Paul, and Milwaukee. In addition, Atlanta, Charleston, Newark, New York, Washington, D.C., as well as cities in Mexico and the Caribbean are targeted for the near future.[6]

**Fare Structure.** Southwest also controls costs through its simplified fare structure. While its 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. To generate revenue, however, Southwest recently introduced a business class, which gave customers preferences in checking in and boarding. Even so, Southwest offers a limited number of different fares compared to other airlines, and it has no requirements to stay over a Saturday night. This simplified fare structure allows the majority of the Southwest's customers (over 80 percent) to book their own ticket through Southwest's Web site (www.southwest.com), which reduces labor costs related to reservations and commissions.

**Labor.** Despite the heavy capital investment demanded in the industry, labor is the largest cost component of airlines. Southwest's labor costs are roughly 35 percent of all expenses.[7]

Southwest currently has nine collective bargaining agreements in place; these agreements cover about 83 percent of Southwest's employees. 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, 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).

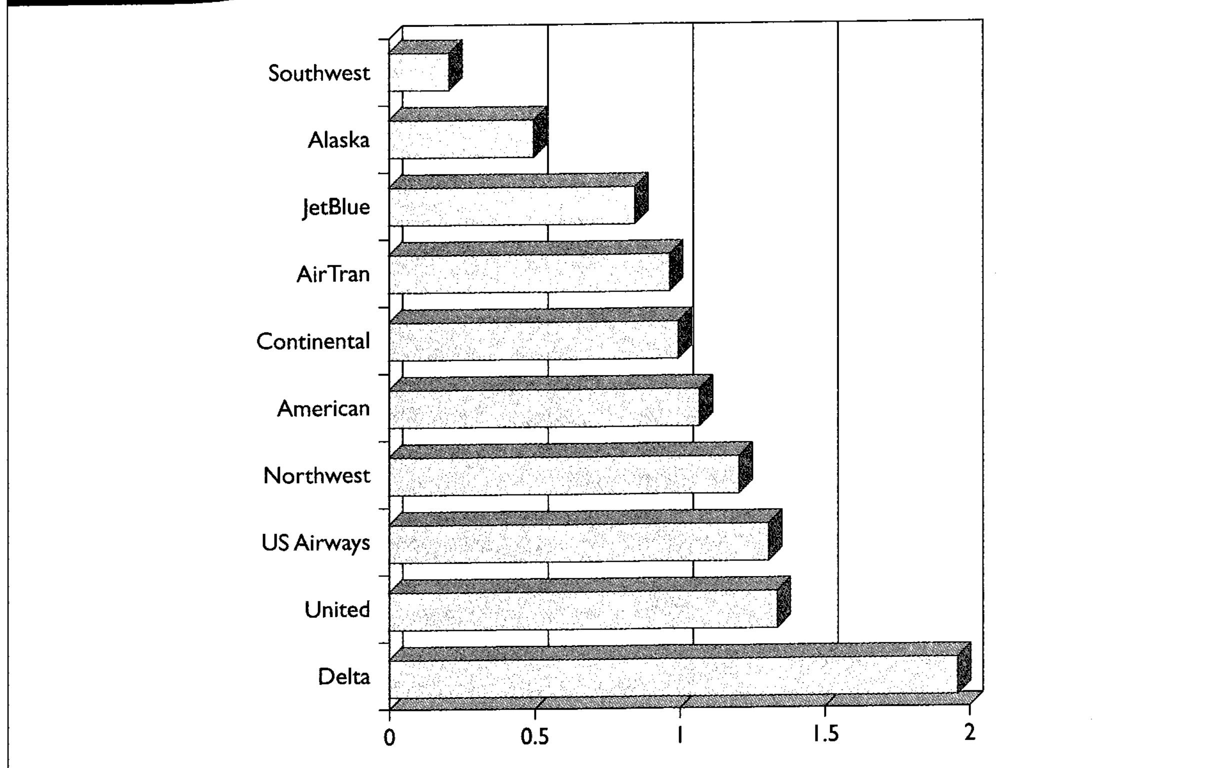
In an industry where unions and management have often been at war—and where unions have the power to resist essential changes—the quality of their relationship is a crucial issue. Southwest has never had a strike, lockout, layoff, or pay cut. Instead, when Southwest seeks to reduce labor costs, as it did in 2004, 2007, and 2009, it offers highly paid employees lucrative buyouts. Southwest's CEO, Gary C. Kelly, meets with union leaders on a quarterly schedule to discuss finances and strategy. Historically, Southwest's base pay has been at or below the market, but with numerous opportunities to share in company success through variable pay programs, including profit sharing and a stock purchase plan. Currently, however, Southwest's pay packages are generally at or above the market because of drastic cuts in salaries by other airlines. Southwest also 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. And this strategy has paid off, as shown in Exhibit SA.2, which charts the customer complaint rates of several airlines. As the exhibit shows, Southwest has had the lowest complaint rate since 1987, the year the U.S. Department of Transportation began collecting this data.[8]

Southwest's Positively Outrageous Service (POS) is different from the customer service associated with other major airlines. At Southwest, service is provided with friendliness, caring, warmth, and company spirit; the staff go out of their way to be helpful. This approach to service leverages Southwest's outstanding relationship with its employees. Call Southwest and a person rather than a computer will answer. 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.[9] This stellar customer service does not include costly amenities like reserved seats or food service, however, and it offers only very limited automatic baggage rechecking. But 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. New customer service initiatives include a completely revamped Rapid Rewards Program (a frequent flier program), fleet-wide implementation of onboard wireless Internet access (completed in 2012), improved baggage tracking, "Fly By" security lanes (reserved for Business

**EXHIBIT SA.2** Complaints per 100,000 Customers Boarded, 2009




Select Customers and Rapid Rewards A-List Members), the Pets Are Welcome on Southwest (PAWS) initiative, and automated outbound messaging that 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 percent a year. Its controlled growth philosophy has been a key to its success.[10] After all, the inability to manage rapid growth has been blamed for the failure of many carriers, including Braniff, People Express, and ValuJet. Thus, Southwest has not participated in the numerous acquisitions and mergers that have occurred in the airline industry over the past decades. Until now.

In 2010, Southwest agreed to buy AirTran Airways for $1.4 billion. The acquisition will increase the airline's revenue and capacity by almost 25 percent. Southwest believes that the acquisition gives it the opportunity to grow quickly and help meet its long-term strategic goals. Specifically, the acquisition of AirTran will allow Southwest to:

- Expand its service to many more customers, adding hundreds of new itineraries to its portfolio.
- Enter markets where it has provided little or no service, such as Atlanta, New York, Boston, and Washington, D.C.
- Have the means to enter smaller cities using the AirTran fleet of 86 smaller Boeing 717s.
- Provide its customers with international options using AirTran's current Mexico and Caribbean routes.

Southwest understands that the integration of AirTran employees into the Southwest culture is not easy. However, if successful, the acquisition will provide a means for quick growth without changing the way Southwest does business.[11]

## Social Responsibility

Part of Southwest's strategy is to 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 more green. The airline recently unveiled their Green Plane to test the latest environmentally friendly cabin materials, and they have launched a more robust onboard recycling program. They also have purchased green power in the form of wind energy, participated in emissions reduction research, and been a leader in fuel conservation efforts, which Southwest estimates saved 8.5 million gallons of jet fuel in 2009.



Some other indicators of the company's efforts to be green are shown in the following data. In 2009, Southwest:

- Recycled 250 tons of electronics.
- Recovered 5.7 billion BTUs of energy from used oil, filters, and waste.
- Recycled 11,000 fluorescent bulbs.
- Recycled 210,000 pounds of batteries.
- Reduced 82,210 metric tons of $CO_2$ emissions through fuel conservation.

As a result, Southwest ranked number 33 on the U.S. Environmental Protection Agency's *Fortune* 500 list for green power partners in 2009.

Southwest also strives to be socially responsible by helping communities. In 2009, Southwest donated more than $11 million and more than 45,000 employee volunteer hours to charities. One of these charities is the Southwest Airlines Employee Catastrophic Assistance Charity, which was started by an employee. This charity offers support to Southwest employees suffering financial hardships resulting from catastrophes. In 2010, Southwest was one of the Top 50 companies recognized as leaders in corporate social responsibility by the Boston College Center for Corporate Citizenship and Reputation Institute.

# The Internal Environment of Southwest Airlines

Southwest, like most airlines, is a formal and centralized organization that 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. And 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 standardization is very high 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. 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 540 Boeing 737s in more than 70 cities and employs about 35,000 people. Nevertheless, Southwest is still substantially smaller than the largest major airlines. For example, American Airlines has more than 75,000 employees. Yet Southwest carries more passengers in the United States than any other airline, and its market value is greater than that of all the other major airlines' combined. After the acquisition of AirTran, Southwest's revenue, capacity, and number of employees will increase by about 25 percent.

## Adaptability

Southwest has been a very nimble organization, quick to take advantage of market opportunities. For example, when American Airlines and US Airways 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 believes the company sees itself "as a speedboat circling around the slow cruise ships."[12]

## Technology

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

Over the last few years, Southwest has spent tens of millions of dollars on new technology to automate and improve various functions. Southwest recently developed an automated boarding pass system with Dell Computers. It has also invested in a system that links ground and air technology, thereby automating flight information that can be used externally, internally, and operationally. This information is displayed on new liquid crystal flat-panel monitors in airports.[13]

Marketing activities explicitly build on the Internet as a primary marketing channel. Southwest was the first carrier to host a Web site (www.southwest.com), which was deemed Best Airline Website by *Air Transport World*. Southwest also has an

Internet feature called Ding!, which notifies subscribers, with visual and audio alerts on their computers, about short-term, special fares for their location.

## Management

Southwest's CEO, president, and chairman of the board is Gary C. Kelly. Two people who were with Southwest from the beginning stepped down from leadership positions a few years ago. Colleen C. Barrett was president and in charge of such key functions as marketing, sales, advertising, human resources, customer relations, and governmental affairs. Cofounder and former CEO Herb Kelleher was until recently chairman of the board. Both retired from their leadership positions in 2008 but plan to remain with the company until 2013.[14] Although no longer a leader of the firm, Herb Kelleher still embodies Southwest's culture.

What set Kelleher apart was his charismatic nature. Even today, his friendly, participative, deeply involved, and caring approach is revered throughout the organization. A very large number of employees know the chairman, and he is reputed to know thousands of them by name. Kelleher's management style, which has been described as a combination of Sam Walton's thriftiness and Robin Williams' wackiness,[15] 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, who has attended the Southwest's annual Halloween party as Edna Turnblad (from *Hairspray*), Dorothy (from *The Wizard of Oz*), and Gene Simmons (from the rock band KISS). In 2010, he attended the party as Woody (the cowboy doll from *Toy Story*). Mike Van de Ven, the chief operation officer, was Buzz Lightyear. Although the Halloween party is the biggest of the year, it is only one of eight company parties thrown yearly to help keep Southwest's culture thriving.[16]

## Culture

The most distinguishing feature of Southwest Airlines is its culture. Forged over 30 years, it 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 with the company, 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 it sends clear signals about the behavior expected at Southwest. In 1991, Colleen Barrett set up 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 have worked especially hard. Flight crews might be surprised with snacks or with help cleaning their planes. One program created by the committee, called Heroes of the Heart, is used to honor employees who are rarely seen by customers but are unsung heroes. A subcommittee selects one group who show 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 Southwest's Heroes of the Heart–designated aircrafts. The program, like the culture overall, creates a sense of family and mission.[17]

The culture also stresses the importance of having fun at work, and humor is a significant aspect of the work environment. Attributes like these 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 Southwest having the lowest employee turnover rate in the industry (about five percent) 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 also 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.





**EXHIBIT SA.3** Southwest Airlines Fast Facts

- Southwest has never had a layoff.
- Southwest has more than 3,100 flights a day.
- Southwest serves over 60 million cans of soda, juices, and water annually.
- Each Southwest aircraft flies an average of six flights per day.
- Southwest's shortest daily flight is 133 miles, between Fort Myers and Orlando.
- If you had purchased $1,000 worth of stock in Southwest airlines in 1972, it would now be worth more than $1,000,000.
- Southwest adopted the first profit-sharing plan in the U.S. airline industry in 1973.
- In 2009, Southwest received more than 90,000 resumes and hired 831 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 more than 100 million bags of peanuts and pretzels annually.
- About 83 percent of Southwest's employees are unionized.
- Southwest's longest daily flight is 2,363 miles, between Providence and Las Vegas.
- More than 2,300 of Southwest's employees have spouses who are also Southwest employees.
- Southwest has been profitable for more than 37 consecutive years.
- About three out of four Southwest passengers fly nonstop.
- Employees own about eight percent of Southwest's stock.
- Southwest has six websites: www.southwest.com, www.swabiz.com, www.swavacations.com, www.swacargo.com, www.swamedia.com, and www.blogsouthwest.com.

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

# HRM at Southwest Airlines

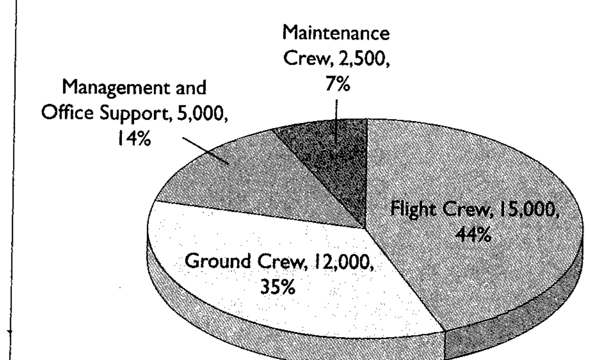
At Southwest Airlines, the HR function is called the People Department. According to the department's mission statement: "[R]ecognizing that our people are the competitive advantage, we deliver the resources and services to prepare our people to be winners, to support the growth and profitability of the company, while preserving the values and special culture of Southwest Airlines." Southwest has about 35,000 employees; of these, 15,000 are flight crew members, as shown in Exhibit SA.4.

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 Southwest's competitors. This importance of HR is reflected in every HR function. Recruiting, selection, training, performance management, compensation, benefits, and labor relations all support Southwest's strategy and culture.

## Recruiting

Given Southwest's reputation as a great place to work, it generally receives many applications for each job opening. In 2009, for example, the company hired 831 people but received more than 90,000 applications. Thus, less than one percent of applicants are actually hired. In theory, the odds of getting into Harvard are higher![18] One could safely say that Southwest's reputation and unique employee-friendly culture make up its greatest recruiting tool. 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?"

**EXHIBIT SA.4** Number of Southwest Employees



## 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. The time and money spent on the recruiting and selection process have resulted in a turnover rate of five percent, the lowest in the industry.

Second, Southwest's selection process matches the unique culture of the company. This process is 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.[19]

As Kelleher describes it, the selection process at Southwest places great emphasis on hiring based on attitude. But the search is also 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 percent 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 the selection and placement process. This kind of centralized process helps the organization because 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 as well, which 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 employees a sense of urgency. The involvement of all levels of management and employees along with the People 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 attitude and 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 whom started their careers in entry-level positions.

**The 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 score of three is considered to be 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 guarantees 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, because in the words of Libby Sartain, the former chief HR officer for Southwest, "we would rather go short and work overtime than hire one bad apple."[20]

**The Interview as a Selection Technique.** In addition to the evaluation of the seven predictors, Southwest uses other methods in the selection process. As at most companies, the process 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 the culture of the company.[21]

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 other unique and clever techniques to assess applicants and their attitudes. 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 the People Department. 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."[22]

## 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, which offers training for every stage of an employee's career. Courses at the University of People include:

- Freedom, LUV, and You (a comprehensive, one-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 (a course on how to evaluate subordinates).
- Every Customer Matters (a new initiative on customer service).

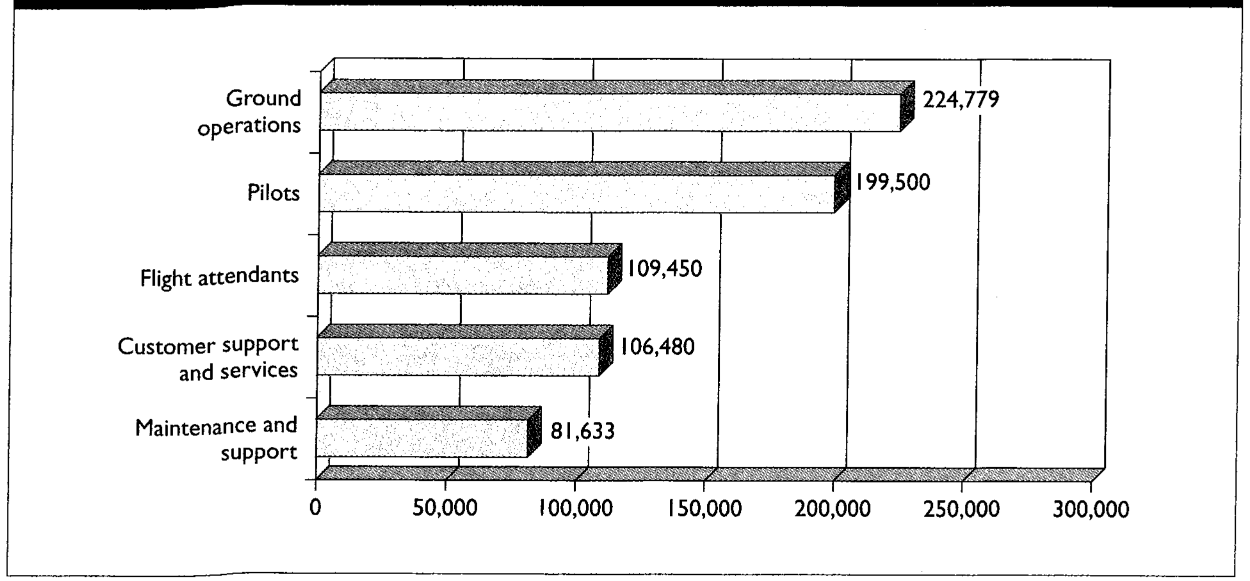
In addition to this internal training, Southwest also encourages employees to attend external training and further specialize in their fields.

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 its origin on the cocktail napkin.

Training is designed 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 into the organization as a whole 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.[23] 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 for employees in 2009. Once a year, all Southwest employees, including all senior management, are

**EXHIBIT SA.5** Total Number of Employee Training Hours, 2009




required to participate in training programs designed to reinforce shared values. Senior managers receive training in strategic leadership. Southwest also has a management-in-training program for 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.[24]

## Labor Relations

The importance of labor relations cannot be underestimated in a company that is about 83 percent 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 airline and closely tie employee fortunes with the company's. Largely because of 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 10-year contract—an unusually long period for a collective bargaining agreement—signed with the pilots in 1995. When the flight attendants' contract negotiations became 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 reigns of the company.[25]

With Gary Kelly at the helm, Southwest now finds itself in the unusual position of being a pay leader coming into contract negotiations. In fact, Southwest's pilots, mechanics, and flight attendants are the best paid in the industry. This is a result of Southwest's long-term contracts coupled with many other airlines getting pay cuts through concessions and bankruptcies. With most contracts needing to be renewed in the next few years, time will tell if the historically cooperative relationships will result in the unions being willing to make concessions at Southwest consistent with the new industry standards.

## Compensation

Unlike the current situation, Southwest historically has paid its employees at or somewhat below the market in base pay, but with plenty of opportunities for above-market pay through a number of different variable pay programs. These included profit sharing and stock purchase plans. In fact, 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 currently is completely tied to a defined contribution plan, consistent with Southwest's view of long-term employee relationships. At present, the company contributes 15 percent of its pretax profits to the plan. In 2009, this meant that Southwest contributed $203 million. Employees are not allowed to contribute to the plan.

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.



Currently, employees own around eight percent 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, are clearly supported by top management, and are unquestionably tied to Southwest's strategy and culture. There are numerous programs in addition to 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, and they can come in the form of 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 also 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. Five-dollar meal vouchers are frequently given for exemplary behaviors as spot awards.[26]

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, club memberships) often enjoyed by their counterparts in comparable organizations, and they even stay in the same hotels as the flight crews. In 2009, Southwest froze the compensation of their senior management as a cost cutting measure, and it 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. These benefits include medical insurance, dental insurance, vision coverage, life insurance, long-term disability insurance, dependent care, adoption assistance, and mental health assistance. Most of these are provided at no cost to the employee as well. Employees and their families also fly free on Southwest and at a discount on other carriers. And 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, because Southwest has never had a layoff, one of the most prized benefits is job security.[27]

Southwest frequently surveys its employees so that it can offer benefits that 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.[28]

## Performance Management

As would be expected, employee evaluations at Southwest are based partly on demonstrating the Southwest Spirit of outrageous customer service. Managers who give an employee superior performance ratings must include documentation regarding 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, for example, delays are attributed to specific units, such as fueling, cleaning, or baggage handling. At Southwest, delays are tied to the entire team or process, thus reducing blame shifting and encouraging employees to assist other functions when needed. In addition, the purpose of performance measurement at most other airlines is to provide accountability, frequently in connection with punitive implications. At Southwest, however, performance measurement is used as a performance management tool to foster cooperation, learning, and improvement.[29]

To promote employee awareness about 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 an individual measure. In addition, 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, and 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.

For more information about the company's HR practices, see the interview with Jeff Lamb, Senior Vice President Administration and the Chief People Officer of Southwest Airlines, in Exhibit SA.6.

# Southwest Airlines' Performance Indicators

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

- Consistently ranked since 1987 by the U.S. Department of Transportation's Air Travel Consumer Report as having the fewest customer complaints.
- Thirty-seven years of profitability.

**EXHIBIT SA.6** Interview with Jeff Lamb, Senior Vice President Administration and Chief People Officer

**Question 1: Tell me about the HR practices at Southwest Airlines.**

It's well-known that we hire for attitude and train for skill. Our HR practices were well established and very successful when I got here, thus I was very cautious in making any changes. However, we are hiring lots of people, so we have to be more efficient. So we looked at a few things about selection that could make a difference. We know that we want to continue hiring people that fit our culture, but many thought that Southwest's culture was indefinable. Yet we have to define it to be able to select based on it. So we came up with what we thought were the core values. We came up with three. They are first, a warrior spirit, which captures the idea of working hard, being the underdog, being a fighter. Second, a servant's heart, which means putting others first, being altruistic and having proactive customer service. Third, a fun-loving attitude. Of course, we also value getting excellent results.

A key indicator of the success of our HR practices is the involvement of front-line employees. Employees are empowered to make decisions, and they contribute to HR decisions. We use interview teams, which include recruiters and front-line employees. When employees love the company and love working for Southwest, they want to get involved and help choose whom they are going to work with. Employees do call recruiters and let them know how applicants treated them at the gate. We are not going to hire someone who was rude to our employees. This empowerment also relates to other areas of HR. For example, our relationship with unions is more guidelines than strict rules. Our employees don't want their hands tied. They are like owners. They want pay for performance. They want to have the freedom to create and innovate.

**Question 2: What is Southwest's philosophy guiding various HR practices?**

It's our mission statement. We have a general mission statement and a mission statement to employees. We are one of the few companies that has that. We are an employer of choice. It's an awesome privilege and responsibility to help create the place that will continue to be a great place to work for the next 30 years. We've hired one-third of our workforce over the last three years. There is always the possibility that the culture could get diluted. We are trying to make sure that doesn't happen. We focus on retention, leadership development, and culture. We have a program called onboarding—it's a training program for employees in their first year. The program is aimed to improve retention by communicating what is great at Southwest and by communicating internal best practices. We have extensive new hire orientations and a new online orientation to help employees learn the Southwest way.

However, we also have to focus on costs. We've reduced staffing costs 56 percent per hire over the last two years. We've done this by investing in new technology, revamping our processes, and working closely with internal customers. For example, we had a retention problem for baggage loaders on the ramp in Baltimore from summer of 2005 to summer of 2006. We hired 167 people and were only able to retain 11. We worked with the Baltimore crew, created a retention champion position, and carved out a team to focus on the situation. At Southwest, we are still below five percent in turnover, which is tremendous for this industry.

**Question 3: How do your HR practices fit with each other?**

The system works together to allow employees the freedom to create and innovate and to allow leaders to recognize them for it. We have tremendous recognition programs, probably quadruple what other companies do. Although it's simplistic, it's really just little things, like random acts of kindness. When your daughter graduates from college and gets a gift from the president, it's something. There's not a leader here who would think twice about taking the team bowling this afternoon as a reward for a team accomplishment. But rewards go beyond recognition. We pay at or above the market. We value our employees and take a paternalistic attitude toward benefits, which tend to be tied to tenure. We have a tremendous retirement plan. We match 7.3 percent for our 401(k)s and also offer a profit-sharing plan, which has paid out over many years. We have a great history of providing stock options.

Performance management also reflects how we value our employees. We have what we call loving feedback. It celebrates successes, it lets people know how they're doing, but it's also honest. Employees are happier to get negative feedback than no feedback at all. Our feedback system really has two fronts. The first is based on metrics, such as daily luggage handling performance. The other front is the conversation, the person-to-person discussion that frequently occurs.

**Question 4: How have selection and development affected Southwest's success?**

Very few companies have a business methodology of putting their people first. Our view is that happy employees lead to happy customers, which create happy shareholders. Thus our strong people practices put the employee first, then the customer and shareholder. When you stand behind your employees, that reverberates throughout the organization. It builds fierce loyalty. Our recent survey of employees showed an incredible level of employee satisfaction. Putting the employees first is hard. When things get tight, it's tempting to cut training and other things that matter to the employees.

**Question 5: What challenges do you see ahead for Southwest Airlines in general and with respect to selection and development?**

One challenge that has to be on our radar is the impending labor shortage. When you look at the numbers, the upcoming retirements, it could create difficulties. You can't be a large organization today and not have it on your radar. So what we're doing is like the fuel hedging, we're doing people hedging. We're focusing on retention and development. Retention is critical. Even with our very low turnover rate, below five percent, that means we need 1,700 employees next year just to replace those that leave. Assuming a one-year salary cost of replacing them, which is conservative, you're talking about $55 million. When we charge on average $100 per flight and make, let's say $10 on each one, that's a lot of flights we have to sell just to cover those costs.

*(continued)*





**EXHIBIT SA.6** *(continued)*

Some would say that maintaining our culture is a challenge. I think it is critically important, but I think all the mechanics are in place. We're treating people like we would want to be treated, letting them know they are valued.

Of course another challenge is costs. We strive to be have the lowest costs and the best customer service. We're using a lot of metrics to achieve this. The language of business is numbers, and you need to know how you're doing. HR has to add value. HR needs to be efficient in what it does, or you can't go asking other departments to be efficient. We have to be competitive to be one of the best places to work.

—Jeff Lamb, Senior Vice President Administration and Chief People Officer, Southwest Airlines
(Interview conducted by Steve Werner on August 30, 2007)

- Consistent financial success that provides thousands of jobs in the aerospace industry.
- A route system that has grown to 72 cities in 37 states, carrying more than 85 million customers on about 540 Boeing 737 aircraft.
- A passenger volume consisting of more domestic passengers and departures than any other U.S. airline in 2009.
- Recognition as a Top Employer in *G.I. Jobs'* 2011 list of Top 100 Military Friendly Employers and *Computerworld's* 2010 Best Places to Work in IT.
- Listed in 2010 by the Boston College Center for Corporate Citizenship and Reputation Institute as one of the Top 50 Companies recognized as leaders in corporate social responsibility .
- Ranked 142 (of 500) on *Newsweek's* 2010 Green Rankings.
- Listed in 2010 by *Hispanic Business* magazine as one of the Top 60 companies for diversity.
- Ranked number one among all airlines—for the 17th year in a row—by the American Customer Satisfaction Index in 2010.
- Ranked seventh in *MSN Money's* Customer Service Hall of Fame for 2010.
- Inclusion in *BusinessWeek's* 2010 list of "Customer Service Champs."
- Ranked 4th in *Fortune's* 2011 list of the World's Most Admired Companies.

No single issue, however, 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 that airline is perceived to have been at fault. Although some FAA safety fines in 2008 and fuselage structural damage in 2011 raised concerns, Southwest has maintained a strong 37-year record of safe, reliable operations and is generally acknowledged to be one of the world's safest airlines.[30]

## Customer Service

Of course, Southwest's customers remain one of the company's main constituencies. And 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, Southwest has consistently been one of the best airlines with respect to customer service as measured by the Department of Transportation Air Travel Consumer Reports. In addition, it has frequently been rated as having the highest on-time record, the best baggage handling, and the fewest customer complaints.

## Employee Satisfaction

Given Southwest's 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. Furthermore, Southwest's corporate reputation for being both ethical and socially responsible makes its employees proud to be a member of the Southwest Family.

Southwest's employees are not just satisfied, however. They are productive. In fact, Southwest's employees are the most productive in the industry. A single agent usually staffs gates, whereas competitors commonly use two or three. Ground crews are composed of six or fewer employees, about half the number used by other carriers. And 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. Employee satisfaction and productivity can largely be attributed to Southwest's culture, but a history of management–labor harmony also likely plays a part.

As noted, labor relations is an important determinant of company survival, and Southwest has had generally peaceful and cooperative labor relations throughout most of its history. With the emphasis today on cost containment, however, Southwest may find it more challenging, as time goes on, to maintain harmonious relations with the unions given that its pilots, flight attendants, and mechanics are currently the highest paid in the industry.

## Continued Profitability

Southwest's high customer service, productive employees, and low-cost strategy have consistently led to profitability in an industry that has frequently lost money. Yet 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. The broader scope of these airlines 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 have made the difference between being profitable or not in many recent quarters. Southwest (like JetBlue) also has the advantage of a younger and more fuel-efficient fleet than its larger competitors.

### Growth

Southwest's steady growth over numerous years is now evident in its market share, another indicator of an organization's performance. By this criterion, Southwest also ranks at the top of the industry. For example, it consistently ranks first in market share in the vast majority of its Top 100 city-pair markets and, overall, has more than half of the total market share in those markets. 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. Successfully integrating AirTran, however, will lead to the single largest change in growth in the history of the company.

## 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 36 years. This strategy 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, numerous challenges are 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 the integration of AirTran.

### Integrating AirTran

For several reasons, successfully integrating AirTran is clearly the greatest challenge ahead for Southwest. First, Southwest has little experience in acquisitions. Second, Southwest's unique culture as well as its strategies and operational methods are substantially different from those of AirTran. Finally, the quick growth, different planes, and new routes will require Southwest to change the way it has been doing things for nearly 40 years.

Southwest has broken the integration of AirTran into four major areas. These are:

1. Onboarding AirTran's employees into the Southwest culture.
2. Converting the customer experience on AirTran flights to the Southwest experience.
3. Establishing a single operating certificate with the FAA.
4. Combining and integrating AirTran operations into Southwest.

Perhaps the most difficult of these will be getting AirTran employees to buy into the Southwest culture. Will AirTran pilots be willing to help clean the planes? Will AirTran flight attendants be willing to lend a hand on their day off? Acceptance of the Southwest culture is the greatest concern that Southwest employees have about the acquisition.[31]

Southwest acquired AirTran because it believed the acquisition would help Southwest meet other challenges, such as controlling costs, increasing revenue, achieving future growth, and remaining competitive. Even with a successful integration, however, these challenges will still be formidable.

### 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 additional cost savings than in other airlines. Southwest's cost advantage due to fuel hedges will be substantially reduced over the next few years as well, and it's commitment to not having layoffs and pay cuts may lead to sustained increases in labor costs compared to other airlines. Finally, the one-time integration costs of the AirTran acquisition (e.g., making the AirTran planes look like Southwest planes) will be an added expense. Of course, one way to offset increased costs is to increase revenue.

### Increasing Revenue

Although it has not started charging luggage fees like most other airlines have, 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.[32] And Southwest is continuing to explore other options to increase revenue. These include assigned seating for a nominal charge, increasing the scope of its cargo services, increasing sales for ancillary services (e.g., hotel rooms, rental cars, vacation packages) on its Web site, and introducing new charges for incidentals.[33] Many of these options mean further changing the way Southwest has been doing business since its inception. Thus, adopting them carries considerable risk. Still another way to increase revenue is to increase the size of the airline through continued growth, even after the acquisition.

### Achieving Future Growth

The acquisition of AirTran not only provides dramatic growth quickly, it also helps position Southwest for future growth. By entering international and smaller markets through AirTran routes, Southwest gains the experience needed to compete in and expand its share in these markets. However, future growth will depend on maintaining its culture and high-quality talent. As companies expand, particularly in size and geographic location, they often find that it becomes increasingly difficult to maintain the same culture. Given the large number of AirTran employees to be integrated, this will be even more difficult for Southwest. The leadership will have its hands full in maintaining the culture and the cost levels that have been so critical to Southwest's success.

### Remaining Competitive

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 at the parent airline.[34] The industry has watched Southwest's tremendous success for 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; and interline and marketing agreements with international carriers. The airline's average stage length has also increased over the last several years. In addition, Southwest has expanded into geographic markets and climates that are not as compatible with its original fair-weather, low-congestion strategy, and its flights now compete head to head with some of the major carriers. The acquisition of AirTran further increases Southwest's use of features that the majors use, including international travel.

## 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—namely, the terrorist attacks of September 11, 2001, and the recent recession. Even in the face of these tremendous obstacles, the company has been able to remain profitable every year. With the acquisition of AirTran, however, it is entering into new territory. In one quick move, it will grow by 25 percent and enter numerous new markets. These new markets include segments it has not tapped before, such as international markets and small regional markets. A successful integration of AirTran will position Southwest for continued growth and success. But for the integration to work, 8,000 AirTran employees will have start thinking and acting like Southwest employees. No other company has been able to copy Southwest's culture. Therefore, the key question is "Can Southwest copy their own culture onto AirTran?"