***Teaching Note:* Case 4 – Southwest: Is LUV Soaring?**

# **Case Objectives**

1. To discuss the choice of competitive strategy, and options for growth.
2. To examine how external and internal forces affect competitive strategy.

See the table below to determine where to use this case:

NOTE: There are both PRIMARY and Secondary chapters that can be used for this case. The Teaching Note gives guidance for the PRIMARY use chapters, and provides suggestions if the instructor wants to use the case to illustrate concepts from the optional Secondary chapters.

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| --- | --- | --- |
| **Chapter Use** | **Key Concepts** | **Additional Reading and/or Exercises** |
| PRIMARY CONCEPT  5: Business-Level Strategy | Competitive strategy; generic strategies | See optional advanced reading, Porter, 1996; additional reading, embedded **video** |
| SECONDARY CONCEPTS  2: External Environment | Industry competition five forces; general environmental factors |  |
| 3: Internal Analysis | Value-chain analysis; resource-based view of the firm; VRIN |  |
| 4: Intellectual Assets | Intellectual and human capital | See optional advanced reading, Freiberg & Freiberg, 1996. |

NOTE: At the end of this Teaching Note is an additional OPTIONAL discussion question that instructors can use for advanced students that addresses concepts from Chapter 11: Strategic Leadership, and Chapter 9: Strategic Control.

# **Case Synopsis**

Southwest Airlines was the pioneer of “low-cost, no-frills” strategy. From its beginnings in 1971, the company had become one of the world’s most profitable major airlines (44 straight years of profitability as of January 2015). The company was known for its unique cost-conscious yet fun-friendly culture and subsequent high employee loyalty. Its former Chief Executive Officer and founder, Herb Kelleher, was a celebrated leader and had been the backbone of the organization, creating the foundation for its present scale. Gary C. Kelly, former Chief Financial Officer of Southwest, and CEO since July 2004, had grown Southwest into a $1.1 billion company by making some bold moves.

Southwest had established itself based on its low-cost operations and unique corporate culture, and had flourished with organic growth, but as opportunities for this kind of growth had disappeared in recent years, Southwest had been forced to rethink this strategy. In September of 2010, Southwest announced it was acquiring AirTran. Although this would give Southwest its desired foothold in Atlanta and flight access to Puerto Rico, Mexico, Central America and the Caribbean, this acquisition was a major change in Southwest’s growth strategy. The AirTran acquisition made Southwest Airlines a much larger carrier with access to more potentially lucrative markets, but a stagnant air travel market and consolidation among the more dominant competitors meant Southwest had to find additional ways to boost profits – with possible options such as increased fees that might challenge its low-cost perception among air travelers.

In addition, as Southwest grew, so did the operational costs: fuel and maintenance on now two different types of aircraft. This plus the challenges of merging employees from two different cultures into a smoothly functioning crew scheduling system had caused recent problems. Was Southwest growing too big and ignoring essential investments that had made the airline so successful for so long? Would the success saga continue under Kelly when the core elements of the company’s original strategy – low-cost, organic, and domestic point-to-point short-haul growth and customer-centric culture – were all simultaneously changing?

# **Teaching Plan**

The Southwest case is a good example of what a firm has to do to sustain a competitive strategy. It also provides an opportunity to discuss how competitive and growth strategies are chosen, and how options are dependent on resources available. Therefore, this case can be positioned in the middle part of the course, just after discussion of the components of strategic analysis and formulation. For more advanced students, it can also serve as an example of the nuances of strategic implementation.

The instructor can also position this case discussion with a sole PRIMARY focus on Chapter 5: Business-Level Strategy, contrasting Southwest to the JetBlue and Emirates cases – in discussing choice of competitive strategy, students are encouraged to choose between low-cost leadership and differentiation, but in the airline industry there is really no choice but competition based on controlling costs. Although students may try to explain how service amenities and features such as leather seats can create a differentiated advantage, customers rarely are willing to pay a premium for these things. This means the differences between carriers’ success often revolve around operational choices and strategic implementation. Uncovering those sometimes subtle differences between airlines can be a challenging yet fruitful discussion.

For *advanced students*, the instructor may wish to assign Michael Porter’s 1996 article “What is Strategy?” (*Harvard Business Review,* November-December, pp. 60-79) as companion reading to the case. Southwest is used as an example in this article of how tight linkages across its value chain activities give it a valuable, rare, in-imitable, and non-substitutable competitive advantage. Southwest also demonstrates how human capital can be essential to competitive strategy. The book ‘*Nuts! Southwest Airlines’ Crazy Recipe for Business and Personal Success’* by Kevin Freiberg and Jackie Frieberg, 1996, Bard Press, Austin Texas, will be a useful source in this regard, and could be assigned to advanced students as optional reading.

# **ICEBREAKER**

Since Southwest is well-known for its “fun” activities, even while flying, ask students if they’ve ever flown Southwest, and whether they had a “fun” experience.

*Have any of you ever flown Southwest? If so, what was the experience like? Was it fun?*

*How did this differ from other flight experiences you’ve had?*

*Based on this, would you fly Southwest?*

Many Southwest customers, and maybe some students, are loyal fans of the airline, not so much because of its low-cost, but because of the customer service experience. It might be interesting to students that Southwest does NOT base its competitive strategy on creating this unique customer service culture – the point is not to differentiate itself from its competitors based on how the customer values the experience, but on being able to DELIVER that experience as cheaply as possible – that’s how Southwest has been able to achieve profitability for 40 straight years!

It’s also good to reflect back on this discussion when answering the case question about choice of competitive strategy, and the need for Southwest to achieve parity in differentiation. If it can’t offer in-flight movies and social networking at your roomy leather seat (the 2009 JetBlue differentiators), the “fun” aspects of travel, from the customer’s point of view, may be a way of Southwest achieving this parity.

As an *optional exercise*, regarding Southwest culture as portrayed by founder Herb Kelleher, show students this **video** of a Southwest Airlines television advertisement from 1988:

<http://www.youtube.com/watch?v=LcT_VsHqXmU>

And this short **video** clip shows one of the newer “specialty” themed planes, Penguin One, a Boeing 737-700 co-branded/painted with images of penguins to celebrate 25 years of partnership with Seaworld. As of this unveiling in 2013, Southwest had 15 planes with specialty livery:

<https://www.youtube.com/watch?v=q0Rkj1_VafY>

And, as an example of how Southwest employees are valued by management, see the 3 minute “GAAP Rap” **video** by Las Vegas employee David Holmes, introduced at the 2009 Shareholder’s meeting by CEO Gary Kelly as Southwest’s “rhythmic ambassador”: <http://www.youtube.com/watch?v=7P2-vEtXSug>

Ask students if the playful sprit of the “sack” ad, the distinctive look of the airplanes, and the obvious appreciation and enjoyment of at least one Southwest employee might make them more or less likely to fly on Southwest Airlines? Why?

Some students may also want to talk about horrific airline experiences, and perhaps the July 2009 problem with a Southwest plane (a hole in the fuselage that opened up during flight – see <http://www.msnbc.msn.com/id/31902513/>), and the fuselage hole that appeared in April 2011 (see <http://www.bloomberg.com/news/2011-04-25/southwest-jet-with-hole-in-fuselage-had-misaligned-rivets-u-s-board-says.html> ) might make them worried about safety. Explain that this is part of what makes the airline industry such a challenging one. Point out that in 38+ years, Southwest has never had a passenger or crew fatality, although one person did die on the ground when a Southwest plane skidded off the runway at Chicago’s Midway airport due to winter conditions in 2005. In 2013 a Southwest plane crash-landed on a runway at New York’s La Guardia Airport as a result of pilot error. Nine people sustained minor injuries, but the accident seriously damaged the aircraft and delayed traffic at the airport for hours. The captain, who was 49 years old at the time of the incident and had more than 7,500 hours behind the controls of a 737, was fired by Southwest about two months later. The NTSB’s final report suggested an examination of Southwest’s training and pilot-oversight programs. See <http://www.wsj.com/articles/southwest-airlines-captain-broke-safety-rules-prior-to-2013-accident-in-new-york-1415508923> for more information. (These incidents are not in the case.) If the instructor has also assigned the JetBlue case, reference to the general external industry environment and management of human assets is appropriate to make here.

NOTE: To get up-to-date news and information about Southwest and various other air carriers, the instructor can visit <http://blogs.star-telegram.com/sky_talk/southwest_airlines/> prior to discussing the case.

Finish up the icebreaker exercise by focusing student attention on the issue of operational choices, and how firms, and leadership, need to provide a CONSISTENT customer experience in order to succeed.

Before engaging in discussion, you might want to test student’s basic knowledge regarding the case and the major concepts. Here are some multiple choice questions to use. (This will get the student’s attention – they can’t answer these if they haven’t read the case!)

Southwest uses the following operational model:

1. Short-hauling
2. Point-to-point
3. Hub-and-spoke
4. Base of operations

ANSWER: b Yes, these are mostly short-haul flights, but the correct designation is “point-to-point.” This is one of the main operational differences between Southwest and many of its competitors.

You can use Southwest to fly into Dallas-Fort Worth (DFW).

1. Yes
2. No

ANSWER: b Southwest only flies into Love Field in Dallas. Why? It’s cheaper and closer to downtown Dallas.

# **Summary of Discussion Questions**

Here is a list of the suggested discussion questions. You can decide which questions to assign, and also which additional readings or exercises to include to augment each discussion. Refer back to the Case Objectives Table to identify any additional readings and/or exercises so they can be assigned in advance.

1. PRIMARY QUESTION: Discuss the basis of Southwest’s competitive advantage and the potential challenges to its strategy.
2. SECONDARY QUESTIONS: What internal resources and assets does Southwest have that may give it a competitive advantage?
3. What are key forces in the general and industry environments that affect Southwest’s choice of strategy?
4. OPTIONAL QUESTION: What growth strategies might Southwest pursue?
5. OPTIONAL EXPANDED DISCUSSION: Assess the effectiveness of Southwest Airlines’ leadership, and the use of strategic controls.

# **Discussion Questions and Responses**

1. ***Discuss the basis of Southwest’s competitive advantage and the potential challenges to its strategy.***

**Referencing Chapter 5: Business-Level Strategy**

How firms compete with each other and how they attain and sustain competitive advantages go to the heart of strategic management. In short, the key issue becomes: why do some firms outperform others and enjoy such advantages over time? The viability of a firm’s success is driven by both the internal operations of the firm and the desires and preferences of the market. Firms that succeed have the appropriate resources and cost structure to meet the needs of the industry and general environment.

They also have a strategy…

A *business-level strategy* is a strategy designed for a firm or a division of the firm that competes within a single business. Within the firm’s industry environment *generic strategies* include basic types of business-level strategies based on breadth of target market (industrywide versus narrow market segment) and type of competitive advantage (low-cost versus uniqueness). Here are the three *generic strategies* that are used to overcome industry forces and achieve a competitive advantage:

* Overall cost leadership
  + Low-cost-position relative to a firm’s peers
  + Manage relationships throughout the entire value chain
* Differentiation
  + Create products and/or services that are unique and valued
  + Non-price attributes for which customers will pay a premium
* Focus strategy
  + Narrow product lines, buyer segments, or targeted geographic markets
  + Attain advantages either through differentiation or cost leadership

Generic strategies are plotted on two dimensions: competitive advantage and strategic target. The overall cost leadership and differentiation strategies strive to attain advantages industry wide, while focusers have a narrow target market in mind.

Both casual observation and research supports the notion that firms that identify with one or more of the forms of competitive advantage outperform those that do not. The strategy that Southwest adopted was *overall cost leadership*. The company was successful in implementing this low-cost strategy by aligning its structure and systems with the strategy. This low-cost strategy was the reason why the company remained profitable even in the worst of times in its industry. Southwest was the pioneer of “low-cost, no-frills” strategy, using low-wage yet productive employees. In order to succeed, however, Southwest needed to achieve competitive parity on differentiation.

As explained in the chapter, *competitive parity* means a firm’s achievement of similarity or being “on par” with competitors with respect to low-cost, differentiation, or other strategic product characteristics. Competitive parity on the basis of differentiation permits the cost leader to translate cost advantages directly into higher profits than competitors. Thus, the cost leader earns above-average returns. A business that strives for a low-cost advantage must attain an **absolute** cost advantage relative to its rivals. This is typically accomplished by offering a no-frills product or service to a broad target market using standardization to derive the greatest benefits from economies of scale and experience. However such a strategy may fail if the firm is unable to attain parity on important dimensions of differentiation such as quick responses to customer requests for services or design changes.

Southwest had been able to offer low-cost services to its customers because it offered no-frills whatsoever. However, in view of the changing competitive scenario, the emergence of competitors such as JetBlue or AirTran forced Southwest to achieve some degree of competitive parity on differentiation. Companies like JetBlue were at an advantage because differentiation was built into their low-cost model. In the case of Southwest, achieving such parity on differentiation could prove to be expensive and have significant impact on its ability to maintain the low-cost position. The reason why Southwest’s Chief Executive Officer, Gary C. Kelly, had not been very keen on implementing an in-flight entertainment system was because it would be costly for Southwest to have such a system. Southwest’s ability to balance low-cost and differentiation was important for it to consider into the future. (**Not in the case:** Southwest is now providing Wi-Fi in the air, on some flights (for a small fee), and has in-flight TV and movie programming via an initial arrangement with DISH Network. See <http://www.southwest.com/wifi/?int=GFOOTER-PRODUCTS-WIFI> ) Here’s also where the instructor can remind students about the “fun” culture in the air, and whether humor can be a differentiating factor.

Instructors can ask students if it’s possible to compete on differentiation in the airline industry. In discussing choice of competitive strategy, students are encouraged to choose between low-cost leadership and differentiation, but in the airline industry there is really no choice but competition based on controlling costs. Although students may try to explain how service amenities and features such as leather seats can create a differentiated advantage, customers rarely are willing to pay a premium for these things. This means the differences between carriers’ success often revolve around operational choices and strategic implementation.

One operational difference that Southwest had made obvious to customers was the decision that “bags fly free”. On the surface this might be seen as a differentiated advantage, but it was actually firmly based in the cost control discipline Southwest had always had: on short-haul flights, which Southwest primarily offered, passengers checked fewer or lighter bags, therefore Southwest incurred no extra fuel demands on these flights. The extra cost most airlines charged for bags was directly based on the higher cost of fuel needed to carry that extra weight. Therefore, what appeared to be a differentiation tactic was actually based on Southwest’s low-cost strategic choice.

A competitive strategy is linked to the value chain, and supported by intangible assets. Southwest had great strengths in its operations and its human capital. Tight links among its activities and assets allowed Southwest to create a service that was unique and valuable to customers. From a resource based perspective, it was not any single activity, but the strong coordination across the various value chain activities, i.e., the tightly linked activity system, that was the source of sustainable competitive advantage for Southwest Airlines. Let’s see how that might be so.

1. ***What internal resources and assets does Southwest have that may give it a competitive advantage?***

**Referencing Chapter 3: Assessing the Internal Environment of the Firm**

When one firm outperforms others by a wide margin over a long period of time, it’s important to figure out how this could be. The answer may lie in how that firm arranges its activities and creates unique bundles of resources that allow it to sustain a competitive advantage. Students should assess the relationships between the elements in Southwest’s *value chain*.

Remember, value-chain analysis is a strategic analysis of an organization that uses value-creating activities. Value is the amount that buyers are willing to pay for what a firm provides them and is measured by total revenue, a reflection of the price a firm’s product commands, and the quantity it can sell. A firm is profitable when the value it receives exceeds the total costs involved in creating its product or service. Creating value for buyers that exceeds the costs of production (i.e. margin) is a key concept used in analyzing a firm’s competitive position.

Every activity should add value. Take a look at Exhibit 3.1 to see the value chain activities. Based on the relationships between these elements, Southwest can make a choice of how to proceed to craft a competitive advantage. See the suggestions below:

|  |  |
| --- | --- |
| **Value chain activity** | **How does Southwest create value for the customer?** |
| **Primary:** |  |
| Inbound logistics (distribution facilities, material control systems, warehouse layouts) | Web-based booking gives greater control on managing seat sales. Customers won’t get bumped. |
| Operations (efficient workflow design, quality control systems) | No assigned seating, no meals served, choice of smaller airports all reduce time and costs. |
| Outbound logistics (consolidation of goods, efficient scheduling, finished goods processing) | Using only one type of aircraft keeps operational costs low. Less congested airports help create quicker and on-time flight departures. |
| Marketing and Sales (motivated sales people, innovative advertising & promotion, effective pricing, proper ID of customer segments & distribution channels) | Using its own website for ticketing as a distribution channel. Market segment properly identified i.e., business travelers flying point-to-point. Effective pricing so far, but may have to start charging fees for extras. |
| Service (ability to solicit customer feedback & respond) | Excellent record of communication with customer to keep them informed of changes or inconveniences. |
| **Secondary (or support):** |  |
| Procurement (win-win relationships with suppliers, reduced dependence on single supplier) | Aircraft procurement plan to support growth. Acquisition of AirTran increases bargaining power. |
| Technology development (state of the art hardware & software, innovative culture & qualified personnel) | Investments in technology, website fully integrated into operations. |
| Human resource management (effective recruitment, incentive & retention mechanisms) | Excellent relationships with employees, reward systems such as stock-option plans, profit sharing, innovative recruitment policies and culture promoting camaraderie…see the “culture committee” and fun. |
| General Administration (effective planning systems to establish goals & strategies, access to capital, effective top management communication, relationships with diverse stakeholders) | CEO Gary Kelly was able to continue strategic vision started by Kelleher. Top management with expertise in airline business, ability to coordinate and integrate activities across the value system, and highly visible to inculcate organizational culture, reputation and values. |

## *Primary Activities*

In terms of primary activities, the key to Southwest’s ability to successfully compete in the market appeared to reside primarily in its operations. From the very beginning, Southwest was able to effectively control costs.

### *Support Activities*

With regards to support activities, a competitive advantage can be achieved by developing a strong general administration that is built around visionary leadership and a supportive human resource management strategy. Southwest’s historically positive relationship with its employees was a major strength, as was its well-known sense of fun.

In addition, see the concept of the *resource-based view of the firm*, and the three key types of resources: *tangible resources, intangible resources*, and *organizational capabilities.* A firm’s strengths and capabilities – no matter how unique or impressive – do NOT necessarily lead to a competitive advantage. The resource-based view of the firm takes the perspective that firms’ competitive advantages are due to their endowment of strategic resources that are valuable, rare, costly to imitate, and costly to substitute. Without these unique resources, the firm can only attain competitive parity. RBV goes beyond a SWOT analysis to integrate internal and external perspectives in a broader competitive context. RBV can reveal how core competencies embedded in a firm can help it exploit new product and market opportunities.

An important issue to focus on here is the importance of intangible resources like innovation and reputation. Especially in mature brands, sustaining reputation is essential. Look at resources that are controlled by Southwest that might enable it to develop and implement value-creating strategies. Based on their reading of the case, students might identify those resources to include:

*Tangible Resources:*

*Financial:* Although cost fluctuations in fuel and fees are hard to anticipate, Southwest has always done an excellent job here, making it the only U.S. airline to be consistently profitable.

*Physical:* New orders for Boeing planes, refurbishment of the fleet after the AirTran acquisition might raise questions about financing and increased capital expenditures.

*Technological*: Doesn’t appear that these resources are any more developed than any other airline.

*Organizational:* Historically excellent relationships with the management hierarchy means there is someone always available to negotiate issues.

*Intangible Resources:*

*Human:* Originally, this was a major strength. Now union troubles, financial and service concerns might have eroded willingness of employees to step up, especially in integration of AirTran employees.

*Innovation and creativity:* Kelleher’s original idea and vision for the airline was innovative and creative. Kelly appears to be continuing this tradition.

*Reputation:* Southwest enjoys a strong reputation for operational efficiency. Winning the “triple crown” of service, on-time, and baggage-handling performance enhances its reliability in the eyes of customers.

Determining whether the internal resources are valuable, rare, difficult to imitate, or difficult to substitute (*VRIN*) can help a firm sustain a competitive advantage. See Exhibit 3.6. Applying the *VRIN* concept, in case of Southwest, an argument may be made that its resources are *inimitable.* This is because there was some *path dependency*, *causal ambiguity* and *social complexity* in its operational history. That these elements provided a competitive edge was evident when competitors such as JetBlue had been unable to fully copy Southwest’s operational model. Especially the human resource, human capital element, had been difficult to replicate. As has been noted, with its efficient low-cost operations, Southwest had an interlocking system of mutually reinforcing competencies that made its resources simultaneously valuable, rare, inimitable and non-substitutable, reinforcing its low-cost leadership strategy, thereby providing a competitive advantage.

For *advanced students*, the instructor may wish to assign Michael Porter’s 1996 article “What is Strategy?” (*Harvard Business Review,* November-December, pp. 60-79) as companion reading to the case. Southwest is used as an example in this article of how tight linkages across its value chain activities give it a valuable, rare, in-imitable, and non-substitutable competitive advantage.

# **Referencing Chapter 4: Recognizing a Firm’s Intellectual Assets**

As mentioned, Southwest was known for its human relations. The human resources department was called the “People Department” to reflect the emphasis placed on its employees, i.e., the human capital. This case provides ample scope to discuss how Southwest attracts and retains human capital, its philosophy of recruitment, its culture etc. There is limited information on training-related aspects. However, the instructor is encouraged to do his/her own research if training needs to be emphasized. The book ‘*Nuts! Southwest Airlines’ Crazy Recipe for Business and Personal Success’* by Kevin Freiberg and Jackie Frieberg, 1996, Bard Press, Austin Texas, will be a useful source in this regard, and could be assigned to advanced students as optional reading.

See the concepts of *intellectual capital*, *human capital* and *social capital*, all of which are intangible assets that a company such as Southwest needs to have in order to compete successfully. Intellectual capital is a measure of the value of a firm’s intangible assets, its reputation, employee loyalty and commitment, customer relationships, company values, brand names, and the experience and skills of employees. Human capital involves the individual capabilities, knowledge, skills, and experience of the company’s employees and managers. Social capital is a function of the network of relationships that individuals have throughout the organization.

Human capital is the foundation of intellectual capital. Intellectual capital is developed through attracting, developing, and retaining human capital. See Chapter 4, Exhibit 4.2.

Southwest was one of those organizations that recognized the importance of both intellectual and human capital for organizational success. The importance it placed on its human capital was clear from the fact that its mission statement made a commitment to its employees of providing a supportive environment. (The instructor can have students read the mission statement in detail at this point, see Case Exhibit 1).

Southwest had been successful in attracting and retaining human capital. Its recruitment philosophy was to “hire for attitudes, and train for skills”. The organization did not compromise on this philosophy even if it meant interviewing several applicants for a low-level job in the organization. The fun culture, reward systems and “no furlough” policy helped retain employees. The culture and rewards created an enhanced identification with the mission and values of the organization, and over the years Southwest experienced less employee turnover rates than its rivals. This had the additional positive effect of reducing costs relative to replacing this human capital. The company’s employees were more productive than employees at competitor organizations (As indicated earlier, the instructor may refer to ‘*Nuts! Southwest Airlines’ Crazy Recipe for Business and Personal Success’* by Kevin Freiberg and Jackie Frieberg, 1996, Bard Press, Austin Texas, for additional information). This illustrated how Southwest was able to increase its *intellectual capital,* the value of its intangible assets, through its focus on developing *human capital*, the capabilities of its employees.

Southwest’s success in retaining its human capital could also be attributed to the nurturing of the “social ties” or *social capital*. There was great emphasis on teamwork. Employees recognized the contribution and importance of each others’ work towards the achievement of organizational goals; the “fun and frolic” environment, the parties and celebrations, all fostered camaraderie that enriched the social relationships in the organization. Employees felt that they were cared for, in a family environment. This had benefits when attracting prospective employees as well, since the extended personal social network could encourage talented people to apply.

Through development of social capital; attracting, developing and retaining human capital, Southwest increased the value of its intellectual capital, therefore increased the value of its intangible assets.

(**Not in the case:** Although past history had been positive regarding unionization and relationships with the various unions Southwest employees joined, as of 2013 contract talks with ground crew workers (ramp and ground operations employees) had stalled: “The Transport Workers Union Local 555 has been in talks with Southwest since July 2011 but the two sides have been unable to reach a deal as the Dallas-based airline has proposed outsourcing jobs, increasing part-time workers and reducing medical benefits.” A Southwest representative responded to news of picketing at Dallas Love Field by saying “Southwest will continue to actively participate in negotiations as we make every effort to reach agreements with our unions that are rewarding, flexible, and secure; ones that provide wage and benefit levels that are fair to Employees, allow Southwest to be competitive, and ensure our long-term success.” See <http://blogs.star-telegram.com/sky_talk/2013/03/southwest-ground-workers-picket-outside-dallas-love-field.html> Certainly resolution of any ongoing unrest in Southwest’s human capital required attention.)

1. ***What are the key forces in the general and industry environments that affect Southwest’s choice of strategy?***

**Referencing Chapter 2: Analyzing the External Environment of the Firm**

Organizational leaders must become aware of factors in the overall environment that might affect their ability to create a competitive advantage. So how do managers become environmentally aware? By doing scanning, monitoring, and gathering competitive intelligence, and using these inputs to develop forecasts. This prepares the firm to do more extensive analysis of the forces in the general environment and the industry or competitive environment.

Environmental scanning involves surveillance of a firm’s external environment to predict environmental changes and detect changes already under way. It is a BIG PICTURE viewpoint of the industry/competition, looking for key indicators of emerging trends – what catches your eye? Alerts the firm to critical trends before changes have developed a discernible pattern and before competitors recognize them.

Environmental monitoring is a firm’s analysis of the external environment that tracks the evolution of environmental trends, sequences of events, or streams of activities. Leaders need to monitor the trends that have the potential to change the competitive landscape – what do you want to track? Firms need to CHOOSE the trends identified via the scanning activity, and regularly monitor or track these specific trends to evaluate the impact of these trends on their strategy process.

What factors or trends might be most important to Southwest? To assess how the*external environment*might affect Southwest’s strategy, it’s necessary to take a look at the factors in the *general external environment*. Southwest must consider the political/legal, economic and global, sociocultural and demographic, and technological forces that might affect the ability of the firm to deliver its service and sustain its business. See which factors in the ***general environment*** students might pick that have a significant impact on the airline business.

*Political-Legal:* Under the legal factors, the deregulation of the airline industry in 1978 provided an opportunity to several players to enter the market. It allowed new market segments such as that of the low cost, point-to-point services to emerge. It thus changed the industry landscape. Also, the bankruptcy laws have a significant role to play as they allow even non-profitable operators to continue in the industry when they are protected. One major change that affected the low-cost carriers such as Southwest was the expiration of the Wright Amendment, which now allowed airlines operating out of Dallas Love Field, like Southwest, to offer unrestricted non-stop flights to destinations in Texas and elsewhere.

*Economic:* The airline industry is susceptible to upturns and downturns with the trends in the economy. A growing economy and booming business mean greater demand for air travel, and a slow-down in the economy means reduced demand, consequent unutilized capacity and intensified competition. The availability of venture capital, and other capital sources have an impact on the number of new entrants into the industry. Interest rate fluctuations have an impact on the cost of operations for companies that have high levels of debt. Furthermore, wars with other nations and increases in fuel prices strongly impact the air industry.

*Sociocultural:* The airline industry is highly susceptible to the extreme events such as the September 11, 2001 attacks on the World Trade Center, and publicity surrounding any air accidents. These create fears in the minds of customers toward air travel and have a severe adverse impact on the industry. It also means increased security concerns, delayed flights, increased turnaround times - all these have an impact on customer perception of value, and therefore affect airline profitability.

*Technological:*  The emergence of Internet technology and other breakthroughs have had an impact on the way the airlines conduct their businesses. For example, the Internet reduced the dependence on ticketing agents. Most of the low-fare airlines sell tickets through their websites. Customer service is being extended by personnel working from their homes. All these have made it possible to reduce the costs of operations making it favorable for the low-cost airlines to operate. Also, with the Internet, customers now search and compare prices of air tickets much more easily than earlier and this accentuates the price competition.

It’s also necessary to assess the segments of the external competitive environment that include competitors, customers, and suppliers, substitutes and new entrants. Porter’s *five-forces model* allows strategists to anticipate where the industry might be most vulnerable.

Help students apply Porter’s ***Five Forces of Competition*** to the airline industry by drawing a diagram on the board similar to the following, and having students fill in the details:

Based on the external environmental factor analysis, the airline industry has many competitors trying to carve out a piece of the “profit” pie. Here are some details:

*Threat of new entrants*: The extent of threat due to new entrants is determined by how high or low are the barriers to entry into an industry. In the airline industry, deregulation and availability of alternate sources of funding reduced the barriers to entry.

Economies of scale. This did not work out well for the players in the airline industry. The hub-and-spoke model developed by the major players, led to more of diseconomies of scale than economies. However, the large investments already made by the major airlines, and their established networks do pose a significant threat to new entrants unless they counter it with highly efficient operations.

Product differentiation. Airlines try to create strong brand identification and customer loyalty by using the frequent flyer programs. When there is strong brand identification, it forces the new entrants to spend heavily on weaning away customers from the existing players, thus discouraging their entry. However, in the airline industry the brand identification has not proved to be so strong as to prevent people from switching to other airlines. Some low-cost players are trying to achieve some product differentiation (e.g., JetBlue providing more legroom, LiveTV at each seat, etc., Southwest emphasizing commitment to customer service). However, these are not very strong barriers to entry as the other entrants are imitating them rather pretty easily.

Switching costs. There are virtually no switching costs for customers. The frequent flier programs attempt to create switching costs. However, when the customers are presented with low-cost options, there is nothing strong enough that could prevent them from switching to other airlines.

Thus, the airline industry faces a high threat of new entrants particularly in the low-cost segment. The barriers can be heightened only when they have very closely tied and ultra-efficient operating routines that competitors find it difficult to copy or imitate.

*Bargaining power of suppliers* is high when there are few suppliers in the industry, there are no easy substitutes to supplier’s products, when the buyer industry is not an important customer of the supplier group, the supplier’s product is an important input to the buyer’s business, the supplier products are differentiated or built up switching costs, or the supplier group poses a credible threat of forward integration. There are only two major suppliers i.e., Boeing and Airbus, to the industry and when the airline trains its pilots on either Boeing or Airbus, switching costs get built in terms of pilots’ training in the event the airline decides to change the supplier. Thus the supplier does enjoy considerable bargaining power. However, there is no credible threat of forward integration by the suppliers such as Boeing or Airbus.

*Bargaining power of buyers*is low as the buyers are not concentrated. While the buyer does not have any switching costs, and there are several choices available, they still lack concentration. Internet impacted in increasing the buyer bargaining power because the buyers can compare the prices more easily and in view of no switching costs, they could choose whichever airline offers a low price. Thus, the buyers may be able to influence the airlines to reduce their prices over time. There is no threat of backward integration from the buyers.

*Threat from substitutes*is high when the distances traveled are shorter. In such cases, the customer can choose to travel by land, by car/limo/bus/rail as they might prove to be cheaper alternatives. However, for longer distances and for more hurried customers, the airlines do not face significant threat from substitute modes of travel.

*The intensity of rivalry among existing competitors* in the airline industry is very high. There are numerous competitors, and in times of low or moderate industry growth, the competition gets fiercer as each one tries to nab customers from the other in order to keep their capacity utilizations at acceptable levels. The exit barriers are high because it is difficult to dispose off grounded planes, as there would be few buyers. Also, due to the bankruptcy laws, even the loss-making companies might still be around for a long time thus intensifying competition. So, it is easier to get into the industry but might be difficult to get out. The only solution for many companies is to merge, which is why there has been so much consolidation in this industry over the years. (See <http://www.investopedia.com/features/industryhandbook/airline.asp#axzz1VjKetXz3> for one source of information on the industry.)

Given such a tough industry environment, Southwest should be admired for its ability to not only survive, but, unlike almost all other U.S. carriers, to remain profitable throughout its history, for 44 consecutive years. Given that it was now much larger and facing competition in new markets, for instance in the international cities where it was an unknown, could Southwest continue with its excellent track record?

Instructors can leave students with this question and possibly move on to discuss other airline cases (JetBlue, Emirates), or can ask students for ideas, and then transition into the following optional discussion.

1. ***OPTIONAL QUESTION: What growth strategies might Southwest pursue?***

**NOTE: there are no PowerPoint slides to accompany the following.**

# **Referencing Chapter 6: Corporate-Level Strategy**

Southwest was facing growth challenges. Back in 2005, then ex-CEO Kelleher said, “I think the airline business is fundamentally an opportunistic business. . . . We suddenly have some opportunities materializing that are new to us.” Up to that point, most of Southwest’s growth had been organic, that is, it occurred by adding more flights on its existing routes, and by adding more cities. Since then, in addition to its first ever code share agreement with ATA, CEO Kelly had linked with WestJet at one time, to provide Southwest customers flight bookings into Canada, and had applied for permission to fly Southwest planes to Canadian cities. This was Southwest’s first attempt to expand outside the U.S. until its acquisition of AirTran in 2011, which would give it access to coveted gates in Atlanta, GA and flights to Puerto Rico, Mexico, Central America and the Caribbean. What else could Southwest do to expand?

See the concept of *diversification*. Some possibilities include:

* Mergers and acquisitions
* Strategic alliances
* Joint ventures
* Internal development

Whatever the choice, it should create value for all stakeholders – employees, suppliers, distributors, and the company itself. The choice of diversification strategy should create *synergy* so that all parties gain something they would not have had on their own.

Companies can achieve synergy through diversification in two ways:

Through related businesses (horizontal relationships)

* Sharing tangible resources
* Sharing intangible resources
* Leveraging core competencies

Or through unrelated businesses (hierarchical relationships)

* Value creation derives from corporate office
* Leveraging support activities

*Core competencies*reflect the collective learning in organizations—how to coordinate diverse production skills, integrate multiple streams of technologies, and market diverse products and services to create value. Core competencies must create superior customer value; the different businesses must all have similar elements in the value chain that require similar skills; and these activities or skills must be difficult for competitors to imitate.

Southwest’s core competency was in its operational activities, including the controls it put in place to insure consistency across its business functions. Because of this consistency, Southwest had the potential to diversify into other related service areas if it chose to do so.

*Sharing activities* means that value chain elements are shared across business units, so that two or more activities are done by one of the businesses. This allows for cost savings, but businesses need to make sure to keep control over quality and customer perception. Again, Southwest had an operational activity, which, as already discussed, was one of its strengths. Taking the lessons learned applying its low-cost strategy to flight operations, Southwest could potentially expand this capability into other areas. From an interview in 2009 **(not in the case)**, Kelly said Southwest was no longer a “niche” player. It could use what it’s learned over the years to open up a new market quickly and successfully – it was now a tactical question rather than a strategic one, same strategy, just adjusting the tactic to the market.

Southwest could also choose to focus on well-planned *strategic alliances* or *acquisition.* Southwest’s alliances had included the codeshare agreement with Westjet, for flights into Canada (subsequently terminated in 2010), and a codeshare with Mexican carrier Volaris to begin in 2011 (**not in the case**). These alliances could allow Southwest to expand internationally. (The following is **not in the case**: The current limitations of the 737 airplane meant Southwest could only travel 3, 365 nautical miles without refueling. This meant that only Canada, Mexico, certain destinations in Central America, the Caribbean, Ireland and England were within reach, although on westbound flights from London’s Heathrow Airport the aircraft would probably have to stop for fuel.)

**(Not in the case**: Regarding acquisition, in July 2009 Southwest had announced a $113.6 million bid for bankrupt Frontier Airline, formerly based in Denver. Southwest would operate Frontier as a wholly-owned subsidiary, and planned to gradually fold Frontier’s resources into Southwest’s operating assets – Frontier had Airbus airplanes that would be retired and replaced with Boeing 737s; Frontier’s employees would have been absorbed into the Southwest culture, but this culture clash proved to be the death of the deal. Southwest employees, specifically the pilots, were concerned about seniority battles, and a Southwest spokesperson said the risk to the culture “would likely not be worth the reward of marginally better financial performance from the Denver market”. See <http://www.businessweek.com/bwdaily/dnflash/content/aug2009/db20090814_542215.htm> for more details. If approved, this would have been Southwest’s first major acquisition.)

Southwest had established its strategy based on its low-cost operations and unique corporate culture, and had flourished with organic growth, but as opportunities for this kind of growth had disappeared in recent years, Southwest had been forced to rethink this strategy. In September of 2010, Southwest had announced it was acquiring AirTran, formerly known as ValuJet. Although this would give Southwest its desired foothold in Atlanta and flight access to Puerto Rico, Mexico, Central America and the Caribbean, this acquisition was a major change in Southwest’s growth strategy.

Although the AirTran acquisition would give Southwest Flight slots at Atlanta, Charlotte, and Reagan National in the Baltimore-Washington region, as well as additional slots at New York’s LaGuardia, and access to international destinations, it would also pit Southwest directly against Delta in Atlanta. In addition, Southwest would have to absorb an additional 8,000 employees into its workforce and culture, plus add another type of plane, the Boeing 717, to its maintenance and operational lineup. (**Not in the case:** However, these planes were being retired and replaced with 737s, and even older 737s were being replaced with newer 737-800s and the newest 737-MAX, while some existing 737s were being outfitted with new lighter seats, adding an extra row of seats to the planes in some cases. See <http://en.wikipedia.org/wiki/Southwest_Airlines>, the Evolve Interior.) Southwest didn’t have expertise in international operations, so would be depending heavily on AirTran’s reservation and logistics expertise here.

**(Not in the case:** By 2013 AirTran still hadn’t been fully integrated into all Southwest operations. There were still changes being made to flight schedules, and adaptations being made to service operations at the new destinations – as Gary Kelly said there were “a lot more new markets under development right now than I think any of us would like. But we want to get this transition done obviously and get to a point with the route network that is productive. So if they don't perform, we'll simply continue to make those adjustments and eliminate the flights that don't perform in lieu of better market opportunities. And what that also ties directly into is that we need to be very mindful of our capacity plans for 2014, and we do have a more cautious outlook for 2014 based on current results.” In other words, the in two years since the initial acquisition, the **synergies from shared activities** expected from the acquisition had not yet been realized.

See the 2013 second quarter earning call transcript at <http://seekingalpha.com/article/1573732-southwest-airlines-co-luv-management-discusses-q2-2013-results-earnings-call-transcript?part=single>

By the second quarter of 2015 the acquisition of AirTran was complete, and Kelly was announcing a record return on invested capital, with excellent load factors and profit margins, primarily due to continued cost controls. Regarding expansion, Kelly acknowledged there were less opportunities in the U.S. now, but the new AirTran routes still offered opportunity for development, including in the higher risk international markets. Regarding future growth, Kelly said: “Southwest Airlines has competitive strength and we want to take forward advantage of those. We're a low cost carrier. We have substantially lower cost than our legacy competitors do. And I think, what people miss is that, we have opportunities to grow that many of our competitors do not and Dallas Love Field is a perfect example of that [adding gates to achieve load factors of 94%]. Houston Hobby International is another perfect example of that [building an international terminal expansion]. So we have not grown Southwest Airlines in three or four years. So we have a history of being prudent and measured and how we approach our business. And certainly, would want to continue that into the future. But we have opportunities to grow like we haven't had in years and we absolutely will grow this airline, that is in the best interest of our shareholders.” See <http://seekingalpha.com/article/3352505-southwest-airlines-luv-ceo-gary-kelly-on-q2-2015-results-earnings-call-transcript> for details.)

The changes over the last five years had been the most drastic in Southwest’s history. Although it is a known fact that most mergers and acquisitions end up destroying value for the acquiring company’s shareholders, Southwest had taken its time to manage the AirTran acquisition slowly, and it appeared that the transition had worked. If Southwest’s growth is going to be driven by international or other route expansion, or by additional M&A’s going forward, are there enough opportunities left for this growth to be profitable and will it be sustainable?

**Not in the case:** For an interesting overview of Southwest’s business model, and how it no longer seems to fit any of the three models used among its competitors (Southwest is not ultra low-cost like an Allegiant Air or Spirit, nor is it a hybrid like Alaskan Airlines or Jet Blue, and it certainly isn’t a full service carrier like Delta/Northwest or United/Continental), see “Southwest Airlines, the US' fourth force, does not neatly fit the emerging US business models” at <http://centreforaviation.com/analysis/southwest-airlines-the-us-fourth-force-does-not-neatly-fit-the-emerging-us-business-models-101176>

Gary Kelly will have to pay close attention to “shared activities” going forward, especially after the planned 2013 merger of American and US Airways will make American Airlines the largest U.S. carrier.

***OPTIONAL EXPANDED DISCUSSION: Assess the effectiveness of Southwest Airlines’ leadership, and the use of strategic controls.***

Southwest is a great case to use to demonstrate the importance of strategic leadership, and how decisions about how to “control” operational elements can make a great difference in the success of a given strategy. Although not every point is covered in the case, the following is an optional expanded discussion that instructors can use to investigate these issues. For instance, emphasis can be placed on the importance of understanding and managing company culture. See the external web links included below. These can be used to augment the case and expand the information available to decide these issues.

**Referencing Chapter 11: Strategic Leadership: Creating a Learning Organization and an Ethical Organization**

In the case of Southwest, as with most companies, implementation issues such as strategic leadership and strategic controls are important for organizational effectiveness. Ask students to discuss how Kelleher and Kelly illustrated the activities of strategic leadership.

See the concept of *leadership*, the process of transforming organizations from what they are to what the leader would have them become. This involves:

* Setting a direction
* Designing the organization
* Nurturing a culture dedicated to excellence and ethical behavior

Southwest Airlines had the advantage of strong leadership right from its beginning. The choice of Lamar Muse, an airline veteran who knew the airline business, laid the initial foundation. While Muse was shaping the organization’s strategy, Herb Kelleher on the other hand, was defending the organization from external regulatory and competitive threats in the courts. Kelleher’s credibility as a leader was thus established from the very beginning. The three critical activities of strategic leadership—setting the direction, designing the organization and nurturing a culture dedicated to excellence—were well balanced at Southwest and that was an important reason for the success of the organization.

***Setting direction***. As outlined in the case, the direction for Southwest was very clear. It aspired to be a low-cost airline providing point-to-point services. The leadership at Southwest ensured that the organization did not digress from this core business and kept the focus on profitability of operations. However, the importance of providing appropriate direction to employees, while stressing the importance of employee behavior to organizational success, was evident in the Mission Statement (see Case Exhibit 1.)

***Organizational design.*** Herb Kelleher believed in being accessible to the employees to not only maintain their morale but also to ensure that the right information and advice flowed through the organization at the right time. That belief manifested itself in open-communication and an organizational culture that was not bureaucratic. This however, did not mean that there were no controls. Kelleher ensured that there was tight cost control for the low-cost strategy to be successful. (Not in the case: As an example, for a long-time, he personally signed off checks greater than $1,000.)

The organization was designed to ensure employee participation at all levels. Employees were made partners in the progress of the firm, and stock options enabled them to share in the company’s financial success. Thus, Kelleher created a sense of ownership among employees which helped in the implementation of Southwest’s strategy.

***Nurturing a culture dedicated to excellence.*** At Southwest, a culture dedicated to excellence was nurtured by making “excellence in customer service” an explicit goal and aligning the reward systems toward that end. Also, the leadership at Southwest was successful in realizing that in order to have excellent customer service, the organization needed happy and satisfied employees. Therefore, the organization openly committed itself to the fact that “employees come first”. Herb Kelleher, with his personality and style, walked the talk of culture at Southwest. Colleen Barrett, as an important person in nurturing this culture, continued this tradition after Kelleher retired – a sign of a successful leadership transition.

Another important aspect to be highlighted is that Kelleher took a very proactive approach toward managing the leadership transition. In 2001, he decided to pass authority into the hands of Colleen Barrett and James Parker, while he still played a role in the strategy process of the organization as the Chairman of the Board. This gave time for the organization and its people to adapt to the new leaders and thus help smooth the transition. Unfortunately, being a quiet diplomat, James Parker could not fill the gap created by Kelleher’s departure. Strained by the extensive labor negotiations, Parker resigned as CEO of Southwest in July 2004. Since then, his successor, Gary C. Kelly, has demonstrated he has the energy and enthusiasm to build on Kelleher’s success in establishing a strong corporate culture and employee loyalty. Although both Kelleher and Barrett had formally retired by 2009, they both remained available to help as needed.

**NOTE – ADDITIONAL VIDEO INTERVIEWS WITH BARRETT AND KELLY:**

Colleen Barrett, employee at SWA since 1971 and President from 2001 until stepping down at age 63 in July, 2008, commented on her old boss Herb Kelleher’s collaborative management style, and how she describes herself as a “servant leader” (a term coined by Robert Greenleaf in the 1950s) in this 25 minute **video** from Knowledge @ Wharton:

<http://knowledge.wharton.upenn.edu/article.cfm?articleid=2006>

In this **video**, CEO Gary Kelly talks about the acquisition of AirTran in 2011: <http://www.youtube.com/watch?v=5EKybZaPjUA>

Would you feel comfortable working for him? If you’re a shareholder or customer, does his message about the acquisition allay any fears you may have had at the time?

Visit the Southwest Airlines website at <http://www.southwest.com/html/southwest-difference/southwest-citizenship/index.html> and take a look around. Think about what they mean by the "Southwest Difference".  
  
Then view the **video** of Southwest CEO Gary Kelly at <http://www.mhhe.com/business/management/videos/DestinationCEO/SouthwestCEO_QT.html> :  
Southwest Airlines CEO Gary Kelly is a 6'3" Texan who wears jeans and cowboy boots and considers himself "just someone who works in the office." When he flies, he always chooses to sit in the noisiest, most cramped last row of the airplane. Kelly makes sure he remembers employees' names and takes time to talk with customers. Kelly came up through the ranks with a rich finance background serving as a former accountant with Arthur Young and Co. and then as CFO (chief financial officer) of SWA.  
  
Kelly never had aspirations to become a CEO, but since assuming the position he has helped Southwest maintain its enviable position as the only airline earning profits every year since its founding in 1972. Kelly is credited with locking up fuel hedging contracts, resulting in paying less for jet fuel than competitor airlines.  
  
Southwest continues to focus on its founding principles: Keep costs down through fast turn-around time at the gate, try to fly all the same planes (737s) so that parts and maintenance costs are reduced, and treat customers like queens and kings. Oh yes, and one other principle: Treat employees even better than the customers.

Do you think Kelly effectively sustains and models the Southwest culture? What traits and skills do you think Kelly possesses that make him an effective leader, an effective strategic manager?

**Referencing Chapter 9: Strategic Control and Corporate Governance**

Regarding the importance of strategic controls,students could be asked to identify what difficulties Kelleher and Kelly encountered in balancing rewards, culture and boundaries.

*Strategic control* involves the process of monitoring and correcting a firm’s strategy and performance. Students can discuss the differences between a “traditional” and “contemporary” approach to establishing control systems. In a *traditional control system,* top management formulates strategies and sets goals. These strategies are implemented, and then performance is measured against the predetermined goals. In a *contemporary control system,* managers continually monitor both the internal and external environments, and identify trends and events that signal the need to revise strategies, goals and objectives. Students should therefore recognize the importance of involving all levels of operating managers in setting performance goals based on continuous monitoring of the internal and external environment (for instance employee surveys and customer feedback).

Because Southwest’s leadership emphasized employee involvement, Southwest used a *contemporary control system* to monitor both internal and external environments. Relying on employee and customer feedback, Southwest could make adjustments where needed, and do so in a timely manner. An example of this was evident in Southwest’s use of company blogs, where dialogue between management, employees, customers and other interested parties helped identify and resolve important issues.

(Although **not in the case,** see the blog activity initiated when Southwest CEO Kelly was wondering what to do about assigned seating: Southwest had several operational differences from other airlines. As of 2013, SWA still did not charge fees for the first or second bag checked, one of the only airlines with no fees. Another operational difference was the concept of “open seating” where customers were not assigned seats, but could choose their favorite seating location once on the airplane. In 2006 customers had challenged Southwest to improve the way it handled boarding. Here is Southwest’s response:

<http://www.blogsouthwest.com/blog/a-message-from-our-ceo-open-season-on-assigned-seating> By 2013, Southwest had changed this to allow customers to choose their seats by being the first to board – which they could elect to do, for a fee! However, the point is that Southwest DID appear to listen to its customers’ feedback.)

Strategic control focuses especially on the roles of informational and behavioral control in the formulation and implementation of strategies. See Chapter 9, Exhibit 9.2. *Informational control* is concerned with whether or not the organization is “doing the right things,” while *behavioral control* is concerned with whether or not the organization is “doing things right” in the implementation of its strategy.

The leadership at Southwest is keenly involved in *informational control*. The focus on low-cost strategy was so clear that the organization consciously nurtured this by ensuring that it didn’t diverge from the core business of providing low-cost, point-to-point flight services as an alternative to ground transport. The organization was very conservative in its expansion strategy i.e., connecting the dots. The company studied the demand conditions of new markets very thoroughly before it decided to enter the markets. Profitability was its prime focus and not just growth. Such an approach helped the company maintain its profitability. Thus, the organization had been effective in “doing the right things”.

Chapter 9 emphasizes the importance of aligning both informational and behavioral control systems with organizational strategy. The information gained from the internal and external environment is reviewed against the firm’s strategy and goals. If the results are not what was expected, then *behavioral controls* can be utilized to encourage employees to “do things right” – employee actions can be influenced through building or maintaining a strong positive culture, creating effective reward and incentive programs, and setting boundaries and constraints to minimize improper and unethical conduct (see Chapter 9, Exhibit 9.3).

Regarding *behavioral controls*, Southwest had been lucky, in a way, for having faced a survival crisis in the initial years. The threat to survival helped forge the “Southwest spirit” or the underdog warrior mentality. That formed the basis of Southwest’s culture. Southwest recognized the importance of a culture that focused on excellence in customer service and that valued employees who could foster such customer service. The culture thrived on openness, communication, fun and celebration which kept employees happy and motivated, and helped them deliver excellent customer service. Storytelling and pep talks by top executives were used effectively to reinforce such culture. Stories of Southwest employees going out of their way to help customers were given wide publicity by featuring such employees as the “Star of the month” in their *Spirit* magazine. Top executives used such stories to help reinforce the importance placed on such behaviors. As for pep talks, Herb Kelleher used to personally step in at times of difficulty to keep up the employees’ motivation and morale.

The organization used a personal touch to communicate to employees that it cared for them. This included, among others, sending birthday cards signed by Colleen Barrett, helping employees cope with any personal crises, and also recognizing their contributions and honoring them. The emphasis on teams and appreciation of each others’ efforts towards organizational goals came in the form of employee recognition programs where members from one department took over others duties for a day and honored them. There was a “culture committee” to take care of these aspects (see the “Hokey Day” example in the case, and a 4 minute **video** of this activity, here <http://www.youtube.com/watch?v=V7P0T9IbYKU&feature=related>.) Creating such a strong culture, decreased the need for boundaries and close monitoring. However, the intensified competition, further growth, and labor restructuring agreements among other airlines were making it very difficult for Southwest to maintain this strong, employee-centered culture.

Another component of behavioral control is motivating with *rewards and incentives*. At Southwest, rewards were directly linked to contribution to bottom-line. By giving employees a share in the profits, stock option plans etc., Southwest effectively made employees responsible for the company’s, and their own fortunes. Employees’ goals were closely aligned with that of the company and they exercised close control on costs and operational excellence so that they gained from sharing the bounty. A “no furlough” policy that gave job security further helped in making employees work for less as compared to the wages at competitive organizations, and helped in the implementation of the low-cost strategy.

The third component is *boundaries*. At Southwest, there were no elaborate rules and regulations. The principle of business was to keep it simple. Cost control, focus on core operations, valuing customers and employees were the fundamentals. This did not mean lack of control. By making employees a part of its strategy, the company exercised effective control with minimal rules and regulations.

With the balancing of informational and behavioral controls, the organization succeeded in exercising effective strategic control. Southwest experienced loyalty of its employees, evidenced by reduced employee turnover rates, even during the downturn in the industry. The effective strategic controls were further reflected in Southwest’s continued profitability

This chapter discusses the importance of a strong, positive *culture* and *reward systems* that rely more on achievement of jointly created and internalized goals and objectives than on constraints imposed by rules and regulations. Behavioral controls involve a system of rewards and incentives coupled with a strong culture. Managers need to understand the need to hire the right people, that training plays a key role, managerial role models are vital, and reward systems need to be clearly aligned with organizational goals and objectives.

An organization can get into problems when it uses one component of behavioral control as a substitute for the other. In case of Southwest, some problems with employees existed because, in the changed circumstances, the employees believed that Southwest was trying to substitute culture for rewards (we’re such a wonderful place you should be willing to make any sacrifice to keep it this way). Southwest had to devise an effective response to this concern. Southwest’s example demonstrates clearly that these three levers—culture, rewards and boundaries—need to be effectively balanced, and that one lever of control cannot take the place of another. While a strong organizational culture can help substitute for other forms such as rewards or boundaries, organizations can get into problems when they try to substitute culture completely for rewards. Instead, rewards and incentives need to be *coupled* with a strong culture. The Southwest example demonstrates how difficult it is to balance these elements.

**NOTE – ADDITIONAL READING, VIDEO INTERVIEWS, COMMERCIALS:**

The price-earnings ratio (P/E) reflects the cost of a company’s stock relative to its earnings per share. A lower ratio is thought to reflect more of a bargain. Compare Southwest’s price-earnings ratio to that of its direct competitors and the industry as a whole using this link:

<http://finance.yahoo.com/q/co?s=LUV>

How does Southwest compare to the competitors listed?

Here’s more information on the AirTran acquisition: <http://www.bloomberg.com/news/2010-09-27/southwest-airlines-agrees-to-buy-airtran-for-1-4-billion-in-cash-shares.html>

And a summary of the 3 major challenges facing Southwest: operating a multi-aircraft fleet, serving international destinations, attracting more business travelers, at least in the Northeast: <http://seekingalpha.com/article/227366-airtran-acquisition-offers-glimpse-of-a-new-southwest>

On the announcement of a profitable quarter in July of 2013, in this **video**, CEO Gary Kelly talked again about how Southwest could remain profitable in the future, and was asked about whether he would consider adding bag fees to become more competitive – which he will not consider doing at this time. He also commented on how almost all other airlines have had to declare bankruptcy in order to survive, or have expanded through consolidation/mergers or acquisitions. Southwest, however, continues to be profitable: <http://video.foxbusiness.com/v/2566005512001/southwest-ceo-on-earnings-added-baggage-fees/>

Southwest is famous for using hedging to try to lock in energy savings. United/Continental and AMR (American Airlines) have also been successful here. The industry issue, trying to move revenues along in the face of a difficult economic environment – consumer travel spending down – affects Southwest as well as anyone else. Kelly suggests that the Southwest’s brand and its culture are some of those rare and inimitable assets that sets his airline apart. Do you agree with his comments?

Southwest has several operational differences from other airlines. Currently, SWA does not charge fees for the first or second bag checked, one of the only airlines with no fees. Another operational difference is the concept of “open seating” where customers are not assigned seats, but can choose their favorite seating location once on the airplane. In 2006 customers challenged Southwest to improve the way it handled boarding. Here is Southwest’s response:

<http://www.blogsouthwest.com/blog/a-message-from-our-ceo-open-season-on-assigned-seating> By 2013, Southwest had changed this to allow customers to choose their seats by being the first to board – which they could elect to do, for a fee! However, the point is that Southwest DID appear to listen to its customers’ feedback.

And announcement of a new service in 2009 to allow pets in the cabin:

<http://www.blogsouthwest.com/blog/southwest-airlines-introduces-new-pet-policy-other-changes>

CEO Gary Kelly commented that he wished to do two things: improve the Customer Experience and increase Customer productivity. Do you think he will be able to do both, and will this sustain Southwest’s differentiated competitive advantage in this area?

Regarding Southwest culture as portrayed by founder Herb Kelleher, watch this 30 second **video** of a Southwest Airlines television advertisement from 1988: <http://www.youtube.com/watch?v=LcT_VsHqXmU>

And this short **video** clip shows one of the newer “specialty” themed planes, Penguin One, a Boeing 737-700 co-branded/painted with images of penguins to celebrate 25 years of partnership with Seaworld. As of this unveiling in 2013, Southwest had 15 planes with specialty livery:

<https://www.youtube.com/watch?v=q0Rkj1_VafY>

And, as an example of how Southwest employees are valued by management, see the 3 minute “GAAP Rap” **video** by Las Vegas employee David Holmes, introduced at the 2009 Shareholder’s meeting by CEO Gary Kelly as Southwest’s “rhythmic ambassador”: <http://www.youtube.com/watch?v=7P2-vEtXSug>

Would the playful sprit of the “sack” ad, the distinctive look of the airplanes, and the obvious appreciation and enjoyment of at least one Southwest employee might make them more or less likely to fly on Southwest Airlines? Why?

And one of a series of **videos** about “a day in the life” of Southwest employees and operations. This 4 minute one shows how the “Culture Committee” of Southwest employees helps ease the day of other Southwest employees, in this “Hokey Day” example, flight attendants are greeted after their plane lands at LAX:

<http://www.youtube.com/watch?v=V7P0T9IbYKU&feature=related>

Does this differentiate Southwest in your mind from other airlines?

Read this article about the emergence of another low-cost airline, Independence Air:

<http://money.cnn.com/2004/06/09/news/midcaps/independenceair/index.htm>

and then the further history of Independence Air, including its bankruptcy announcement in January 2006 after only two years of service:

<http://en.wikipedia.org/wiki/Independence_Air>

Another low-cost no-frills airline that HAS been successful is Allegiant Air. This small airline operates scheduled and chartered flights from small towns to vacation destinations such as Las Vegas, lowering costs by flying used aircraft with minimal staff, and charges fees in flight for things like food and beverages, souvenirs, and bookings partnerships with hotels, car rental companies and tourist attractions at its destinations. For more information on this airline’s business model, see <http://en.wikipedia.org/wiki/Allegiant_Air>

Since it is fairly easy for an airline to start up, how serious of a threat are newer discount airlines such as JetBlue to Southwest Airlines? What steps, if any, should Southwest executives take to combat this threat?

JetBlue, especially, has come under attack for its failure to support customers during the weather-related events of February 2007. JetBlue published a Customer Bill of Rights, available here:

<http://www.jetblue.com/about/ourcompany/promise/index.html>

Southwest has a Customer Service Commitment, as an extension of their Mission Statement. Download their full Commitment .pdf document from their website, here, and compare it with JetBlue’s Bill of Rights:

<http://www.southwest.com/about_swa/customer_service_commitment/customer_service_commitment.html>

In addition, *Business Week*’s first ever ranking of the 25 companies who provide the best customer service had Southwest in 13th place (the only airline on the list), and dropped JetBlue from contention altogether based on their February 2007 customer service failure. Here’s a description of how Southwest handled things when weather affected travelers:

<http://www.businessweek.com/stories/2007-03-04/customer-service-champs> In what way might Southwest’s operational expertise and long history of “dedication to the highest quality of Customer Service” give it a continuing competitive edge?

In July 2009, a scheduled Southwest flight from Nashville to Baltimore had to make an emergency landing in Charleston, West Virginia after a "football sized" opening in the airplane's fuselage caused depressurization of the 737-300’s passenger cabin. This incident recalled the FAA penalty imposed on Southwest for failure to conduct safety inspections in 2007. Southwest says it had increased inspections and oversight since then, and the Nashville plane had been through routine maintenance earlier in the month. Boeing, and the National Transportation Safety Board are conducting investigations. See <http://www.msnbc.msn.com/id/31902513/> for the story and a **video** of the damage.

And then in April 2011, it happened again - a flight from Phoenix to Sacramento had to turn back after a six-foot-long in-flight fuselage rupture caused rapid decompression at 36,000 feet. Boeing took responsibility for the investigation here. See a story and **video**: <http://www.avweb.com/avwebflash/news/SouthwestAirlines812_InFlightFuselageRupture_204403-1.html> and another story here: <http://www.huffingtonpost.com/2011/04/02/fuselage-rupture-forces-emergency-landing-southwest_n_843925.html>

In 2013 an incident occurred at LaGuardia airport in NY when a Southwest plane’s nose gear collapsed while landing as a result of pilot error. Only nine people sustained minor injuries, but the accident seriously damaged the aircraft and delayed traffic at the airport for hours. The captain, who was 49 years old at the time of the incident and had more than 7,500 hours behind the controls of a 737, was fired by Southwest about two months later. The NTSB’s final report suggested an examination of Southwest’s training and pilot-oversight programs. See <http://www.wsj.com/articles/southwest-airlines-captain-broke-safety-rules-prior-to-2013-accident-in-new-york-1415508923> for more information. The point is that Southwest had an excellent safety record, with these four events the only major ones in the last 15 years. Southwest has consistently been named to the list of the safest airlines in the world. (See <http://en.wikipedia.org/wiki/Southwest_Airlines>, incidents and accidents.)

**References**

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