Southwest Airlines: A Case Study Linking Employee Needs Satisfaction and Organizational Capabilities to Competitive Advantage

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This article analyzes the sources of Southwest Airlines' competitive advantage using an integrative approach, employing economic analysis tools to illustrate the roles of commitment and organizational capabilities in delivering competitive advantage at Southwest. A framework is presented illustrating that much of the value Southwest generates is (1) created through employee needs satisfaction, (2) converted to customer and shareholder value via organizational capabilities, and (3) captured by the firm as a result of its cost advantage and superior service. This three-part framework may be applicable to other labor-dependent service organizations. © 1996 by John Wiley & Sons, Inc.

Introduction

Southwest Airlines has demonstrated its superior comprehensive strategy by (1) being the only major United States (US) airline to earn a profit throughout the early 1990s, (2) having one of the most successful airline stocks,[1] and (3) being the only airline to ever win the industry's "triple crown" (measures of customer satisfaction).[2] As an example of Southwest's success, both Continental[3] and United Airlines have copied aspects of its strategy in their efforts to improve profitability.

Southwest's success may be due largely to its unusual focus on creating value for employees. "LUV" and "FUN," the cornerstones of Southwest's employee-relations approach, represent concern and respect for the individual, as well as the conscious creation of an environment that encourages all employees to have fun on the job. Southwest's low turnover and high productivity[4] suggest that the airline creates significant value for employees.

Southwest's success is *also* dependent on its organizational capabilities that enable it to convert some of the value created for employees to customer and shareholder value. As a result of these capabilities,

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employees deliver both low cost and superior service which form the basis of Southwest's competitive advantage (Porter, 1985), enabling it to capture value. Thus Southwest provides an example of competitive advantage created through people, as suggested by Pfeffer (1994).

The creation and maintenance of Southwest's competitive advantage can be seen as a virtuous cycle.[5] Describing this cycle requires theories of motivation, organizational capabilities, and strategic positioning. First, Southwest *creates value* for its employees, which increases their motivation. Second, Southwest *converts some of that value* to customer and firm value by designing operating processes, and encouraging behavioral norms that enable employees both to reduce cost and to improve service. Third, Southwest *captures value* through low costs and superior service (relative to its competitors). This create value, convert value, capture value cycle may apply to some portion of competitive advantage in other labor-dependent services (services where labor is both a large proportion of total costs and employees can dramatically affect day-to-day quality).

One goal of this article is to illustrate the role human resources can play in creating and sustaining competitive advantage. The Southwest case illustrates how a focus on human resources in organizational values and culture and the use of specific human resource tools can aid in delivering competitive advantage. It is a particularly good example because commercial airlines form an industry in which competitive advantage is generally acknowledged to be difficult, if not impossible, to obtain. Southwest uses a variety of human resource practices to create value for employees and to convert that value to customer and shareholder uses. Human resource practices also play a role in the ultimate capture of value as they must be aligned with an organization's competitive positioning, technology, and environment if value created through an organization's people is to be captured by the firm.

Conventional Strategic Approaches to Airlines

Southwest's competitors historically have relied on a more conventional interpretation of their competitive status and managed their organizations accordingly. Since the early 1980s, they have focused on the *barriers to entry* created by hub and spoke networks, and by sophisticated customer segmentation and information via computer reservation systems.

These actions are consistent with the strategy literature. This literature suggests that *contestability* (an airline's inability to keep a route profitable because its competitors can enter the route and "contest" it) is not ubiquitous due to investment in certain tangible assets, specifically hub and spoke networks and computer reservation systems (Bailey et al., 1986; Ghemawat, 1989). This literature offers an insightful alternative to the predictions of pure contestability in a deregulated airline environment (Baumol et al., 1982). It does not, however, explain the success of a carrier such as Southwest, which uses neither hubs nor sophisticated customer segmentation schemes made possible by yield- and information-driven computer reservation systems.[6]

Southwest does present an unusual case. Yet it is difficult to consider it an aberration occupying a niche in the airline game given this statement by Bennett from a 1993 Department of Transportation study:

> For the year ended September 30, 1992, Southwest controlled or strongly affected price for more than 60% of the travelers in the most dense markets under 500 miles . . . [and] . . . In the top 100 48-state markets for the industry, which account for about one third of domestic passengers, Southwest is the dominant airline (p. 2).

This begs the question of whether *tangible* impediments to contestability exclusively suffice as the most meaningful variables of success in the airline industry. Southwest's continuing success suggests that employee commitment may play a greater role than previously ascribed. Hints of this idea exist in the competition literature, ". . .a dispirited workforce could exact a severe economic penalty . . . " (Ghemawat, 1989, p. 8). Yet the role of employees in the operation of an airline tends to be viewed as a possible *disadvantage to be avoided*, rather than a possible *advantage to be pursued.*

Another Approach to Airline Strategy

Southwest's fundamental strategy, as described by its management, is to compete against the car. Southwest serves the traveler wanting friendly, reliable, low-cost service on short-haul (generally under ninety-minute) flights. Southwest CEO, Herb Kelleher, believes his company has been successful because friendly, reliable, low cost service is "more for less, not less for less." Delivering more for less requires rapid aircraft "turn" (the time an aircraft is "parked" at a gate) standardization of machinery, adherence to published schedules, extensive selection and training of all employees, and restriction of service to those airports characterized as uncongested.[7] Southwest closely adheres to these operating principles. In contrast, less disciplined carriers (such as the now defunct People Express) focus on only a few of these principles and often apply them inconsistently. Perhaps most important (and in starkest contrast to People Express), Southwest's management acknowledges that the company's growth is limited to the rate it can hire and train new people who fit into its culture.

An examination of Southwest's competitive strategy using value analysis (Brandenburger & Stuart, 1996; Brandenburger & Nalebuff, 1995) illustrates the effects of motivation and organizational capabilities on the airlines' operations. It also illustrates how those operations simultaneously contribute to a low cost and differentiated strategic position which has been sustained for more than 22 years.

Value analysis is based on Porter's (1980, 1985) concept of value chains and cooperative game theory. At its heart, value analysis is an economic analysis tool that illustrates where value is created and which constituent will ultimately capture it. The simplest way to approach value analysis is to examine the creation of value. Consider a value chain consisting of a buyer, a firm, and a supplier. For any value to be created by a firm, the buyer's *willingness to pay* (the worth of a good or service sold by the firm to the buyer) must be greater than the supplier's *opportunity cost* (the amount of worth suppliers believe they can receive for their goods or labor if sold to other firms). For example, in order for a retail store to create value, a shopper (the buyer) must be willing to pay more for an item than what its manufacturer (the supplier) charges the store for the item.

Adding value is not enough. The next step in value analysis asks the question, "Who captures that added value?" To answer this question *price* (the price charged by the store or firm) and *cost* (the firm's total costs for a good or service) must be considered. Figure 1 depicts a generic value analysis that illustrates what portion of added value will be captured by each constituent. Willingness to pay (the amount a customer, or buyer, is willing to pay for a good or service) is at the top of the diagram because it (optimally) is the largest amount. The difference between willingness to pay and price is the amount of value captured by the buyer. For example, if a buyer thinks a pie is *worth* $8.00 and a bakery charges $6.00 for it, the buyer gets $2.00 in *value*[8] by purchasing the pie. The difference between price and cost is the amount of value captured by the bakery. If the bakery's price for a pie is $6.00 and its total costs per pie are $5.00, it captures $1.00 in value on the sale. Finally, the difference between the bakery's cost and the suppliers' opportunity costs is the value captured by suppliers. If the bakery's costs per pie are $5.00 while suppliers of flour, shortening, fruit, labor, etc. would be willing to part with their supplies for as little as $3.00, the suppliers capture $2.00 in value. Note that employees are considered one type of supplier.

One important implication of value analysis is that *all four* of these elements (willingness to pay, price, cost, and opportunity cost) may be changeable. Thus the "game" (business), which is often considered "zero sum" and played by varying only price and cost, is often a pie which can be *expanded* through increases in willingness to pay and decreases in opportunity cost. Southwest Airlines is a good example of a company adept at expanding the pie. Southwest does this by: (1) increasing its passengers' *willingness to pay*, (2) decreasing the *price* passengers are charged, (3) decreasing its *cost*, and (4) reducing employees' *opportunity cost*.

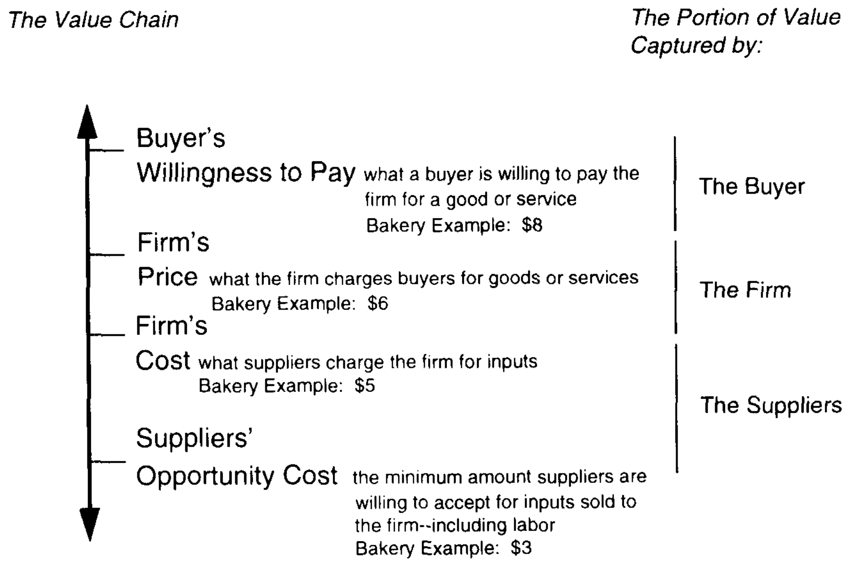

Figure 1. Value creation and division: Value analysis for a generic firm. Notes: 1) "Value captured by" refers to the amount of value the buyer, the firm, or the suppliers capture as a result of being in the relationship. 2) The arrows suggest that each point on the value chain (buyer's willingness to pay, firm's cost, etc.) can and does move. For example: willingness to pay can increase if the quality of a service increases. Source: Adapted from Brandenburger and Stuart (1996).

Willingness to Pay

Southwest increases its passengers' willingness to pay by (1) providing higher levels of service (defined as reliability and conformance), (2) offering frequent departures to and from its cities, and (3) amusing its passengers. As a result, Southwest is differentiated in the eyes of many travelers who will choose it over another carrier if ticket prices are similar or very close. Herb Kelleher describes this result simply: "Everybody values a very good service provided at a very reasonable price."[9]

Higher levels of service refer to more on-time flights, fewer lost bags, and fewer passenger complaints. Statistics compiled by the Department of Transportation indicate that Southwest consistently outperforms its competitors on these service dimensions. Southwest defines *frequent departures* as numerous daily flights to and from cities served so that passengers can fly at their convenience. The airline *amuses passengers* by playing jokes and generally fooling around, which makes the end of a long day a bit more entertaining and takes some of the tension out of delays. At the same time, Southwest's *strict* and *serious* attention to safety has helped it to achieve the best safety record among the major airlines.

Southwest has been called a "no-frills" carrier, which suggests that willingness to pay would decline. Yet the services Southwest does not offer are considered relatively unimportant by its passengers. Meals are not critical on flights averaging 65 minutes. Interline baggage transfer is not important to passengers flying from departure to destination on one airline (Southwest books only tickets involving its own flights). Assigned seating is not essential on short flights; passengers who care about their seats can arrive early and guarantee their choice. Thus:

Increased willingness to pay, a result of 1) superior timeliness and baggage handling, 2) fewer situations resulting in complaints, 3) frequency of departure, 4) employee attitude	<u>less</u> *reduced willingness to pay,* a result of no 1) meals, 2) assigned seats, and 3) interline baggage transfer	<u>results in</u> *a net increase in willingness to pay*[10]

Price

Southwest operates with one long-term price structure[11] as opposed to the multiple structures used by the other major airlines to intricately segment customers. Southwest's pricing strategy is to offer the lowest (or equivalent) airline fare in a specific market.

As Southwest's cost position is lower than those of its competitors[12] (see Table I), it can maintain a low price position indefinitely while competitors matching its price slowly bleed. Because of their higher cost structures, competitors generally have no interest in dropping their prices below Southwest's, which enables Southwest to determine the price floor. This gives Southwest the opportunity to set price at a level where it can operate profitably. Thus profit, or added value captured by the firm, is not "competed" away.

Cost

One of the most significant costs an airline incurs is personnel (see Table I). According to Bob Crandall, CEO of American Airlines, "There isn't any other industry where labor is as important a part of the overall

Table I. 1992 Comparative Data on Selected Major Airlines.

	Airline				
	American	Delta	Southwest	USAir	Continental*
Cost per ASM** (cents)	8.93	9.44	7.03	10.83	8.39
Wages and benefits per ASM (cents)	3.07	3.58	2.35	4.18	1.93
Wages as a percent of total expenses	34.34	37.94	29.78	37.7	23.56
Fuel as a percent of total expenses	13.63	12.75	14.45	10.99	14.93
Maintenance and repair as a percent of total expenses*** (Ave. '90-'92)	5.7	--	7.3	6.4	--

* Operating under bankruptcy protection at the time
** Available Seat Mile
*** Source: Company annual reports. Note: may exclude capital carrying costs of inventory.
Source: *Commercial Aviation Report*, May 15, 1993.

cost mix" (Vietor, 1994, p. 88). Most Southwest employees are directly involved in moving passengers from departure to destination as gate agents, ramp agents, baggage handlers, flight attendants, or pilots. As such, these individuals have a direct bearing not only on cost, but also on passengers' experiences which affect their willingness to pay. *Thus the same input responsible for a significant portion of total cost (labor) is also capable of differentiating the service Southwest delivers.* (This is the essence of labor dependence).

Southwest pays its employees (84% of whom are unionized) at mean industry levels and offers good benefits by industry standard. Thus it gains no cost advantage based on pay scales or lack of benefits. Southwest's employees, however, are vastly more productive than those of other major airlines.[13] This occurs because, *in effect*, flight attendants and pilots are paid whether they are in the air or on the ground; ground crews (baggage handlers and ticket, gate, and ramp agents) are paid whether or not they are preparing a flight for take-off. While the average airline takes approximately 45 minutes[14] to turn around an aircraft (passengers disembark, plane is cleaned, baggage and supplies are loaded, plane is refueled, and new passengers board), Southwest averages only 17 minutes. In addition, Southwest will not initiate service to a new city unless it envisions at least eight flights per day originating there. Thus its in-the-air and on-the-ground employees are highly productive, reducing unit labor cost. In addition, aircraft utilization increases, reducing capital equipment cost. The combined effect of these cost reductions can be seen in Southwest's 1992 available seat mile cost of $0.0703 (see Table I), the lowest of the major carriers.

Why can Southwest reduce costs through tighter scheduling of aircraft turnarounds (17 minutes vs. 45 minutes)? There are three reasons. First, standardized aircraft (The entire fleet consists of 737s). Second, no meals: Reprovisioning is easier and faster. Third, and most important, operating processes such as boarding procedures and cross-functional coordination (Gittell, 1995) *combined with* employee "hustle." From the minute a Southwest flight touches down until the minute it clears the gate, every member of the flight and ground crews does everything and anything necessary to get the next flight segment out on time. Pilots sometimes carry bags to facilitate departures.

Southwest employees may be willing to hustle and engage in these unusual operating processes as a result of their commitment to the airline. This commitment may stem from Southwest's meeting certain of their economic and non-economic needs. Such a phenomenon has been described by numerous authors in the social-psychological and organizational theory literatures. The commitment construct is discussed by Mowday, Porter, and Steers (1982), Walton (1980, 1985a, 1985b, 1986), and Hackman (1985). Identification and exchange theory concepts are discussed by March and Simon (1958). Drawing on these theories, it is reasonable to surmise that commitment stems from the needs fulfillment employees receive at Southwest.

The vehicles for non-economic needs fulfillment at Southwest are what the company calls "LUV" and "FUN." LUV refers to one of the company's core values involving the way individuals treat each other. LUV includes respect for individuality and genuine caring for others. In practice, LUV reflects the adage, "Do unto others as you would have them do unto you"; others are defined as members of the Southwest organization *including* customers. According to a Southwest manager, "At Southwest, the community is most important . . . without the success of the community, you can't have personal success" (see endnote 9). An executive listing Southwest's unwritten rules places compassion toward internal and external customers first. However, LUV (at least at Southwest) is not blind. Employees who consistently fail to meet the organization's standards are asked to leave. Customers behaving unacceptably are invited to fly on other airlines.

FUN is exactly what its name suggests. Southwest practices a "whistle while you work" philosophy resulting in flight attendants who hide in the overhead bins to surprise unsuspecting passengers and gate agents who conduct contests such as "who has the biggest hole in their sock." FUN occurs throughout the company through jokes, parties, and generally entertaining behavior. A front-line manger notes, "We're kind of a big family here, and family members have fun together" (see endnote 9).

Herb Kelleher sums up FUN at Southwest in saying, "We demonstrate by *example* that you don't have to be uptight to be successful" (see endnote 9).

Neither FUN nor LUV happens inadvertently. Southwest's selection processes screen out the dull, pompous, and uncaring by asking interview questions such as "What was your most embarrassing moment?" Boring or self-centered responses quickly separate the majority from the few likely to fit. According to one manager, "We're looking for the things that cannot be taught" (see endnote 9). LUV and FUN are embedded into the Southwest culture and reflected in the company's operating policies. Employees are permitted to dress casually all summer; flight attendants typically wear shorts and sneakers. A video was distributed throughout Southwest showing a group of employees (including the CEO) doing the "Southwest Airlines Shuffle" (also called the "Just Plane Fun Rap" see endnote 9), of which the following is an excerpt:

> We're the southwest team, that's what we are
> No MVP, we're each a big star
> It's fun to fly and it's fun to serve
> And fun is what our customers deserve.

Company-sponsored parties are frequent. Employees are encouraged to dress in costumes for holidays; the CEO dressed as a bunny once to serve Easter eggs to passengers. One employee commented, "It's not just a job . . . there are charity benefit games . . . you can travel to the chili cookoff, to the Christmas party, to the Halloween celebration . . . there is always something going on" (Levering and Moskowitz, 1993, p. 415). The president of the flight attendants' union openly states, "They encourage you to come out and have a good time" (see endnote 9). FUN and LUV produce commitment that changes employees' perception of their relationship with the airline which in economic terms reduces their opportunity cost.

Opportunity Cost

Opportunity cost for an individual is the minimum amount of remuneration that person will accept for a given amount of effort. Remuneration consists both of monetary compensation,[15] which fulfills some amount of economic need, and of some degree of non-economic needs fulfillment.

That Southwest's excellent employee relations support a decrease in opportunity cost among its employees relies on a simple stylized analysis in three steps. *First,* from the individual employee's perspective, if total remuneration (the sum of monetary and non-monetary compensation) increases, so does the total value that employee receives. In Southwest's case, monetary compensation is average for the industry, while non-monetary compensation is greater than that provided by competitors (perhaps due to FUN and LUV). As a result, the employee portion of value increases. *Second,* note that cost does not increase (or only increases modestly[16]) when an organization provides non-monetary needs fulfillment for its employees. *Third,* when the employee portion of value increases more than the corresponding increase in cost (if any), opportunity cost decreases[17]. This decrease in opportunity cost is also consistent with the employee's perception of the situation; if another organization were to offer a job to the employee at the same wages, but with a lower level of non-monetary needs fulfillment, the employee would view this offer as less attractive than his or her current position. *In effect, Southwest creates value by managing its employees in a way that is worth more to the employees than the approach costs Southwest.*

The Creation of Value through Organizational Capabilities

Organizational capability[18] is defined by Ulrich and Lake (1990, p. 40) as: A business's ability to establish internal structures and processes that influence its members to create organization-specific competencies and thus enable the business to adapt to changing customer and strategic needs. Southwest's skill in creating value for its employees is a capability meeting both this definition and that of Barney (1992) in that it (1) is rare, (2) is difficult to duplicate, and (3) contributes to competitive advantage[19].

The creation of value for employees taken out of context is not an organizational capability. Any organization can create some level of value for employees. Southwest's ability to create value for employees qualifies as an organizational capability because Southwest consistently creates more value for employees than do its competitors. Southwest's capability in creating value for employees stems from a combination of two mutually reinforcing (and highly interrelated) elements: (1) Southwest's culture, predominantly FUN and LUV, and (2) the organization's human resource practices which are summarized in Table II.

The Conversion of Value through Organizational Capabilities

Ultimately, the decline in opportunity cost previously described is not entirely value captured by the employee/supplier. Some portion of it is recaptured by Southwest in the form of *superior quantity and quality of effort* from employees, which in turn produces lower costs and higher levels of service.[20] The process of recapturing value for both customers and shareholders is an organizational capability comprised of both (1) operating processes, and (2) behavioral norms derived from the Southwest culture. Operating processes such as cross-functional coordination

Table II. Human Resource Practices at Southwest Airlines.

H.R. Practice	At Southwest	Implications
Selection	*Kelleher: "At Southwest, hiring is a religious experience."* • *Look for energetic employees who are caring and desire to 1) serve others, and 2) have FUN.* • Use attitude-based selection procedures. • Use peer selection. • Involve customers in interview process. • Willingness to ensure employee fit through active use of 1 year probationary employment periods. Self selection occurs via peer pressure for high productivity.	Employees fit with each other and the culture, facilitating operating processes, reducing turnover, and increasing commitment. Employees share FUN with customers resulting in high satisfaction for both.
Training	• FAA-mandated training for many employees. • Other formal training includes leadership training for managers and supervisors stressing coaching over policing. Customer care training for all customer contact employees, including pilots. • Informal training includes induction into culture: development of shared expectations regarding value to be received from the organization and value to be delivered through effort.	Coaching as primary management style. Customer care skills ubiquitous. Company and employees have consistent expectations, reducing ambiguity and stress.
Compensation	• Monetary compensation at mean industry levels plus profit sharing (8% of salary recently) in lieu of a pension plan. • High satisfaction and personal fulfillment for those fitting with the culture.	Total compensation (monetary and non-monetary) very high, resulting in superior effort and loyalty.

Table II. (Cont.)

H.R. Practice	At Southwest	Implications
Nurturing and Spreading Company Values	• Publish reports of frequent company parties and events in "Luvlines" (newsletter). • Publish a book describing "outrageous" acts of service. • Encourage employees to diversify profit-sharing investment portfolios *out* of Southwest stock. • Send important information to employees in FUN packaging such as Cracker Jack boxes. • Organize volunteers for charities (Ronald McDonald House) and fund raisers ("plane pull" tug-of-war). • Send birthday, anniversary, child birth, etc. cards.	Culture remains strong despite growth and increasing physical isolation of some employees.
Employee Involvement	• Open door policy coupled with active listening to employee concerns by top management. • "Come to Jesus" meetings (open discussions between/among employees and departments to acknowledge and resolve operating problems). • Employee-led initiatives: Pilots developed new take-off and landing protocols conserving fuel; employees created a fund to defray high fuel costs during Gulf War. • LUV aspect of culture requires respect for contributions of all employees encouraging involvement. • Numerous and frequent company parties.	Informal problem avoidance and resolution. Rapid problem resolution. Front-line generated improvements implemented. Front line valued. Lowers costs. Reinforces value of employees and culture. Enhances commitment. Increases non-monetary compensation and networks.
Promotion	• 80% of higher-level jobs are filled internally.	Creates opportunity, strengthens culture, and reduces costs.
Union Relations *84% of workforce is unionized*	• Respect for both individual employees and the unions as their representatives. • Contracts state any employee can perform any function. • Non-adversarial relations.	Organizational goals must be consistent with employee goals. Efficiency and service improved. Focus on costs and service.
Attendance Policy	• Highly flexible within constraints of safety, FAA regulations, and the need for work to get done.	Enhances commitment.

and boarding procedures[21] help Southwest turn aircraft in 17 minutes and thus reduce cost, as do behavioral norms regarding appropriate levels of employee effort. Other behavioral norms, such as those concerning the extension of LUV to customers, encourage the delivery of friendly, on-time, hassle-free service. Both types of norms are rooted in Southwest's culture which values hard work and customer satisfaction. A Southwest manager who is a former United Airlines employee described the quantity of work performed by individuals at Southwest in saying, "Wow, I didn't know you could do this much . . . it's just something that's been ingrained [at Southwest] . . . it's something that's expected of you" (Levering & Moskowitz, 1993, p. 415).

While Southwest's capability in converting value through behavioral norms and operating processes is important, it does not create value for customers and shareholders alone. Employees must be *willing to sustain* these norms and *participate* in these operating processes. Employees are *willing* and *do participate* because Southwest also has a capability in creating value for them. Thus capabilities are necessary in both the creation of value for employees and its conversion if value is to be available for customers and the firm.

Southwest follows a three-step path to competitive advantage. The first two steps are the creation and conversion of value (already discussed). In step three, Southwest captures some of the value converted in step two for its shareholders[22] via its ability to set a price floor due to its low cost position. The creation, conversion, and capture of value at Southwest creates a virtuous cycle described in Figure 2, which provides an abstract illustration of how the firm's capabilities combine with its strategy to create employee value and convert it into customer and shareholder value. Table III provides information supporting the assertions[23] in Figure 2.

Conclusion: The Three Stages of Value in Labor-Dependent Organizations

Southwest Airlines is an organization that, like many service companies, is labor dependent. The creation and division of much of the value created by such organizations can be described in three stages[24]:

Value Creation

At Southwest, management views employees as the heart of the service delivery system or as a supplier capable of differentiating the organization from its peers through service level and cost. Both perspectives are logical, given that employee performance (which can vary dramatically) has a significant impact on both the quality and cost of service.

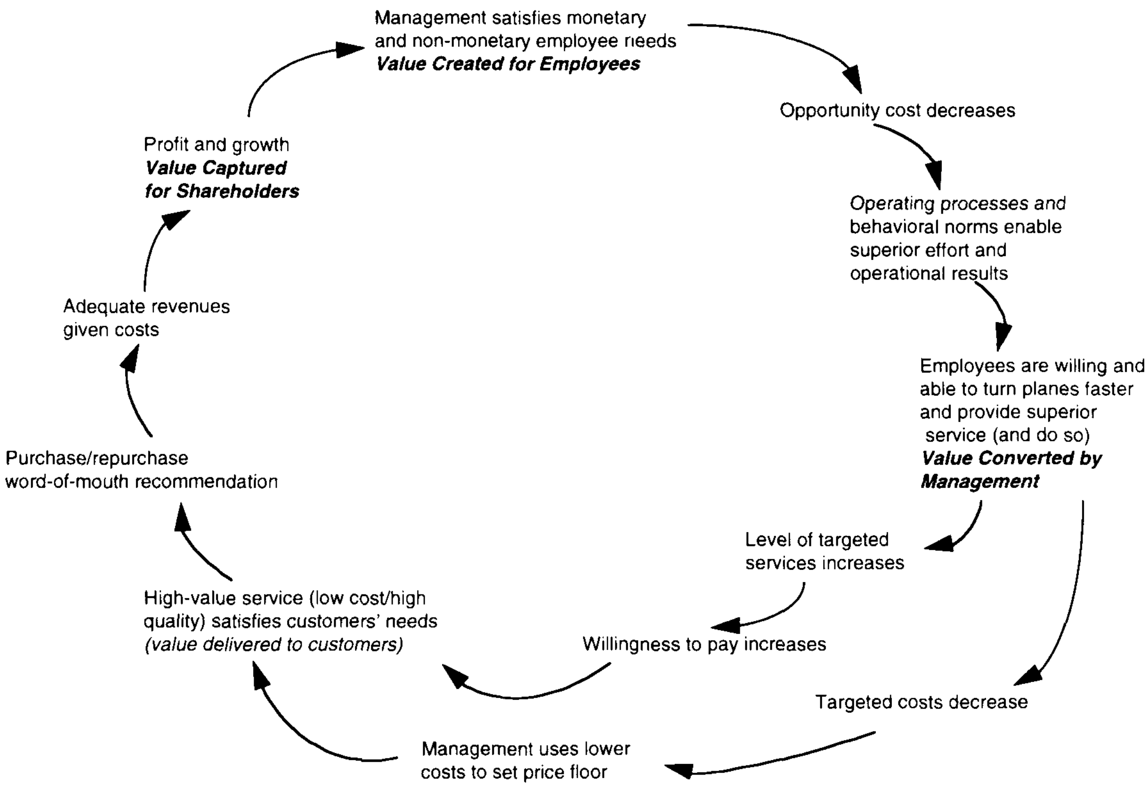

Figure 2. The Southwest Airlines Virtuous Cycle.

Table III. Evidence Supporting the Assertions in the Southwest Airlines Virtuous Cycle.

Employee Satisfaction (value created for employees):

• Southwest management reports that non-management-induced turnover is "substantially below" the industry average.
• Unionized employees are willing to work with no restrictive work rules.
• Southwest is one of the top ten U.S. companies to work for (the only airline of the ten), according to Levering and Moskowitz (1993).
• Anecdotal evidence from multiple sources over time suggests that employees have fun on the job. The president of one of the unions has been videotaped (openly) saying, "Our members enjoy coming to work in the morning."

Productivity (value converted by management):

• Southwest averages 81 employees per aircraft in contrast to the industry average of 134.
• Southwest uses an average of 2.2 station personnel per 1,000 passengers, in contrast to an industry average of 4.2 (figures adjusted for differences in routes and aircraft; see Gittell, 1995).
• Southwest aircraft turn time averages only 63% of the industry average (adjusting for routes and aircraft; see Gittell, 1995).

Customer Satisfaction (value delivered to customers):

• Southwest has won the "triple crown" (fewest late flights, fewest mishandled bags, and fewest passenger complaints, according to Department of Transportation records) for three years in a row (36 consecutive periods). No competitor has won this award for one period.
• When Southwest enters a new market, air travel in that market increases an average of 30% (Gittell, 1995).

Financial Success (value captured for shareholders):

• Southwest's stock value increased 21,775% between 1972 and 1992 (Pfeffer, 1994).
• Southwest's available seat mile cost remains the industry's lowest (7.08¢ in 1994).
• Southwest was the only major U.S. airline to earn a profit in 1992 and has been profitable in every year since initiating flights.
• Southwest is the only major airline with A rated secured debt.
• Southwest has over 65% market share in its top 100 markets.

Southwest management acts to fulfill employee needs as a means of creating value which can ultimately be converted to organizational uses. Value is created through a variety of vehicles including FUN and LUV.

Value Conversion

After creating value for employees, management takes actions to convert that value into value which can accrue to customers and shareholders. In effect, management uses some part of the value it creates for employees by extracting superior employee effort (quantity and quality) to satisfy the needs of customers and shareholders, which in turn creates value for them. Management plays a critical role in the conversion stage by ensuring that employees are willing and expected to provide superior effort and that they have the tools, training, and operating procedures they need so that superior effort delivers superior results.[25]

Value conversion is a critical part of an organization's efforts to achieve internally derived competitive advantage. Without it, the organization may find itself with needs-fulfilled, committed employees who add nothing to customers' satisfaction or to the firm's financial performance.[26]

Value Capture

Value creation and conversion illustrate how value is formed for different organizational constituents. They do not, however, indicate where value will ultimately reside. Value capture illustrates what portion of value suppliers, customers, and the firm will ultimately hold. Southwest's low cost position enables the airline to set price at a level where it can capture value for itself and thus its shareholders.

Human Resource and General Management Implications

The implications of the Southwest Airlines case study revolve around the ability of this unusual organization to achieve an internally derived competitive advantage. This advantage was created and has been sustained because (1) Southwest's strategic positioning as a low-price, high-service airline enables it to capture value, *while* (2) Southwest's organizational capabilities enable it to deliver that low price and high service. Thus the first implication of the case study is that *both aspects of strategy (structural and process-oriented) must be in harmony to create and sustain internally derived competitive advantage.*

The second implication similarly focuses on the importance of harmony (sometimes called "fit" or "alignment"). Harmony is also important at the operating level. Southwest's operating processes, organizational culture, and human resource practices reinforce one another in the creation and conversion of value.

The third implication of the case study stems from its illustration of how crucial human resources can be to the achievement and maintenance of competitive advantage. Southwest's competitive advantage is not structurally achieved; it does not stem from a patent, a barrier to entry, or a "gentleman's agreement" which limits competition in a oligopoly. Southwest's competitive advantage is ground out day in, and day out. It can falter at any moment. Yet it does not, because Southwest's human resource practices continually (1) help employees to place value on their relationship with the organization, and (2) enable the organization to convert that value into low cost and superior service.

The fourth implication is a by-product of the third: While competitive advantage through people is difficult to achieve and hard to sustain, it is also not easy to duplicate. This paper has suggested that Southwest's competitive advantage *could* be copied. In the paper's introduction, the efforts of Continental and United to emulate aspects of Southwest's strategy were noted. Aspects appear not to include human resources, however, as neither Continental nor United has made a serious effort to copy the way Southwest treats its people. The reason may lie in the enormous amount of time and effort it would require to change the values and culture of these airlines to enable them to treat their people as well as Southwest's people are treated (despite employee ownership in United's case). Thus while competitive advantage derived from culturally entrenched human resource practices may easily evaporate if not carefully managed, in fact it is not easily, or rapidly, duplicated.[27]

Herb Kelleher's behavior provides evidence supporting this point. After Continental announced its decision to emulate aspects of Southwest's strategy, Kelleher invited Continental to benchmark Southwest's operations. He argued that while a competitor might buy similar planes and adopt similar procedures, it would never be able to copy Southwest's peoples' spirit.

Human resource professionals and general managers need to consider the role human resources plays at Southwest and contrast it to human resources in their organization. For those managing labor-dependent firms without the benefit of structural sources of competitive advantage, the Southwest model offers a path to competitive advantage worth examining. Readers should not infer that the Southwest model requires every organization to dedicate itself to FUN and LUV. It does suggest, however, that human resources can and should help to create and convert value at labor-dependent firms. Southwest uses a variety of human resource practices to this end, including (1) rigorous selection procedures and a "hard-nosed" willingness to remove those employees (and customers) who do not fit with the culture, (2) substantially above-average total compensation (combined monetary and non-monetary), (3) respect for the individual, (4) extensive training focused on the delivery of value as defined by the customer, (5) the nurturing and spreading of culture directly tied to organizational capabilities, and (6) active encouragement and facilitation of employee involvement (see Table II).

These particular human resource practices may, or may not, be helpful in a particular organization's effort to create and convert value, although they have been helpful to a wide variety of organizations in numerous labor-dependent industries (Heskett et al., 1990). The fifth implication of the case study is that it is the responsibility of human resource professionals and operating managers to identify which tools will be most effective in their organizations' effort to create value for employees given their unique situations. Human resource professionals must also collaborate with operating managers to determine how to convert that value to organizational uses.

A corollary (and sixth) implication of the Southwest model is that human resource departments can neither create employee value nor convert the value created for employees to organizational uses on their own. At Southwest, human resource practices are implemented by everyone in the organization, in part because of their consistency with the organization's values and culture. The human resource department acts as facilitator and cheerleader. As suggested by Ulrich and Lake (1990), human resource issues must first and foremost be the responsibility of operating management if competitive advantage through people is to be achieved.

Southwest is not alone in its reliance on its people to deliver competitive advantage. Significant portions of the success enjoyed by other "breakthrough" (Heskett et al., 1990) service companies can be attributed to their ability to design and implement human resources practices that create and convert value through their people. These success stories include Nordstrom, Taco Bell, ServiceMaster, and Disney, among others. While these firms span many industries and use different strategies and operating systems, each has recognized that for labor-dependent services, the creation of value for customers and shareholders begins with the creation of value for employees.

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Endnotes

1. See Pfeffer (1994, p. 4), who reports a 21,775% increase in the value of Southwest stock between 1972 and 1992.
2. Information on Southwest Airlines stems from the Harvard Business School (HBS) case "Southwest Airlines: 1993" by James L. Heskett, case writer Roger Hallowell, the author's casewriting experience, and "Mobilizing People for Breakthrough Service," video number 2 in the series *People, Service, Success,* Harvard Business School Press, 1993.
3. *New York Times,* 2/1/94. Note that as of May 1995, Continental had abandoned its "Continental Lite" service, likely due to the airline's failure to achieve a reasonable on-time arrival record using a quick aircraft turnaround strategy.
4. See Table III, which is discussed in the section titled "The Conversion of Value through Organizational Capabilities."
5. Schlesinger and Heskett (1989) introduce the concept of a "virtuous cycle" in service firms, suggesting that employee satisfaction leads to customer satisfaction which in turn leads to organizational success. This virtuous cycle is described in contrast to the "cycle of failure" in which dissatisfied employees cause customer dissatisfaction which leads to lower profit and growth.
6. Computer reservation systems were also assumed to provide a distribution advantage in the sale of tickets. This was somewhat shared by Southwest until May 1994 (Southwest's timetables were listed on the major systems, although tickets could not be purchased through them). Despite being delisted by Apollo, System One, and World Span (remaining on Sabre) in June, 1994 Southwest experienced its highest load factor since August 1980 (O'Brian, 1994).
7. Restriction of service to certain types of airports is not discussed in this paper. This practice provides additional time savings to Southwest in addition to those described (i.e., not associated with the 55 vs. 45 minute gate times). Southwest management estimated that this saving was as high as approximately 5 to 10 minutes per flight (average time saving vs. the most congested US airports). Additional savings may result from Southwest's low ($2.50) average per-passenger airport facility fee, in contrast to the higher average fees other carriers may experience. Differences are highly carrier specific, relating to airports served, average distance flown, and load factors. In light of Southwest's very short average distance flown, Southwest may pay as much, or more, in airport fees per mile flown than some of its long-haul competitors.

8. Note the difference between "value" and "worth" as used here. Worth refers to the total benefit a product or service delivers as perceived by the purchaser, while value refers to that total benefit *less* the cost to the purchaser of acquiring the good or service. (This definition applies at all levels of the value chain regardless of who the purchaser is: buyer, firm, or supplier).
9. Quotations from individuals at Southwest Airlines not otherwise referenced are from the video "Mobilizing People for Breakthrough Service" video number 2 in the series *"People, Service, Success,"* Harvard Business School Press, 1993.
10. To view this situation algebraically, consider Southwest vs. an average competitor. The net increase in willingness to pay (over that of an average competitor) will be defined as "W" The cost to produce W is included in " X" (defined in footnote 20).
11. Southwest does offer two-for-one discounts and certain off-peak fares. First class is not offered.
12. Three often cited, but misunderstood, cost advantages are discussed briefly here: (1) While the average airline food and beverage cost was $5.83 per passenger in 1992 (Henderson, 1993), Southwest's (only peanuts and beverages) was considerably lower. The $5.83 figure, however, is not directly comparable, because many airlines have eliminated or scaled back their food service on short flights (which compare to Southwest's flights more directly). (2) Savings have also been attributed to Southwest's single aircraft type. Yet they do not appear to accrue via maintenance and repairs, which are consistently higher than at either American or USAir (see Table I) in spite of Southwest's fleet being the youngest of the major carriers. (3) Finally, while Southwest is known for its tradition of frugality, that tradition is no more intense than that which Robert Crandall has instilled at American. Thus no "frugality" benefit should accrue to Southwest that is not also experienced by its larger rival.
13. See Table III.
14. See Gittell (1995) for an excellent discussion of this process.
15. Monetary compensation is assumed to include benefits.
16. While cost may increase (the cost of efforts contributing to non-monetary employee needs fulfillment), under competent management it is assumed to increase considerably less than the corresponding increase in value created for employees.
17. Algebraically, consider that while cost increases as a result of programs designed to meet the non-economic needs of employees by an amount equal to "X," the suppliers'/employees' portion of supplier/employee value increases by 3X (Southwest holds monetary compensation steady by paying industry wages and simultaneously adds extra non-monetary needs fulfillment in an amount equal to 3X). Therefore, cost increases by X, and employee opportunity cost decreases by 3X. At this point, the airline has lost X amount of value, while the employee/suppliers have gained 3X of value.
18. There is a growing body of literature on organizational capability of which only a few works can be mentioned here. Ulrich and Lake (1990) present one of the first published statements of the capabilities argument with a focus on the role of employees in organizational capability. Stalk, Evans, and Shulman (1992) offer a highly readable discussion of what capabilities are and how they enable organizations to achieve competitive advantage. Collis and Montgomery (1995) add to that earlier work discussing the need for strategy to integrate both capabilities and structural perspectives. Barney (1992) provides an insightful integration of organizational behavior and strategy research using organizational capabilities as his primary vehicle. Peteraf (1993) discusses organizational capabilities from an economist's perspective, offer-

ing an understanding which begins to reconcile the process-oriented organizational capabilities view of competition with the more structural approach advocated by many industrial organization economists. Wernerfelt (1984) wrote one of the earlier pieces on capabilities which remains seminal.

19. Barney also states that an organizational capability should be "without substitutes," a category that can be collapsed into the "rare" category noted.
20. Algebraically, perhaps 2X. *To summarize:* Southwest creates additional value equal to 3X + W at a cost of X, or a net increase in total value created over its average competitor of 2X + W. Southwest has been able to capture X of that added value.
21. Southwest's use of color-coded boarding passes in lieu of assigned seats is easily duplicable by new entrants whose customers are not accustomed to receiving assigned seats, thus only qualifying as a capability in competition against established carriers.
22. Subject to "holdup" as suggested by Ghemawat (1989).
23. Although suggested in Figure 2, causality cannot be scientifically determined.
24. These three stages (particularly the first two) are somewhat parallel to the three elements Walton (1980) describes as critical to high-commitment organizations: (1) generate high commitment, (2) utilize high commitment for business and human gains, and (3) depend on high commitment for organizational effectiveness.
25. Walton (1980) suggests a somewhat similar concept in what he calls the "soundness of the work structure."
26. A similar conclusion underlies work performed by Schneider and Bowen (1993) and Schlesinger and Zomitsky (1991) involving employees' capability to serve customers.
27. A similar conclusion is reached by Gronroos (1990).