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Southwest Airlines

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Southwest Airlines (Southwest), the once scrappy underdog in the U.S. airline industry, was one of the largest U.S. airlines and, based on number of passengers, one of the largest in the world. The company, unlike all of its major competitors, had been consistently profitable for decades and had weathered energy crises, the September 11 terrorist attacks, and the 2008-09 recession. An insight into Southwest's operating philosophy can be found in the company's 2001 annual report:

> *Southwest was well poised, financially, to withstand the potentially devastating hammer blow of September 11. Why? Because for several decades our leadership philosophy has been: we manage in good times so that our Company and our People can be job secure and prosper through bad times.… Once again, after September 11, our philosophy of managing in good times so as to do well in bad times proved a marvelous prophylactic for our Employees and our Shareholders.*

Now in its 45th year of service, Southwest was facing some major challenges. Legacy carriers in the United States had become more efficient, and the mega-mergers involving Delta/Northwest, Continental/United, and American/US Airways were shaking up the industry. Smaller companies like JetBlue, Alaska, and Spirit were pressuring Southwest's cost advantage and low-fare focus. Southwest had the highest labor cost per employee in the U.S. airline industry. With more than 50,000 employees, the company was a long way from the small scrappy upstart challenging the industry with its innovative strategy.

The U.S. Airline Industry

The U.S. commercial airline industry was permanently altered in October 1978 when President Jimmy Carter signed the Airline Deregulation Act. Before deregulation, the Civil Aeronautics Board regulated airline route entry and exit, passenger fares, mergers and acquisitions, and airline rates of return. Typically, two or three carriers provided service in a given market, although there were routes covered by only one carrier. Cost increases were passed along to customers, and price competition was almost nonexistent. The airlines operated as if there were only two market segments: those who could afford to fly, and those who couldn't.

Deregulation sent airline fares tumbling and allowed many new firms to enter the market. The financial impact on both established and new airlines was enormous. The fuel crisis of 1979 and the air traffic controllers' strike in 1981 contributed to the industry's difficulties, as did the severe recession that hit the United States during the early 1980s. During the first decade of deregulation, more than 150 carriers, many of them start-up airlines, collapsed into bankruptcy. Eight of the 11 major airlines dominating the industry in 1978 ended up filing for bankruptcy, merging with other carriers, or simply disappearing from the radar screen. Collectively, the industry made enough money during this period to buy two Boeing 747s.[1] The three major carriers that survived intact—Delta, United, and American—ended up with 80% of all domestic U.S. air traffic and 67% of trans-Atlantic business.[2] The rapid growth of Southwest was in stark contrast to the much slower growth of its major competitors.

Competition and lower fares led to greatly expanded demand for airline travel. Controlling for inflation, the average price to fly one domestic mile dropped by more than 50% after deregulation. By the mid-1990s, the airlines were having trouble meeting this demand. Travel increased from 200 million travelers in 1974 to

700 million in 2007 in the U.S. Demand fell significantly during the recession and then started to grow again in 2010. With the fall in the price of crude oil in 2014, airline profitability soared.

Since the 1978 deregulation, new entrants had created a challenge for the existing airlines. During the period 1994 to 2004, 66 new airlines were certified by the FAA. By 2004, 43 had shut down. Most of the new airlines competed with limited route structures and lower fares than the major airlines. The new airlines created a second tier of service providers that saved consumers billions of dollars annually and provided service in markets abandoned or ignored by major carriers. Over the past few years, the number of new entrants in the United States slowed considerably, perhaps reflecting the market power of American, Delta, and United after their mergers.

Although deregulation fostered competition and the growth of new airlines, it also created a regional disparity in ticket prices, and adversely affected service to small and remote communities. Airline workers generally suffered, with inflation-adjusted average employee wages falling from $42,928 in 1978 to much lower levels over the subsequent decades. About 20,000 airline industry employees were laid off in the early 1980s, while productivity of the remaining employees rose 43% during the same period. In a variety of cases, bankruptcy filings were used to diminish the role of unions and reduce unionized wages. Between 2000 and 2011, 51 U.S. passenger and cargo airlines filed for bankruptcy—13 of them in 2008.[3] In the most recent round of bankruptcies, airline workers at American, Delta, and other major airlines were forced to accept pay cuts of up to 35%.

Industry Economics

About 80% of airline operating costs are fixed or semi-variable. The few variable costs per passenger included food costs and ticketing fees. The operating costs of an airline flight depended primarily on the distance traveled, not the number of passengers on board. The crew and ground staff sizes were determined by the type of aircraft, not the passenger load. Once an airline established its route structure, most of its operating costs were fixed until the route structure was changed.

Because of the high fixed-cost structure, the airlines developed sophisticated software tools to maximize capacity utilization, known as load factor. Load factor was calculated by dividing RPM (revenue passenger miles—the number of passengers carried multiplied by the distance flown) by ASM (available seat miles—the number of seats available for sale multiplied by the distance flown).

On each flight by one of the major airlines (excluding Southwest), there were typically many categories of fares. The airlines analyzed historical travel patterns on individual routes to determine how many seats to sell at each fare level. All of the major airlines used this type of analysis and flexible pricing practice, known as a "yield management" system. These systems enabled the airlines to manage their seat inventories and the prices paid for those seats. The objective was to sell more seats on each flight at higher yields (total passenger yield was passenger revenue from scheduled operations divided by scheduled RPMs). The higher the ticket price, the better the yield.

Although reducing operating costs was a high priority for the airlines, the nature of the cost structure limited cost reduction opportunities. Fuel costs (37% of total operating costs at Southwest in 2004; 23% in 2015) were beyond the airlines' control, and many of the larger airlines' restrictive union agreements limited labor flexibility. Over the past few decades, the airline industry had one of the worst net operating margins when measured against other industries. Airlines were far outpaced in profitability by industries such as banks, health care, consumer products, and oil and gas.

In recent years, a la carte or ancillary revenues such as baggage fees and change fees had become increasingly important for most airlines. Some low-cost airlines, such as Spirit and Allegiant, generated more than 25% of total revenue from ancillary fees. In contrast to most of its competitors, Southwest did not charge for checked bags.

To manage their route structures, the major airlines (except Southwest) maintained their operations around a hub-and-spoke network. The spokes fed passengers from outlying points into a central airport—the hub—where passengers could travel to additional hubs or their final destination. For example, to fly from Phoenix to Boston on Northwest Airlines, a typical route would involve a flight from Phoenix to Northwest's Detroit hub. The passenger would then take a second flight from Detroit to Boston.

Establishing a major hub in a city like Chicago or Atlanta required a huge investment for gate acquisition and terminal construction. JetBlue's 2009 facility at JFK in New York had cost about $800 million. Although hubs created inconveniences for travelers, hub systems were an efficient means of distributing services across a wide network. The major airlines were very protective of their so-called "fortress" hubs, and used the hubs to control various local markets. For example, Delta handled about 80% of Detroit's passengers and occupied nearly an entire Detroit terminal. And, Delta's deal with the local government assured that it would be the only airline that could have a major hub in Detroit. When Southwest entered the Detroit market, the only available gates were already leased by Delta (Northwest at the time). Northwest subleased gates to Southwest at rates 18 times higher than Northwest's costs. Southwest eventually withdrew from Detroit, and then re-entered, one of only three markets Southwest had abandoned in its history (Denver and Beaumont, Texas, were the other two; Southwest re-entered Denver in 2006).

Recent U.S. Airline Industry Performance

Despite steadily growing customer demand, the airline industry always seemed to be one recession away from crisis. The industry in 2017 was very profitable, a marked contrast to the heavy losses of just a few years earlier (with the exception of Southwest). The continuing consolidation in the industry was expected to lead to lower operating costs and higher ticket prices.

The industry faced a number of challenges:

1. **Customer Service.** Customer complaints about service issues such as lost bags, deceptive ticket prices, poor customer service, and reduced legroom were at an all-time high.
2. **Security.** Passengers were frustrated by long lines in security and invasive security procedures.
3. **Fuel.** Volatile fuel costs were a constant uncertainty.
4. **Maintenance.** The aging of the general aircraft population meant higher maintenance costs and eventual aircraft replacement. The introduction of stricter government regulations for older planes placed new burdens on operators of older aircraft.
5. **Air-Traffic Delays.** Increased air-traffic-control delays caused by higher travel demand and related airport congestion were expected to negatively influence customer satisfaction.
6. **Environmental Regulation.** Following actions in Europe, various U.S. groups were advocating new standards and taxes on airline emissions.
7. **Open Skies Agreement**. Legislation allowing greater access to U.S. markets by non-U.S. carriers was expected to increase competitive pressure.

Southwest Airlines Background

In 1966, Herb Kelleher was practicing law in San Antonio when a client named Rollin King proposed starting a short-haul airline similar to California-based Pacific Southwest Airlines. The airline would fly the Golden Triangle of Houston, Dallas, and San Antonio and, by staying within Texas, avoid federal regulations. Kelleher and King incorporated a company, raised initial capital, and filed for regulatory approval from the Texas Aeronautics Commission. Unfortunately, the other Texas-based airlines, namely Braniff, Continental, and Trans Texas (later called Texas International), opposed the idea and waged a battle to prohibit Southwest from flying. Kelleher argued the company's case before the Texas Supreme Court, which ruled in Southwest's favor. The U.S. Supreme Court refused to hear an appeal filed by the other airlines. In late 1970, it looked as if the company could begin flying.

Southwest began building a management team, and the purchase of three surplus Boeing 737s was negotiated. Meanwhile, Braniff and Texas International continued their efforts to prevent Southwest from flying. The underwriters of Southwest's initial public stock offering withdrew, and a restraining order against the company was obtained two days before its scheduled inaugural flight. Kelleher again argued his company's case before the Texas Supreme Court, which ruled in Southwest's favor a second time, lifting the restraining order. Southwest Airlines began flying the next day, June 18, 1971.[4]

When Southwest began flying to three Texas cities, the firm had three aircraft and 25 employees. Initial flights were out of Dallas' older Love Field airport and Houston's Hobby Airport, both of which were closer to downtown than the major international airports. Flamboyant from the beginning, original flights were staffed by flight attendants in hot pants. By 1996, the flight attendant uniform had evolved to khakis and polo shirts. The *Luv* theme was a staple of the airline from the outset and became the company's ticker symbol on Wall Street.

Southwest management quickly discovered that there were two types of travelers: convenience, time-oriented business travelers, and price-sensitive leisure travelers. To cater to both groups, Southwest developed a two-tiered pricing structure. In 1972, Southwest was charging $20 to fly between Houston, Dallas, and San Antonio, undercutting the $28 fares of the other carriers. After an experiment with $10 fares, Southwest decided to sell seats on weekdays until 7:00 p.m. for $26 and after 7:00 p.m. and on weekends for $13.[5] In response, in January 1973, Braniff Airlines began charging $13 for its Dallas-Houston Hobby flights. This resulted in one of Southwest's most famous ads, which had the caption "Nobody's going to shoot Southwest out of the sky for a lousy $13." Southwest offered travelers the opportunity to pay $13 or $26 and receive a free bottle of liquor. More than 75% of the passengers chose the $26 fare, and Southwest became the largest distributor of Chivas Regal scotch whiskey in Texas. In 1975, Braniff abandoned the Dallas-Houston Hobby route. When Southwest entered the Cleveland market, the unrestricted one-way fare between Cleveland and Chicago was $310 on other carriers; Southwest's fare was $59.[6] One of Southwest's problems was convincing passengers that its low fares were not just introductory promotions but regular fares.

Southwest Operations

Southwest's business model maintained many of its original attributes: primarily short-haul (less than 500 miles) and point-to-point flights, a fleet of Boeing 737s, high-frequency flights, no baggage fees, and low fares. Two service area were different: (1) with the acquisition of Air-Tran, Southwest became an international company with flights to Mexico and the Caribbean; (2) new boarding processes were introduced in 2007 that included early boarding for an additional fee.

Southwest was the only large airline to operate without major hubs, although cities such as Baltimore, Chicago, Dallas, Denver, Las Vegas, and Phoenix were increasingly important transit points for Southwest trips. For example, there were 239 daily departures from Chicago, Southwest's busiest airport. Point-to-point service provided maximum convenience for passengers who wanted to fly between two cities, but insufficient demand could make such nonstop flights economically unfeasible. For that reason, the hub-and-spoke approach was generally assumed to generate cost savings for airlines through operational efficiencies. However, Southwest saw it another way: hub-and-spoke arrangements resulted in planes spending more time on the ground waiting for customers to arrive from connecting points.

Turnaround time—the time it takes to unload a waiting plane and load it for the next flight—was faster at Southwest than at the other major airlines. This time savings was accomplished with a gate crew 50% smaller than other airlines. Pilots sometimes helped unload bags when schedules were tight. Flight attendants regularly assisted in the cleanup of airplanes between flights.

Southwest pioneered a no-frills approach: no reserved seating or meals were offered. Seating was first come, first served. As to why the airline did not have assigned seating, Kelleher explained: "It used to be we only had about four people on the whole plane, so the idea of assigned seats just made people laugh. Now the reason is you can turn the airplanes quicker at the gate. And if you can turn an airplane quicker, you can have it fly more routes each day. That generates more revenue, so you can offer lower fares."[7]

Unlike some of the major carriers, Southwest rarely offered delayed customers a hotel room or long distance telephone calls. Southwest had only a limited participation in computerized reservation systems, and did not sell tickets on travel websites such as Expedia, Travelocity, and Orbitz. Consumers had to go to the airline's website, and check other online travel sites for comparative prices. Southwest was the first national carrier to use internet ticketing. About 85% of customers checked in online or at a kiosk. Southwest was also one of the first airlines to use ticketless travel, offering the service first in 1995. Southwest had one of the most generous frequent flyer programs.

Over the years, Southwest's choice of markets resulted in significant growth in air travel at those locations. In Texas, traffic between the Rio Grande Valley (Harlingen) and the Golden Triangle grew from 123,000 to 325,000 within 11 months of Southwest entering the market.[8] Within a year of Southwest's arrival, the Oakland-Burbank route became the 25th largest passenger market, up from 179th. The Chicago-Louisville market tripled in size 30 days after Southwest began flying that route. Table 1 shows a comparison of Southwest across several years from 1971 to 2016.

Table 1. Southwest Across the Years

	1971	1999	2007	2016
Size of Fleet (end of year)	4	306	515	714
Number of Employees	195	29,005	34,378	53,000
Number of Passengers Carried	108,554	52,600,000	101,947,800	118,171,211
Number of Cities Served	3	55	64	98 U.S. cities; 7 other countries
Number of Trips Flown	6,051	602,578	1,160,699	1,267.358
Total Operating Revenues (millions $)	2.33	4,736	7,369	19,820
Net Income (millions $)	-3.8	433	645	2,181

Sources: Southwest Airlines Co Annual Reports, and company website.

Southwest's Performance

The average Southwest flight had a duration of two hours and two minutes, and a length of 757 miles. This was up from 462 miles in 1999 and 394 in 1996. Each plane flew about six flights daily, higher than the industry average. Planes were used an average of 11 hours a day. Table 2 shows that Southwest's cost per available seat mile was lower than the legacy carriers (American, Delta, United), but not lower than some of the newer and smaller carriers such as JetBlue (one of the reasons for JetBlue's lower cost per ASM was its longer average flight length—1,087 miles[9] at JetBlue). Southwest's on-time arrival and departure record, for many years near the top in the industry, deteriorated significantly in the 2010-2014 period. By 2016, the arrival rate had improved and was ahead of JetBlue and American (see Table 2).

Table 2. Airline Operating Data 2016

	American	**Delta**	**JetBlue**	**Southwest**	**United**
Load Factor	83.1%	82.3%	85.1	84.0%	82.9%
Operating Cost per ASM (cents)	11.94	12.98	9.92	11.22	12.22
Revenue per ASM (cents)[1]	11.55	13.41	11.21	12.52	11.31
On-time Performance[2]	79.38%	86.48%	75.01%	80.8%	81.71%

[1] Calculated by dividing operating revenue by available seat miles
[2] U.S. Bureau of Transportation Statistics

Source: Company data.

Exhibits 2-10 provide data on the major U.S. competitors for the period 2010-2016:

- Exhibit 1. Operating Margins
- Exhibit 2. Total Revenue Passenger Miles
- Exhibit 3. Passenger Yield (Passenger Revenue per RPM)
- Exhibit 4. Load Factor
- Exhibit 5. Cost per Available Seat Mile
- Exhibit 6. Net Debt: Southwest Is the Lowest in All Years

Southwest bucked the airline industry trend by earning a profit for 44 consecutive years. Since 1987, Southwest consistently ranked first in fewest overall customer complaints as published in the Department of Transportation's Air Travel Consumer Report.

Southwest accomplished its strong record by challenging accepted norms and setting competitive thresholds for other airlines to emulate. The company established numerous new industry standards. Southwest flew more passengers per employee than any other major airline, while at the same time had the fewest number of employees per aircraft. Southwest maintained a debt-to-equity ratio lower than the industry average and, unlike United and American, had an investment grade credit rating. The company had never curtailed service because of a union strike, and no passenger had ever died because of a safety incident.

Of the total 737 fleet, 581 aircraft were owned and the remainder were either on capital leases or operating leases. The average age of the Southwest fleet was 12 years, the lowest for the major carriers.

Herb Kelleher

Herb Kelleher was CEO of Southwest from 1981 to 2001. In 2001, at age 71, Kelleher stepped down as CEO but remained Chairman until 2008 when he resigned from the Board of Directors. Kelleher's leadership style combined flamboyance, fun, and a fresh, unique perspective. Kelleher played Big Daddy-O in one of the company videos, appeared as Elvis Presley in in-flight magazine advertisements, and earned the nickname "High Priest of Ha-Ha" from Fortune.[10] Although Kelleher was unconventional and a maverick in his field, he led his company to consistently new standards for itself and for the industry. Sincerely committed to his employees, Kelleher generated intense loyalty to himself and the company. His ability to remember employees' names and to ask after their families was just one way he earned respect and trust. At one point, Kelleher froze his salary for five years in response to the pilots agreeing to do the same. Often when he flew, Kelleher would help the ground crew unload bags or help the flight crew serve drinks. His humor was legendary and served as an example for his employees to join in the fun of working for Southwest. He was called "a visionary who leads by example—you have to work harder than anybody else to show them you are devoted to the business."[11]

Although Kelleher tried to downplay his personal significance to the company, especially when he gave up the CEO position in 2001, many analysts following Southwest credited the airline's success to Kelleher's unorthodox personality and engaging management style. As one analyst wrote, "The old-fashioned bond of loyalty between employees and company may have vanished elsewhere in corporate America, but it is stronger than ever at Southwest."[12] From October 1 to December 2001, Kelleher, CEO James Parker, and COO Colleen Barrett voluntarily relinquished their salaries. Gary Kelly, Southwest's former CFO, became CEO in 2004.

Southwest Spirit

Customer service far beyond the norm in the airline industry was not unexpected at Southwest and had its own name—Positively Outrageous Service. Some examples of this service included: a gate agent volunteering to watch a dog (a Chihuahua) for two weeks when an Acapulco-bound passenger showed up at the last minute without the required dog crate; an Austin passenger who missed a connection to Houston, where he was to have a kidney transplant operation, was flown there by a Southwest pilot in his private plane. Another passenger, an elderly woman flying to Phoenix for cancer treatment, began crying because she had no family or friends at her destination. The ticket agent invited her into her home and escorted her around Phoenix for two weeks.[13] The case writer observed a flight attendant offer to help babysit a new father's baby.

Southwest Airlines customers were often surprised by Southwest Spirit. On some flights, magazine pictures of gourmet meals were offered for dinner on an evening flight. Flight attendants were encouraged to have fun; songs, jokes, and humorous flight announcements were common. One flight attendant had a habit of popping out of overhead luggage compartments as passengers attempted to stow their belongings, until the day she frightened an elderly passenger who called for oxygen.[14] Herb Kelleher once served in-flight snacks dressed as the Easter Bunny.

Intense company communication and camaraderie was highly valued and essential to maintaining the esprit de corps found throughout the firm. The Southwest Spirit, as exhibited by enthusiasm and extroverted personalities, was an important element in employee screening conducted by Southwest's People Department. Employment at Southwest was highly desired. In 2015, Southwest received 372,925 job applications. Once landed, a job was secure. The airline had never furloughed employees because of a business downturn (the company had used some voluntary employee buyouts). Voluntary employee turnover was around 2.5%, the lowest rate in the industry. In 2017, Southwest had about 50,000 employees.

During initial training periods, efforts were made to share and instill Southwest's unique culture. New employee orientation, known as the new-hire celebration, had in the past included Southwest's version of the Wheel of Fortune game show, scavenger hunts, and company videos including the "Southwest Airlines Shuffle" in which each department introduced itself, rap style, and in which Kelleher appeared as Big Daddy-O. To join the People Department (i.e., Human Resources), employees required frontline customer experience.

Employee initiative was supported by management and encouraged at all levels. For example, pilots looked for ways to conserve fuel during flights, employees proposed designs for ice storage equipment that reduced time and costs, and baggage handlers learned to place luggage with the handles facing outward to reduce unloading time.

Table 3. Culture—Excerpts from Southwest.com

The Culture Services Department is charged with championing a Culture through which everyone knows that he or she matters.

We strengthen and promote our legendary Culture by encouraging our Employees through celebration, recognition, and appreciation. Employees are encouraged to attend annual Company-wide celebration events, such as the Southwest Rally, Spirit Party, and Chili Cook-off. We also encourage Employees to stand up to recognize one another through awards and programs such as Kick Tail, LUV Reports, Winning Spirit Award, President's Awards, and our milestone anniversary celebrations. In order to promote and foster a fun and healthy work environment, we work to appreciate every Employee through our 400+ member Company-wide Culture Committee and our 130+ Local Culture Committees.

Southwest Airlines Gratitude (SWAG) Points
At Southwest Airlines, gratitude is a way of life. It's part of our Culture to appreciate and recognize one another, and it's exhibited in a multitude of ways—from a Leader or a peer saying "great job," to receiving an award like Winning Spirit, to attending the Annual Awards Banquet on one of your milestone anniversaries. Employees can also earn and redeem Southwest Airlines Gratitude (SWAG) Points for Guest Passes for friends and family, Rapid Rewards® Points, merchandise, gift cards, or event tickets.

Southwest placed great emphasis on maintaining cooperative labor relations: 83% of all employees were unionized and represented by 11 different unions. Southwest pilots belonged to an independent union and not the Airline Pilots Association, the union that represented more than 60,000 pilots. In 1974, Southwest was the first airline to introduce employee profit sharing. Through the plan, employees owned between 13% and 15% of the company's stock.

Herb Kelleher summed up the Southwest culture and commitment to employees:

> *We don't use things like TQM. It's just a lot of people taking pride in what they're doing… You have to recognize that people are still the most important. How you treat them determines how they treat people on the outside… I give people the license to be themselves and motivate others in that way. We give people the opportunity to be a maverick. You don't have to fit in a constraining mold at work—you can have a good time. People respond to that.*[15]

Southwest Imitators

Southwest's strategy spawned numerous imitators, in the United States and around the world. Some of the imitators outside the United States achieved huge success, such as Ryan Air and Air Asia. Most of the U.S. imitators fared badly. Two decades ago, the legacy carriers attempted to compete directly with Southwest. The Shuttle by United, a so-called airline within an airline, was started in October 1994. United's objective was to create a new airline owned by United with many of the same operational elements as Southwest: a fleet of 737s, low fares, short-haul flights, and less-restrictive union rules. United saturated the West Coast corridor with short-haul flights on routes such as Oakland-Seattle, San Francisco-San Diego, and Sacramento-San Diego. The Shuttle was unable to achieve the same level of productivity as Southwest, and in 2001 United discontinued Shuttle service and folded the remaining flights into its regular service. US Airways did the same with its Metrojet discount service. In 2003, United started a new discount carrier called TED, which also failed.

Some of the attempts to imitate Southwest were almost comical. Continental Lite (CALite) was an effort by Continental Airlines to develop a low-cost service and revive the company's fortunes after coming out of bankruptcy. In March 1994, Continental increased CALite service to 875 daily flights. Continental soon encountered major operational problems with its new strategy.[16] With its fleet of 16 different planes, mechanical delays disrupted turnaround times. Various pricing strategies were unsuccessful. The company was ranked last among the major carriers for on-time service, and complaints soared by 40%. In January 1995, Continental announced that it would reduce its capacity by 10% and eliminate 4,000 jobs. By mid-1995, Continental's CALite service had been largely discontinued. In October 1995, Continental's CEO was ousted.

A Successful Startup: JetBlue Airways

Morris Air, patterned after Southwest, was the only airline Southwest had acquired. Prior to the acquisition, Morris Air flew Boeing 737s on point-to-point routes, operated in a different part of the U.S. than Southwest, and was profitable. When Morris Air was acquired by Southwest in December 1993, seven new markets were added to Southwest's system. In 1999, Morris Air's former president, David Neeleman, announced plans for JetBlue Airways, a new airline based at New York's JFK Airport. JetBlue had a successful IPO in April 2002, with the stock rising 70% on the first day of trading. JetBlue had a geographically diversified flight schedule that included both short-haul and long-haul routes. Although JetBlue was viewed as a low-fare carrier, the airline emphasized various service attributes, such as leather seats, free LiveTV (a 24-channel satellite TV service with programming provided by DirecTV) and pre-assigned seating.

In 2017, JetBlue served 97 cities in the United States, Mexico, the Caribbean, and South America with more than 19,000 employees. Jet Blue had a fleet of 32 Airbus A321 aircraft, 130 Airbus A320 aircraft, and 60 Embraer 190 regional jet aircraft. JetBlue's annual revenue was almost $7 billion, about one-third that of Southwest.

Southwest Expansion

Southwest grew steadily over the years, but the growth was highly controlled. New airports were carefully selected and only a few new cities were added each year. As Kelleher wrote to his employees in 1993, "Southwest has had more opportunities for growth than it has airplanes. Yet, unlike other airlines, it has avoided the trap of growing beyond its means. Whether you are talking with an officer or a ramp agent, employees just don't seem to be enamored of the idea that bigger is better."[17]

In October 1996, with the initiation of flights to Providence, Rhode Island, Southwest entered the northeast market. The entry into the northeast region of the U.S. was, in many respects, a logical move for Southwest. The northeast was the most densely populated area of the country and the only major region where Southwest did not compete. New England could provide a valuable source of passengers to Florida's warmer winter climates. Southwest's entry into Florida exceeded initial estimates.

Despite the large potential market, the northeast offered a new set of challenges for Southwest. Airport congestion and air-traffic-control delays could prevent efficient operations, lengthening turnaround time at airport gates and wreaking havoc on frequent flight scheduling. Inclement weather posed additional challenges for both air service and car travel to airports. Nevertheless, Southwest continued to add new northeast cities, including Baltimore, Boston, Hartford, Newark, New York, Philadelphia, and Pittsburgh.

With the acquisition of AirTran in 2011, Southwest became an international airline with flights to various Caribbean and Mexico cities. In 2016, Southwest added three destinations in Cuba.

Future Challenges

Although Southwest was profitable and had a strong financial position, competition was stiff. The newly merged legacy carriers were becoming more efficient, and smaller players like JetBlue and Spirit had lower costs than

Southwest. While Southwest's employee productivity remained high, its operating costs were rising. Difficult labor negotiations were leading to actions unusual at Southwest, such as a Dallas radio ad bashing CEO Gary Kelly for outsourcing maintenance work:

> *"While our company is making record profits and executive pay is through the roof, Gary Kelly wants to outsource much of our maintenance work, with some of it going to foreign countries using noncertified mechanics," the ad, voiced by a mechanic with 40 years at Southwest, reads. "His plan threatens our jobs, and it could threaten the safety of our customers."*[18]

Looking forward, various questions loomed. Would Southwest be able to maintain its position as America's most prosperous airline? Could Southwest maintain its strong and unique culture as it grew to more than 50,000 employees? Could Southwest grow profitably in international markets? Would the major airlines finally learn how to compete on cost with companies like Southwest and JetBlue?

According to CEO Gary Kelly, "Our purpose is to connect customers to what's important in their lives with friendly, reliable, and low-cost air travel. We take great care of our employees, so they can take great care of our customers. If we do that well, we can take great care of our shareholders.[19]… We still have an underdog mentality. It's not a comfortable country-club environment for us… We're still a maverick."[20]

Exhibit 1. Operating Margins for Major U.S. Airlines

Source: Company data.

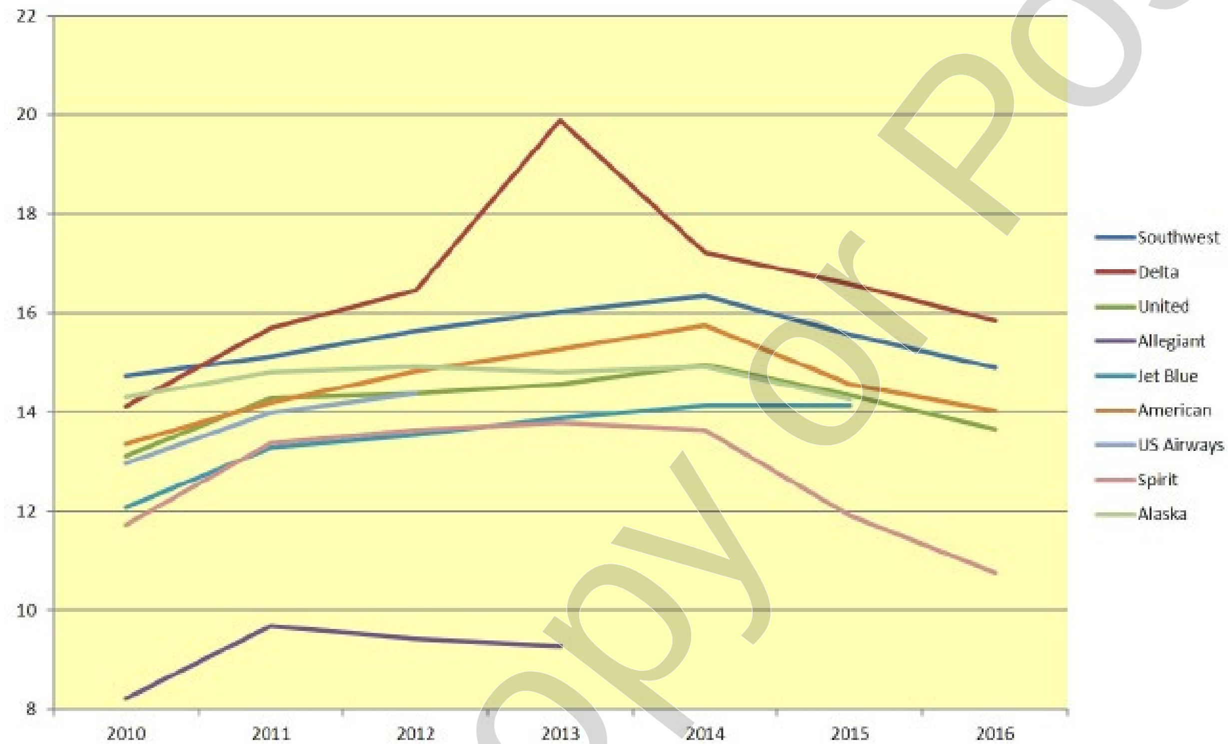
Exhibit 2. RPM (Revenue Passenger Miles) for Major U.S. Airlines (000,000)

	2010	2011	2012	2013	2014	2015	2016
Southwest	78,047	97,583	102,875	104,348	108,035	117,500	124,798
Delta	193,169	192,767	192,974	194,988	202,925	209,625	213,098
United	122,182	181,763	179,416	178,578	179,015	183,642	186,181
Allegiant	5,466	5,641	6,514	7,129	7,826	8,945	10,283
JetBlue	28,279	30,698	33,563	35,836	37,813	41,711	
American	134,298	136,386	136,620	138,878	217,870	223,010	223,477
US Airways	69,593	71,321	73,318	N/A	N/A	N/A	N/A
Spirit	6,664	8,007	9,664	12,001	14,160	17,995	21,582
Alaska	20,350	25,032	27,007	28,833	30,718	33,578	

Source: Company data.

Exhibit 3. Passenger Revenue per RPM (in cents) for Major U.S. Airlines

Passenger Revenue per Revenue Passenger Mile, also known as Passenger Yield, is computed by dividing assenger revenues by revenue passenger-miles.

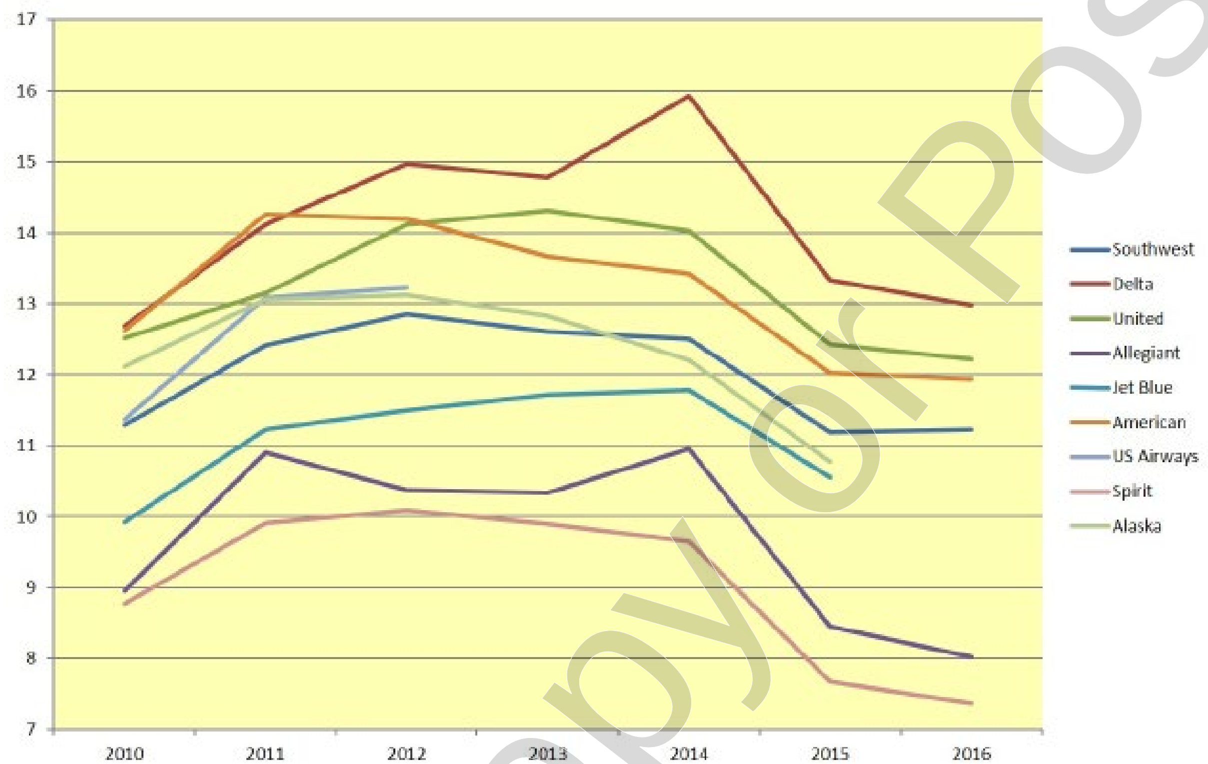


Source: Company data.

Exhibit 4. Load Factors for Major U.S. Airlines

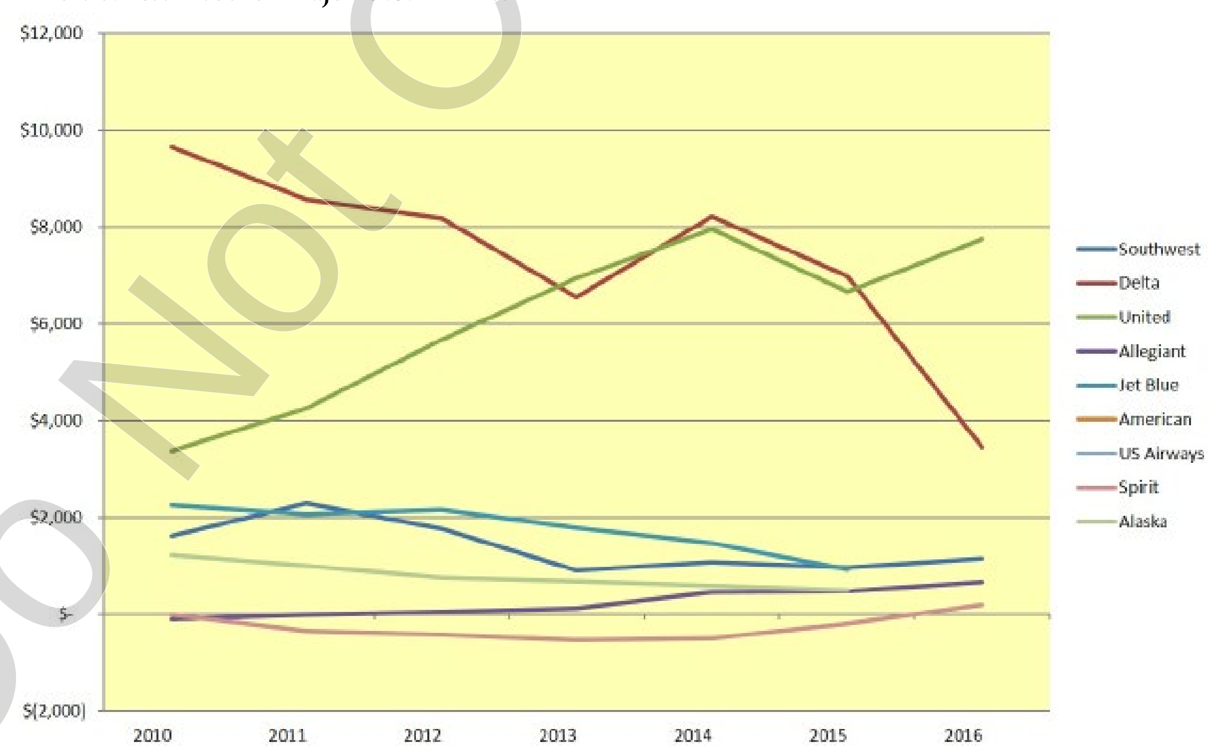
Source: Company data.

Exhibit 5. Unit Cost (cents/ASM) for Major U.S. Airlines



Source: Company data.

Exhibit 6. Net Debt for Major U.S. Airlines



Source: Company data.

Endnotes

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